BLB&G Bernstein Litowitz Berger & Grossmann LLP

The Advocate

FOR INSTITUTIONAL INVESTORS

Fall 2011

Government Goes After Insider Trading…

But Where are the Financial Crisis Prosecutions?

The Myth of Director Liability

Little Risk for Those at the Top

Dodd-Frank, One Year Later

Promises Unfulfilled

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Inside Look

As we go to press this fall, economic prospects are dim. Prominent economists of all stripes see the distinct possibility of another recession, continued struggles with high unemployment, and few remaining tools to improve global economic prospects. These trends are of course directly related to the mortgage meltdown and financial collapse. Yet despite all that is now known about the fraud and malfeasance at the root of the financial crash, policy responses to date from the government have offered precious little reform.

In this edition of *The Advocate*, we look more closely at some of the enforcement and reform efforts taken by the government to provide our readers with a view of what is being done, what is not, and perhaps what ought to be. In our cover story — "Government Goes After Insider Trading, but Where are the Financial Crisis Prosecutions?" (page 4) — BLB&G associate Kristin Meister discusses the important recent indictments and convictions of a number of financial executives caught in a wide-ranging insider trading web, but raises an important issue: Does this focus come at the expense of aggressive prosecution of the individuals behind the fraud at the heart of the financial collapse?

On page 12, firm associate Joseph Goodman takes a close look at the obstacles that have prevented full implementation of the Dodd-Frank financial reform act, as the promise of financial reform hoped for by supporters of Dodd-Frank has yet to be realized.

On a corporate governance note, we are delighted to reprint a recent column by *The New York Times* "Deal Professor," Steven Davidoff, professor at Michael E. Moritz College at Law at The Ohio State University — "Despite Worries, Serving at the Top Carries Little Risk." (See page 18.) In the piece, Professor Davidoff highlights the benefits — and comparatively few drawbacks — to serving as a director for a public company. In addition, BLB&G partner Mark Lebovitch and associate Jeremy Friedman discuss a Delaware Supreme Court indicating that courts may be treating corporate directors with increasing deference.

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.

Please note that we always make the current issue of *The Advocate* (as well as all past issues) available on our website at www.blbglaw.com. If you need any help in tracking down current or archival essays, please do not hesitate to contact us.

The Editors

Government Goes After Insider Trading

But Where are the Financial Crisis Prosecutions?

By Kristin Meister

In the wake of the financial crisis of 2008, the public's calls for accountability have fallen on deaf ears. While investigative reports, congressional inquiries, and other in-depth examinations of the financial crisis have demonstrated that fraud at every level of the mortgage and financial sectors played a central role in bringing on the economic collapse, to date no significant players have been charged criminally, and the SEC has brought few enforcement actions related to the root causes of the crisis.

Instead, the government has focused its attention on aggressively pursuing widespread insider trading and achieving an admirable string of convictions. These prosecutions exposed financial fraud reminiscent of a Hollywood movie — the culprits were known by colorful nicknames by their sources in the corporate world, used and destroyed disposable cellphones to avoid being caught, and at least one wrongdoer fled the country and is a fugitive from justice. In a first for government prosecutions of securities fraud, many were eventually captured on wiretap boasting about their misdeeds.

Notwithstanding the nefarious nature of these actions, in the end, the schemes at the heart of these frauds resulted in personal profits of, at most, tens of millions

RAJ RAJARATNAM
CONVICTED: 11 YEARS

Recent prosecutions have exposed financial fraud reminiscent of a Hollywood movie. The culprits were known by colorful nicknames, like "Octopussy," and many were eventually captured on wiretap boasting about their misdeeds.

RAJAT GUPTA
INDICTED

DANIELLE CHIESI
CONVICTED: 30 MONTHS

ZVI GOFFER
CONVICTED: 10 YEARS

of dollars. On the other hand, Wall Street's extraordinary recklessness and abandonment of risk management led to a financial collapse costing investors and taxpayers billions, if not trillions, of dollars. Executives at major esteemed financial institutions successfully relied on obscure financial instruments — and regulators' ignorance of how these instruments worked — to evade detection and make billions of dollars in short-term profits. While observers have praised the insider trading prosecutions, they have also raised the question of whether some of the vast resources devoted to combating insider trading would be better spent targeting the pervasive wrongdoing at the heart of the financial crisis — and preventing the next collapse.

Continued on next page.

Recent prosecutions have targeted a range of hedge fund employees, such as portfolio managers and analysts, who relied on illegal tips from a widespread network, including consultants, junior attorneys at Manhattan law firms, and board members of corporations.

Recent Insider Trading Convictions Paint a Grim Story of Fraud and Corruption

Over the past few months, high-profile prosecutions and SEC enforcement actions targeting insider trading have resulted in a slew of convictions and fines reaching from hedge fund chiefs to junior-level traders. While in the past insider trading was typically viewed as being confined to the boardroom or the CEO's office, it is clear from the government's probe that this view is outdated. Indeed, a recent *Bloomberg* article commented on the "democratization and globalization of what is allegedly inside information," noting that it is "not just in the hands of the CEOs and CFOs anymore." In fact, recent prosecutions have targeted a range of hedge fund employees, such as portfolio managers and analysts, who relied on illegal tips from a widespread network, including consultants, junior attorneys at Manhattan law firms, and board members of corporations. While prosecutors have been working for years investigating a web of companies that allegedly helped ferry illegal corporate information to individual investors to boost profits, it is only recently that this massive endeavor — joint criminal and civil investigations by the SEC, FBI and the U.S. Attorney's Office for the Southern District of New York — has borne fruit.

At the heart of the government's prosecutions was the insider trading ring led by billionaire Raj Rajaratnam, founder of the hedge fund Galleon Group. Hedge funds such as Rajaratnam's made their fortunes betting on short-term moves triggered by catalysts such as surprises in quarterly earnings, a surge in customer orders, or the announcement of a new product. Rajaratnam got rich by illegally obtaining this information before the rest of the market. His network of tippers had connections everywhere and involved low level employees as well as high ranking individuals at *Fortune 100* companies, including insiders at IBM and Intel. *Bloomberg* reported that Rajaratnam "would tell potential clients that if his analysts needed to take someone's secretary out to get information on a company, he'd gladly foot the bill for the date." According to the government, Rajaratnam reaped $64 million in illicit profits from his schemes before he was caught. In May of this year, Rajaratnam was found guilty on 14 counts of conspiracy and securities fraud due to insider trading. In October, he was sentenced to 11 years in prison and fined $10 million for his crimes.

