

The Advocate

Spring 2010

FOR INSTITUTIONAL INVESTORS

Securities Lending Fallout: Losing Other People's Money



Full Disclosure

*Recapturing truth
in our capital markets*

Supreme Court Tackles Statute of Limitations

When does the clock start?

Wall Street's Race to the Bottom

Are we there yet?

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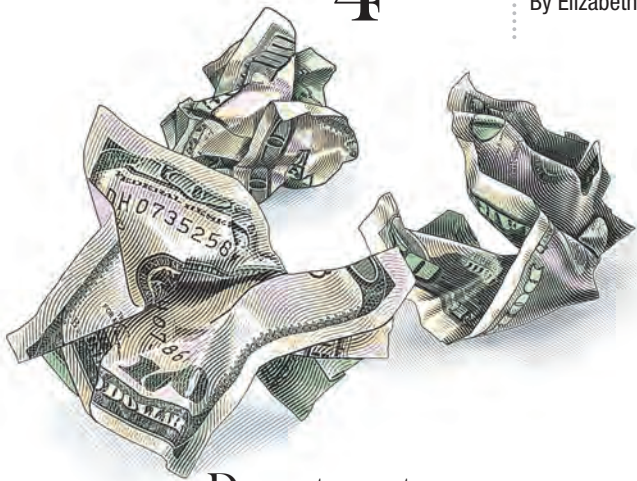
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Going GREEN

As part of BLB&G's firmwide Going Green Initiative, this publication has been printed on recycled paper. If you would prefer to receive *The Advocate for Institutional Investors* as an electronic pdf file instead of a printed copy, please contact Dalia El-Newehy at dalia@blbglaw.com.



We hope that the new year finds you well. *The Advocate for Institutional Investors* opens 2010 with an exciting new look. We have considered the wonderful feedback we have received over the years, and are proud to unveil our new format. With more content than ever before, and now published on a bi-annual basis, we hope you enjoy the new *Advocate* and continue to find it a valuable educational resource.

In this issue, we address four important matters affecting institutional investors.

First, in our cover story, Partner Timothy DeLange and Associate Ian Berg provide a trenchant analysis of widespread abuses by securities lending agents that have led to disastrous results for institutional investors in the wake of the financial meltdown.

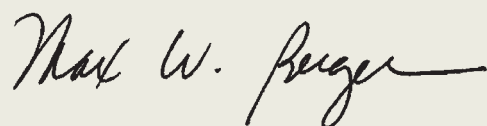
Second, in "Wall Street's Race to the Bottom," Harvard Law Professor and TARP Congressional Oversight Panel Chair Elizabeth Warren defends the consumer financial protection legislation currently under review in Congress, and exposes the large scale lobbying efforts by Wall Street against the proposed reform.

Third, Associate Ann Lipton examines the U.S. Supreme Court's important interpretation of when the clock starts to run on the statute of limitations when a company is actively trying to conceal fraudulent conduct.

Finally, Associate Noam Mandel discusses ways to recapture the spirit of full disclosure as he chronicles the goings-on at Bank of America and its star-crossed merger with Merrill Lynch.

As always, you will find a compilation of the most significant recent developments in securities litigation, regulation and corporate governance in our regular "Eye on the Issues" column by "Eye" editor, Associate Katherine Sinderson.

Please note that current and past issues of the *Advocate* are available on our website at www.blbgilaw.com. If you need assistance locating particular essays, please do not hesitate to contact us.



Other People's The Unrealized Conflicts of Securities Lending **Money**

By Timothy DeLange and Ian Berg

Lending agents are not responsible for any investment losses, and thus are incentivized to seek maximum gains, regardless of increased risk, placing their interests in direct conflict with their clients' interests.

The primary goal of most institutional investors, such as public pension funds, is to prudently invest their assets and develop a portfolio that will accommodate long-term financial needs. Accordingly, these investors typically hold large blocks of individual securities in their portfolio, hoping that the value of those securities will appreciate over time. Over the past twenty years, institutional investors and other large stock holders have increasingly used these long-term holdings to reap short-term profits through "securities lending" programs.

Securities lending utilizes long-term stock holdings that would otherwise sit idle by temporarily lending them out on a cash-collateralized basis and investing the cash in safe, short-term investments for a modest return. Borrowers typically use the securities to cover short positions, to hedge positions or to take advantage of arbitrage opportunities. Although the concept of securities lending dates back more than a century, the practice became widespread in the 1970s when custodial banks initiated formal programs to broker loans involving their custodial clients.

In its most basic form, securities lending is where a loan results in a transfer of title or ownership of certain securities to a borrower, who is obligated to return the same type and amount of securities in the future. Modern securities lending programs typically work as follows (see charts on opposite page):

Step 1: A securities lender, typically an institutional investor or other large securities holder, deposits its securities with a lending agent, which is often that institution's custodial bank.

Step 2: The lending agent offers a block of securities to a borrower, typically a hedge fund or other short-seller, in exchange for cash, usually 102 to 105 percent of the market value of the securities.

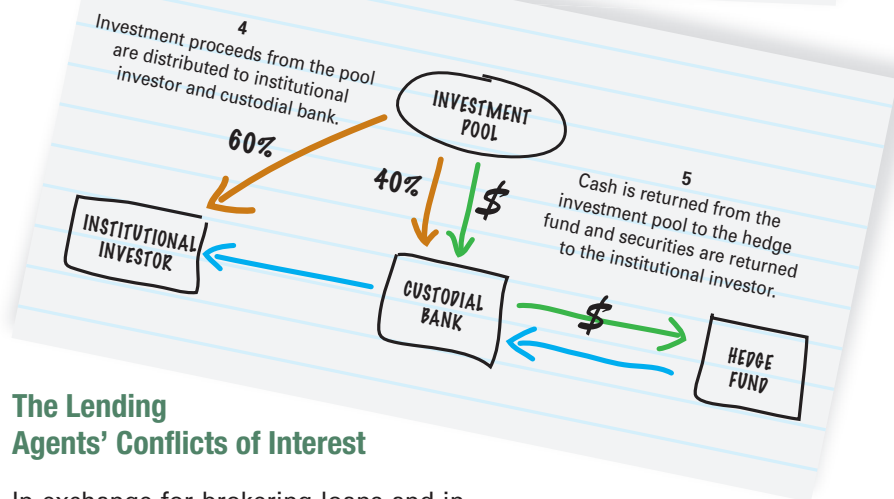
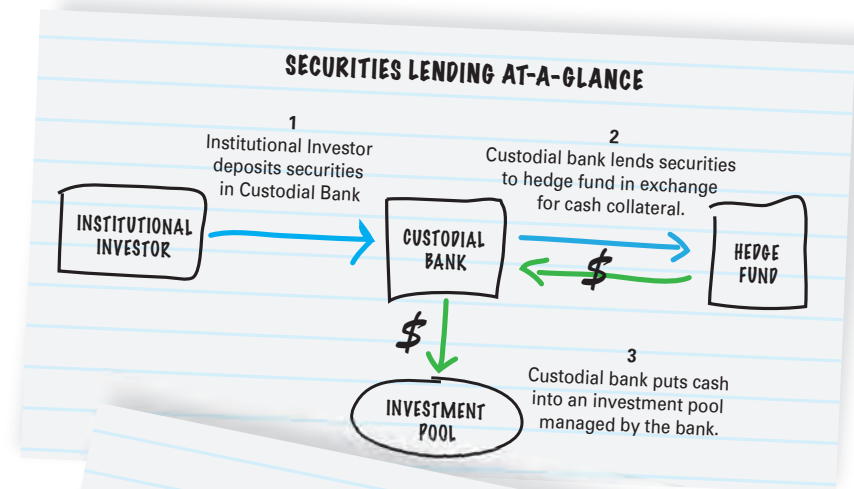
Step 3: The lending agent then deposits the cash into an investment pool managed by the lending agent or an affiliate.

