

Securities Litigation, Regulation & Enforcement Developments Winter 2010

Federal Jury Holds Vivendi Liable, Exonerates Former Officers

OVER 3,000 CLASS ACTIONS have been commenced under the anti-fraud provisions of the federal securities laws since the enactment of the Private Securities Litigation Reform Act of 1995 (“PSLRA”). It is exceedingly rare, however, for these massive actions to actually proceed to trial, as most are either settled or dismissed. In fact, only 15 such class actions have actually proceeded to trial during the 14 years since the PSLRA’s enactment. Of those, only eight have been tried to a verdict (the other seven settled during trial).

The largest federal securities class action ever to proceed to a trial concluded on Jan. 29 in the U.S. District Court for the Southern District of New York, resulting in a jury verdict completely exonerating Schulte Roth & Zabel’s client, one of the defendants in the case. The case took seven years to get to trial and involved numerous sophisticated accounting, financial reporting and securities law issues.

The plaintiff class in *In re Vivendi Universal, S.A. Securities Litigation* consisted of all non-insider purchasers of shares in Vivendi Universal—the giant

media and communications company that includes Universal Music Group (the world’s largest music company)—from Oct. 30, 2000 through Aug. 14, 2002, in the United States, France, the United Kingdom and the Netherlands. The defendants were Vivendi itself, its former CEO Jean-Marie Messier and SRZ’s client, Guillaume Hannezo, Vivendi’s former CFO.

In the mammoth and complex trial, which lasted almost four months, the plaintiffs claimed that the defendants violated Section 10(b) of the Securities Exchange Act (the “Act”) by making false and misleading statements for the purpose of concealing the company’s true liquidity condition, resulting in a substantial decline in the value of Vivendi’s shares when the “truth” allegedly was revealed to the market. In addition, Mr. Hannezo and Mr. Messier were charged with violating Section 20(a) of the Act, for purported “controlling person” liability for Vivendi’s alleged Section 10(b) violations. Although Vivendi was found to be liable, the SRZ trial team, led by litigation partners [Marty Perschetz](#) and [Michael Swartz](#), persuaded the jury that Mr. Hannezo was not liable for any of the alleged violations and committed no wrongdoing whatsoever. The jury also found Mr. Messier not liable.

Prior to the verdict, SRZ won an important interim victory by prevailing on a motion for judgment as a matter of law dismissing all claims against Mr. Hannezo that were based on Vivendi public statements that Mr. Hannezo himself did not actually make for public attribution. The ruling, which we had contended was controlled by the Supreme Court decision in *Central Bank of Denver v. First Interstate Bank of Denver*, limited the scope of Mr. Hannezo’s potential liability, even though there was evidence that he had participated in drafting, reviewing or approving several of these statements as the company’s CFO.

The jury’s verdict in favor of SRZ’s client in the *Vivendi* trial represents a unique and important victory for the SRZ trial team in a landmark case. ■

Inside

2 | **Top 10 SEC Enforcement Developments of 2009**

2 | **SEC Enforcement FY2009 Results**

6 | **Enforcement and Litigation Cases to Watch in 2010**

10 | **SRZ Expands Enforcement and Litigation Capabilities**

Top 10 SEC Enforcement Developments of 2009

As 2009 BEGAN, the economic crisis, an unprecedented and unpopular government bailout of Wall Street, and the Bernie Madoff Ponzi scheme prompted calls to increase securities oversight and enforcement. As a result, 2009 was a year of intense activity and change at the SEC. Below, we highlight what we consider to be the ten most significant developments.

1. New SEC Leadership and Tone

While 2009 saw many changes at the SEC, perhaps none was as significant as the addition of new senior officials. Mary L. Schapiro's return to the SEC as Chairman helped assuage fears that the SEC would continue to drift in the face of challenging market conditions, but did not eliminate calls to cut the SEC's authority.

Schapiro wasted no time hiring a number of well-regarded former federal criminal prosecutors, all from the Southern District of New York's U.S. Attorney's Office—Robert Khuzami, Enforcement Division Director, Lorin L. Reisner, Deputy Director, and George S. Canellos, Regional Director of the SEC's New York Regional Office. With Schapiro, these senior officials quickly established a new tone and approach. Indeed, their first few months on the job were marked by a panoply of new and creative initiatives whose full impact may not be known for years. Most recently, the SEC hired Carlo DiFlorio to reinvigorate its embattled Office of Compliance, Inspections and Examinations.

2. New Enforcement Tools: "Southern Districtization" of the SEC

Apart from its new personnel, the most significant change to the Enforcement Division is its adoption of tactics used successfully by federal criminal prosecutors to leverage resources and build cases efficiently. Due to the pedigree of key Enforcement officials, some have termed the SEC's adoption of these tactics as the "Southern Districtization" of the SEC.

Khuzami's much-anticipated policy to encourage cooperation by individuals could be the most significant development. By offering cooperation, deferred prosecution and non-prosecution agreements within a framework to evaluate cooperation, including the timing and benefit of the information provided to the SEC's inquiry, only time will tell whether the policy will fulfill Khuzami's prediction that it will be a potential "game changer."¹

¹ See SEC Press Release No. 2010-6, "SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations," Jan. 13, 2010.

