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LOCKED OUT
"Rakoff Fever" Sweeps the Federal Bench
Goldman Cited for Conflicts of Interest
Martin Act Interpreted for Private Claims
Courts Challenge SEC's No-Admit Settlements
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GOING GREEN
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While our economy continues to suffer from the dislocations and imbalances left by the subprime mortgage debacle and subsequent financial crisis, corporate America continues to seek means by which it can avoid oversight and accountability. Efforts by government regulators are sometimes inconsistent, and the need for aggressive private enforcement of the securities laws has arguably never been greater. In this edition of The Advocate, we look at some recent attempts by companies to limit their accountability to shareholders, and highlight breathtaking corporate misconduct as executives ignore fundamental business ethics. In addition, we chronicle the evolving regulatory and judicial environment and its impact on the institutional investor community.

In our cover story — “Locked Out: The Carlyle Group Tries to Bar Investors from Court” (page 4), BLB&G associate Ann Lipton discusses the implications of the attempt by Carlyle Group LP to insert provisions in the group’s IPO registration statement limiting the access of shareholders to litigation.

On page 8, firm partner Mark Lebovitch and associate Jeremy Friedman provide a review of the Delaware Court of Chancery’s recent landmark decision in In re El Paso Corporation Shareholder Litigation in their article “Goldman Sachs and the Art of the Deal — Heads: We Win! Tails: You Lose!” In its ruling, the Court rebukes Goldman Sachs for neglecting to acknowledge blatant conflicts of interests when advising their corporate clients on the acquisition by Kinder Morgan of the El Paso Corporation.

In addition, firm associate Katherine Stefanou discusses the significance of the recent decision by New York’s highest court, ruling that the Martin Act — which empowers the Attorney General to pursue financial fraud prosecutions — does not deprive investors of the right to bring private lawsuits, in her article “New Opportunities Emerge for Private Claimants: Interpreting the Martin Act” (page 16).

On page 20, firm associate Stefanie Sundel closes out the issue discussing the import of recent decisions by New York Federal Court Judge Jed Rakoff and several of his colleagues that challenge what they believe to be potentially insufficient settlement practices by the SEC in “Rakoff Fever Sweeps the Federal Bench.”

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, and if you need any help in tracking down prior issues or essays please do not hesitate to contact us.

The Editors
As private equity giant Carlyle Group LP prepared to join rivals Blackstone Group LP and KKR & Co. as a publicly traded company this year, it made headlines with a stunningly "shareholder-unfriendly" proposal to eliminate the litigation rights of its future public owners.

On January 10, Carlyle amended its registration statement in advance of its forthcoming initial public offering ("IPO") to include a provision declaring that any and all investor disputes would be decided in private arbitration proceedings rather than in a court of law.

Although Carlyle ultimately removed the provision after widespread publicity and SEC objections, it is likely only a matter of time before more companies attempt to insert similar provisions in their registration statements and corporate charters. Because class action claims are usually unavailable in arbitrations — Carlyle’s clause explicitly prohibited them — and because arbitration proceedings generally disadvantage individual plaintiffs to the benefit of corporate defendants, if such clauses become widespread, it will take away an important check on corporate conduct and deal a tremendous blow to investor rights.

"Shareholder Unfriendly" Provision in Company’s IPO Registration Statement Would Have Blocked Access to Litigation

A Closer Look at the Problems Posed by Arbitration

Beginning in the 1980s, arbitration clauses began to proliferate in the small print of consumer, employee, and investor contracts. As a result, when investors and workers seek to challenge corporate defendants for bad behavior arising out of these contracts, they have been forced out of court and into private arbitration. Specifically, federal courts have relied upon the Federal Arbitration Act ("FAA") to require that plaintiffs bring their claims in private arbitration proceedings — as opposed to courts of law — and to strike down all state attempts to regulate arbitration provisions. Passed in 1925, long before the creation of the modern class action, the FAA provides clear guidance that an arbitration provision in a contract "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."

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This trend favoring mandatory private arbitration over judicial review has long been troubling to consumer advocates, because arbitration proceedings tend to favor corporations over consumers and investors.

Further, the Supreme Court has upheld forced arbitration clauses that prevent employees from bringing class actions, including civil rights lawsuits and lawsuits against investment brokers for securities fraud. In addition, in *AT&T Mobility LLC v. Concepcion*, the Supreme Court recently struck down a California law that forbade companies from including waivers of class actions in consumer contracts (in that case, in cellular phone contracts).

This trend favoring mandatory private arbitration over judicial review has long been troubling to consumer advocates, because arbitration proceedings tend to favor corporations over consumers and investors. First and most obviously, to the extent that these provisions forbid class actions, arbitration prevents plaintiffs from taking advantage of the economies of scale that make class actions the only effective way to litigate many types of claims.