This corruption did not stop with Rajaratnam. For example, Zvi Goffer, a former day trader at Galleon, was convicted in June of 12 counts of securities fraud and two counts of conspiracy to commit insider

trading. He was later sentenced to 10 years in prison. His younger brother, Emanuel, and another hedge fund trader were convicted at the same trial. According to the government, Goffer was the ringleader for trading on tips about 3Com Corp. and Axcan Pharma. Colloquially, Goffer was known as "Octopussy" due to his extensive connections in the corporate world. Among other sources, Goffer's trial revealed that he utilized two former junior patent lawyers with the law firm Ropes & Gray to leak confidential details about proposed mergers. According to *The Wall Street Journal*, one of the patent lawyers testified at trial about "how he would watch the printers of lawyers working on deals to see if they would leave documents behind." To avoid detection, he explained that "he was instructed to destroy one cell phone used for tips by breaking it in half, submerging it in water and then throwing away the pieces."

The insider trading convictions have not been limited to the traders with the Galleon Group. Among others, Danielle Chiesi, a beauty-queen turned analyst with the hedge fund New Castle who regularly and secretly passed along tips to hedge fund managers (including Rajaratnam), was convicted in January after pleading guilty to three counts of conspiracy to commit securities fraud. Chiesi leaked information about IBM, Advanced Micro Devices, and Sun Microsytems, earning her hedge fund $1.7 million. Chiesi was linked to a former IBM executive who provided confidential tips to Chiesi and to her boss, who pled guilty and received 27 months in jail. Wiretaps played at her trial revealed that Chiesi boasted about playing her source "like a finely tuned piano," and that she saw insider trading as a "conquest" that was "mentally fabulous" for her.

And it appears that these prosecutions may only be the beginning. On October 26, 2011, Rajat Gupta, the former head of consulting firm McKinsey & Co. and former board member of both Goldman Sachs Group, Inc., and The Procter & Gamble Company, was indicted on charges of leaking confidential information to Rajaratnam. Preet Bharara, the United States Attorney in Manhattan, explained the charges:

"Rajat Gupta was entrusted by some of the premier institutions of American business to sit inside their boardrooms, among their executives and directors, and receive their confidential information so that he could give advice and counsel for the benefit of their shareholders. As alleged, he broke that trust and instead became the illegal eyes and ears in the boardroom for his friend and business associate, Raj Rajaratnam, who reaped enormous profits from Mr. Gupta's breach of duty. Today we allege that the corruption we have seen in the trading

Continued on page 22.

While observers have praised the insider trading prosecutions, they have also raised the question of whether some of the vast resources devoted to combating insider trading would be better spent targeting the pervasive wrongdoing at the heart of the financial crisis—and preventing the next collapse.

Quotable

"His crimes and the scope of his crimes reflect a virus in our business culture that needs to be eradicated."

U.S. District Judge Richard Holwell imposing sentence on Galleon Group's Raj Rajaratnam.

Eye on the issues

By Sean O'Dowd

Obama Taps Former Ohio AG as Director of CFPB; Confirmation Remains Uncertain

On July 17, President Obama nominated former Ohio Attorney General Richard Cordray to head the new Consumer Financial Protection Bureau, which has been without a director since its creation in 2010. Mr. Cordray, who joined the CFPB last December as head of enforcement, garnered national attention in Ohio for his aggressive investigations into misconduct by financial companies during the housing crisis. Among his notable cases, Mr. Cordray sued the nation's three leading credit rating agencies on behalf of Ohio's pension funds, alleging that the agencies had improperly inflated their ratings of mortgage-backed securities. At press time, Mr. Cordray's confirmation remained in doubt, with a majority of senators saying they would refuse to vote on any individual nominee and instead favored the creation of a commission to run the agency.

>> http://www.whitehouse.gov/the-press-office/2011/07/17/president-obama-announces-richard-cordray-director-consumer-financial-pr

Richard Cordray

Regulators Fail to Collect Billions in Unpaid Fines

Two government agencies responsible for enforcing the federal securities laws have failed to collect over $4.5 billion in fines and other penalties since 2005. The Securities and Exchange Commission, the nation's primary securities regulator, and the Commodity Futures Trading Commission, which oversees futures and options markets, collectively imposed over $12.3 billion in penalties on individuals and firms accused of financial wrongdoing during that time. This total included fines, disgorgement of ill-gotten gains, and restitution for victims. To date, however, the SEC has failed to collect a third of the penalties it imposed, and the CFTC has been unable to collect a full three-fourths of the fines it levied. The federal agencies' collection woes have resulted in part from the fact that, while the fines are intended to deter future wrongdoing and maximize any recovery for investors, CFTC officials are not permitted to consider a wrongdoer's ability to pay when recommending penalties. In addition, in many cases, there may be essentially no assets to recover.

>> The Wall Street Journal, July 8, 2011

Government Sues 17 Firms Over Sale of Toxic MBS to Fannie and Freddie

The Federal Housing Finance Agency ("FHFA"), acting as conservator for Fannie Mae and Freddie Mac, has sued 17 of the nation's largest financial institutions for selling toxic mortgage-backed securities to government-sponsored enterprises Fannie Mae and Freddie Mac. In September, the FHFA filed suit against Morgan Stanley, Goldman Sachs, Bank of America, Merrill Lynch/First Franklin, Countrywide, Citigroup, and 11 other banks and mortgage originators on the grounds that they had misrepresented the quality of the loans backing the securities. Specifically, the lawsuits charge that the mortgage loans were significantly riskier than described in the marketing and sales materials that defendants presented to Fannie Mae and Freddie Mac, and thus violated federal securities laws, state negligent misrepresentation laws, and state fraud laws.

