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Investors, Reeling from Financial Collapse, Look to Obama Administration with a Hopeful Eye

By John Rizio-Hamilton

As President Barack Obama takes office in the wake of a string of financial scandals, investors are considering a number of reforms to a legal and regulatory system that has allowed fraud to flourish and thrown the country into its worst recession in decades.

Over the past several years, Congress, the Supreme Court, and the Securities and Exchange Commission ("SEC") have, through action or inaction, curtailed investor rights in a number of important ways. These rollbacks have included the elimination of a private right of action against "secondary actors" who assist in securities fraud, the withering of enforcement actions by the SEC, the imposition of regulations that prevent investors from electing independent directors, and the proliferation of executive pay structures that incentivize fraudulent conduct. As a direct consequence of these and other developments, corporate wrongdoers have run amok, enriching themselves while destroying trillions in shareholder value.

President Obama has given investors reason to hope he might level the playing field by reversing some or all of these rollbacks of the past eight years. On December 18, 2008, while introducing Mary Schapiro, his nominee for Chairwoman of the SEC, he clearly stated that "financial regulatory reform will be one of the top legislative priorities of my administration....And if the financial crisis has taught us anything, it's that this failure of oversight and accountability doesn't just harm the individuals involved, it has the potential to devastate our entire economy. That's a failure we cannot afford."

One initiative that investor advocates will likely pursue is the legislative reversal of two Supreme Court rulings that have eliminated private securities fraud liability for so-called "secondary actors" — i.e., people or entities that actively participate in a fraudulent scheme but

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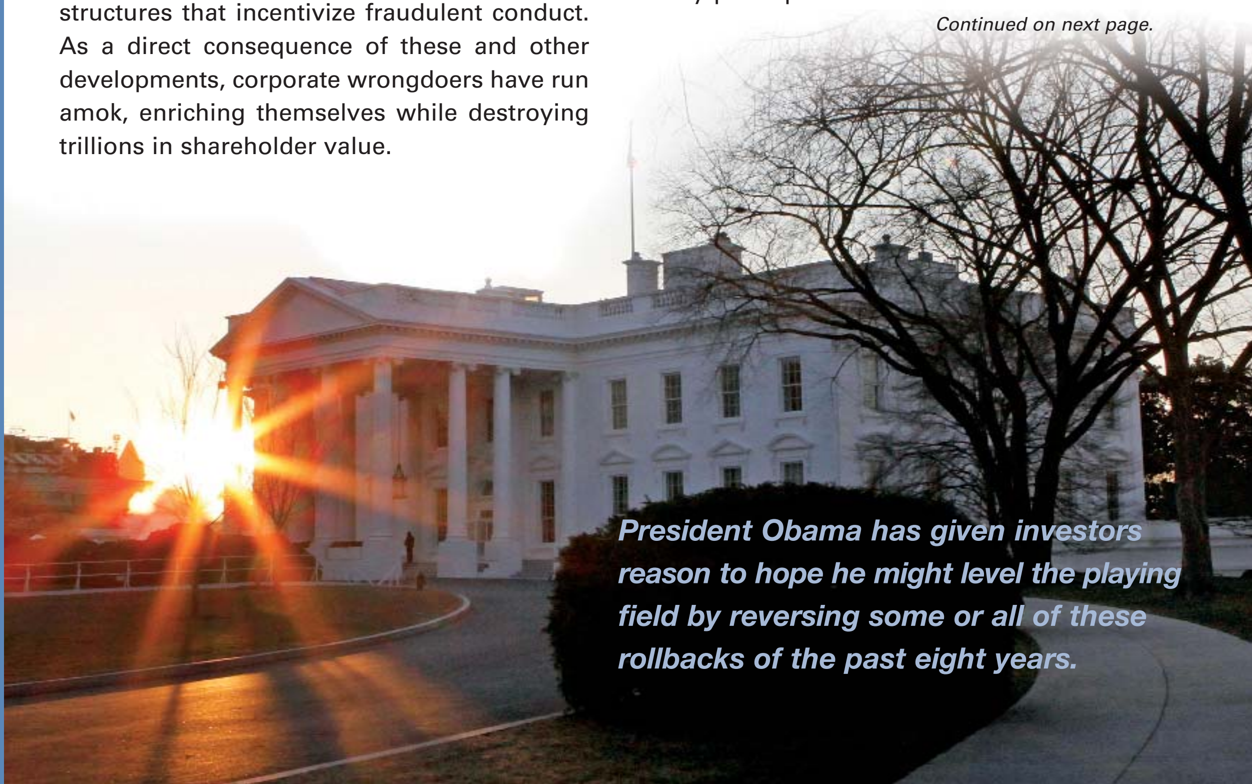