Step 4: The investment pool is used to acquire safe, short-term assets, with proceeds distributed to the securities lender, minus a percentage fee paid to the lending agent.

Step 5: Upon request, or at a negotiated time, cash is returned to the borrower in exchange for the securities being returned to the lending agent.

In the 1990s and 2000s, the demand for securities lending grew with the expansion of global securities markets and the exponential increase in short-selling and hedge funds with related trading strategies. In 2007, there was an estimated \$5.5 trillion worth of securities on loan through various lending programs. These securities lending programs attracted institutional investors because they were marketed as a relatively low-risk venture that was consistent with the conservative investment philosophy and guidelines of most participants. Indeed, most securities lending program contracts require the custodial bank or investment pool manager to invest the collateral funds conservatively and prudently to safeguard principal and to maintain adequate liquidity. Moreover, most collateral pools are restricted to short-term investments because shorter investment periods usually have less volatility.

With an emphasis on short-term assets, collateral investments should, in theory, be well insulated from a market downturn. Such theory, however, overlooks the substantial conflicts of interest among the custodial banks and brokers that facilitate the largest and most widely-used securities lending programs. Indeed, recent experience shows that these conflicts likely ensured that reinvested collateral would suffer losses that otherwise could have been avoided, or at least mitigated.



The Lending Agents' Conflicts of Interest

In exchange for brokering loans and investing collateral, lending agents receive a percentage of the investment returns, typically 30 to 40 percent. Lending agents are not, however, responsible for any investment losses. In other words, institutional lenders shoulder 100 percent of collateral reinvestment losses, yet receive only 60 to 70 percent of the gains. Thus, lending agents are incentivized to seek maximum gains, regardless of risk, placing their interests in direct conflict with their clients' interests. The result is that lenders might not invest collateral consistent with appropriate risk controls and investment guidelines, causing the institutional investor to unknowingly bear a disproportionate risk to the collateral received.

This is exactly what happened on an industry-wide basis in the period leading up to the credit crisis of 2008. Several

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custodial banks that run securities lending programs and manage collateral investment pools were caught holding riskier, long-duration asset-backed and mortgage-backed securities when they were supposed to be holding safer and less volatile short-duration assets. While such securities had boosted the returns to lending agents and institutional investors alike during the boom years of the economy, by early 2008, the value of these long-term securities had steeply declined, leaving the institutional investors (but not the lending agents) at risk of significant losses.

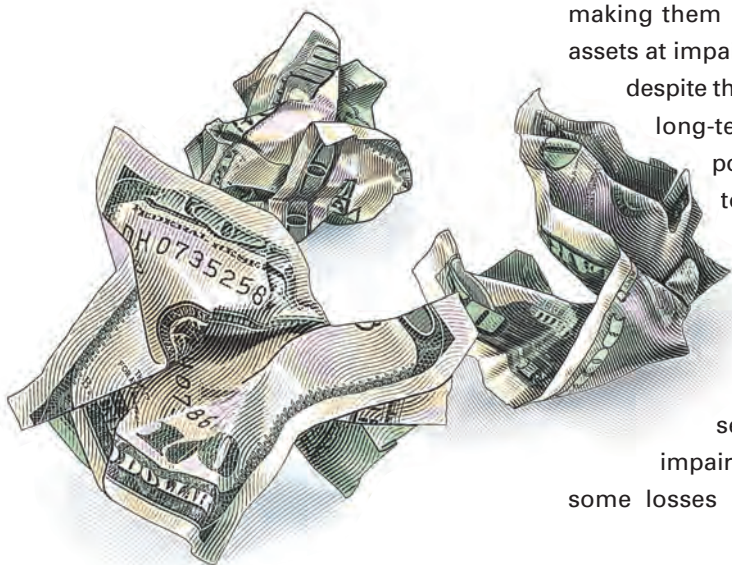
As the unrealized losses for investors mounted, the conflicts of interest between institutional investors and lending agents became more severe. Not only did the lending agents have no exposure themselves to past or future losses of the investments, but many were also self-dealing, profiting from investments in entities in which they held a direct or indirect financial interest. In addition, governing accounting principles would require the lending agents to consolidate any realized losses from the related-entity collateral investment pools on their own balance sheets — making them more reluctant to sell the assets at impaired values. Consequently,

despite the declining values of these long-term securities, collateral pool managers largely failed to adjust their investment strategies in favor of safer, short-term securities. In other words, though the lending agent banks had the opportunity to sell the assets at a slightly impaired value (thereby realizing some losses but mitigating exposure

and preventing greater future losses), lending agents almost uniformly declined to do so, maintaining that the long-duration asset-backed securities in the cash collateral pools were not impaired and that valuations would soon return to normal levels.

As a result, by the Fall of 2008, the major securities lending programs were no longer producing gains and were, in fact, showing significant losses. Indeed, *Pensions & Investments* magazine estimates that valuation problems in the enhanced cash collateral pools that back securities lending programs were negatively impacting as many as 90 percent of U.S. pension funds and many defined contribution plans. A majority of these losses were the direct result of an illiquid market for long-duration asset-backed securities in the wake of the collapse of Lehman Brothers and CIT, as well as the government bail-out of AIG. Notably, these events occurred after the lending agents were already aware of the declining values of long-duration assets held in their respective investment pools. In stark contrast, the market for short-term investments — the types that collateral pools were intended to invest in, and that lending agents purported to invest in — was less affected by these events and the general economic downturn.

Market volatility in the pricing of long-duration securities caused the net asset value of the cash collateral pools to decrease across the industry, including at the three leading global custodians and largest securities lending agents: Northern Trust, State Street and The Bank of New York Mellon. The lending agents — who were incentivized to sit tight while asset values continued to decline and



collateral deficiencies grew — prohibited several institutional investors from exiting their respective securities lending programs.

A “collateral deficiency” occurs when the lending agent determines that a substantial portion of the invested collateral is so impaired that it will be insufficient to repay borrowers upon redemption. Contractually, when there is a collateral deficiency, the institutional investor has to make up the difference between the collateral pool and what is owed to the borrowers. For example, in September 2008, Northern Trust, one of the largest securities lending agents, declared a collateral deficiency of \$885 million on a pool that held upwards of \$70 billion in assets and is now demanding payment from its institutional investor clients.