SEC ENFORCEMENT FY2009 RESULTS

Investigations

- 5% increase in pending investigations (4,316 vs. 4,088)
- 6% increase in investigations opened (944 vs. 890)
- 100% more formal investigations opened (496 vs. 233)
- 32% fewer informal investigations opened (448 vs. 657)

Enforcement Proceedings

- 70% of investigations resulted in enforcement action within 2 years of opening investigation (8% increase)
- 170% increase in disgorgement orders (\$2.09 billion vs. \$774 million)
- 35% increase in penalties imposed (\$345 million vs. \$256 million)
- 82% more TRO actions and 78% more asset freeze orders
- 30% more cases coordinated with criminal actions (154 vs. 108)
- 92% of cases result in "successful" outcome for SEC (through litigation, settlement or default judgments, calculated on per-defendant basis)

Settlements

- 626 settling defendants (fewest since Sarbanes-Oxley's enactment)
- 435 settling individuals and 191 settling companies
- 58% of settlements involve disgorgement or penalty

Sources: U.S. Securities and Exchange Commission Division of Enforcement, Select SEC and Market Data Fiscal 2009 Report, available at <http://www.sec.gov/about/secstats2009.pdf>; Robert Khuzami, Director, SEC Enforcement Division, "Testimony Concerning Mortgage Fraud, Securities Fraud and the Financial Meltdown: Prosecuting Those Responsible," Dec. 9, 2009, available at <http://www.sec.gov/news/testimony/2009/ts121109rk.htm>; SEC's 2009 Performance and Accountability Report, available at <http://www.sec.gov/about/secpar2009.shtml>; and Jan Larsen, Dr. Elaine Buckberg and Dr. Baruch Lev, SEC Settlements Trends: 3Q09 Update, Number of Settlements Declines in Transitional FY 2009, NERA Economic Consulting (Dec. 7, 2009).

On a more practical level, the government's recent high-profile insider-trading criminal and civil actions revealed the use of wiretaps and consensual recordings never before used in insider-trading investigations. With DOJ alumni now heading the Enforcement Division, increased cooperation between the SEC and prosecutors is a foregone conclusion. The DOJ-led Financial Fraud Enforcement Task Force, with the SEC as part of the steering committee to coordinate with two dozen other federal agencies, promises to strengthen efforts to combat financial crime.² Indeed, Khuzami recently testified that the SEC coordinated 75% of its "most recent high-priority cases" during 2009 with criminal and other regulators.³

² See Press Release, "President Obama Establishes Interagency Financial Fraud Enforcement Task Force," Nov. 17, 2009.

³ Robert Khuzami, Director, SEC Enforcement Division, "Testimony Concerning Mortgage Fraud, Securities Fraud and the Financial Meltdown: Prosecuting Those Responsible," Dec. 9, 2009.

3. Internal SEC Changes: Delegation and Specialized Units

Schapiro and Khuzami both unveiled internal changes that will modify not only who makes important decisions, but how the SEC is organized to do so.

Schapiro ended a pilot program under which Staff attorneys were required to seek settlement ranges from the Commission before commencing civil penalty negotiations with a public company.⁴ Although designed to ensure consistency, critics claimed the policy caused unnecessary delays and deterred Staff from seeking penalties.

The Commission delegated to Khuzami, who sub-delegated to “senior officers,” the ability to open formal investigations on a one-year trial basis.⁵ Thus, Staff no longer need Commission authority to open formal investigations or, more importantly, to issue subpoenas seeking documents and testimony. (Commission approval is still required to go to court seeking to enforce subpoenas.) Similarly, Khuzami delegated to senior Staff the authority to make routine investigation-related decisions, such as issuing *Wells* notices or settlement demands.

Khuzami also announced the creation of five specialized units dedicated to complex and high-priority areas, including units for Asset Management, Market Abuse, Structured and New Products, Foreign Corrupt Practices and Municipal Securities and Public Pensions.⁶ To maximize resources, Khuzami “flattened” the management structure of the Division, redeploying branch chiefs from supervision to conducting investigations and announced plans to hire additional trial lawyers and enhance technology, support staff and other resources.⁷

The SEC also created the Office of Market Intelligence to handle tips and complaints in an effective and efficient manner.⁸ To supervise that office, the Enforcement Division hired its first chief operating officer, who is also responsible for initiatives to relieve Staff of administrative duties and permit them to devote more time to

investigating cases and bringing enforcement actions.⁹

4. Hedge Fund Focused Insider-Trading Investigations and Litigation

Perhaps not since the 1980s scandals involving Ivan Boesky, Dennis Levine and Michael Milken, has insider trading been such a focus for the SEC (and criminal authorities) and the public. Khuzami’s message to the hedge fund industry couldn’t be clearer: The SEC is “committed to pulling back the curtain on hedge fund operations and taking a close look at their activity,”¹⁰ especially regarding insider-trading claims.

Indeed, within a span of three weeks beginning in October, the SEC filed three high-profile hedge-fund related insider-trading actions: *SEC v. Galleon*, the “biggest hedge fund insider-trading case ever brought,” according to Khuzami¹¹; *SEC v. Tang*; and *SEC v. Cutillo*.¹² These actions (and related criminal proceedings) involve 30 individuals and allege more than \$60 million in alleged insider-trading gains or losses avoided. As noted, these cases revealed the government’s extensive use of wiretaps and consensual recordings.¹³ Khuzami ominously warned that “[p]ersons involved in illegal insider-trading schemes now must rightly consider whether their conversations are under surveillance.”¹⁴

The SEC also has ratcheted up efforts to collect evidence about how information is shared among hedge funds and others through more expansive informational requests in insider trading and other investigations. Rather than limiting requests for information to specified topics, some of the SEC requests now seek “all emails” from certain hedge fund personnel as well as communications between hedge funds and third-party providers, such as administrators, auditors and prime brokers. By casting a wider net, the SEC hopes to collect more evidence about relationships with which to build additional insider-trading cases.

⁴ Mary L. Schapiro, “Speech by SEC Chairman: Address to Practicing Law Institute’s ‘SEC Speaks in 2009’ Program,” Feb. 6, 2009.

⁵ See Robert Khuzami, Director, SEC Enforcement Division, “Testimony of Robert Khuzami Concerning Events Surrounding Bank of America’s Acquisition of Merrill Lynch,” Dec. 11, 2009.

⁶ See SEC Press Release No. 2010-5, “SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence,” January 13, 2010.

⁷ See Robert Khuzami, Director, SEC Enforcement Division, “Testimony of Robert Khuzami Concerning Strengthening the SEC’s Vital Enforcement Responsibilities,” May 7, 2009.

