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ARTICLES

The SEC's Increasing Focus on Hedge Funds

By Peter M. Saporoff and Breton Leone-Quick

Recent history makes it clear that hedge fund managers are on the brink of facing an unprecedented increase in the number of Security and Exchange Commission (SEC) investigations and enforcement proceedings that will affect their operations. How did we get here? A starting point of sorts was the negative press concerning the SEC's failures to detect or prevent the Madoff Ponzi scheme. This negative reaction was soon followed by passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which provides the SEC with much more direct regulatory oversight of fund managers by requiring many currently unregistered fund managers to register as investment advisers and by requiring certain investment advisers who are still exempt from registration to disclose certain information to the SEC. Pub. L. No. 111-203, H.R. 4173, §§ 403–408. As a result of these developments, the SEC will have much more information at its disposal to initiate investigations against fund managers.

During this same recent period, the SEC's enforcement staff also underwent several internal changes that will increase its presence in the hedge fund industry. For example, the enforcement division created national specialized units, including the Asset Management Unit, which will focus on investment advisers, mutual funds, hedge funds, and private equity funds. Robert Khuzami, [Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement](#) (Aug. 5, 2009). This unit will prepare for its work by providing enhanced training for staff members on issues unique to the target industries and by hiring more professionals with industry experience who bring a greater depth of understanding to their work. In addition, enforcement staff have recently been more frequently involved in audits of advisers by the staff of the Office of Compliance Inspections and Examinations (OCIE) when the OCIE staff encounters anything suspicious that may warrant closer scrutiny.

This article examines some of the SEC's recent and notable enforcement activity involving hedge funds and discusses some of the developments that signal how the SEC could proceed against fund managers in the near future. This article also identifies just a few of the many difficult issues that fund managers may face when subjected to an SEC investigation.

The Scope of Recent Investigations

The most highly publicized enforcement proceedings against hedge fund managers over the past couple of years have been in connection with Ponzi schemes and insider trading allegations. Developments in these cases provide a road map of where the SEC is likely to proceed with respect to future investigations and enforcement proceedings against hedge fund managers.

Ponzi Schemes

Bernard Madoff and Tom Petters ran two of the largest Ponzi schemes in history, both of which unraveled in the past few years. Both Madoff and Petters relied on hedge funds to provide proceeds for their schemes, and various regulators, including the SEC, have alleged that a few of these funds were complicit in the schemes to a certain degree.

Over the past couple of years, the Department of Justice (DOJ) has shown that it is willing and able to prosecute the alleged architects of the larger Ponzi schemes, and the sanctions the SEC can seek do not match the punitive and deterrent impact of a criminal indictment, conviction, and lengthy incarceration. For example, while the SEC can seek to bar individuals from the industry, such a bar is probably not all that necessary to ensure that the alleged architects of such schemes never work in the industry again, given the egregious and highly public nature of Madoff-type frauds, coupled with the potential for a statutory disqualification if there is a criminal conviction. Likewise, penalties do not serve much of a purpose because oftentimes no funds are available, or what little money is left is best used to compensate victims. Moreover, receivers and bankruptcy trustees often assume the role of liquidating any available assets and securing the greatest recovery possible for investors. Given the reality that SEC sanctions serve, at best, a moderate role in remediating some of the damage inflicted by the largest Ponzi schemes (or in deterring other such schemes), the SEC's focus with respect to suspected Ponzi schemes will most likely turn to investigating funds actively to stop such schemes well before they rise to the catastrophic level of a Madoff or Petters situation.

Fund managers, therefore, can expect to see greater scrutiny of their operations, even if there are no indications of fraud. For example, in early March 2011, the SEC announced it was undertaking a sweep of all funds that were consistently beating market indices by 3 percent. Joe Weisenthal, "The SEC Warns Hedge Funds: If you Beat the Market by 3%, We Are Looking into You," *Bus. Insider*, Mar. 10, 2011, 2011 WLNR 4783413. In some respects, these general sweeps may help prevent the next Madoff, but they may lack the scope and depth necessary to prevent the next Petters. Even though Madoff ran the larger of the two Ponzi schemes, it would have been the easier one to uncover given the numerous red flags, including suspicious returns, the lack of a reputable outside auditor, and the fact that a Madoff-controlled entity served as the organization's broker. Petters's scheme, in comparison, provided much greater transparency as to its operations but was sufficiently complex to cleverly conceal the massive fraud.