Several other lending agents, including Wells Fargo, JPMorgan, U.S. Bank, State Street and The Bank of New York Mellon, have also declared collateral deficiencies. Investors are now being asked to contribute additional funds to make up for the significant realized and unrealized losses in the collateral pools. If an institutional investor wanted to accept its realized losses and exit its respective securities lending program, the institutional investor would still have to make up its share of the collateral deficiency caused by unrealized losses on impaired assets.

Institutional Investors Fire Back

Stuck between the proverbial rock and a hard place, several investors have filed claims against these lending agents and others, alleging that the lending agents improperly invested collateral pool assets

and acted in their own undisclosed interests at the expense of their clients— in clear violation of their fiduciary duty and in breach of their contractual arrangements. The need for greater transparency and investor protections, particularly in regards to lending agents’ conflicts of interest, is also increasingly becoming a topic of discussion among institutional investors and regulators. On September 29, 2009, the SEC hosted a “Securities Lending and Short Sale Roundtable” discussing these issues. While the SEC commissioners and panelists generally agreed that securities lending is critical to a properly functioning market, in part because such lending creates greater liquidity and enhances short-selling ability, the SEC has decided to explore possible regulation of what SEC Chairman Mary Schapiro called an “opaque” multi-trillion-dollar securities lending market.

The promise of future regulatory safeguards may offer some comfort to institutional investors that severe losses from securities lending can be avoided in the future; however, it offers little consolation to institutional investors who are struggling to make up for the losses already incurred. The lessons for any institutional investor are to actively monitor your securities lending program and collateral investments, to be mindful of collateral deficiencies of any amount, and to potentially take action to protect your assets, as several institutional investors have already done.

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Wall Street's Race

By Elizabeth Warren

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Jamie Dimon is wrong. We shouldn't expect a crisis 'every five to seven years.'

Banking is based on trust. The banks get our paychecks and hold our savings; they know where we spend our money and they keep it private. If we don't trust them, the whole system breaks down. Yet for years, Wall Street CEOs have thrown away customer trust like so much worthless trash.

Banks and brokers have sold deceptive mortgages for more than a decade. Financial wizards made billions by packaging and repackaging those loans into securities. And federal regulators played the role of lookout at a bank robbery, holding back anyone who tried to stop the massive looting from middle-class families. When they weren't selling deceptive mortgages, Wall Street invented new credit card tricks and clever overdraft fees.

In October 2008, when all the risks accumulated and the economy went into a tailspin, Wall Street CEOs squandered

what little trust was left when they accepted taxpayer bailouts. As the economy stabilized and it seemed like we would change the rules that got us into this crisis—including the rules that let big banks trick their customers for so many years—it looked like things might come out all right.

Now, a year later, President Obama's proposals for reform are bottled up in the Senate. The same Wall Street CEOs who brought the economy to its knees have spent more than a year and hundreds of millions of dollars furiously lobbying Washington to kill the president's proposal for a Consumer Financial Protection Agency (CFPA).

Within the thousands of pages of print in the "Restoring American Financial Stability Act" now before the Senate, the consumer agency is the only proposal that would help families directly. Even those most concerned about the role of personal responsibility concede that it is hard for families to make smart decisions and to compare products when the paperwork on mortgages, credit cards and even checking accounts has morphed into reams of incomprehensible legalese.

The consumer agency is a watchdog that would root out gimmicks and traps and slim down paperwork, giving families a fighting chance to hang on to some of

to the Bottom

their money. So far, Wall Street CEOs seem determined to stop any kind of watchdog. They seem to think that they can run their businesses forever without our trust. This is a bad calculation.

It's a bad calculation because shareholders suffer enormously from the long-term cost of the boom-and-bust cycles that accompany a poorly regulated market. J.P. Morgan CEO Jamie Dimon recently explained this brave new world, saying that crises should be expected "every five to seven years."

He is wrong. New laws that came out of the Great Depression ended 150 years of boom-and-bust cycles and gave us 50 years with virtually no financial meltdowns. The stability ended as we dismantled those laws and failed to replace them with new laws that reflected modern business practices.

The reputations of Wall Street's most storied institutions are evaporating as the lack of meaningful consumer rules has set off a race to the bottom to develop new ways to trick customers. Wall Street executives explain privately that they cannot get rid of fine print, deceptive pricing, and buried tricks unilaterally without losing market share.

Citigroup learned this the hard way in 2007, when it decided to clean up its credit card just a little bit by eliminating universal default—the trick that allowed it to raise rates retroactively, even for consumers that did nothing wrong. Citi's reform resulted in lower revenues and no new customers, triggering an embarrassing public reversal.

Citi explained sheepishly that credit cards were now so complicated that customers couldn't tell when a company offered something a little better. So Citi went back to something a little worse. Without a watchdog in place, the big banks just keep slinging out uglier and uglier products.

With their reputations in tatters, the CEOs have decided to go on the offensive in Washington. They might have had some thoughtful suggestions for how to better shape a consumer agency. Instead, they have unleashed lobbyists who are determined to do anything to kill the consumer agency.

The latest lie is that the CFPB is "big government." The CEOs all know that the current regulatory structure, which they support, is big government at its worst: bureaucratic, unaccountable and ineffective. The CFPB will consolidate seven separate bureaucracies, cut down on paperwork, and promote understandable consumer products. In the process, it will stabilize the industry, rebuild confidence in the securitization market, and leave more money in the pockets of families. Complaining about short, readable contracts and efforts to slim down bureaucracy only further diminishes the banks' credibility.

This generation of Wall Street CEOs could be the ones to forfeit America's trust. When the history of the Great Recession is written, they can be singled out as the bonus babies who were so short-sighted that they put the economy at risk and contributed to the destruction of their own companies. Or they can acknowledge how Americans' trust has been lost and take the first steps to earn it back.

“Wall Street CEOs seem determined to stop any kind of watchdog.”



Chris Hartlove

Elizabeth Warren is the Leo Gottlieb Professor of Law at Harvard Law School and is currently the chair of the TARP Congressional Oversight Panel.

By Katherine Sinderson

SEC Charges Goldman Sachs With Fraud

The SEC filed a civil lawsuit against Goldman, Sachs & Co. and one of its vice presidents for defrauding investors by misstating and omitting key facts about a financial product tied to sub-prime mortgages as the U.S. housing market was beginning to falter. Robert Khuzami, Director of the SEC's Enforcement Division, stated in a press release that "The product was new and complex, but the deception and conflicts are old and simple. Goldman wrongly permitted a client that was betting against the mortgage market to heavily influence which mortgage securities to include in an investment portfolio, while telling other investors that the securities were selected by an independent, objective third party." According to news reports, the SEC Commissioners split along party lines in deciding whether to bring the case, which was authorized by a 3-2 vote.