⁸ See Robert Khuzami, Director, SEC Enforcement Division, “Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement,” Aug. 5, 2009.

⁹ See SEC Press Release No. 2009-220, “Adam Storch Named Managing Executive of SEC’s Enforcement Division,” Oct. 16, 2009.

¹⁰ Robert Khuzami, Director, SEC Enforcement Division, “Remarks at Press Conference,” Oct. 16, 2009; see also Luis Aguilar, Commissioner, SEC, “Speech by SEC Commissioner: Hedge Fund Regulation on the Horizon – Don’t Shoot the Messenger,” June 18, 2009.

¹¹ See Robert Khuzami, Director, SEC Enforcement Division, “Remarks at Press Conference,” Oct. 16, 2009.

¹² See *SEC v. Galleon Mgmt., LP*, No. 09-CV-8811(JSR) (S.D.N.Y. filed Oct. 16, 2009); *SEC v. Cutillo*, No. 09-CV-09208 (LAK) (S.D.N.Y. filed Nov. 5, 2009); *SEC v. Tang*, No. 09-CV-05146 (JCS) (N.D. Cal. filed Oct. 30, 2009).

¹³ Jennifer Forsyth, “Defense Counsel Hired for ‘Not Your Garden Variety Insider Trading Case,’” *Wall Street Journal* (Oct. 16, 2009).

¹⁴ Robert Khuzami, Director, SEC Enforcement Division, “Remarks at AICPA National Conference on Current SEC and PCAOB Developments,” Dec. 8, 2009.

In addition, the SEC is seeking to expand the parameters of insider trading. In *SEC v. Cuban*, for instance, the SEC is attempting to overturn the dismissal of an insider-trading case brought under the “misappropriation theory” where the SEC alleged that the trader promised to keep information confidential but did not promise not to trade based upon that information. In dismissing the case, the court questioned SEC Rule 10b5-2, which specifies certain non-exclusive bases for bringing misappropriation insider-trading cases.¹⁵ In *SEC v. Rorech*, the SEC brought its first case alleging insider trading in credit default swaps, thereby signaling its intention to broaden the SEC’s insider-trading focus beyond traditional equity markets and into more complex products and markets.¹⁶ There, the Court denied defendants’ motion for judgment on the pleadings, finding that the issue of whether the particular CDS at issue was a security-based swap could not be decided as a matter of law.¹⁷ And *SEC v. Dorozhko* involves an insider-trading claim against a computer hacker who owed no duty to the source of the allegedly misappropriated information or the issuer.¹⁸ In their own way, each of these cases is part of the SEC’s aggressive efforts to expand insider-trading liability.

5. Pursuit of Financial Crisis Cases

The SEC has pursued numerous financial crisis-related investigations, many of which have already resulted in enforcement actions.

For example, the SEC achieved a number of settlements involving the marketing and sale of auction rate securities, including requiring ARS repurchases and other arrangements that the SEC says have restored \$60 billion in liquidity to the ARS market.¹⁹

The SEC also brought actions against former executives of two of the largest subprime mortgage lenders, Countrywide Financial and New Century Financial Corp.²⁰ Both cases assert insufficient disclosure of risks of the lenders’ subprime loan portfolio as the market deteriorated. The Countrywide case also alleges market manipulation and insider trading by the former CEO, while New Century also asserts accounting allegations. In another notable case related to the financial crisis, *SEC v. Reserve Management Co.*, the SEC

alleged that the Reserve Primary Fund money market fund failed to disclose material facts about the fund’s vulnerability as Lehman Brothers sought bankruptcy protection, leading to the fund’s \$62.5 billion collapse.²¹

Finally, although a jury rejected related criminal claims, the SEC will pursue its civil case against the former Bear Stearns hedge fund managers whose funds incurred substantial losses due to investments in collateralized debt obligations based largely on subprime mortgage-backed securities.²²

6. Effective Use of Traditional Tools

The SEC continues to pursue ongoing investigations, open new ones and pursue an increasing number of enforcement actions. Robert Khuzami’s first-day promise that the SEC’s enforcement efforts would be “Swift, Smart, Strategic and Successful”²³ may be new, but there’s nothing novel about the SEC’s basic approach. For example, as noted below, the SEC has brought many emergency actions seeking TROs and asset freezes in response to alleged Ponzi schemes.

Perhaps recognizing the negative impact that even an undisclosed investigation can have on those involved, the Staff seemingly have increased efforts to close stale matters, including recommendations not to pursue enforcement actions. Most notable here are the stock option backdating investigations underway since 2005. Anecdotally, at least, it appears that the SEC is attempting to obtain closure on investigations involving dated conduct.

Meanwhile, the SEC’s actions this year also have renewed old debates, such as the use and size of corporate penalties. That issue was central to Judge Jed S. Rakoff’s rejection of the September 2009 proposed \$33 million settlement between the SEC and Bank of America. Judge Rakoff criticized the settlement as a “contrivance” to provide the SEC with the “façade of enforcement.”²⁴ He also pointedly asked why shareholders should face the double-whammy of paying a financial penalty for alleged harm caused by unnamed corporate executives, deeming such result “worse than pointless: It further victimizes the victims.”²⁵

¹⁵ *SEC v. Cuban*, 2009 WL 2096166 (July 17, 2009) (dismissal order).

¹⁶ *SEC v. Jon-Paul Rorech and Renato Negrin*, No. 09-CV-4329 (JGK) (S.D.N.Y. filed May 5, 2009).

¹⁷ See *id.*, Order and Opinion (Dec. 9, 2009).

¹⁸ *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009).

¹⁹ Among others, the SEC has settled ARS-related proceedings with UBS, Citigroup Capital Markets, Wachovia, Banc of America Securities, TD Ameritrade, RBC Capital Markets Corp., Deutsche Bank, Morgan Keegan & Co., Inc. and Merrill Lynch.