Second, arbitrations are usually held in secret, and the decision of the arbitrator does not have to be based on governing law. There is no right to appeal, extremely limited judicial review, and discovery is very limited — making it particularly difficult for claims where most of the relevant evidence is in the defendant’s hands (such as in a securities action).

Finally, arbitrators are private entities who are selected and paid for by the parties, and may favor industry defendants, because industry defendants are “repeat players” that appear before them many times. Indeed, the Minnesota Attorney General and the San Francisco City Attorney recently sued one of the biggest players in consumer arbitration, alleging that its arbitrations were biased in favor of credit card company defendants. According to the Minnesota Attorney General, “The company said it was impartial but, behind the scenes, it worked alongside credit card companies to get them to put unfair arbitration clauses in the fine print of their contracts and to appoint the [company] as the arbitrator.” The arbitration company denied the allegations, but quietly agreed to bow out of the arbitration business altogether.

When it comes to securities fraud claims, arbitration poses additional concerns. Securities fraud cases are important not just to compensate defrauded investors, but also as a mechanism for deterring fraudulent conduct by punishing bad actors. Just last year, professors at Rutgers University and Emory University conducted a study demonstrating that private securities class actions significantly deter accounting fraud.

These functions simply cannot be served in the context of private arbitration — all but the very largest investors will not be able to bring claims at all, and so long as arbitrations are kept secret, there is no chance for public accountability and deterrence of future misconduct. As Professor Daniel Morrissey of Gonzaga State School of Law stated recently and unequivocally in the *The National Law Journal*, “Arbitration will result in more investment fraud. Removing the deterrent effect that potential shareholder class actions and derivative suits afford would undermine the beneficial purposes of both the federal securities laws and state fiduciary duties. It could very well return us to the pre-Depression ‘pump and dump’ days.”
A Much Deserved Public Outcry — “The Most Shareholder-Unfriendly Corporate Governance Structure in Modern History”

It is no wonder, then, that Carlyle’s attempt to impose mandatory arbitration and class action waivers on all public investors attracted such a public outcry. Three senators authored a letter to Chair Schapiro of the SEC protesting the arbitration provision. As they put it, the provision would “delegate out to private companies” the interpretation of federal securities laws, “with no guarantee that federal law would be properly applied. Even in cases of gross misapplication of the law, there is no opportunity for appeal or judicial review….The private arbitration system has been shown to have a repeat-player bias — favoring companies that hire them over and over again, as opposed to the individual shareholders who bring a single claim.”

Other commentators agree. Professor and New York Times columnist Steven Davidoff described the Carlyle Group’s proposal as “the most shareholder-unfriendly corporate governance structure in modern history….The effect is to essentially eliminate any ability of shareholders to sue the board for even the most egregious acts.”

The SEC also agrees. In fact, the SEC — which reviews all registration statements before they go to the public markets — has for 30 years resisted corporate attempts to amend their charters to forbid shareholder suits and require arbitration. In 1990, the SEC blocked the IPO of a Philadelphia savings and loan when it attempted to enforce mandatory arbitration on all investors. The SEC’s view and advocacy casts doubt on the enforceability of arbitration provisions in future IPOs.

Under pressure from the SEC and investor activists, the Carlyle Group in February amended its registration statement to remove the mandatory arbitration provisions. However, the issue has not ended with Carlyle. There is no doubt that companies will include similar clauses in their charters and registration statements in the future and, under new SEC Commissioners, they may succeed. In fact, former SEC Chair Harvey Pitt stated publicly that the provision would have been permitted when he was Chair of the SEC. Further, as Professor John Coffee put it, recent Supreme Court decisions “may have initiated a revolution that could end most shareholder litigation involving public corporations….Stay tuned. This story will continue.”

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Goldman Sachs and the Art of the Deal

Heads: We Win! Tails: You Lose!

Delaware Court Chastises Goldman for Indifference to Conflicts of Interest in Landmark El Paso Decision

On February 29, 2012, Chancellor Leo Strine of the Delaware Court of Chancery issued a landmark ruling in In re El Paso Corporation Shareholder Litigation that promises to change the way Wall Street banks handle potential conflicts of interest when advising their clients on corporate transactions. Wall Street firms are regularly paid tens of millions of dollars to advise their corporate clients on whether potential transactions are in the best interests of shareholders. Most professionals, like attorneys or auditors, are subject to well-established ethical obligations to recuse themselves from providing advice when their personal financial interests are adverse to the interests of their clients. Chancellor Strine’s opinion in El Paso highlights the disturbing fact that, even following the recent financial crisis and a consistent stream of stunning revelations and corporate scandals, some Wall Street firms and corporate executives still think these basic rules do not apply to them.