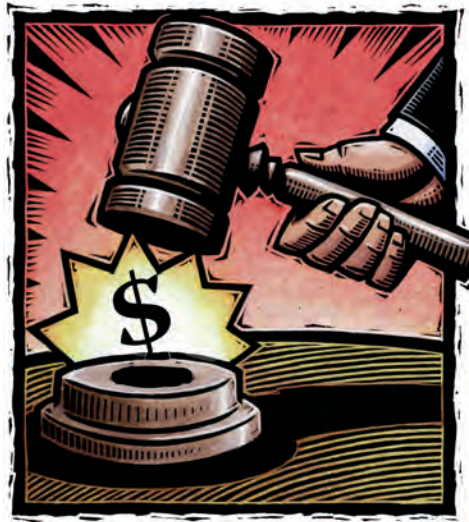
>> <http://www.sec.gov/news/press/2010/2010-59.htm>, April 16, 2010; *The Wall Street Journal*, April 20, 2010

Securities Class Action Filings Down

Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse have released a report on federal securities class action filings in 2009 which shows that 169 federal securities class actions were filed, a 24 percent decrease from the previous year. Additionally, only 114 unique issuers were sued, a decrease of 32 percent from 2008. The report noted that the financial sector continued to have the highest level of litigation activity with 84 filings.

>> http://securities.stanford.edu/clearinghouse_research/2009_YIR/Cornerstone_Research_Filings_2009_YIR.pdf

Judge Condemns Wall Street's "Culture of Corruption"



When sentencing a former Credit Suisse securities dealer to five years in prison and a \$5 million fine in one of the first major criminal actions stemming from the subprime crisis, Federal judge Jack B. Weinstein had harsh words for Wall Street. Judge Weinstein lamented the

"the pernicious and pervasive culture of corruption" on Wall Street stating, "The blame for this condition is shared not only by individual defendants...but also by the institutions that employ them, those who carelessly invest, and those who fail to regulate." The defendant was convicted of misleading investors into believing that the subprime-backed securities being purchased in their accounts were actually backed by federally guaranteed loans. Judge Weinstein concluded, "The most compelling aspect of this case may be its illumination of the need to reconsider how compensation is calculated and investment products are marketed by the financial industry. Systemic reform is needed; mere '[c]ompetition in product and capital markets can't be counted on to solve the problem.'"

>> *Statement of Reasons in United States v. Butler, 08-cr-370 (E.D.N.Y.)*

Quotable

“The staggering sums involved... reflect more than the magnitude of the defendant's fraud. They also evince an industry beset by **avarice** that has been allowed to run rampant by regulators and negligent supervisors alike.”

New York Federal court Judge Jack B. Weinstein condemning "the pernicious and pervasive culture of corruption" on Wall Street in sentencing a former Credit Suisse securities dealer to five years in prison.

Congress Investigates New York Fed's Role In AIG Statements

The House Oversight and Government Reform Committee held a hearing to examine advice that the Federal Reserve Bank of New York provided to American International Group (AIG) concerning the use of its government bailout funds. Evidence shows that outside counsel for the New York Fed recommended that information about specific payments to banks be excluded from a December 2008 SEC



filing by AIG. In particular, counsel to the New York Fed proposed that AIG delete disclosures that it would use government bailout money to pay counterparties, including Goldman Sachs and a number of foreign banks, a full 100 cents on the dollar to liquidate credit default swap positions, which some have called a "backdoor bailout" of those banks. The Obama administration and the New York Fed maintain that the Fed was unaware of any advice to limit disclosures.

>> http://oversight.house.gov/index.php?option=com_content&task=view&id=4756&Itemid=2



Senate Judiciary Committee Questions SEC Enforcement Efforts

In December, the Senate Judiciary Committee questioned the Director of the SEC's Division of Enforcement, Robert Khuzami, and other federal officials responsible for investigating mortgage and financial fraud regarding a lack of enforcement actions against executives whose wrongful conduct contributed to the economic crisis. The hearing, entitled "Mortgage Fraud, Securities Fraud and the Financial Meltdown: Prosecuting Those Responsible," probed the gaps that still exist in the current regulatory regime. Although Khuzami pointed to the SEC's suit against former Countrywide Financial Corp. CEO Angelo Mozilo as an example of the SEC's enforcement efforts, Committee Chairman Ted Kaufman of Delaware pressed Khuzami and the other witnesses to pursue more of these types of cases. Chairman Kaufman implored, "In the boom-and-bust cycle brought about by the speculative housing bubble and all of its attendant fraud, the average American paid an enormous price...We must never let this happen again. And the only way to do that is, first, through effective regulation, and second, through effective law enforcement."

>> <http://judiciary.senate.gov/hearings/hearing.cfm?id=4215>

Obama Announces New Financial Fraud Task Force

In response to the number and complexity of government investigations linked to the economic crisis, President Barack Obama issued an executive order creating the Financial Fraud Enforcement Task Force. The task force, which will be led by the Justice Department and overseen by officials in the Treasury Department, SEC and Department of Housing and Urban Development, will provide for a more coordinated response from government agencies to combat financial

fraud. When announcing the enforcement task force, Attorney General Eric H. Holder Jr. remarked, "This task force's mission is not just to hold accountable those who helped bring about the last financial meltdown, but to prevent another meltdown from happening."

>> <http://www.whitehouse.gov/the-press-office/executive-order-financial-fraud-enforcement-task-force>

Continued on next page.

Continued from page 11.

Executives of Collapsed Financial Firms Cashed In

A recently released study examining executive compensation at Bear Stearns and Lehman Brothers Holdings Inc. contradicts the “standard narrative”



Lehman CEO
Richard Fuld
testifying before
Congress in 2008

that “the meltdown of the two financial giants largely wiped out the wealth of their top executives,” and belies claims that these executives lacked incentive to take excessive risks to achieve short-term results. According to the study, executives at the two companies cashed out nearly \$2.5 billion from the firms between 2000 and 2008. The authors of the study conclude that while executives did appear to suffer large losses when these companies collapsed during the financial crisis, these “paper” losses were, in most cases, more than off-set by the significant realized gains achieved in the previous years.

>> The study, “The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008,” can be found at: <http://papers.ssrn.com>

Large Banks Masked Debt Levels

A recent SEC study drawing on data from the New York Fed concludes that the 18 largest U.S. banks understated the debt levels used to fund their securities trades for each of the past five quarterly periods.

“Repo” transactions, while legal, lower the perceived level of leverage at each reporting period.

They were able to mask their debt by entering into “repo” transactions, where the banks sold a security, but agreed to buy it back at a later date, typically using the repo proceeds to fund other transactions. The practice, while legal, lowers the perceived level of leverage at these institutions at each reporting period. The SEC is now seeking detailed information from large financial firms about repos, suggesting that the agency may be looking for accounting tricks that mask risky behavior and positions.

>> *The Wall Street Journal*, April 9, 2010.