²⁰ SEC Litig. Release No. 21068 (Jun. 4, 2009).

²¹ *SEC v. Reserve Management Company, Inc.*, No. 09-CV-4356 (S.D.N.Y. filed May 5, 2009).

²² *SEC v. Ralph R. Cioffi, et al.*, No. 08-CV-2457(FB) (E.D.N.Y. filed June 19, 2008); SEC Litig. Release No. 20625 (June 19, 2009); see also *SEC Expects to Proceed with Bear Stearns Case*, Reuters, Nov. 12, 2009.

²³ See Robert Khuzami, Director, SEC Enforcement Division, “Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement,” Aug. 5, 2009.

²⁴ *SEC v. Bank of America Corp.*, No. 09-CV-6829(JSR) (S.D.N.Y. Sept. 14, 2009 order) (“Rakoff Order”) at 8; see also Kara Scannell, “BoFA Ruling Questions an SEC Weapon,” *Wall Street Journal* (Sept. 16, 2009).

²⁵ Rakoff Order, at 11.

7. Focus on Ponzi Schemes

Although the SEC was criticized for missing Bernie Madoff's \$65 billion alleged Ponzi scheme, it aggressively has pursued other alleged Ponzi schemes, including claims against investment advisers or those posing as such. During fiscal 2009, 20% of the SEC's enforcement cases involved alleged Ponzi schemes or Ponzi-like payments,²⁶ including a noteworthy case against R. Allen Stanford concerning an alleged \$8 billion fraud.²⁷ In the typical Ponzi-scheme case, the SEC files an emergency action, seeks an asset freeze and appoints a receiver to maximize investor recovery and stop the alleged fraud.

8. Creative Efforts to Expand Liability

In addition to insider trading, the SEC has stepped up enforcement in other areas. For example, 2009 saw the SEC's first use of Sarbanes-Oxley § 304's "clawback" provision. In *SEC v. Jenkins*, the SEC seeks the return of \$4 million in bonus and stock sale profits from the former CEO of CSK Auto Corp.²⁸ The case is noteworthy because the clawback suit is premised solely on the company's restatement; it does not allege that the CEO violated the securities laws, though the SEC filed a settled action against the company and is litigating related proceedings against other executives.

The SEC also filed its first enforcement action for violation of Regulation G, which requires companies to reconcile GAAP and non-GAAP financial measures and prohibits use of misleading non-GAAP financial data. In its settled action, *SEC v. Safenet, Inc.*, the SEC asserted that the company, its former CEO, CFO and three former accountants improperly used non-GAAP financial measures and imposed a \$1 million fine against the company.²⁹

Finally, the SEC appears to be expanding Section 20(a) control person liability. In two settled matters, the SEC charged three individuals based solely on control person liability, without alleging that the defendants violated or aided and abetted the alleged underlying violations.³⁰ That is, the SEC did not allege that the defendants acted knowingly or with *scienter*. Thus, while violations of the federal securities laws generally require more than negligence, by alleging only control person

liability,³¹ the SEC obtained penalties that it otherwise could not obtain without alleging knowing or *scienter*-based conduct. The courts of appeals are split about whether the SEC can bring an enforcement action based solely on control person liability.³² Whether the SEC will attempt to do so in a litigated matter remains to be seen. If it does so successfully, the SEC may have added another weapon to its arsenal.

9. Negative Inspector General Reports

The SEC's newly relevant and powerful Office of Inspector General ("OIG") issued a series of negative reports about the SEC during 2009. Most noteworthy was the OIG's Madoff report, which detailed multiple failures by Staff in numerous offices to respond appropriately to at least six detailed and substantive complaints raising significant "red flags."³³ The report revealed that the Staff conducted no fewer than five examinations of Madoff's operations, but the investigators' inexperience and failure to appreciate or follow up on inconsistencies prevented a thorough and comprehensive investigation that, according to the OIG's report, would have uncovered Madoff's fraud years ago.

10. Ongoing Restoration of the SEC's Reputation

We may never know how realistic the proposal was early this year to eliminate the SEC or combine it with other regulators. But after the SEC's new leadership took over in early 2009, the SEC's reputation has improved significantly. Moreover, the administration is proposing substantially increasing the SEC's \$1 billion budget and expanding its regulatory authority. Most notable are proposals for the SEC to regulate the \$600 trillion derivatives market and increase its oversight of the hedge fund and private equity industries. Armed with new leadership, organizational structure, enforcement tools and attitude, the SEC seems eager to reassert itself as a preeminent federal agency and tough Wall Street cop. ■

²⁶ *SEC 2009 Performance and Accountability Report*, Appendix B: "Major Enforcement Cases," at 128-29.

²⁷ *SEC v. Stanford International Bank, Ltd., Stanford Group Company, Stanford Capital Management, LLC, R. Allen Stanford, James M. Davis, Laura Pendergest-Holt, Gilberto Lopez, Mark Kuhrt and Leroy King*, No. 3:09-cv-0298-N (N.D. Tex. Second Amended Complaint, filed June 29, 2009).

²⁸ *SEC v. Jenkins*, No. 2:09cv-01510(JWS) (D. Ariz. filed July 22, 2009).

²⁹ *SEC v. Safenet, Inc.*, No. 09-CV-2117 (D.D.C. filed Nov. 12, 2009).

³⁰ SEC Litigation Rel. No. 21162, "SEC Charges Nature's Sunshine Products, Inc. With Making Illegal Foreign Payments," (July 31, 2009); SEC Litigation Rel. No. 21170, "SEC Charges Hank Greenberg and Howard Smith for Roles in Alleged AIG Accounting Violations" (Aug. 6, 2009).

³¹ Section 21(d)(3) of the Exchange Act permits the SEC to seek civil penalties against a person who violates the Exchange Act. Section 21(B) permits the SEC to impose penalties in administrative proceedings against a regulated entity (or associated person) that willfully violated the federal securities laws.