>> http://www.fhfa.gov/webfiles/22599/PLSLitigation_final_090211.pdf

SEC Destroys Records Of At Least 9,000 Investigations

According to an SEC whistleblower, over the past 17 years, the agency systematically and illegally destroyed working files for between 9,000 and 18,000 preliminary investigations into financial misconduct. In July, Darcy Flynn, an SEC enforcement attorney who recently assumed responsibility for managing the agency's enforcement records, informed Congress that files for thousands of early investigations — or "Matters Under Inquiry" — had been destroyed despite the fact that the National Archives and Records Administration required these records to be maintained for 25 years. Among the documents destroyed were records of early-stage investigations of the Bernard L. Madoff fraud as well as investigations into market manipulation, insider trading, and fraud involving industry leaders like Goldman Sachs, Lehman Brothers, Bank of America, and AIG. The document disposal is currently under investigation by Congress, the National Archives, and the SEC's inspector general.

>> The New York Times, August 17, 2011

New Study Confirms Securities Class Actions Deter Accounting Fraud

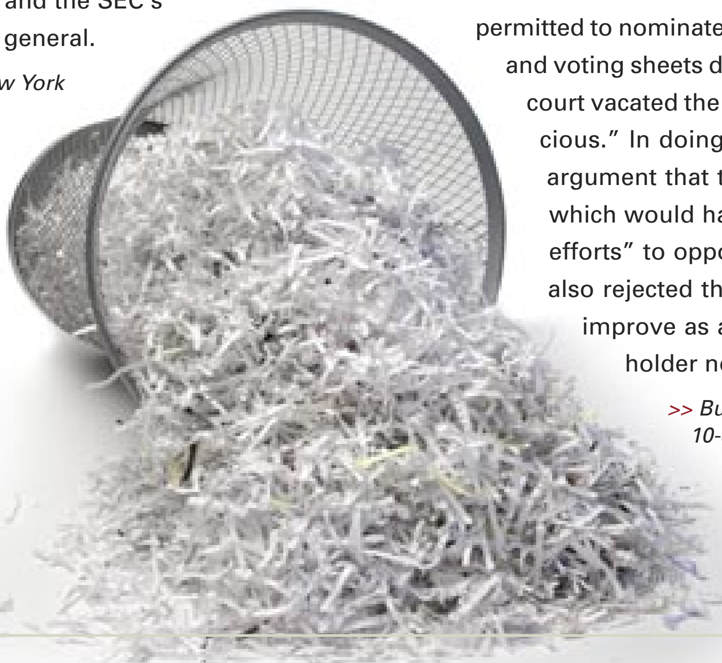
A groundbreaking new study has confirmed that securities class action litigation deters overly aggressive and fraudulent corporate accounting in a statistically significant way. The independent study, which examined the impact of both class action lawsuits and SEC enforcement actions between 1996 and 2006, concluded that firms in industries that had been subject to SEC enforcement actions or securities class actions alleging violations of Generally Accepted Accounting Principles ("GAAP") experienced significant reductions in discretionary accruals in subsequent reporting periods. The authors observed that securities class actions may actually be more effective at deterring fraud than SEC actions, because class actions recover twice as much on average as regulatory actions and are substantially more common than SEC actions and, thus, more likely to affect the average firm. Although the results are still preliminary, the investigators from Emory University, Rutgers University, and the University of Washington found after reviewing 1,111 class actions and close to 500 SEC actions that accounting practices were more conservative by a "statistically and economically significant" margin.

>> http://blogs.law.harvard.edu/corpgov/2011/07/25/the-deterrence-effects-of-sec-enforcement-and-class-action-litigation/

Federal Court Voids Investor Protection On "Proxy Access"

On July 22, 2011, the United States Court of Appeals for the District of Columbia sided with the Chamber of Commerce and the Business Roundtable and vacated an SEC rule that would have given institutional investors greater influence in the make-up of corporate boards of directors. Under Exchange Act Rule 14a-11, institutional investors and other shareholders holding over 3% of a company's shares would have been permitted to nominate director candidates to appear on the proxy statements and voting sheets distributed by the company to all investors. The appeals court vacated the rule, however, holding that it was "arbitrary and capricious." In doing so, the court accepted the Chamber of Commerce's argument that the rule would prove expensive for corporate boards, which would have to conduct "significant media and public relations efforts" to oppose candidates nominated by shareholders. The court also rejected the SEC's argument that corporate performance would improve as a result of "hybrid boards" that included some shareholder nominees.

>> Business Roundtable and Chamber of Commerce v. SEC, No. 10-cv-1305 (D.C. Cir., July 22, 2011)



Eye on the issues

States, DOJ Seek To Finalize Foreclosure Settlement With Top Banks

The U.S. Department of Justice and a coalition of state attorneys general are attempting to finalize a settlement with some of the nation's largest banks over improper foreclosure practices. Under the terms of the proposed agreement, the banks would pay tens of billions of dollars in penalties and correct a variety of documentation errors and "robosigning" abuses that infected the foreclosure process. In exchange, the settlement would release the banks from liability for certain future legal claims. The negotiations have stalled over a dispute about how broad the liability release should be. In August, New York's Attorney General was removed from the executive committee of attorneys general overseeing the negotiations after he expressed concern that the settlement could extinguish potential legal claims for a wide range of bank misconduct in addition to foreclosure practices. Other attorneys general had similar reservations, with California's Attorney General announcing in late September that she would pull out of the talks entirely and commence her own investigation and Massachusetts's Attorney General stating in early October that she would be initiating separate litigation because she had "lost confidence" in the banks' willingness to settle on appropriate terms. Discussions are ongoing, and California's Attorney General remained open to rejoining the coalition if a "stronger" deal could be reached with the banks.

>> The Wall Street Journal – October 7, 2011

New "Say on Pay" Provisions Rarely Used By Investors

Despite new "say on pay" regulations giving investors the opportunity to vote on executive compensation, to date shareholders have voted against senior officer pay packages only 2 percent of the time. As of June 14, only 32 of the 1,998 companies holding annual meetings saw a majority of shareholders record "no" votes. Although these votes are not binding, the results were considered surprising in a year when median executive pay climbed 35 percent to $8.4 million and when shareholder advisory group Institutional Shareholder Services ("ISS") recommended no votes for 293 companies. The lack of "no" votes may be partly explained by the fact that many companies aggressively challenged ISS's recommendations in direct mailings to shareholders.