Kinder Morgan is an energy pipeline operator. In 2006, Goldman Sachs assisted Rich Kinder, the founder of Kinder Morgan, in taking the company private in one of history’s largest private equity buyouts. Goldman Sachs acquired a $4 billion equity stake in the company and control of two seats on Kinder Morgan’s Board of Directors.

Five years later, in August 2011, Kinder Morgan’s CEO privately approached El Paso Corporation’s CEO, Douglas Foshee, about buying El Paso. Despite Goldman’s massive ownership interest in Kinder Morgan (the potential buyer), Goldman sought and obtained a key role advising El Paso (the target) on whether the sale was in the best interests of El Paso’s shareholders. The conflict of interest was plain, as Goldman would profit if Kinder Morgan paid the lowest possible price to acquire El Paso. Making matters worse, Goldman demanded a fee of $20 million for its “advisory services” and staffed the

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Even following the recent financial crisis and a never ending stream of stunning revelations and corporate scandals, some Wall Street firms and corporate executives still think basic rules of ethical conduct do not apply to them.
It appears that Goldman Sachs has learned nothing from its role in the 2008 financial crisis, the $550 million SEC fine and high-profile public rebuke it received for betting against its own clients in 2010, or the various other scandals that have tarnished Goldman’s reputation in recent years.

Corporate insiders also had misaligned personal incentives. While negotiating the terms of a potential sale with Rich Kinder, El Paso’s CEO Foshee and other members of El Paso’s senior management learned that Kinder planned to sell off one of the company’s core businesses after acquiring El Paso. Foshee and his senior managers saw an opportunity to profit by acquiring these assets from Kinder Morgan. If these managers tried to buy these assets from El Paso while it remained a public company, they would face harsh scrutiny from El Paso’s investors and the courts. As a result, it was in the El Paso CEO’s personal interest to complete a deal with Kinder Morgan even if it was at a less than ideal price for El Paso’s shareholders. Remarkably, CEO Foshee did not tell the Board about his conflict of interest. Instead, he served as the deal’s primary negotiator and aggressively advocated for the deal to the El Paso Board, even at prices below the Board’s clearly stated “floor” price for any deal.

Each of these conflicts of interest came to the forefront when Kinder Morgan, after initially agreeing to pay $27.55 per share of El Paso stock, informed El Paso that the deal had to be renegotiated. Citing an “error” in its valuation model, Kinder Morgan claimed that it would not complete the deal unless El Paso accepted less money per share. Instead of calling out Kinder Morgan’s gamesmanship, El Paso’s Foshee and his financial advisors readily agreed to recut the deal at a lower price for El Paso shareholders and to accept stock warrants of speculative value.

On October 21, 2011 a group of public pension fund shareholders filed a class action assignment with a banker who personally owned more than $300,000 in Kinder Morgan stock.

Rather than remove Goldman from the transaction to avoid this blatant conflict of interest, El Paso retained Morgan Stanley as a second financial advisor. The retention of Morgan Stanley did nothing to cleanse Goldman’s conflict of interest. In fact, Morgan Stanley’s entire $38 million advisory fee for the transaction was contingent on a sale to Kinder Morgan — exactly what Goldman Sachs wanted. In other words, Morgan Stanley, which was supposed to provide El Paso’s Board with unbiased advice, was given a $38 million incentive to justify a sale to Kinder Morgan (and its owner, Goldman Sachs) regardless of whether this was the best option for El Paso’s shareholders.
action lawsuit alleging, among other things, that the El Paso Board breached its fiduciary duties in connection with the sale to Kinder Morgan and that Goldman Sachs aided and abetted the Board’s breaches. After hearing the evidence, Chancellor Strine expressed concerns “that Goldman [would] seek to maximize the value of its multi-billion dollar investment in Kinder Morgan at the expense of El Paso.” In fact, documents uncovered during the discovery process revealed that even Goldman’s co-advisor, Morgan Stanley, expressed dismay at Goldman’s willingness to enmesh itself into the deal, writing internally that Goldman’s behavior was “shameless.”

Chancellor Strine concluded that “Foshee’s velvet glove negotiating strategy — which involved proffering counter-offers at levels below the level he was authorized by the Board to advance — can now be viewed as having been influenced by an improper motive.” As a result of Goldman and Foshee’s misconduct, the Chancellor held that “plaintiffs have a probability of showing [at a full trial on the merits] that more faithful, unconflicted parties could have secured a better price from Kinder Morgan.” It appears that Goldman Sachs has learned nothing from its role in the 2008 financial crisis, the $550 million SEC fine and high-profile public rebuke it received for betting against its own clients in 2010, or the various other scandals that have tarnished Goldman’s reputation in recent years.

Chancellor Strine’s opinion is a wake-up call to Goldman and other corporate fiduciaries and gatekeepers who are entrusted with investors’ money, as well as a significant statement by one of the nation’s most important judges.