³² Compare *SEC v. J.W. Barclay & Co. Inc.*, 442 F.3d 834, 843 n.14 (3rd Cir. 2006) (rejecting Section 20(a) control person liability claim) and *SEC v. First Jersey Sec. Inc.*, 101 F.3d 1450 (2d Cir. 1996) (upholding Section 20(a) liability).

³³ *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme*, SEC Office of Inspector General, Report of Investigation No. OIG-509 (Aug. 31, 2009).

Enforcement and Litigation Cases to Watch in 2010

BY ALL ACCOUNTS, 2010 promises more noteworthy developments in the securities enforcement and litigation area. The newly constituted SEC Enforcement Division, now headed and staffed by former criminal prosecutors, has signaled a more aggressive approach. In addition to hedge funds—which the Enforcement Division has singled out as one of its most important priorities—the Division’s other areas of focus include: insider trading (by hedge funds and others), market manipulation, valuation, investor communications, violations of the Foreign Corrupt Practices Act, Ponzi schemes and Sarbanes-Oxley Section 304 “clawback” actions involving executive compensation. In the class action and private securities litigation arena, pending decisions from the Supreme Court addressing questions of jurisdiction, statutes of limitations and the proper role of courts in evaluating “excessive” compensation, among others, are sure to have a substantial impact on the business community and investors alike. The following are some of the more notable cases to watch in the upcoming year.

SEC v. Bank of America

The SEC had pledged to increase the capacity and willingness of its trial unit to try cases against those it believes have violated the securities laws. Still, few would have predicted that 2010 would start off with not one, but two, SEC cases against Bank of America before the same judge arising out of its merger with Merrill Lynch.

In September 2009, Southern District of New York Judge Jed. S. Rakoff rejected a \$33 million settlement between the SEC and Bank of America to resolve the SEC’s charge that Bank of America failed to disclose its prior agreement authorizing Merrill to pay year-end bonuses of up to \$5.8 billion to its employees. Judge Rakoff’s decision presented the SEC with several choices: drop the case, renegotiate the terms of the settlement, pursue the action administratively or fight the case in court.

The SEC chose to continue to litigate. On Jan. 12, 2010, the SEC filed a second action charging Bank of America with violations of the federal proxy rules by failing to disclose extraordinary financial losses that Merrill sustained prior to a shareholder vote to approve the merger.³⁴ The filing followed a ruling by Judge Rakoff the day before that the charges be brought separately from the SEC’s pending case against Bank of America, which challenges the

bank’s disclosures about bonuses paid to Merrill executives.³⁵

Most recently, the SEC announced a second settlement, again subject to Judge Rakoff’s approval, that attempts to resolve both cases against Bank of America. The current settlement will impose a \$150 million fine to be paid to Bank of America shareholders who allegedly were harmed by the disclosures at issue. It also will require Bank of America to take specified steps designed to strengthen its corporate governance and disclosure practices.

This new settlement responds to much of Judge Rakoff’s prior criticism, but the matter is not over yet. The same day the SEC settlement was announced, New York Attorney General Andrew Cuomo filed new fraud charges against Bank of America and its former CEO, Kenneth Lewis, and former CFO, Joseph Price, alleging that they lied to government officials and investors regarding the losses at Merrill. Just why the NYAG and the SEC—which acknowledged the NYAG’s support and cooperation when announcing its settlement—reached different conclusions regarding the executives may be a question Judge Rakoff will pose to the SEC.

SEC v. Rorech

The coming year also may see an expansion of the SEC’s enforcement authority in the insider-trading arena. In December 2009, the SEC won an early skirmish in its first insider-trading case involving credit default swaps (“CDSs”) when Judge John Koeltl denied defendants’ motion for judgment on the pleadings in *SEC v. Rorech*.³⁶ This case—along with the establishment of a new unit in the Enforcement Division focused on derivatives and new products—signals the SEC’s resolve to expand its horizon beyond the equities markets and into more complex products.

The SEC brought its insider-trading claim in this case in May 2009 against Renato Negrin, a former hedge fund portfolio manager, and Jon-Paul Rorech, a salesman at Deutsche Bank Securities, Inc. The SEC alleged that the defendants had engaged in insider trading in the CDSs of VNU N.C., a Dutch media conglomerate that owns Nielsen Media and other companies. According to the complaint, Rorech learned from investment bankers at Deutsche Bank, which was serving as lead underwriter for a proposed bond offering by VNU, about a change to the structure of the offering that was expected to increase the price of the CDSs on

³⁴ *SEC v. Bank of America*, S.D.N.Y., No. 10-cv-0215.

³⁵ *SEC v. Bank of America*, S.D.N.Y., No. 09-cv-6892.

³⁶ *SEC v. Rorech*, S.D.N.Y., No. 09-CV-4329.

VNU bonds. Rorech allegedly tipped Negrin about the contemplated change, and Negrin then purchased CDSs on VNU for the fund. Following the public announcement of the restructured offering, the price of VNU CDSs increased, earning the fund a \$1.2 million profit.

In August 2009, both defendants moved to dismiss the SEC's complaint on the pleadings, arguing, most notably, that Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") did not provide the SEC with the authority to regulate the CDSs at issue because they were not "securities-based swap agreements."³⁷ Specifically, the defendants argued that because the price term in the CDS contracts specified a particular number (383 basis points), and did not instead refer to the price, yield, value, or volatility of the underlying securities (in this case, bonds), the price of the CDSs could not have been "based on" those characteristics of the securities.