>> ISS 2011 U.S. Season Review: 'Say on Pay'

KPMG Study Reveals That Most Fraud Is Committed By Management

In an analysis of global patterns of fraud designed to identify the "typical fraudster," auditing firm KPMG found that most corporate fraud cases involve management, including members of senior management. KPMG's review, which examined 348 reported and unreported fraud investigations in 69 countries, found that high-level corporate officials committed more than one-third of corporate frauds, with middle management involved in 29 percent of frauds, and members of corporate boards of directors and general corporate employees each responsible for 18 percent of frauds. With respect to U.S. executives, KPMG found a relationship between "greater oversight responsibility" and "greater opportunity for bigger frauds." The primary motivations for fraud, according to KPMG, were personal enrichment and pressure to conceal losses or poor performance in an effort to reach business targets. The overwhelming majority of frauds in the study were perpetrated by corporate insiders, rather than third parties, and fraudsters were most likely to work in a company's finance department, followed by the CEO's office and the operations and sales departments. Relatively few frauds were committed by short-term employees, and most fraudsters in the study worked at their company for more than five years before the fraud was detected.

>> KPMG Analysis of Global Patterns of Fraud – June 2011; http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Documents/who-is-the-typical-fraudster.PDF

Regulators Seek Comment On Long-Awaited "Volcker Rule"

On October 11, 2011, federal financial regulators released proposed language for the so-called "Volcker Rule," a provision of the July 2010 Dodd-Frank financial reform legislation aimed at limiting speculative investments by banks. The rule is named for former Federal Reserve chairman Paul Volcker, who originally proposed its enactment. Under the proposed language, insured depository institutions would be prohibited from engaging in "proprietary trading," or using deposited funds to back trades made for the bank's own personal accounts, which some commentators blame for contributing to the 2008 financial crisis and the demise of Lehman Brothers and Bear Stearns. Trades in U.S. government-backed obligations such as Treasury bills would be exempted from the proprietary trading bar. The Volcker Rule would also restrict banks' investments in private equity or hedge funds, barring ownership stakes greater than 3 percent. Banks would be required to enact internal controls to implement the rule. Regulators — including the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the SEC — are inviting public comment on the proposal through January 13, 2012, with the rule scheduled to take effect on July 21, 2012.

>> http://www.fdic.gov/news/board/2011Octno6.pdf

Banks Received $1.2 Trillion In Undisclosed Loans from Federal Reserve

During the 2008 recession, financial firms received $1.2 trillion in previously unreported emergency loans from the Federal Reserve. This figure far eclipses the $160 billion of publicly disclosed funding provided to the top ten U.S. financial firms under the Treasury Department's Troubled Asset Relief Program. Under the newly revealed loan program, which was designed to stave off a potential depression, the Federal Reserve loaned billions of dollars to many of the world's largest banks. For example, Morgan Stanley received $107 billion, Citigroup received over $99 billion, Bank of America received $91 billion, and Royal Bank of Scotland received $84.5 billion. The loan to Morgan Stanley was almost triple the size of Morgan Stanley's combined profits for the previous decade. The magnitude of the trillion-dollar lending program was only revealed in August after the United States Supreme Court declined to hear an appeal by banks that sought to keep the loans secret. The Federal Reserve stated that it does not expect to experience credit losses under the program and reported that it had earned $13 billion in interest and fees as of December 2009.

>> Bloomberg Markets – August 22, 2011(http://www.bloomberg.com/news/2011-08-21/wall-street-aristocracy-got-1-2-trillion-in-fed-s-secret-loans.html)

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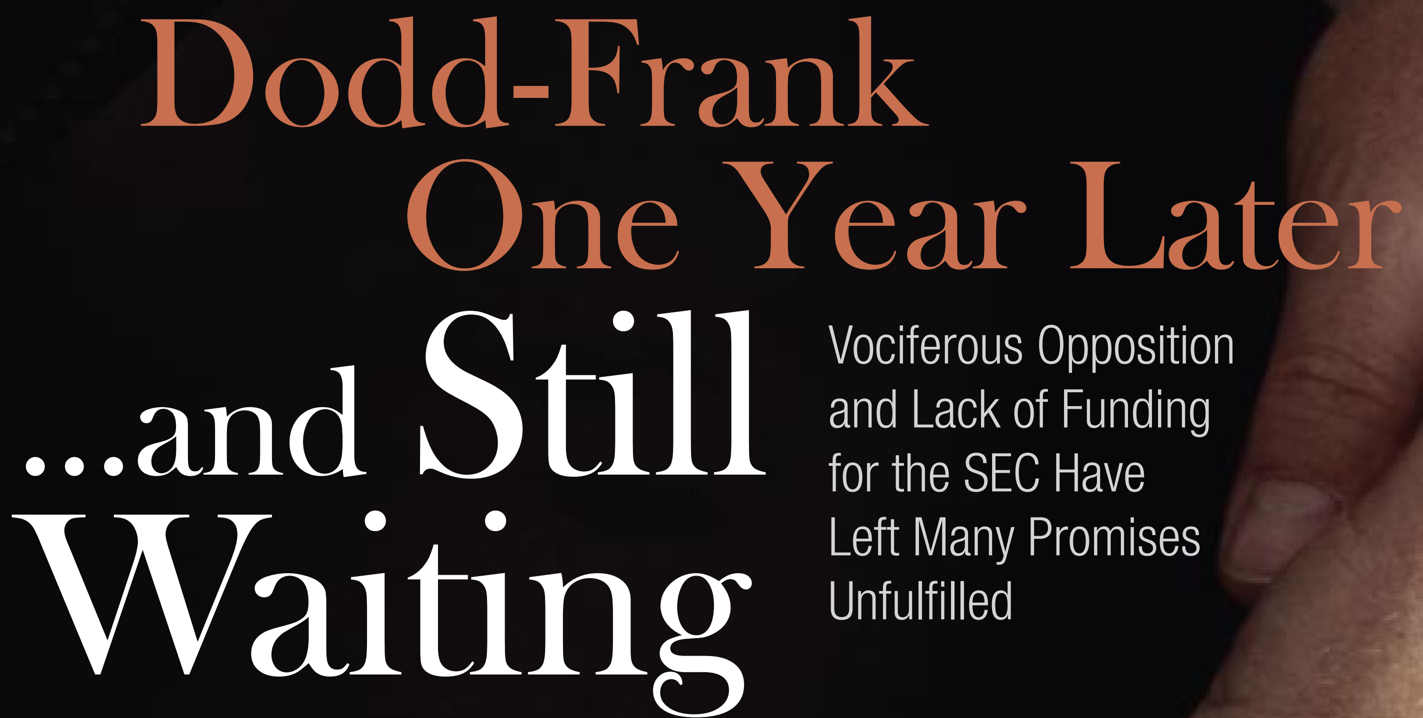