Lehman Brothers Bankruptcy Examiners’ Report Released

On March 11, 2010, the bankruptcy examiner’s 2,200 page report detailing the collapse of Lehman Brothers was made public. According to the report, Lehman’s collapse was the result of a combination of the economic climate and the conduct of Lehman’s executives, which ranged from “serious but non-culpable errors of business judgment to actionable balance sheet manipulation.” According to the report, in order to “buy itself time” as conditions deteriorated during 2008, Lehman “painted a misleading picture of its financial condition.” For example, the report states that Lehman “sought to cushion bad news by trumpeting that it had significantly reduced its net leverage ratio,” while failing to disclose that it had been using an “accounting device,” known as Repo 105, that had “no substance.” The report concluded that there are “colorable claims” against the company’s executives; and against the company’s auditor, Ernst & Young.

>> <http://lehmanreport.jenner.com/>

Shareholders Prove Vivendi Securities Fraud at Trial

In one of the handful of securities class actions to go to trial since the enactment of the PSLRA, a jury has found Vivendi SA, owner of Universal Music Group, liable on 57 counts of securities fraud. Plaintiffs argued that Vivendi hid from investors the debt it assumed in a \$77 billion acquisition spree that transformed the French company into a global telecommunications giant, and that investors lost billions when Vivendi’s true financial condition emerged. Although the jury found the company liable to the Class it did not find liability on the part of the two senior executives named as defendants. Based on the jury’s estimates of fraudulent stock price inflation, an attorney for the plaintiffs estimated damages to reach \$4 billion. Vivendi has announced that it will appeal the jury verdict to the Second Circuit.

>> *In re Vivendi Universal, S.A. Securities Litigation*, U.S. District Court, Southern District of New York, No. 02-05571

“Say on Pay” Legislation Introduced

Senator Robert Menendez has introduced “say-on-pay” legislation that would give shareholders of public companies an advisory vote on executives’ pay and create new rules to punish executives whose risk-taking leads to failure or fraud.

“We can’t afford to have short memories and allow the type of reckless corporate practices that got us into this economic mess in the first place to take root all over again.”

Under this proposal, shareholders would be given a nonbinding vote on proposed executive compensation packages, and publicly-traded companies would have to disclose in their annual reports the ratio of executive pay to median company employee pay. Regulators and investors would have the authority to claw back executive bonuses if it is later discovered that those executives engaged in misconduct on the job, and any executive fired for cause would be barred from receiving generous severance packages or “golden parachutes.” Senator Menendez announced that these measures were intended to protect against another financial crisis, stating, “We can’t afford to have short memories and allow the type of reckless corporate practices that got us into this economic mess in the first place to take root all over again.”

>> *S. 3049, the Corporate Executive Accountability Act of 2010*

The SEC Approves New Proxy Disclosure Rules

On February 28, 2010, the SEC implemented new proxy disclosure rules on compensation risks and director qualifications. With respect to compensation risks, companies are now required to disclose any risks arising out of

pay incentives for employees (not just named executive officers) that are “reasonably likely to have a material adverse effect” on financial performance, such as compensation policies unique to business units that carry a significant portion of a company’s risk profile. In addition, a reporting company will have to explain its reasoning for electing certain leadership structures, including maintaining a non-executive chairman or combining the roles of board chair and CEO.

SEC Chairman Mary L. Schapiro commented on the new rules, stating, “Good corporate governance is a system in which those who manage a company — that is, officers and directors — are effectively held accountable for their decisions and performance. But accountability is impossible without transparency.”

>> <http://www.sec.gov/rules/final/2009/33-9089fr.pdf>



SEC Chairman
Mary Schapiro

House and Senate Committee Approve Financial Reform Legislation

In December, the House of Representatives voted to approve the “The Wall Street Reform and Consumer Protection Act of 2009.” Among other things, the bill includes an annual “say on pay” mandate, authorizes regulators to ban inappropriate or imprudently risky compensation practices, and requires financial firms to disclose incentive-based compensation structures. The bill also includes a permanent exemption for small issuers with less than \$75 million in market cap from the outside

auditor attestation requirements of the Sarbanes-Oxley Act, and would clarify the standards for extraterritorial application of the securities laws. The House bill will have to be reconciled with any financial reform legislation that emerges from the U.S. Senate. The Senate Banking Committee recently passed Senator Dodd’s Wall Street reform bill, which is now headed for the Senate floor for debate.

>> *H.R. 4173, The Wall Street Reform and Consumer Protection Act of 2009*

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Ready...Set...

Go!

By Ann Lipton

Supreme Court to
Set the Clock on
Statute of Limitations
in Merck/Vioxx

Unlike other civil litigants, plaintiffs filing securities fraud complaints are subject to the heightened pleading standards of the Private Securities Litigation Reform Act (PSLRA). Because the pleading rules are so demanding, the issue of when the statute of limitations begins to run is of great importance.

The United States Supreme Court is expected to soon issue a ruling definitively determining when the statute of limitations for securities fraud actions begins to run. The statute of limitations, which limits the amount of time shareholders have to bring securities fraud actions, provides that shareholders have the lesser of “2 years after the discovery of the facts constituting the violation” or “5 years after such violation” to file a complaint. In other words, once an investor has learned of the facts constituting the fraud, the statute would run for two years from that point. Additionally, all lawsuits would be barred after five years, no matter when the fraud was discovered. In applying the statute of limitations, lower courts have split over when “discovery of the facts” is deemed to occur and, thus, when the clock starts to run. In *Merck v. Reynolds*, the Supreme Court is poised to address this issue for the first time.

A Problem Defined

Unlike other civil litigants, plaintiffs who file securities fraud complaints are subject to the heightened pleading standards of the Private Securities Litigation Reform