In denying the defendant's motion, Judge Koeltl acknowledged that the face of CDS contracts did not reveal whether a material term of the CDSs was "based on" a security. He added, however, that "it cannot be that traders can escape the ambit of Section 10(b) and Rule 10b-5 by basing a CDS's material term on a security, but simply omitting reference to the security from the text of the CDS contract." The defendants conceded that the CDSs at issue could be bought and sold on the secondary market, and therefore, according to Judge Koeltl, the amount at which they could be bought and sold would "'normally' be described as the 'price' of the instrument." The court found that whether the price of the CDSs was *actually* based on the value of the underlying bond presented a question of fact that could not be resolved at that stage of the proceedings.

Just what facts will prove dispositive on the issue of whether the CDSs at issue fall under the prohibitions of Section 10(b) and Rule 10b-5 remains to be seen. What *is* clear from Judge Koeltl's decision is that courts will take a flexible approach in determining whether novel financial instruments are securities and look to "the 'economic reality' of the instruments and the public's expectations of their nature." This, in turn, may embolden the SEC to bring similar cases

seeking to expand the scope of its enforcement authority in this area.

SEC v. Cuban

Another high-profile insider-trading case on appeal to the Fifth Circuit calls into question the scope of the SEC's ability to bring such cases under the so-called "misappropriation theory." In July 2009, a federal district court in the Northern District of Texas dismissed the SEC's insider-trading case against Dallas Mavericks owner Mark Cuban involving his sale of 600,000 shares of Mamma.com stock after he was advised by the company's CEO of the company's efforts to raise capital through a PIPE offering.³⁸

Under the misappropriation theory, which the Supreme Court adopted in *United States v. O'Hagan*, a person violates Section 10(b) of the Exchange Act and Rule 10b-5 when he "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."³⁹ Rule 10b5-2, adopted by the SEC in 2000, delineates certain circumstances giving rise to a "duty of trust or confidence" for purposes of the misappropriation theory," including "[w]henever a person agrees to maintain information in confidence."

In its complaint, the SEC had alleged that Cuban misappropriated confidential information when he sold Mamma.com stock after agreeing to maintain the confidentiality of the material nonpublic information about the offering. The court disagreed that this was sufficient to constitute insider trading under the misappropriation theory, rejecting the SEC's long-held position, as reflected in Rule 10b5-2, that third parties who agree to accept nonpublic information on a confidential basis may not trade on the information. The court reasoned that, while the SEC adequately pled that Cuban entered into a confidentiality agreement (a point that Cuban disputed), it did not allege that he agreed to refrain from trading on, or using for his own benefit, the information the CEO was about to share and, therefore, there was no "deception".

A ruling in favor of Cuban could impede the SEC's ability to bring similar cases in the future, though its potential impact should not be overstated given its limited precedential value outside of the Fifth Circuit. The case does suggest, however, that companies interested in sharing information with potential investors will need to be specific if they do not want the recipient of the information to trade.

³⁷ Congress passed the Commodity Futures Modernization Act in 2000 to extend the rules promulgated by the SEC under Section 10(b) to prohibit fraud, manipulation, and insider trading. . . to "security-based swap agreement[s] (as defined in section 206B of the Gramm-Leach-Bliley Act)." Section 206B of the Gramm-Leach-Bliley Act defines "securities-based swap agreement" as a "swap agreement. . . of which a material term is based on price, yield, value, or volatility of any security or any group of index of securities or any interest therein."

³⁸ *SEC v. Cuban*, N.D. Tex., No. 3:08-cv-02050-D.

³⁹ 521 U.S. 642 (1997).

Merck & Co., Inc. v. Reynolds

In the case of *Merck & Co., Inc. v. Reynolds* (08-905), the Supreme Court will decide whether the two-year statute of limitations period to bring a lawsuit under the Exchange Act begins when the plaintiff has obtained knowledge that the defendant acted with the intent to defraud, or simply when the plaintiff obtained general knowledge of facts pointing to potential fraud. The statute provides, in relevant part, that a complaint alleging “fraud, deceit, manipulation, or contrivance” under the Exchange Act “may be brought not later than the earlier of . . . 2 years after the discovery of the facts constituting the violation[] or . . . 5 years after such violation.”⁴⁰

Purchasers of Merck stock initially brought the action in November 2003 in the District of New Jersey alleging that the company had misrepresented the safety risks and commercial viability of its anti-inflammatory painkiller Vioxx. The suit followed an October 2003 article published in *The Wall Street Journal* describing the results of a study that found an increased incidence of heart attack associated with the use of Vioxx. Merck moved to dismiss the claim as time-barred, arguing that the plaintiffs were on “inquiry notice” of the claim before November 2001 (and thus outside of the two-year statute of limitations period). Specifically, Merck cited a September 2001 warning letter from the FDA to Merck stating that the company’s marketing of Vioxx had been misleading, as it had downplayed the risks of heart attack associated with the drug. The warning was covered extensively by the media and investment analysts at the time.

The district court granted the motion, but the Third Circuit reversed on appeal, holding that the statute of limitations did not begin to run until the plaintiffs had knowledge of facts suggesting that Merck had acted with *scienter*. The Third Circuit found that prior to November 2001, the plaintiffs lacked sufficient knowledge of the facts constituting their claim. Publication of the FDA’s warning letter had little effect on the market, according to the court, with Merck’s stock price falling briefly following its publication, then quickly rebounding, as investors and analysts remained bullish on the future of Vioxx. On the other hand, according to the Third Circuit’s decision, the study published in 2003 was sufficient notice to investors that Merck had fraudulently marketed the drug. The holding—that, under the “inquiry notice” standard applicable to federal securities claims, the statute of limitations does not begin to run until the plaintiff has evidence of *scienter*—is in accord with the Ninth Circuit, but

departs from other courts of appeals, which have adopted the more stringent standard.

The Supreme Court heard oral argument on Dec. 1, 2009. How it resolves this question of statutory construction could have significant implications for defendants’ ability to defeat claims on statute of limitations grounds. The Court’s adoption of the more stringent standard also might encourage plaintiffs to bring actions earlier in order to avoid dismissal.