Without the efforts of the public pension fund investor plaintiffs in this instance, these facts would not have come to light. It is essential that institutional investors continue to play a significant role in ensuring that Goldman, other Wall Street firms, and corporate titans finally play by the rules.

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Chancellor Strine’s opinion is a wake-up call to Goldman and other corporate fiduciaries and gatekeepers who are entrusted with investors’ money, as well as a significant statement by one of the nation’s most important judges.

Quotable

“Words such as ‘honesty,’ ‘integrity’ and ‘fair dealing’ apparently do not mean what they say; they do not set standards; they are mere shibboleths…. If Goldman’s claim of ‘honesty’ and ‘integrity’ are simply puffery, the world of finance may be in more trouble than we recognize.”

New York Federal Court Judge Paul Crotty in his June 21, 2012 opinion largely denying the defendants’ motion to dismiss and allowing a shareholder suit against Goldman Sachs and three top executives to go forward.
Official are confirming that the broadly drafted whistleblower provisions of the Dodd-Frank financial overhaul legislation are not limited to employees who uncover fraud at their company. The heads of the whistleblower offices at the Securities and Exchange Commission and the Commodity Futures Trading Commission have taken the position that the July 2010 law — which awards whistleblowers a percentage of any recovery if they uncover a company’s violation of the securities laws — extends to third-parties who identify fraud within a company. In fact, the SEC and CFTC are actively encouraging corporate outsiders to identify and report fraud. Some say that by making potentially lucrative whistleblower awards to outsiders who identify fraud, the legislation may create a cottage industry of “professional whistleblowers” that retain investigators and apply forensic accounting techniques to identifying and reporting fraud. The SEC and CFTC officials viewed this as a positive development, as it would incentivize the public to “connect dots in ways they hadn’t been connected before” and, thus, identify fraud earlier.

> **Source:** Compliance Week, March 15, 2012

**Dodd-Frank Whistleblower Protections Not Limited to Employees**

**Institutional Leadership of Securities Class Actions Contributes to Governance Reforms, Says New Report**

A new study from shareholder advisory group Institutional Shareholder Services (“ISS”) confirms that institutional investor activism — and securities class action litigation in particular — has played a key role in realizing corporate governance reforms. The study notes that since the enactment of the Private Securities Litigation Reform Act in 1995, which favors the appointment of institutional investors as lead plaintiffs in class action litigation, public pension funds and other institutions have played a significant role in pushing through corporate reforms. As lead plaintiffs, institutions have the authority to accept or reject settlements, which can include monetary damages for class members as well as various types of “equitable relief” that require companies to affirmatively alter their practices and structure. For example, class action settlements have included provisions requiring corporate defendants to alter their practices with respect to executive compensation, shareholder participation in board nominations, board independence and transparency, and director term limits.

> **Source:** ISS 2011: “Governance Reforms Through Securities Class Actions”
Shareholder Advocates Make Case Against Staggered Board

Shareholder advocacy groups are increasingly — and successfully — making the case to public companies against “staggered” boards of directors, in which fewer than half of a company’s board members are up for election in a given year. Staggered boards — also known as “classified” boards, because they are divided into different “classes” of directors who are eligible for election in different years — make companies less responsive to shareholders by making it impossible to replace a majority of the board in a given calendar year. Investor advocates such as Harvard Law School’s Shareholder Rights Project have been reaching out to publicly held companies with board “declassification” proposals that would place all directors up for election on an annual basis. The Harvard program has submitted such proposals to public companies on behalf of institutional investors including the Illinois State Board of Investment, the Los Angeles County Employees Retirement Association, the North Carolina Department of State Treasurer, the Ohio Public Employees Retirement System, and the Nathan Cummings Foundation. In 2002, over 300 members of the S&P 500 had staggered boards, while ten years later that figure has been reduced to 126. However, staggered boards are still common in initial public offerings, with nearly 90% of companies going public in 2012 including staggered boards. One likely explanation is that new companies have not yet faced pressure from shareholders and investor activists to declassify their boards.

Source: http://srp.law.harvard.edu/releases/Press-release-OPERS-SRP.pdf

Shareholders Vote “No” On Citigroup Executive Compensation

Citigroup shareholders voiced their opposition to an executive compensation package that would have awarded Citi CEO Vikram Pandit $14.9 million. In a vote conducted under the Dodd-Frank law’s new “say-on-pay” rule, 55 percent of Citigroup’s shareholders voted against a pay package that would have awarded Pandit and four other top executives millions of dollars in bonuses for achieving 2011-2012 earnings targets that were less than half of what the bank earned in 2009-2010. Although the vote was nonbinding, it was widely seen as a rebuff to Citigroup’s leadership, and the Board immediately stated that it would consult with representative shareholder groups to better understand their concerns. Two major proxy-voting firms, Institutional Shareholders Services and Glass Lewis, had recommended voting against it, citing a “misalignment” between executive pay trends in the industry and Citigroup’s recent results. In voting against the policy, the California Public Employees’ Retirement System expressed similar concerns that “the bank has not anchored rewards to performance.” The vote follows several years of negative results at Citigroup, which lost over 90 percent of its share price since 2006. With the vote, Citigroup became the largest company and the first Wall Street bank to experience a “no” on executive compensation.