Dodd-Frank One Year Later …and Still Waiting

Vociferous Opposition and Lack of Funding for the SEC Have Left Many Promises Unfulfilled

By Joseph Goodman

It has been more than a year since President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act"). The official purpose of the Act is to "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices and for other purposes." The Act proposed to achieve these goals by expanding the SEC's power in certain important ways, providing for additional regulation of aspects of the financial sector, and creating several new regulatory bodies. Dodd-Frank's provisions did not go into effect immediately, and lawmakers left many of the details to be fleshed out by regulators. However, due to vociferous opposition and a lack of funding, many of the Act's provisions have still not been implemented. In this article, we examine the additional powers and responsibilities assigned to regulators, the steps taken to put them into practice, and the ways in which the promise of Dodd-Frank has been left unfulfilled.

Continued on next page.

In August, the SEC's new whistleblower office opened and a webpage was launched to help whistleblowers report violations and apply for rewards. A similar program had previously existed at the SEC, but it resulted in few prosecutions. Thus, it remains to be seen whether the new program, with a new website and larger rewards for a greater range of violations, will be more successful.

Additional Powers and Responsibilities to the SEC

Pursuant to the Act, the SEC was supposed to gain many of the enforcement powers that have been stripped from private litigants over the last several decades, including the power to pursue the ratings agencies and persons who provide crucial assistance to those violating investor protection laws. One year later, however, it remains unclear how much impact these revised powers will have, particularly in light of the numerous hurdles regulators face in implementing the Act's provisions.

Regulation of Credit Ratings Agencies

Dodd-Frank established a new regulatory structure to oversee credit ratings agencies. In enacting Dodd-Frank, Congress expressly found that the ratings agencies had been compromised by their relationships with investment banks and that, as a result, the agencies issued inflated ratings on securities backed by pools of mortgage loans. Thus, Congress concluded that the ratings agencies "contribut[ed] significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States." Investors relied on these erroneous ratings and suffered billions of dollars in damages. To address these problems, Dodd-Frank placed "Nationally Recognized Statistical Rating Organizations," like Standard and Poor's, Moody's, and Fitch, under a new system of regulation and accountability.

Despite the magnitude of the problems, the SEC has not yet established a new office to oversee credit ratings agencies. Instead, due to severe budgetary limitations, the SEC has simply added personnel to existing offices to perform examinations on the ratings agencies and has deferred full implementation of these regulations "due to budget uncertainty."

Whistleblowers

Dodd-Frank provides the SEC authority to pay financial rewards to whistleblowers who provide "original information" about a securities law violation. On August 12, 2011, the SEC's new whistleblower office opened and a webpage—www.sec.gov/whistleblower—was launched to help whistleblowers report violations and apply for rewards. To be eligible, the information must lead to a successful SEC enforcement action resulting in a monetary penalty greater than $1 million. The SEC, at its discretion, may pay a whistleblower up to 30 percent of the penalty. A broad range of actors are eligible to benefit from the whistleblower provisions, including even those who may have been complicit in the underlying conduct.

A similar program had previously existed at the SEC, but it was limited to insider trading cases, awards were capped at 10 percent of the penalties, and it resulted in few prosecutions. Thus, it is unclear

whether the new program, with a new website and larger rewards for a greater range of violations, will be more successful.

Aiding and Abetting Claims

Private litigants are unable to bring claims against accounting firms, consultants, and law firms that assist a company in violating the federal securities laws. While the SEC has been able to bring certain aiding and abetting claims against those who assist in the perpetration of a fraud, Dodd-Frank authorizes the SEC to bring aiding and abetting claims under several other investor protection statutes. Perhaps more significant for investors, however, Dodd-Frank also makes it easier for the SEC to establish aiding and abetting claims by lowering the necessary state of mind from acting "knowingly" to "recklessly." The lowered standard increases the likelihood that third parties who help carry out a fraudulent scheme will be held liable in SEC civil suits.

Unfortunately for investors, to date, the SEC has had limited success in pursuing aiding and abetting claims under the new provisions of Dodd-Frank, at least partly because the statute may not apply retroactively. For example, on June 6, 2011, in *SEC v. Daifotis*, Judge William H. Alsup of the U.S. District Court for the Northern District of California dismissed the SEC's aiding and abetting claims against two executives at subsidiaries of Charles Schwab on the ground that Dodd-Frank's provisions could not be applied retroactively. Thus, the effect of the SEC's increased authority remains to be seen.

Application of Antifraud Laws to Wrongdoing or Securities Transactions Occurring Outside The United States

The Supreme Court recently decided that certain private litigants who purchased their securities abroad could not bring suit in the United States, even if a significant part of the fraud occurred in the United States. Dodd-Frank attempts to restore some protections for these investors by providing the SEC the right to bring these claims. Specifically, Dodd-Frank allows the SEC to bring suits related to "conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors," or "conduct occurring outside of the United States that has a foreseeable substantial effect within the United States."

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One year later, it remains unclear how much impact the SEC's revised powers will have, particularly in light of the numerous hurdles regulators face in implementing the Act's provisions.

At more than 2,000 pages, Dodd-Frank authorizes regulators to write the details of over 300 new rules and invites them to study more than 100 others. Congress set aggressive deadlines for regulators to make rules to enforce Dodd-Frank, and, unsurprisingly, they are not being met.

The impact of this provision also is uncertain at best, as it appears that these provisions may not be applied retroactively. Thus, it appears that the SEC will not be able to use the new law against the perpetrators of frauds contributing to the recent financial crisis.