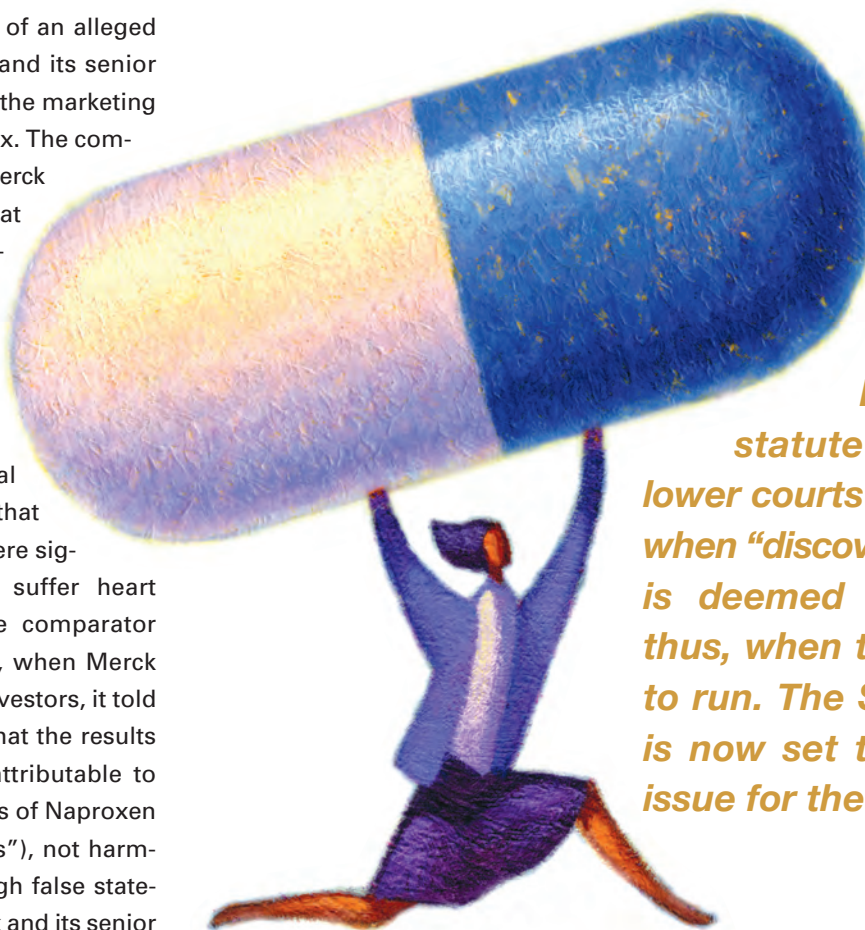
Act (PSLRA). The PSLRA requires complaints alleging securities fraud to describe the alleged fraud in great detail and to create a “strong inference” that the defendant(s) made the misleading statements or omissions at issue with wrongful intent. Because these pleading requirements are so demanding, it may take a considerable amount of time before all of the facts necessary to constitute the fraud are publically available. This is so because the perpetrators of the fraud typically remain in control of the company after the fraud is first disclosed, and make efforts to conceal all of the facts necessary to plead plaintiffs’ claims with the particularity that the PSLRA requires. While, in hindsight, one may find indications of potential misconduct that were missed, investors often only learn of facts sufficient to meet the PSLRA pleading standards once the entirety of the fraud is exposed. Thus, if the statute of limitations is deemed to begin to run before all of those facts are revealed, plaintiffs with legitimate claims may find themselves time-barred even before they could ever file a meritorious suit. The *Merck* case illustrates this point.

The Merck Case

The *Merck* case arises out of an alleged securities fraud by Merck and its senior officers in connection with the marketing of the pain relief drug, Vioxx. The complaint alleges that senior Merck officers long believed that Vioxx raised the risk of suffering harmful cardiovascular events, such as heart attacks, but continued to assure the market otherwise. For example, in 2000, a large-scale clinical trial known as VIGOR showed that patients who took Vioxx were significantly more likely to suffer heart attacks than users of the comparator drug, Naproxen. However, when Merck reported these results to investors, it told investors that it believed that the results of the VIGOR trial were attributable to cardio-protective properties of Naproxen (the “Naproxen hypothesis”), not harmful effects of Vioxx. Through false statements such as these, Merck and its senior officers allowed Vioxx to remain on the market garnering billions in revenues.

In November 2003, an investor filed the first securities complaint against Merck, alleging that a recently published independent large-scale epidemiological study (which concluded that patients who took Vioxx had greater rates of heart problems than patients taking other pain-relief drugs) showed that Merck’s prior representations regarding Vioxx were false and misleading. Notwithstanding the filing of this and other similar actions, much of Merck’s fraudulent scheme

Continued on next page.



In applying the statute of limitations, lower courts have split over when “discovery of the facts” is deemed to occur and, thus, when the clock starts to run. The Supreme Court is now set to address this issue for the first time.



remained unknown. That changed after Vioxx was subsequently withdrawn from the market. On November 1, 2004, *The Wall Street Journal* published an article leaking internal Merck emails which indicated that Merck and its senior officers never, in fact, believed in the Naproxen hypothesis and, to the contrary, had concluded that Vioxx was to blame for the disparity in cardiovascular events.

The defendants moved to dismiss investors' fraud action, arguing that the case

was time-barred because investors should have suspected that Merck might have committed securities fraud more than two years prior to the filing of the initial complaint in November 2003. The

defendants relied on the doctrine of "inquiry notice," which generally posits that an investor who receives "storm warnings" of securities fraud but fails to reasonably investigate will be charged with knowledge of whatever a reasonable investigation would have uncovered. Some courts, however, have gone even further, adopting a rule that an investor who fails to investigate a "storm warning" will be charged with knowledge of the fraud even if a reasonable investor could not have uncovered the fraud if he or she had conducted a reasonable investigation. The *Merck* case was being argued in a circuit that had adopted this latter rule, and thus defendants argued that the investors' claims were time-barred

because "storm warnings" of securities fraud existed more than two years before the filing of the first complaint. Specifically, the defendants noted that prior to November 2001, certain scientific and media articles indicated that Vioxx might be associated with increased heart attack risk; several personal injury lawsuits had alleged that Vioxx caused heart attacks; and the FDA had published a Warning Letter admonishing Merck for failing to better inform physicians that the "Naproxen hypothesis" was a theory rather than a proven fact. Defendants contended that because (in their view) the investor plaintiffs had failed to conduct an investigation into these purported "storm warnings," they should be deemed to have "discovered" the fraud at the time of these "storm warnings," regardless of whether a reasonable investigation into those storm warnings would have led to discovery of Merck's fraud.

The District Court presiding over the action accepted the defendants' argument that there were storm warnings more than two years prior to the filing of the complaint, and dismissed the case as time-barred. On appeal, the Third Circuit Court of Appeals reversed that decision, holding that there was no reason for a reasonable investor to suspect that Merck had committed securities fraud more than two years prior to the filing of the complaint. The defendants petitioned for *certiorari* to the United States Supreme Court, which granted their petition.

While oral argument is an uncertain predictor of ultimate outcome, a number of Justices appeared skeptical of Merck's position during oral argument, and sympathetic to the potential paradox facing plaintiffs.

The Supreme Court Argument

Merck argued before the Supreme Court that the statute of limitations should run from the date that investors first have reason to suspect that a defendant made a false statement in connection with the purchase or sale of securities. The defendants conceded that such an interpretation of the statute of limitations could, in some cases, cause the limitations period to expire before a plaintiff could “discover” the requisite “facts constituting the fraud,” but contended that such a rule was necessary to keep “ostrich” plaintiffs from ignoring obvious signs of fraud and using securities fraud actions as a form of insurance policy against market losses. The plaintiffs countered that, by its terms, the statute of limitations begins to run from “discovery of the facts constituting” the fraud, not “suspicion” of fraud, and the “facts constituting the fraud” must be facts sufficient to support each element of the cause of action they must ultimately prove. The plaintiffs further argued that there was no basis to impute to investors knowledge of facts that was not available to be discovered, such as secret information entirely within the defendant’s control. The Solicitor General of the United States filed an *amicus*, or “friend of the court,” brief supporting plaintiffs’ position, and arguing that the statute of limitations does not begin to run until a plaintiff could or should have discovered facts sufficient to plead a complaint that would survive a motion to dismiss.

While oral argument is an uncertain predictor of ultimate outcome, a number of Justices appeared skeptical of Merck’s interpretation of the statute of limitations.