Source: The Wall Street Journal, April 17, 2012

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Watchdog Proposes “Term Limits” for Auditors

The Public Company Accounting Oversight Board (“PCAOB”) has advanced a new proposal for challenging the overly-cozy relationships between accounting firms and the public companies they audit. PCAOB Chair James Doty has suggested requiring publicly traded companies to periodically rotate the firms that perform their audits. Currently, auditing firms often stay with the same clients for years, or even decades, and these lucrative, long-term relationships may give audit firms an incentive to be overly deferential to the companies that pay them. Prominent supporters of the proposal include former Federal Reserve Chair Paul Volcker, former SEC Chair Arthur Levitt, and former TIAA-CREF Director John Biggs. However, the proposal has been aggressively challenged by members of the Congress, and may be killed in congressional committee after heavy lobbying by the accounting industry. The PCAOB is also exploring other ideas for improving auditor independence. One such idea includes a requirement that audit firms be hired and paid by third-party insurance firms responsible for compensating investors for false financial reports. The PCAOB has also proposed improving transparency by making its disciplinary proceedings public. At present, these proceedings are sealed until all appeals are exhausted, a process that can take years.

Source: http://pcaobus.org/News/Events/Pages/03212012_PublicMeeting.aspx
Source: Reuters, March 29, 2012

AGs Reach $25 Billion Mortgage Settlement; States May Still Pursue Some Fraud Claims

The attorneys general for 49 states and the federal government agreed to a long-delayed $25 billion settlement with five of the country’s largest mortgage-servicing firms arising out of the banks’ wrongful foreclosure practices. Under the deal, at least $13 billion will be set aside for borrowers who are underwater on their mortgages, and at least $7 billion will be set aside for other forms of relief, including forbearance and benefits for service members. The remainder of the settlement funds will be divided between the federal government and every state except for Oklahoma, which declined to participate. The settlement talks had been derailed last year when several attorneys general refused to sign off on what they considered overly-broad waivers that could have released the banks from virtually all related securities fraud claims. These attorneys general, including New York’s Eric Schneiderman, had been kicked off the committee of top lawyers negotiating the settlement. Schneiderman and others rejoined the talks earlier this year. Under the final settlement, participating states agreed to waive many potential claims against the settling banks, although they retain the authority to initiate criminal prosecutions and to pursue claims relating to mortgage-backed securitizations.

Source: http://www.atg.wa.gov/uploaded-Files/Home/About_the_Office/Cases/National_Mortgage_Settlement/National_Settlement_Executive_Summary.pdf
Source: Christian Science Monitor, February 11, 2012
Policy Proposal: Disclose Rating Agency Fees

Bloomberg Markets columnist Jonathan Weil has recently proposed a new rule that would require public companies to disclose the fees they pay to credit rating agencies that rate their securities. While securities laws require companies to publicly disclose payments to other “opinion vendors” such as audit firms, no disclosure is required of fees to credit rating agencies. Publicizing the amount of such fees could improve transparency for an industry that has repeatedly failed to uncover problems at rated companies until after it was too late. Indeed, fee disclosures in the auditing context have proved useful to investors in the more than ten years since they have been required. For example, exceptionally low auditing fees paid by Fannie Mae to KPMG served as a red flag to investors that the KPMG’s audit was not as fulsome as it should have been. Conversely, extraordinarily high audit fees to companies have caused investors to question the auditor’s impartiality. Requiring disclosure of fees paid to credit rating agencies would give investors important insight into a process that, for now, remains opaque.

Source: Bloomberg Markets, April 2012

Regulator Approves New Rules On High-Speed Trading

The Commodity Futures Trading Commission, which oversees the futures and options markets, has announced plans to increase monitoring of the high-speed trading firms that increasingly shape market movements. The agency plans to use a sophisticated computer system that can track all orders by these high-frequency traders. However, the new program will not be able to track trades as they occur because real-time software would be prohibitively expensive for the government agency. High-speed traders have been widely blamed for the 2010 “flash crash,” in which the Dow Jones Industrial Average plummeted over 1,000 points on the afternoon of May 6, 2010, before recovering its losses over the course of just a few minutes. The flash crash occurred when the trading algorithms used by various high-frequency trading firms reacted to a mutual fund’s unusually large trade by selling off successively larger positions to one another, having a “hot potato” trading effect. The sell-off was halted only after an automatic feature on the Chicago Mercantile Exchange stopped trading for five seconds, allowing the market to resume normal function. The SEC has also announced increased monitoring of high-speed trading, as the two agencies prepare to implement the July 2010 Dodd-Frank financial overhaul legislation.