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HOPEFUL EYE

Continued from page 1.

make no public statements. In the first of these decisions, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 511 U.S. 164 (1994), the Supreme Court held by a narrow 5-4 margin that defrauded investors could not bring suit under Section 10(b) of the Securities Exchange Act of 1934 against those who "aided or abetted" the fraud.

In *Central Bank*, investors in defaulted bonds sought to sue the Central Bank of Denver, which was the indenture trustee of the bonds. The plaintiff claimed that Central Bank was liable as an aider and abettor of the fraud because it knew that the collateral securing the bonds was inadequate, in plain violation of the terms of the bond covenants, but let the bond issue proceed anyway. The SEC supported the plaintiff's position. Nevertheless, the Supreme Court rejected this theory of liability. Expressly disregarding the question of "whether imposing civil liability on aiders and abettors is good policy," the Supreme Court held that defrauded investors could not bring a private right of action against entities that had aided and abetted a fraud, but had made no public statement themselves. Although the Court substantially limited the claims that investors could pursue against so-called "secondary actors," such as lawyers, accountants, or banks, that assist in a fraud, it did indicate that those claims could survive in narrow circumstances. Specifically, the Court wrote that those claims could proceed when the secondary actor either employs a "manipulative device," such as engaging in sham transactions that allow a company to falsify its financial results, or when the secondary actor makes a statement in connection with the fraud, such as when an auditor certifies financial statements that are false.

Then, in 2008, in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta,* 128 S. Ct. 761 (2008), the Supreme Court further

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limited the circumstances under which investors could pursue fraud claims against secondary actors. In *Stoneridge*, the Court held, again by a narrow 5-3 margin (with one Justice recusing himself), that defrauded investors in Charter Communications could not bring a securities fraud action against Scientific-Atlanta (one of Charter's vendors), even though Scientific-Atlanta had agreed to engage in sham transactions with Charter so that Charter could artificially inflate its financial results. The Court reasoned that, because Scientific-Atlanta had not made any false statements on which Charter investors relied, then it could not be held responsible for the fraud. Instead, the only source of recovery for the defrauded investors was against Charter itself. For a fuller description of the *Stoneridge* decision, see "Silence is Golden: *Stoneridge* Decision Deals a Blow to Investors' Scheme Liability Claims," in the *Advocate* for the fourth quarter of 2007.

Those two decisions have made it next to impossible for wronged investors to sue a variety of "secondary actors" for their active, culpable participation in fraudulent schemes-including "gatekeepers" who are supposed to protect investors from misconduct, such as lawyers who structure fraudulent transactions, accountants who conceal wrongdoing, and rating agencies that knowingly give pristine ratings to junk debt. Further, the prohibition on aiding and abetting liability is unique in the context of civil securities fraud; indeed, aiding and abetting liability is routinely recognized in the criminal context and a variety of other civil contexts. Indeed, the SEC is explicitly permitted to bring such securities fraud claims — an authority it has inadequately utilized. Given the manner in which this unique prohibition has allowed active participants in fraud to escape the consequences of their conduct, investor rights advocates are likely to urge the next Congress to legislatively overrule both *Central Bank* and *Stoneridge* by expressly authorizing a private right of action against aiders and abettors.