Justice Breyer stated that Merck’s contention that the statute of limitations could lapse before plaintiffs could ever discover evidence of recklessness or intent “doesn’t make sense.” Justice Kennedy suggested that issuers could not endorse higher pleading standards for securities fraud claims and seek to have the statute of limitations for securities fraud begin to run before such facts are available, stating “[T]he companies can’t have it both ways. They can’t endorse [the higher pleading standard] and then say just an inquiry notice of a... general nature suffices. You have to have specific evidence of scienter [wrongful intent]. And there’s nothing here to indicate that the plaintiffs had that.”

A decision is expected this year. BLB&G is co-lead counsel for the plaintiffs. Additional briefs in support of plaintiffs were filed by AARP and the Detectives’ Endowment Association, Change to Win (an alliance of five unions representing over 5.5 million members), the Council of Institutional Investors, the National Association of Shareholder and Consumer Attorneys (NASCAT), the National Coordinating Committee for Multiemployer Plans (NCCMP), 28 law professors, 26 State Attorneys General, numerous public pension systems, and two medical school professors. *Amicus* briefs in support of defendants were filed by the Pharmaceutical and Research Manufacturers of America (PhRMA), the Chamber of Commerce, the Washington Legal Foundation, and the Securities Industry and Financial Markets Association.

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What is...

Petition for Writ of Certiorari

(informally called “Cert Petition”)

A document which a losing party files with the Supreme Court asking the Supreme Court to review the decision of a lower court. It includes a list of the parties, a statement of the facts of the case, the legal questions presented for review, and arguments as to why the Court should grant the writ.

Finding the Way Back

Reanimating the Spirit of Full Disclosure in Our Capital Markets

By Noam Mandel

We stand in the midst of what has come to be called the Great Recession, the most serious financial crisis since its forbear, the Great Depression, wreaked havoc on the world economy. That earlier disaster was precipitated by the stock market crash of 1929 and the bursting of a speculative financial bubble based largely on rumor, half-truths, and untruths. The tremendous human cost of that calamity underscored the need to initiate a new era of financial regulation, and created the political will to do so. Establishing transparent and reliable disclosure practices was central to these new regulations and the trust it begat became a cornerstone of American financial markets. Since that time, United States markets have been the premier worldwide destination to invest and raise capital—a function of the unique faith placed in the basic trustworthiness of our system.

So what went wrong?

To divine how we got here, we can look back over the development of the current system of regulations and ask whether practice has met theory, and whether our laws have led us to live up to our ideals. The heart of the securities regulation

regime instituted in the 1930s was the principle of full disclosure. Having recognized that information is the life-blood of modern securities markets, policymakers put in place laws and regulations designed to ensure that the information flowing through the markets was materially accurate, complete and not otherwise misleading. New disclosure requirements were enshrined into law with the purpose to remedy the lack of truthful and reliable information that pervaded securities markets in the lead-up to the 1929 crash. Ferdinand Pecora, chief counsel and lead investigator of the Senate Banking Committee's investigation into the Great Depression put it plainly: "Had there been full disclosure of what was being done in furtherance of these schemes, they could not long have survived the fierce light of publicity and criticism. Legal chicanery and pitch darkness were the banker's stoutest allies."

To cast light on this darkness, the philosophy of disclosure has always been guided by the principle of "materiality," which helps delineate the parameters of the duty to disclose that applies to public corporations and their insiders. Over the years, the Supreme Court and other federal

Continued on page 20.



Today, as policymakers are once again gearing up to consider a new wave of potential regulatory reforms, it is worthwhile to ask what can be done to ensure that the spirit of the securities laws is honored as much as the technical letter of the law.

No matter the technical requirements and legal penalties in place, if the prevailing attitude sees the requirements of meaningful corporate disclosure as a formalistic nuisance, then the legal requirements will never fully produce the desired corporate behavior or prevent such collapses in the future.

courts have expounded upon the materiality principle, defining its boundaries and creating legal tests that are easy to state. Put simply, the law regards information as material if a reasonable investor would care about it. The value of securities trading on exchanges is determined through the horse-trading of information on the open market, creating a “total mix” of available data that translates into the price of a stock. Accordingly, information is material if a reasonable investor would find the information relevant to that total mix of information. The rule is applied with reference to the particular decision made by an investor in any given instance. Thus, information in a proxy solicitation seeking a shareholder vote is material if a reasonable investor would consider the information in deciding how to cast their vote. Similarly, information in a press release summarizing financial data is material if a reasonable investor would consider it in deciding whether to buy the stock on an exchange, and so on.

These rules should not be difficult to apply, especially not if the intention is to provide the investing public with a thorough and truthful view of a company’s financial affairs, rather than to conceal something that insiders would rather investors not know. Of course, that may be the heart of the problem. No matter the technical requirements and legal penalties in place, if the prevailing attitude sees the requirements of meaningful corporate disclosure as a formalistic nuisance, then the legal requirements will never fully produce the desired corporate behavior or prevent such collapses in the future.

This attitude can be seen in one of the most controversial stories comprising the narrative of our Great Recession: the acquisition of Merrill Lynch by Bank of America. Under our securities laws, shareholders at both companies were entitled to vote on the merits of the transaction. Absent shareholder approval of the proposed transaction, the deal could not be completed—no matter what management or the Board of Directors of either company thought of its merits. The securities laws are designed to ensure that shareholders are provided with all material information concerning the transaction, so that they can vote in an informed manner. Towards that end, the securities laws require that the companies make disclosures concerning the transaction in a proxy statement distributed to all shareholders.

The conduct of Bank of America and Merrill Lynch in connection with the merger suggests that making shareholders fully aware of all the material facts relating to the proposed transaction was not their intent. For one, the parties had agreed that Merrill could pay nearly \$6 billion in bonus compensation to its employees prior to the acquisition irrespective of Merrill’s financial performance—a sum that equaled 12 percent of the value of the entire transaction and was clearly of significance to investors. Nevertheless, this information was not disclosed to investors and was, instead, buried in a so-called “disclosure schedule”—that is, in a document exchanged only between Bank of America and Merrill Lynch and never meant to see the light of day. Similarly, in the two and a half months between the time the proposed merger

was announced and the shareholder vote on the transaction, Merrill suffered catastrophic losses of at least \$14 billion on a pre-tax basis. Nonetheless, neither Bank of America (which was aware of these losses) nor Merrill Lynch informed investors of these losses prior to the shareholder vote. As a result, Bank of America shareholders—oblivious to both the large bonus payments going to Merrill employees or Merrill’s disastrous losses—voted overwhelmingly in favor of the transaction. Weeks later, when the truth became disclosed (including Bank of America’s need to obtain a \$138 billion bailout in order to consummate the Merrill acquisition), Bank of America shares plummeted, losing 50 percent of their value in the span of three trading days.

This conduct has spawned numerous governmental investigations as well as lawsuits by the SEC and investors. In these actions, Bank of America has in-

sisted that it did nothing wrong, arguing that it did not need to disclose either the bonuses or the losses because SEC rules did not specifically mandate their disclosure and that it did not violate the securities laws because none of its statements in its proxy to shareholders were false or misleading as a result of that non-disclosure. While the merits of these assertions will be judged in a court of law, their very proffer speaks volumes about the mindset of corporate disclosure.