SEC Spares Top Banks From Toughest Penalties

The Securities and Exchange Commission has given a pass to some of the country’s largest banks when it comes to imposing the most severe penalties in its arsenal. These under-utilized penalties include removing legal protections that insulate companies for liability for errors in financial forecasts and denying companies the ability to participate in fast-track stock or bond offerings. Although the SEC has the authority to sanction companies for fraud by removing a number of important privileges, a New York Times investigation identified nearly 350 cases in which the agency had permitted companies settling fraud charges to avoid these penalties. For example, JPMorganChase, which has settled six fraud cases in the past 13 years, was not subjected to the SEC’s most stringent penalties and, instead, repeatedly received waivers from the SEC permitting it to instantly raise money from the public markets without prior government approval. Similarly, Bank of America and Merrill Lynch, which collectively settled 15 fraud cases, received waivers on numerous occasions. The New York Times identified only a single Wall Street bank, Citigroup, that had been subjected to the SEC’s most serious penalties.

New Opportunities Emerge for Private Claimants

Interpreting The Martin Act

By Katherine Stefanou

In a landmark case for private investors seeking remedies in New York, New York’s highest court recently overturned decades of case law that had prevented private litigants from pursuing “non-fraud” claims (such as negligence, failure to disclose, or misrepresentation) related to a securities transaction. Specifically, in Assured Guaranty v. J.P. Morgan Investment Management, the court held that the Martin Act, New York’s statute empowering the state Attorney General to pursue financial fraud prosecutions, does not prevent private investors from bringing lawsuits based on non-fraud claims. The decision will have significant implications as it opens up New York state courts as suitable venues for meaningful securities claims by private investors.

The Martin Act provides New York’s Attorney General with extraordinary powers to combat financial fraud. It creates criminal and civil liability for defendants who engage in a wide variety of fraudulent conduct in the “advertisement, investment, advice, purchase, or sale” of any security within or from New York. Accordingly, the Martin Act gives the Attorney General broad jurisdiction over the enormous number of securities transactions that occur “within or from” New York. Unlike the federal securities laws, or common law fraud, the Martin Act does not require the Attorney General to prove scienter (defendants’ knowledge of the wrongdoing), reliance, or damages to successfully bring claims. The Martin Act also gives the Attorney General broad investigatory powers, including the ability to subpoena any document from any individual or company doing business in New York. Additionally, people called for questioning in Martin Act cases are not granted a right to counsel or a right against self-incrimination. The Act provides New York’s Attorney General with power that exceeds that of any regulator in any other state.

Through the 1930s and 1940s, the Martin Act was largely unused. Decades later, following an increase in financial scandals centered around Wall Street, then-Attorney General Eliot Spitzer aggressively revived the Martin Act as a formidable enforcement tool.
The Martin Act provides New York’s Attorney General with extraordinary powers to combat financial fraud — powers that exceed that of any regulator in any other state. While the Attorney General’s power is well established, there was ambiguity as to whether the statute prohibited certain non-fraud claims brought by private investors, leaving it solely to the Attorney General to bring such claims.

New York state and federal courts, starting with a state court’s decision in CPC Int’l Inc. v. McKesson Corp in 1987, interpreted the Martin Act as prohibiting (or “precluding”) private suits based on non-fraud causes of action. Since McKesson, defrauded investors have often been precluded from pursuing these common law remedies when their claims were based on facts that would also allow the Attorney General to bring such claims under the Martin Act. As noted above, these types of non-fraud claims include common law claims of breach of fiduciary duty, negligence, failure to disclose, or misrepresentation.

In December 2011, the New York Court of Appeals in Assured Guaranty finally determined that non-fraud common law claims were not preempted by the Martin Act. In that case, the plaintiff alleged claims of breach of fiduciary duty and gross negligence against its investment manager, J.P. Morgan, for investing funds in mortgage-backed securities while knowingly concealing the risks of those investments from its clients. Based on the case law discussed above, the trial court found that the claims were preempted by the Martin Act, and dismissed the action solely based on this procedural barrier to recovery. The Appellate Division reversed the trial court, holding that a private common law claim is not preempted by the Martin Act unless it also “cast[s] what is clearly an obligation under the…Act as a common-law cause of action.”

The Appellate Division’s decision appeared to settle the issue in New York state courts, but federal courts continued to find that common law claims were preempted by the Martin Act. However, one federal decision dismissing a claim brought by an investor defrauded in the
Madoff Ponzi scheme noted that the Appellate Division’s decision was not the “last word” on the subject because the New York Court of Appeals (New York’s highest court) had not addressed the issue.