Jones v. Harris Associates

The Supreme Court’s pending decision in *Jones v. Harris Associates* (08-586), argued in November 2009, could have broad implications for fund industry participants and the question as to what constitutes “excessive” advisory fees under the Investment Company Act of 1940 (“ICA”). The petitioners—shareholders in several mutual funds formed and advised by Harris—brought a claim in federal district court alleging that the company breached its fiduciary duty to the shareholders under Section 36(b) of the ICA by charging them “excessive” fees and failing to provide material facts relating to compensation to the funds’ board members and shareholders.

The district court rejected that claim, relying on the bedrock 1982 decision in *Gartenberg v. Merrill Lynch Asset Management, Inc.*,⁴¹ in which the Second Circuit held that a breach of fiduciary duty occurs only when an adviser “charge[s] a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.” In granting Harris’s motion for summary judgment, the court concluded that because the fees paid by petitioners were comparable to those paid by other mutual funds, no breach of fiduciary duty for purposes of Section 36(b) had occurred.

On appeal, the Seventh Circuit affirmed the district court’s decision but rejected the *Gartenberg* approach as relying “too little on markets.” Because there was no evidence that Harris had misled the mutual fund’s board about the facts material to its decision, the court held, the board’s approval of the fee precluded any claim that the advisor had breached its fiduciary duty.

At oral argument before the Supreme Court in November, the parties—as well as the United States, which filed an *amicus* brief—generally agreed (in line with *Gartenberg*) that under Section 36(b), an advisory fee should fall within a range of fees that could result from arm’s-length negotiations, but

⁴⁰ 28 U.S.C. § 1658(b).

⁴¹ 694 F.2d 923 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983).

disagreed on how to apply that standard. According to the petitioners, the best gauge of whether the fee was excessive was to compare it to the fees the advisor charged to its institutional clients. The respondents, on the other hand, pointed to the fact that the fee must be approved by independent members of the board, and that Congress, noting this, did not intend to put courts in the position of effectively reviewing the fees *de novo*. The respondents added that, even if the Seventh Circuit had applied the wrong test, it was inappropriate to compare the fee to non-mutual fund fees because of the different and more extensive services provided to mutual funds. The United States, for its part, endorsed the existing *Gartenberg* approach, acknowledging the role of the courts as an additional check on advisor compensation.

It is difficult to predict how this case will be decided. While it appears the Court does not have a majority of votes to adopt the Seventh Circuit's market-based approach, neither is it eager to place the judiciary in the position of making fee determinations. Regardless, the decision may offer broader lessons on how the courts might go about evaluating claims of excessive compensation, currently a hot-button issue.

Morrison et al. v. National Australia Bank Ltd.

In November 2009, the Supreme Court agreed to hear its first "foreign-cubed" case (i.e., where (1) *foreign* plaintiffs (2) sue a *foreign* issuer in a U.S. court for (3) violations of the anti-fraud provisions of the U.S. securities laws, based on securities transactions in a *foreign* country). In *Morrison v. National Australia Bank Ltd.* (08-1191), the central issue facing the Court is what standard to use to determine whether or not there is a sufficient nexus with the U.S. to support jurisdiction over a private claim of transnational securities fraud.

The plaintiffs in *Morrison* were foreign shareholders of National Australia Bank ("NAB"), an Australian corporation, who sued NAB for allegedly defrauding its shareholders by overvaluing the mortgage holdings in its wholly owned subsidiary HomeSide Lending Inc. ("HomeSide"), a Florida-based corporation. The plaintiffs contended that the fraud primarily occurred in Florida because, among other things, HomeSide was located there and the false numbers at issue were created there. The district court disagreed and dismissed the action for lack of subject matter jurisdiction, finding that HomeSide's conduct "amounted to, at most, a

link in the chain of a scheme that culminated abroad."⁴²

The Second Circuit affirmed that decision,⁴³ holding that the appropriate test for subject matter jurisdiction is whether the "activities in this country were more than merely preparatory to a fraud and culpable acts or omissions occurring here directly caused losses to investors abroad." Stated another way, the issue "boils down to what conduct comprises the heart of the alleged fraud." Applying that standard, the court concluded that NAB's actions and omissions (e.g., overseeing operations, including those of its subsidiaries; and reporting to shareholders and the financial community) were "significantly more central to the fraud and more directly responsible for the harm to investors than the manipulation of the numbers in Florida."

The Supreme Court's decision could resolve the conflict among circuits as to the standard for determining whether there is a sufficient connection to the US to permit a private action under Rule 10b-5 in transnational fraud cases. The District of Columbia Circuit, for example, has held that jurisdiction will not be met unless all elements of the alleged fraud occurred domestically. The Third, Eighth and Ninth Circuits require only "some activity designed to further a fraudulent scheme."

Where the Supreme Court comes out on this issue holds great interest for the business community, given the increasingly transnational nature of our economy. ■

SRZ Partner Martin Perschetz Named Litigator of the Week

Martin Perschetz was named a "Litigator of the Week" by *The AmLaw Litigation Daily* for his representation of former Vivendi CFO Guillaume Hannezo in *In re Vivendi Universal, S.A. Securities Litigation*.

In reflecting on the jury's decision, Marty told the *Daily* "They viewed the individual defendants as credible, A large part of our defense was that...[Hannezo] acted honestly and in good faith throughout. Sometimes that's easier for the jury to translate when it comes to individuals as opposed to a company."

⁴² *In re National Australia Bank Securities Litigation*, 2006 WL 3844465 (S.D.N.Y.).

⁴³ *Morrison v. National Australia Bank Ltd.*, 547 F.3d 167 (2d Cir. 2008).

SRZ Expands Enforcement and Litigation Capabilities

IN 2008, INCREASING CALLS for heightened regulation of the securities industry amid the unfolding financial crisis convinced Schulte Roth & Zabel that our financial services clients would find themselves subject to increased governmental oversight, regulation and enforcement activity.