Today, as policymakers are once again gearing up to consider a new wave of potential regulatory reforms, it is worthwhile to ask what can be done to ensure that the spirit of the securities laws is honored as much as the technical letter of the law.

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Events Calendar

Upcoming National Events for Fiduciaries

JUNE 2010							JULY 2010							AUGUST 2010						
S	M	T	W	T	F	S	S	M	T	W	T	F	S	S	M	T	W	T	F	S
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27	28	29	30				25	26	27	28	29	30	31	29	30	31				

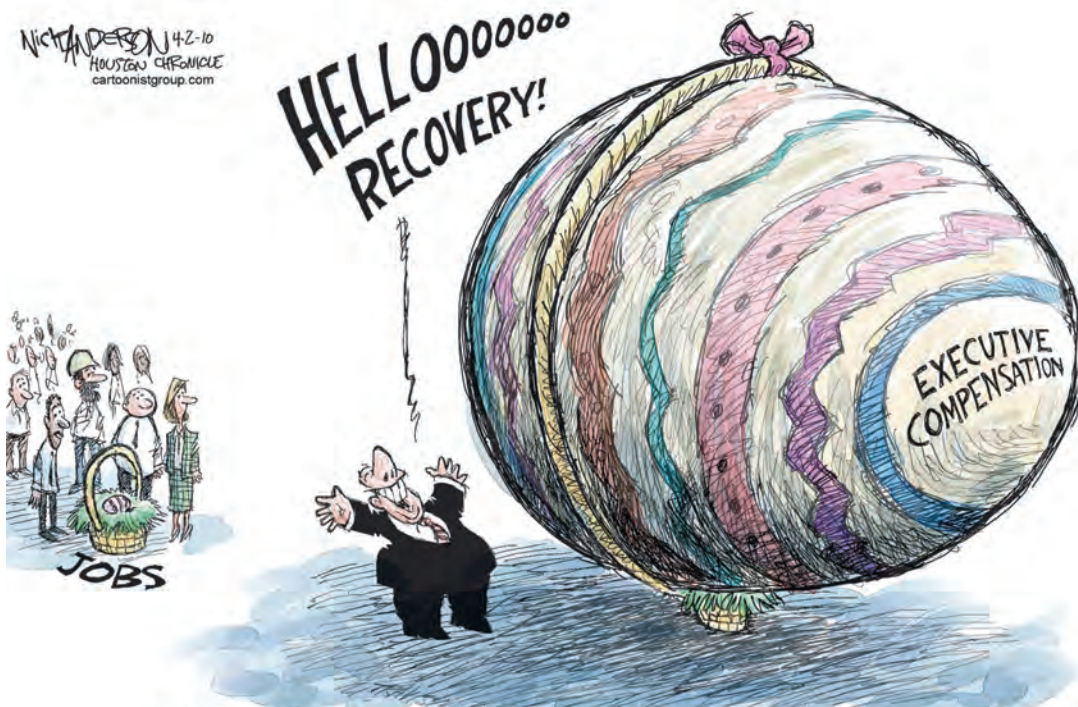
SEPTEMBER 2010							OCTOBER 2010						
S	M	T	W	T	F	S	S	M	T	W	T	F	S
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19	20	21	22	23	24	25	17	18	19	20	21	22	23
26	27	28	29	30			24	25	26	27	28	29	30
							31						

2010

June 28-30	2010 International Corporate Governance Network Annual Conference Fairmont Royal York Hotel; Toronto, Canada www.icgn.org
August 22-25	National Association of State Treasurers Annual Conference Colonial Williamsburg Lodge; Williamsburg, VA www.nast.org
September 19-21	Council for Institutional Investors 2010 Fall Meeting Hotel Del Coronado; Coronado, CA www.cii.org
October 9-14	National Council on Teacher Retirement Annual Conference Westin La Cantera; San Antonio, TX www.nctr.org
December*	Institute for International Research Public Fund Boards Forum www.iirusa.com

* Exact date to be determined

Laughs & Laments



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The Advocate for Institutional Investors is published by Bernstein Litowitz Berger & Grossmann LLP, ("BLB&G") 1285 Avenue of the Americas, New York, NY 10019, 212-554-1400 or 800-380-8496. BLB&G prosecutes class and private actions, nationwide, on behalf of institutions and individuals. Founded in 1983, the firm's practice concentrates in the litigation of securities fraud, corporate governance and shareholder rights, intellectual property, general commercial litigation, alternative dispute resolution, distressed debt and bankruptcy creditor representation, civil rights and employment discrimination, consumer protection and antitrust actions.

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April 27, 2010

Major Victory for Investors

Unanimous U.S. Supreme Court Rules that Merck/VIOXX Securities Fraud Suit Can Move Forward

After this issue of *The Advocate* had gone to press, in a unanimous decision, the U.S. Supreme Court affirmed the Third Circuit's decision that Merck investors can move forward with their class action alleging that Merck and its senior officers made fraudulent misstatements and omissions concerning the adverse cardiovascular effects of the painkiller VIOXX. As Ann Lipton's article "Ready, Set...Go!" (see page 14, inside) makes clear, the statute of limitations issues raised and ruled on in this case are a critical piece of the foundation for maintaining clear and transparent capital markets.

In an opinion penned by Justice Breyer, the Court held that the statute of limitations does not begin to run until the plaintiff either actually knows of the facts constituting the fraud, or could have discovered them with reasonable diligence. The Court rejected Merck's argument

that the period runs from the moment a plaintiff suspects a misstatement, holding that such an interpretation would be inconsistent with the plain language of the statute. The Court went on to conclude that on the facts of this case, the plaintiffs could not have discovered Merck's fraud more than two years prior to the filing of the complaint, as defendants made efforts to conceal the wrongful conduct.

Justice Scalia, joined by Justice Thomas, filed an opinion concurring in part and concurring in the judgment. Justice Scalia argued that the statutory text should be interpreted to begin the limitations period only at the moment a plaintiff actually discovers the fraud, regardless of what a hypothetical reasonable plaintiff would have discovered. Justice Stevens, separately concurring in part and concurring in the judgment, wrote that the Court should not have decided the question whether the statute runs from the time a reasonable plaintiff could have discovered the fraud, because on the facts of this case, whether an "actual knowledge" standard was employed, or a standard involving a hypothetical reasonable plaintiff, the outcome would have been the same.

The Court held that the statute of limitations does not begin to run until the plaintiff either actually knows of the facts constituting the fraud, or could have discovered them with reasonable diligence.

BLB&G serves as counsel to the court-appointed institutional lead plaintiff in this case, the Public Employees' Retirement System of Mississippi, whose legal interests are directed by Mississippi Attorney General Jim Hood. Attorney General Hood, who played an active role in leading the litigation, applauded the Supreme Court's ruling, stating:

"Rather than rewarding defendants for concealing their wrongful conduct, the Court's decision today will help ensure that defrauded investors will get their day in court, and have their claims decided on the merits."