Consumer Financial Protection Bureau

Dodd-Frank also provided for the creation of the Consumer Financial Protection Bureau ("CFPB"), which was established as a "watchdog dedicated to safeguarding consumer financial security" and which formally began operations on July 21, 2011. The CFPB inherits consumer protection responsibilities from seven agencies and has authority to police "unfair, deceptive, or abusive" financial services products. The CFPB will create new rules and enforce existing ones for banks having assets of at least $10 billion and the thousands of related companies, including mortgage brokers, payday lenders and student loan companies. According to Americans for Financial Reform (AFR), a coalition of consumer groups: "The CFPB has authority to write rules affecting mortgage down payments and disclosures, loan modifications, credit card rates and fees, bank overdraft programs, credit score usage, and eligibility for student loans, credit cards, prepaid cards and more. . . . The [CFPB] will have the authority to impose fines on companies, require restitution (repayment) to aggrieved consumers, rescind consumer contracts and/or file lawsuits against firms that violate its rules."

Opposition to the CFPB, however, has been forceful. The Chamber of Commerce has called it an "unprecedented expansion of government intervention" and a "new tax" on small businesses. Some Republican members of Congress have called the CFPB a "rogue agency" with an "authoritarian structure" and "one of the greatest assaults on economic liberty in [a] lifetime." In May, the House Committee on Financial Services passed three bills designed to weaken the CFPB. Other bills passed by the committee sought to change the leadership structure of the Bureau from a single director to a bipartisan commission and sought to prevent the Bureau from assuming any power until the Senate confirms a director. Senate Minority Leader Mitch McConnell of Kentucky and 43 other Republicans announced in May that they would not vote to confirm anyone as director until changes were made to its structure: "Senate Republicans still aren't interested in approving anyone to the position until the President agrees to make this massive new government bureaucracy more accountable and transparent to the American people." Despite this opposition, President Obama nominated Richard Cordray, former Ohio Attorney General and the head of the Bureau's Enforcement Division, to be the first Director of the CFPB on July 18, 2011. Although his nomination is currently pending before the Senate, certain Republicans have indicated they will block a vote, leaving the CFPB without leadership.

Roadblocks to Implementation of Dodd-Frank

Congress left many of the details of Dodd-Frank to be worked out by various agencies, and regulators have been working to

develop rules to implement many of Dodd-Frank's provisions. It is a daunting task. At more than 2,000 pages, Dodd-Frank authorizes regulators to write the details of over 300 new rules and invites them to study more than 100 others. Congress set aggressive deadlines for regulators to make rules to enforce Dodd-Frank, and, unsurprisingly, they are not being met. The House Committee on Financial Services reported that, a year after passage: 62 percent of rules have yet to be proposed; deadlines have been met in only 33 of the 163 required rule-makings; 7 studies have been missed; and only 51 of Dodd-Frank's 400 total rulemaking requirements have been completed. In July 2011 alone, 104 rule-making deadlines were missed. "The decisions that are coming down are not promising," said Ted Kaufman, the former Democratic senator from Delaware who worked on the legislation. "The regulators are not making the hard decisions. If the Congress would not make the hard decisions, how can you expect the regulators to make them?"

These delays have given the financial industry additional time to lobby the government to unwind Dodd-Frank rules well after its passage; indeed, forceful opposition and a lack of funds have made it difficult to implement most of Dodd-Frank's provisions. The tedious rulemaking process also requires the participation of 20 different regulatory agencies, thus occasionally pitting one agency against another.

In addition to the logjam of regulation, lack of funding has seriously hampered Dodd-Frank's implementation. For example, the House Appropriations Committee cut the SEC's fiscal 2012 budget request by $222.5 million, to $1.19 billion (the same as 2011), even though the SEC's responsibilities were vastly expanded under Dodd-Frank. An SEC memo on the Committee's proposed budget warns: "We may be forced to decline to prosecute certain persons who violate the law; settle cases on terms we might otherwise not prefer; name fewer defendants in a given action; restrict the types of investigative techniques employed; or conclude investigations earlier than we otherwise would." According to a report by Boston Consulting Group, Inc., the SEC is about 400 employees short of what it needs to manage its current workload: "Without sufficient human resources, the agency will be unable to complete the requirements of Dodd-Frank while maintaining its current activities." SEC staff levels have declined since 2005 and employees consistently complain their departments are understaffed. In testimony to the Senate Banking Committee earlier this year, SEC

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Despite Worries, Serving at the Top Carries Little Risk

The Myth of Accountability for Corporate Directors

By Steven M. Davidoff

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They are paid millions, but some complain that it's no longer worth it.

These men and women argue that, as corporate directors and officers, they have too much chance of liability for a company's operations. Because of this, they claim, the risks of serving as a director or officer have become too great, and it will become harder to recruit and retain competent directors and officers. But the truth is that they have about the same chance of being held liable for their poor management of a public firm as they have of being struck by lightning.

The day-to-day management of a company is largely regulated by state law. Since most companies are incorporated in Delaware, this means Delaware law. And Delaware law on this matter sets an extremely high standard for finding directors and officers liable for a company's mismanagement. A Delaware court is not going to find them liable no matter how stupid their decisions are. Instead, a Delaware court will find them liable only if they intentionally acted wrongfully or were so oblivious that it was essentially the same thing.

Under this standard, a Delaware court recently refused to hold Citigroup's board accountable for its decision to enter the subprime mortgage market, a decision that resulted in billions of dollars in losses and the company's near failure. The boards of Bear Stearns and Lehman Brothers are also scot-free so far.

And only last week the board and management of Massey Energy won a case in Delaware Chancery Court that would make it significantly more difficult for them to be held liable for their ostensible poor oversight of the company's safety practices that led to the Upper Big Branch mine explosion and the death of 29 men.

Even if there is liability or a settlement, it is almost always covered by insurance of directors and officers. One study found that from 1980 to 2006, there were only two instances of directors of a company incorporated in Delaware being required to personally pay for their misconduct.

One of those involved litigation against the board of Fuqua Enterprises. The Fuqua directors had the unfortunate luck to be insured by Reliance Enterprises, which

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Although they claim the risks are great, the truth is that corporate directors have about the same chance of being held liable for their poor management of a public firm as they have of being struck by lightning.

went bankrupt. They paid an undisclosed portion of a $7 million settlement.