J.P. Morgan appealed the Appellate Division’s decision in Assured Guaranty to the Court of Appeals. Attorney General Schneiderman appeared in court in support of the private litigants. He argued that it was critical to restore the rights of private citizens to bring these suits because such actions assist regulators in enhancing integrity and accountability in the market place. In an unanimous decision, the Court of Appeals held that the Martin Act does not preclude a private litigant from bringing a non-fraud common law cause of action, such as negligence or misrepresentation. The Court of Appeals’ conclusion was based on the recognition that the purpose of the Martin Act is not impaired by private actions because “proceedings by the Attorney General and private actions further the same goal — combating fraud and deception in securities transactions.”

Under this ruling, New York’s highest court has empowered private citizens to seek their own remedies and perhaps even assist the “Sheriff of Wall Street” — New York’s Attorney General — in combating financial fraud.

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“Rakoff Fever” Sweeps the Federal Bench

By Stefanie J. Sundel

Calculating the “Public Interest” in SEC Settlements: The Role of the Federal Courts
On October 19, 2011, the SEC accused Citigroup of securities fraud for creating a billion-dollar CDO securitized by toxic mortgage assets and selling CDO interests to misinformed investors. As a result of these illicit sales and a bet against the very CDO assets it helped select, Citigroup made $160 million in fees and trading profits. Meanwhile, CDO investors lost approximately $700 million. Notwithstanding Citigroup’s egregious securities violations, the SEC only filed charges of “negligence” against Citigroup.

That same day that the SEC filed its complaint, the SEC and Citigroup settled the action. As is customary when enforcement actions are settled, the SEC filed its complaint simultaneously with a pre-packaged consent judgment. A consent judgment is a type of civil settlement embodied in a judicial order that only a court can approve and enforce. The consent judgment agreed upon by the SEC and Citigroup required the bank to pay $285 million, prohibited Citigroup from violating the securities laws in the future, and mandated certain prophylactic measures for three years that were tailored to Citigroup’s violations (including an enhanced internal controls process for the review and approval of offerings of CDOs and other mortgage-related securities). Significantly, however, the settlement did not require Citigroup to admit to any wrongdoing, and allowed Citigroup to continue to deny any related allegations — a “no-admit” settlement.

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Judges across the country are catching what has been referred to as “Rakoff Fever.” At least four other federal judges have cited his decision in questioning whether settlements proposed by federal agencies serve the public interest.
The SEC championed its no-admit settlement with Citigroup as a victory for investors, and Citigroup was “pleased to put [the] matter behind” it. Only one obstacle remained: U.S. District Judge Jed S. Rakoff. Judge Rakoff’s assignment to the case immediately sparked speculation about whether he would scrutinize and reject another settlement between the SEC and a financial institution (just as he did in the SEC’s 2009 case against Bank of America, where he rejected the initial settlement).

Judge Rakoff did not disappoint. Eight days into the case, Judge Rakoff instructed the parties to answer nine pointed questions that signaled his misgivings about the proposed settlement. Specifically, Judge Rakoff questioned how a fraud of this magnitude could be the result of simple “negligence,” why the court should approve a settlement in a case in which the SEC alleged a serious securities fraud but the defendant neither admits nor denies wrongdoing, and whether there is an overriding public interest to determine whether the SEC’s charges are true. The SEC responded that the public’s interest is not part of the “applicable standard of judicial review.” So long as a settlement is not “unfair, inadequate, or unreasonable,” the SEC said it “ought to be approved.” Judge Rakoff disagreed.

In a fiery opinion issued on November 28, 2011, Judge Rakoff “regretfully” rejected the SEC and Citigroup’s no-admit settlement. The fundamental failing was that the proposed settlement did not provide a sufficient evidentiary basis for the court to perform any meaningful assessment of the facts leading to the settlement. “An application of judicial power that does not rest on facts,” Judge Rakoff explained, is an “engine of oppression” that is “inherently dangerous.” Judge Rakoff further characterized the SEC’s no-admit settlements as “hallowed by history, but not by reason,” explaining that they deprive a court of “even the most minimal assurance” that the requested relief has any basis. He also chided the SEC for asserting that he was not empowered to consider the public’s interest in deciding whether to approve the settlement. He explained:

“[W]hen a public agency asks a court to become its partner in enforcement by imposing wide-ranging injunctive remedies on a defendant, enforced by the formidable judicial power of contempt, the court, and the public, need some knowledge of what the underlying facts are....”

Refusing to serve as “a mere handmaiden to a settlement privately negotiated on the basis of unknown facts,” Judge Rakoff rejected the proposed settlement and directed the parties to be prepared for a July 2012 trial.