Petters did not operate a hedge fund himself; rather, he developed a complex financing scheme that relied on receiving funding from hedge funds operated by third parties. The basis of the Petters sales pitch was that a large number of manufacturers of consumer electronics regularly needed to liquidate excess or outdated inventory and that numerous big-box retailers were willing to purchase that inventory. Complaint at ¶ 41, *SEC v. Thomas J. Petters*, No. 09-1750 (D. Minn. July 8, 2009). To facilitate these transactions, according to Petters, a middleman was generally needed to finance and coordinate the transaction by purchasing the electronics from the manufacturer and reselling them to the retailer. An entity controlled by Petters purportedly



played the role of the middleman but needed funding from outside sources to help finance the transactions.

The way this financing transaction purportedly earned safe, constant returns for investors was that entities controlled by Petters would issue hedge funds (or entities controlled by those funds) 90-day promissory notes that bore an interest rate of around 3 percent. The proceeds from the notes were to be used to purchase the consumer electronics from the manufacturers. Once the electronics were sold to the retailers, the feeder fund would receive the proceeds earned from the sale as payment for the note, and a small fee was then sent to the Petters-controlled intermediary. In addition to this plausible premise, the transactions purportedly had numerous checks and balances to ensure that they occurred as advertised and in a way that minimized risk.

First, the Petters intermediary would not issue a note to the feeder funds until it had the following documents in hand: an invoice from the seller and a corresponding purchase order from the buyer, proof of insurance on the goods, and a Uniform Commercial Code (UCC) financing statement for the goods. This process allegedly ensured that the transaction was in place before the feeder fund had to make any expenditures and seemingly guaranteed payment. A primary remaining risk, however, would be for the retailer to default on the purchase order. But this risk was purportedly managed by ensuring that the buyers who were involved were only well-established, big-box retailers with high credit ratings. Thus, the flow of funds for this financing transaction was represented as occurring as follows: The money that the hedge funds paid to obtain the notes was wired directly from the funds' bank accounts to the sellers, and the money from the retailers flowed back directly to the hedge funds.

The problem with this investment strategy, as it turned out, was that there *were* no transactions, and Petters simply used the proceeds from new notes to pay off the notes that were due. Setting aside Petters's forgery of invoices, purchase orders, UCC financing statements, and other supporting documentation, the biggest breakdown in the scheme occurred with respect to the flow of funds. Rather than the proceeds from the feeder funds going directly to the sellers, and the proceeds from the sales to the retailers going back to the feeder funds, all funds flowed through Petters-controlled entities, according to the SEC. *Id.* at ¶¶ 89–97. The SEC has also alleged that investors in the feeder funds were not told that the money was flowing through Petters and not, as allegedly represented, between the funds and the sellers and buyers directly. Interestingly enough, the SEC has not alleged that the feeder funds had actual knowledge that Petters was faking the underlying transactions. This sets up an interesting dynamic in which the feeder funds were not seen as being directly complicit in the fraud itself, in that they did not know that the transactions were wholly fabricated, but they allegedly failed to disclose to investors that a process that guarded against such a fraud was not being followed.

Because unwinding a complex fraud such as this can be extremely difficult (notably, it took an internal whistleblower to bring Petters down), the SEC is now more likely to conduct investigations of funds using a far broader scope and deeper reach than in its prior investigations

in an attempt to ensure it is not missing anything. See Ashby Jones, “[Deanna Coleman Takes the Stand: A Blue Monday for Petters?](#),” *WSJ Blogs*, Nov. 2, 2009. After all, many of the world’s most sophisticated investors conducted extensive due diligence of Petters and still decided to invest. Put another way, if the SEC is going to be able to uncover complex frauds such as the one perpetrated by Petters, its investigations will have to exceed the scope and depth of the thousands of hours of collective due diligence spent by those sophisticated investors that were nonetheless insufficient to uncover the fraud. This is the regulatory mind-set that hedge fund managers will be facing as the SEC pursues its investigations henceforth.