Developments in recent months have confirmed that belief, as the SEC, the Department of Justice and other regulators have taken unprecedented and aggressive steps to scrutinize the hedge fund industry. Formation of the SEC's Asset Management Unit is but one aspect of that agency's intensified focus on hedge funds, particularly as relates to insider-trading concerns. Meanwhile, criminal prosecutors have embraced a broad array of criminal investigative techniques to examine financial services firms.

Not only did SRZ anticipate these developments, we proactively planned for them. Over the past 18 months, we added a number of leading securities litigators to our Washington, D.C. and New York offices to enhance our securities enforcement, securities litigation and white-collar defense capabilities. Many of these lawyers are veterans of the SEC's Enforcement Division or former federal prosecutors, and all have extensive experience and successful track records representing financial services clients in high-profile securities-related matters. Key partner additions include:

[Howard Schiffman](#)—a former SEC trial lawyer with 30 years' experience in SEC enforcement and securities litigation matters.

[Richard J. Morvillo](#)—a former SEC Enforcement branch chief with substantial experience in regulatory enforcement, white-collar defense and securities litigation.

[Peter H. White](#)—a former federal prosecutor whose white-collar trial experience includes 80 federal and state jury trials and many more bench trials.

[Pat S. Conti](#)—a former SEC Enforcement branch chief and in-house compliance lawyer whose experience includes advising on securities compliance and enforcement matters.

[Ida Wurczinger Drain](#)—a former SEC Enforcement attorney and Special Counsel to SEC Commissioner Shad with extensive experience providing compliance counseling and regulatory representation.

[Mark S. Mandel](#)—a former chief of the New York office of the SEC's Division of Broker-Dealer Enforcement who represents clients in securities class action and enforcement matters.

Other recent additions to the Litigation Group with significant securities regulatory compliance, enforcement and litigation experience include special counsel [Eric A. Bensky](#), [William M. Mann](#), [Jeffrey F. Robertson](#) and [James M. Wines](#).

With more than 100 litigators and a strong presence in New York and Washington, we now have one of the largest, most experienced and formidable securities enforcement and white-collar criminal practices of any major law firm. And while other firms may have similar litigation capabilities, none have a complementary investment management practice that is as well known as ours, a valuable asset to our litigators in conducting internal investigations and defending enforcement actions and other litigation. ■

Schulte Roth & Zabel Litigation Partners and Special Counsel

Robert M. Abrahams

+1 212.756.2355 | robert.abrahams@srz.com

Pat S. Conti

+1 202.729.7477 | pat.conti@srz.com

Harry S. Davis

+1 212.756.2222 | harry.davis@srz.com

Ida Wurczinger Draim

+1 202.729.7462 | ida.draim@srz.com

Marc E. Elovitz

+1 212.756.2553 | marc.elovitz@srz.com

Alan R. Glickman

+1 212.756.2210 | alan.glickman@srz.com

Howard O. Godnick

+1 212.756.2220 | howard.godnick@srz.com

William H. Gussman

+1 212.756.2044 | bill.gussman@srz.com

Marcy Ressler Harris

+1 212.756.2271 | marcy.harris@srz.com

Mark S. Mandel

+1 212.756.2319 | mark.mandel@srz.com

David K. Momborquette

+1 212.756.2268 | david.momborquette@srz.com

Richard J. Morvillo

+1 202.729.7479 | richard.morvillo@srz.com

Martin L. Perschetz

+1 212.756.2247 | martin.perschetz@srz.com

Betty Santangelo

+1 212.756.2587 | betty.santangelo@srz.com

Howard Schiffman

+1 202.729.7461 | howard.schiffman@srz.com

Gary Stein

+1 212.756.2441 | gary.stein@srz.com

Sung-Hee Suh

+1 212.756.2418 | sung-hee.suh@srz.com

Michael E. Swartz

+1 212.756.2471 | michael.swartz@srz.com

Robert. J. Ward

+1 212.756.2166 | robert.ward@srz.com

Peter H. White

+1 202.729.7476 | peter.white@srz.com

Eric A. Bensky

+1 202.729.7465 | eric.bensky@srz.com

Yocheved Cohen

+1 212.756.2200 | yocheved.cohen@srz.com

Gregory A. Kasper

+1 212.756.2241 | gegory.kasper@srz.com

William M. Mann

+1 202.729.7473 | william.mann@srz.com

Jeffrey F. Robertson

+1 202.729.7478 | jeffrey.robertson@srz.com

Harry Sandick

+1 212.756.2592 | harry.sandick@srz.com

James M. Wines

+1 202.729.7463 | james.wines@srz.com

New York

Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
+1 212.756.2000
+1 212.593.5955 fax

Washington, DC

Schulte Roth & Zabel LLP
1152 Fifteenth Street, NW, Suite 850
Washington, DC 20005
+1 202.729.7470
+1 202.730.4520 fax

London

Schulte Roth & Zabel International LLP
Heathcoat House
20 Savile Row, London W1S 3PR
+44 (0) 20 7081 8000
+44 (0) 20 7081 8010 fax

www.srz.com

Disclaimer

The information in this newsletter has been prepared by Schulte Roth & Zabel LLP ("SRZ") for general informational purposes only. It does not constitute legal advice, and is presented without any representation or warranty whatsoever as to the accuracy or completeness of the information or whether it reflects the most current legal developments. Distribution of this information is not intended to create, and its receipt does not constitute, an attorney-client relationship between SRZ and you or anyone else. Electronic mail or other communications to SRZ (or any of its attorneys, staff, employees, agents or representatives) resulting from your receipt of this information cannot be guaranteed to be confidential and will not, and should not be construed to, create an attorney-client relationship between SRZ and you or anyone else. No one should, or is entitled to, rely in any manner on any of this information. Parties seeking advice should consult with legal counsel familiar with their particular circumstances. Under the rules or regulations of some jurisdictions, this material may constitute advertising.