“[I]m supposed to exercise my power but not my judgment...[and become] a mere handmaiden to a settlement privately negotiated on the basis of unknown facts....Why should the Court impose a judgment in a case in which the SEC alleges a serious securities fraud but the defendant neither admits nor denies wrongdoing?”

U.S. District Judge Jed S. Rakoff in challenging and ultimately rejecting Citigroup’s proposed $285 million securities fraud settlement with the SEC. Citigroup admitted no wrongdoing and Judge Rakoff questioned how a fraud of this magnitude could be the result of simple “negligence.”

An investigation by The New York Times recently uncovered nearly 350 instances in the past decade where the SEC gave financial companies a pass on a variety of punishing sanctions in its arsenal.

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On December 15, 2011, however, the SEC filed an appeal with the U.S. Court of Appeals for the Second Circuit and sought a stay of the proceedings pending the Court of Appeals’ review of the decision. The Court of Appeals has granted the SEC’s stay request, but Judge Rakoff’s ruling continues to gain momentum nonetheless. Indeed, judges across the country are catching what has been referred to as “Rakoff Fever.” At least five other federal judges have cited his decision in questioning whether settlements proposed by federal agencies serve the public interest — four in cases brought by the SEC and one in a case brought by the Federal Trade Commission.

The SEC has also adopted a revision (albeit a minor one) to its policy for no-admit settlements on the heels of Judge Rakoff’s decision. Defendants are no longer allowed to say they neither admit nor deny civil fraud charges when, at the same time, they admit to or have been convicted of criminal violations. Nor are they allowed to say they neither admit nor deny civil fraud charges when they enter into an agreement with criminal authorities to defer prosecution or to not be prosecuted as part of a settlement.

Aside from this small step forward, however, the SEC still insists that no-admit settlements are critical to its enforcement efforts. SEC Chair Mary L. Schapiro maintains that the Commission’s settlement practices “clearly have deterrent value,” and that companies simply “won’t settle...if they have to admit” wrong-doing. But those who support Judge Rakoff believe that the SEC’s no-admit settlements are not a real deterrent to future bad behavior because they do not extract a heavy enough price in dollars or reputation. As Judge Rakoff put it, settling the SEC’s charges for “pocket change” is considered just another “cost of doing business” for financial firms.

Indeed, the Commission routinely grants Wall Street’s largest institutions no-admit settlements and other waivers from legal liability as part of cash settlements in securities fraud cases. An investigation by *The New York Times* recently uncovered nearly 350 instances in the past decade where the SEC gave financial companies a pass on a variety of punishing sanctions in its arsenal. Remarkably, close to half of the SEC’s no-admit settlements and sanction waivers went to “repeat offenders” that “had settled previous fraud charges by agreeing never again to violate the very laws that the SEC was now saying that they had broken,” according to *The Times* investigation. Senator Charles E. Grassley (R-Iowa), who serves on committees that oversee the SEC, told *The Times*, “It’s really hard to see why the SEC isn’t using all of its weapons to deter fraud....No wonder recidivism is such a problem.”

Despite mounting public outcry over the SEC’s settlement practices, the Second Circuit has already stacked the odds against Judge Rakoff’s position. On March 15, 2012, the Court of Appeals preliminarily determined that the SEC and Citigroup would likely succeed in getting Judge Rakoff’s decision overturned. The Circuit expressed serious doubts as to whether Judge Rakoff “gave the obligatory deference to the SEC’s views in deciding that the settlement was not in the public interest” and noted that “it is

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not correct that the court had no basis available to assess the underlying facts.”

In teeing up the appellate issues to be argued on September 12, 2012, the Second Circuit also recognized that the case “raises important questions” about the “division of responsibilities between the executive and judicial branches.” Indeed, there is a lot at stake in this appeal. The role of federal courts as an independent check on the parties, even when one party is a federal agency, is at stake. The rule of law being applied equally to everyone, even powerful Wall Street banks, is at stake. And, whether a federal agency has to determine that a settlement is in the public interest or not is also at stake.

The appeal has also highlighted a flaw in the enforcement of the federal securities laws. The structure of the U.S. civil justice system is based on opposing parties advocating different positions before judicial officers. The theory is that when opposing parties battle it out, the truth best comes to light. In the context of the appeal of Judge Rakoff’s decision, however, that structure has broken down. Because both parties to the appeal want the settlement enforced and Judge Rakoff’s decision overturned, there are, in effect, two appellants and no appellee.

To fill this rare adversarial void, at Judge Rakoff’s recommendation, the Circuit has approved John “Rusty” Wing — a former colleague of Rakoff’s from the U.S. Attorney’s Office — as counsel “to argue in support of the district court’s position.” Mr. Wing is now uniquely tasked with convincing the Second Circuit that district courts can stand up for the public interest and the rights of investors even when the SEC does not. Hopefully, Mr. Wing will fight for shareholders’ rights as well as his new client has.

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