The other known personal liability case involved the sale in 1980 of the TransUnion Corporation. The 10 TransUnion directors paid a total of $1.35 million. There you have it, no more than $8.35 million in personal payments by directors over more than 26 years.

There can also be liability for board members and executive managers under federal law. These are largely securities fraud cases where the directors or officers make a misstatement or omission.

This has nothing to do with the oversight of the company, but often there are misstatements about accounting or the company's financial condition. Instances of personal liability for officers and directors in these cases are only a bit less rare, again because the standards are high and insurance often covers the matter.

The same study found only nine cases where a director was held personally liable for securities fraud in a 26-year period. Three of these were highly notable — Enron, WorldCom and Tyco.

And no directors from the financial crisis have yet been found liable under these laws. Officers are faring just as well, and the only prominent payment was by Angelo R. Mozilo of Countrywide Financial Corporation. He paid $22.5 million of a $73 million fine. The rest was paid by Bank of America. Meanwhile, the fines of David Sambol, Countrywide's former president, and Eric P. Sieracki, the ex-chief financial officer, were paid in full by Bank of America.

The only financial crisis case to go to trial, involving officers of BankAtlantic, had its jury verdict finding civil liability overturned by the judge. And unlike with Enron and WorldCom, it seems there will be no criminal cases involving securities fraud stemming from the financial crisis.

What about the Dodd-Frank financial reform, you might ask? It doesn't change much. The main provision concerning the personal liability of officers and directors involves systemically important financial institutions, or the "too big to fail" entities. And if one fails, Dodd-Frank authorizes the Federal Deposit Insurance Corporation to claw back two years of compensation from those held substantially responsible for the failure.

This is a weak penalty. An economically important bank with hundreds of billions of dollars in assets fails, and the penalty is only two years of pay? Nonetheless, the Securities Industry and Financial Markets Association and a number of other industry groups objected to the FDIC's proposed rules on this requirement. The financial industry groups again argue that such a standard will drive away directors and officers as well as make it harder to recruit these people.

This is laughable. First, we've already seen that liability for boards and management is extremely rare. Moreover, many of the directors of Lehman and Bear Stearns continue to serve on other boards, and one Lehman director, Jerry A. Grundhofer, has apparently been so chastened about the liability issue surrounding large banks that he is serving on the Citigroup board.

More telling, there is no empirical evidence whatsoever supporting this argument. Instead, you have the occasional self-serving statements by officers and directors that they are resigning because of "liability"

reasons. Officers in particular like to say that they are taking a company private for this reason. But more often than not, it is because there is more money in being private.

This is not to say that it has not become more difficult to be a director or officer. Regulation has certainly increased. So has scrutiny. This has made the work of being a director or officer of a public company harder and more time-consuming. And yes, if a company declares bankruptcy, these people will lose a lot of their investment and may in rare circumstances have to pay back some of their salary.

But is that too much to ask? According to a recent study by Equilar for *The New York Times*, the median salary of a chief executive at the top 200 major companies was $9.6 million last year. Salaries for chief financial officers at companies listed on the S&P 500 stock index shot up last year by 26.1 percent, according to Equilar, and the median salary is now $3 million.

The prominent law firm Wachtell, Lipton, Rosen & Katz recently issued a memorandum calling for director salaries to increase because of the increased burdens on this position. Outside director salaries average about $200,000 for *Fortune 500* companies, according to global consulting firm Tower Watson.

The upside of serving as a director or officer thus appears huge. The downside is very limited. Yes, there will be increased regulation to comply with and some of it may even be unjustified, but that conflates liability with regulation. Remind directors and officers of this the next time they complain about the risk they are taking because of their jobs. ◆

More on the Myth of Director Accountability

A Little Fear Can Go a Long Way

By Mark Lebovitch and Jeremy Friedman

Challenging the common lament that the risk of personal liability deters good people from serving as corporate directors — and that salaries must be high as a result — Professor Davidoff points out that officers and directors “have about the same chance of being held liable for their poor management of a public firm as they have of being struck by lightning.”

While personal liability has always been rare, corporate directors once knew that if they did not try to do their jobs or were blatantly asleep at the switch, they faced some risk of liability. Although the legal standards governing director behavior have not materially changed in years, recent decisions indicate that how judges apply those standards may be less protective of shareholders than in the past.

While many factors may combine to sway the application of law in a particular direction, we believe one reason for softening judicial oversight of directors in recent years may be the Delaware Supreme Court’s opinion in *Ryan v. Lyondell*. The trial judge in that case declined to dismiss claims against directors and required them to stand trial to determine whether “two months of slothful indifference [by the defendant board] despite knowing that the Company was in play” (that is, considering a potential sale) amounted to bad faith. Although the judge’s opinion showed his skepticism of the shareholders’ position, he held it was a close enough call that a trial was merited.

The corporate community publicly attacked the judge for daring to make the directors sit through trial. The Delaware Supreme Court not only reversed the judge, but it seemed to rebuke him for his decision. The resulting backlash was applauded by Wall Street and corporate CEOs, and it undoubtedly sent a clear message to Chancery Court judges (and even other judges) considering whether to hold directors personally liable.

As Davidoff’s article demonstrates, the status quo essentially guarantees that directors face no risk of personal liability, regardless of their conduct. In our view, the benefits — to shareholders, corporations, and the economy in general — of judges casting even a slightly more critical eye on director conduct far outweigh any risk of misplaced personal liability. ◆

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Prosecutors have not brought a single charge against any major executive at a Wall Street bank in connection with conduct leading up to the financial collapse. This is despite the fact that other investigations and reports, including the Financial Crisis Inquiry Commission, have made clear that the mortgage meltdown was caused by corporate wrongdoing.

Insider Trading

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cubicles, investment firms, law firms, expert consulting firms, medical labs, and corporate suites also insinuated itself into the boardrooms of elite companies."

Interestingly, the government is not even alleging that Gupta received any monetary benefit from the alleged crime.