Investor advocates also will push for President Obama to reinvigorate the SEC. Under the stewardship of current Chairman Christopher Cox, the SEC has decreased exponentially its number of enforcement actions. This inaction had led to a severe decline in investor protection, a result that has recently become very clear with the SEC's failure to properly regulate either Bear Stearns or Lehman Brothers before their collapse. The agency's failing became even more apparent in its utter failure to effectively investigate the largest financial fraud in history-the estimated $50 billion Ponzi scheme run by Bernard L. Madoff — even after numerous sophisticated investors and members of the SEC warned of Madoff's Ponzi scheme. Indeed, under Cox's watch, the SEC sharply decreased the number of securities fraud prosecutions it pursued. In 2000, the SEC prosecuted 437 fraud cases. Through the first 11 months of 2008, the agency's fraud prosecutions had plummeted to 133.

Against that backdrop, President Obama recently nominated Mary Schapiro to replace Chairman Cox. Schapiro, who formerly headed the Financial Industry Regulatory Authority ("FINRA"), the National Association of Securities Dealers, and the Commodity Futures Trading Commission, is an experienced regulator. Nevertheless, early reaction to her nomination has been mixed. While New York Senator Charles Schumer has praised

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her as "the kind of strong and experienced regulator we need in these times," Robert Banks, a director of the Public Investors Arbitration Bar Association, said that under Schapiro, FINRA had "not put much of a dent in fraud."

Investors also will look to the Obama administration to overturn recently-enacted SEC rules that significantly limit investors' ability to hold corporations accountable. One particular problem facing investors is that boards of directors, which management largely selects, do not effectively supervise executives. Nominating independent directors is especially difficult because the current proxy rules require any nomination to occur by way of a full, formal, and prohibitively expensive proxy solicitation. In response, investor advocates likely will propose new legislation or regulatory rules that allow shareholders to nominate independent directors without incurring the expense of launching a full proxy solicitation, perhaps by placing the names of independently-nominated directors on the company's own proxy card.

The current rules governing voting by brokers also unfairly constrain investors' ability to elect independent directors. Under the current regime, brokers who hold securities in "street name" on behalf of others are permitted to vote those shares as they please, even though the brokers have no economic interest in the corporation. Because the brokers almost always support a company's management, brokers typically vote these "street name" shares in a way that frustrates investors' efforts to elect independent directors. In response, investor advocates will likely propose legislation or rule changes that eliminate broker voting in board of directors elections.

Finally, investors will likely seek reform on the issue of executive pay. Although responsible executives who build long-term shareholder value should be rewarded accordingly, in recent years executive pay systems have incentivized management to increase short-term profit and in turn, their bonuses, by throwing all caution to the wind. Investor advocates likely will pursue two reforms that seek to recalibrate these incentives by aligning them with long-term corporate and shareholder interests. The first is the newly-proposed "say on pay" legislation that allows shareholders to cast advisory votes on corporate compensation policies. This legislation, titled the "Shareholder Vote on Executive Compensation Act," passed in the House of Representatives in March of 2007. In April of 2008, as Senator, President Obama introduced corresponding legislation in the Senate. Expect investor advocates to urge the prompt passage of the Senate bill and its reconciliation with the House legislation. For more on executive pay and "say on pay" legislation, see Ian Berg's article in this month's *Advocate*.

Also expect investor advocates to pursue "claw-back" legislation. This legislation, which has not yet been introduced, would provide for the forfeiture of incentive compensation paid to corporate executives based on fraudulent financial results. The legislation also would likely include a private right of action, so that investors could enforce the claw-back provision on their own, without depending on SEC or other agency action.

Legislative and regulatory change is never easy. Indeed, enacting all of the above initiatives is a tall order, even with the reform-oriented optimism surrounding the incoming Obama administration. The continued support of institutional investors is a key part of the effort to ensure that President Obama's goal of adding significant investor protections becomes a reality.

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