All in all, government prosecutors have obtained dozens of convictions of hedge fund workers and corrupt employees of public companies, who collectively reaped millions of dollars in profits for themselves. Numerous observers, however, worry that that the systemic, pervasive misconduct in the financial sector uncovered through the insider trading prosecutions may only scratch the surface of illegal behavior fueled by greed in corporate America. As Goffer announced during his sentencing, "an erroneous lesson I learned early on was that in order to get ahead on Wall Street you had to be willing to 'get an edge'… I was willing to go to great lengths, even grossly illegal lengths, to get an edge. Pride and greed were my constant companions."

Has the Government's Focus on Insider Trading Come at the Expense of Other Prosecutions in an Era of Such Pervasive Wrongdoing?

While it is laudable that the government has unearthed and brought to justice this insider trading ring, the question remains: In light of the widespread fraud and corruption that led to the worst financial downturn in generations, are these prosecutions merely a sideshow from what should be the main event? John Hueston, a former lead *Enron* prosecutor, asked the same question, wondering: "Have they committed the resources in the right place? Do these scandals warrant apparent national priority status?"

The last issue of *The Advocate* ("Too Big to Fail or Too Big to Challenge?"), discussed how prosecutors have not brought a single charge against any major executive at a Wall Street bank in connection with conduct leading up to the financial collapse. In the most high-profile government lawsuit to date, the SEC settled with Angelo Mozilo on the eve of his trial for a fraction of the millions he squirreled away as Countrywide's CEO. This is despite the fact that other investigations and reports, including the Financial Crisis Inquiry Commission, have made clear that the mortgage meltdown was caused by corporate wrongdoing and Wall Street's abandonment of risk management, and would have been avoidable if regulators had detected and worked to reverse these practices. Following the collapse, the government could have brought prosecutions to punish the principal actors that crashed the financial system, thus deterring similar misconduct in the future. As it stands, however, the government has not brought these prosecutions, and as we get further removed from the nadir of the financial collapse, such prosecutions grow less and less likely. Commenting on this precise issue earlier this year, Lynn Turner, a former chief accountant for the SEC, provided *Rolling Stone* with his candid assessment of regulatory failures concerning the financial sector: "I think you've got a wrong assumption — that we even have

a law-enforcement agency when it comes to Wall Street."

Indeed, the extensive resources devoted to bringing down the Rajaratnam ring — including, for the first time in a securities case, the use of wiretaps, which are traditionally reserved for drug trafficking and organized crime — raises several questions: Where were the wiretaps on the whole confederacy of Wall Street executives and traders who knew they were recklessly trading in extraordinarily risky financial instruments? Where were the wiretaps to build federal RICO or securities fraud cases? Where were the wiretaps on the bank executives who played fast and loose with the pension funds of hard-working regular people? And now, after the financial collapse, when email records of key executives illuminate their contemporaneous knowledge of the wrongdoing, where are the prosecutions?

Charles Ferguson, an academic and filmmaker whose movie about the financial crisis, "Inside Job," won the 2011 Academy Award for best documentary, and who famously criticized the government's failure to prosecute bank executives from the stage at the Oscars, has specifically called out what he sees as an inordinate focus on insider trading at the cost of more impactful prosecutions. As he told *The New York Times*: "The total amounts of money and the consequences in insider trading are trivial compared to the damage caused by the behavior that caused the financial crisis." He continued, "I'm not saying that insider trading isn't a serious crime, but the government should be deploying more resources to investigate those cases."

Quotable

"We're never going to put a face or faces on this crisis. It's going to be the crisis of anonymity."

Professor James Cox, Duke Law School, on the subprime mortgage meltdown and subsequent global financial collapse (*Bloomberg News*, "SEC Cases Bypass Top Execs To Target Employees for Negligence," October 20, 2011)

The recent insider trading convictions serve to highlight that, with many on Wall Street, greed continues to trump ethics. But while prosecutors are pursuing and convicting some inside traders, Wall Street is again recording record profits and lavishing executives with exorbitant compensation and exit packages. Many executives continue to encourage short-term gains without concern for long-term consequences — and yet are effectively given a pass. If we are to have any chance of preventing the next financial crisis, we need to fix the underlying corporate culture that brought about the Great Recession. Prosecuting those who engaged in the illicit conduct leading to the financial crisis would go a long way toward reining in such abuses in the future. ◆

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Now, after the financial collapse, when email records of key executives illuminate their contemporaneous knowledge of the wrongdoing, where are the prosecutions?

Quotable

"That one in seven frauds is now discovered by chance puts question marks over the effectiveness of controls and management review at detecting and preventing fraud.... It is highly likely, therefore, that many known instances of fraud go unreported."

KPMG, reporting on its 2011 analysis of global patterns of fraud in "Who is the Typical Fraudster?"

Dodd-Frank

Continued from page 21

Chairman Mary Schapiro stated that the SEC needs a larger budget and eventually 800 more workers to implement the regulatory demands of Dodd-Frank.

Despite the fact that Dodd-Frank is intended to prevent another economic meltdown, there are vociferous calls to repeal it. "It was doomed at the outset and nothing can possibly salvage it," said Arthur Levitt, a former SEC chairman. Financial industry trade magazines such as *American Banker* contribute to industry alarmism with headlines such as "Will Dodd-Frank drive the financial industry overseas?" Indeed, large banks are spending millions to lobby Congress in an effort to stifle Dodd-Frank's implementation. The twenty-six largest financial firms spent more money on lobbying in recent months than during the peak of the initial reform fight in 2010. The American Bankers Association by itself has spent $2.2 million on lobbying and has eleven lobbyists working on the CFPB. The Chamber of Commerce has an entire division devoted to fighting Dodd-Frank. In the first few months of 2011, the Chamber spent $17 million on federal lobbying, far more than any other group, with a dozen lobbyists focused on the CFPB alone.

Repeal of Dodd-Frank also has become a popular position for several Republican Presidential candidates, with Rep. Michele Bachmann calling for its repeal and Mitt Romney agreeing, claiming that "The extent of regulation in the banking industry has become extraordinarily burdensome following Dodd-Frank." Meanwhile, President Obama has stated his position clearly: "I will fight any efforts to repeal or undermine the important changes that we passed."

It thus appears that Dodd-Frank and its unfulfilled promise will be a focal point of the 2012 elections. ◆

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