Insider Trading

Initiating actions based on alleged insider trading is well within the SEC’s traditional bailiwick given that such enforcement actions are intended, in part, to protect the integrity of the public markets. The continuing investigation and proceedings centering on insider trading by fund manager Raj Rajaratnam through his Galleon Group is the largest and most extensive government investigation into insider trading in the hedge fund world (or any other sector for that matter) to date.

The Galleon cases highlight two developments: the SEC’s successful acquisition of covert wiretap communications that were originally obtained by the DOJ and the SEC’s use of an administrative proceeding, rather than federal court, to bring an enforcement action. The most significant development with respect to the Galleon cases was the use of covert wiretaps by the DOJ to gather evidence. What attracted somewhat less notice, however, was the SEC’s request (during discovery in its case) that certain defendants produce the recorded communications from the wiretaps they had received from the DOJ in the criminal actions against them. Defendants objected to their production, but the district court held that the recordings had to be produced to the SEC.

However, the Second Circuit vacated the district court’s order through a writ of mandamus. *SEC v. Rajaratnam*, 622 F.3d 159 (2d Cir. 2010). The Second Circuit first noted that nothing in the applicable wiretap statute “explicitly or implicitly prohibits the disclosure” of the wiretap recordings to the SEC. *Id.* at 175–76. The court then questioned whether the SEC had “an independent right of access to the materials” and, if so, “whether the district court properly balanced any such right against the privacy interests at stake.” *Id.* at 177. With respect to the first prong, the Second Circuit held that the district court correctly determined that the SEC had a right to the information pursuant to Federal Rule of Civil Procedure 26, but that that right was not absolute. The Second Circuit concluded that the district court did not properly weigh the defendants’ relevant privacy interests against the SEC’s right to the information “(1) by ordering the disclosure of the conversations prior to a ruling on the legality of the interceptions, and (2) by failing to limit the disclosure order to relevant conversations.” *Id.* at 185. It then vacated the district court’s order and remanded the matter for further proceedings.

Once back in the district court, the SEC renewed its motion to compel after the motion to suppress the wiretaps in the criminal case was denied. Memorandum, *SEC v. Galleon Mgmt. LP*, No. 09-cv-8811 (S.D.N.Y. May 11, 2011). In response, the defendants agreed to produce certain of the wiretap communications, but refused to produce others, and argued that the SEC's request was too broad, that their privacy interests outweighed the SEC's interest in the communications they did not produce, and that production should be postponed until after the criminal trial. The court rejected the defendants' arguments and ordered that they produce all of the requested communications in two phases.

The second notable development from the Galleon cases was the fact that the SEC initiated an administrative action rather than the usual federal court action against Rajat Gupta, who is alleged to have passed inside information along to Rajaratnam. *In the Matter of Rajat K. Gupta*, File No. 3-14279 (SEC Mar. 1, 2011) (Order Instituting Public Administrative and Cease-and-Desist Proceedings). It would be premature to conclude that this single instance signals a shift away from federal court actions to administrative proceedings in insider trading cases. But it would not be surprising to see some sort of shift, given the advantages the SEC experiences when proceeding administratively, including limited discovery rights for defendants (which could be a consideration where there is a parallel criminal proceeding), no right to a jury, and no requirement to comply with the Federal Rules of Evidence (which is particularly relevant in insider trading cases, which are more likely to be based on hearsay evidence that would be subjected to stronger challenges in federal court under the rules).

Passage of the Dodd-Frank Act provides an added incentive for the SEC to proceed administratively. This is because the act gives the SEC the ability to impose a civil penalty on any individual in a cease-and-desist proceeding. Pub. L. No. 111-203, H.R. 4173, § 929P. Prior to the act, the SEC could only impose civil penalties in administrative proceedings against individuals associated with broker-dealers, investment advisers, or investment companies. Given the administrative advantages to the SEC, it is not surprising that Gupta has taken the rather unprecedented step of filing an action in federal court, seeking a declaration that the SEC cannot apply the Dodd-Frank civil penalty provisions retroactively and seeking an order enjoining the SEC from proceeding administratively against him. Complaint for Declaratory and Injunctive Relief, *Gupta v. SEC*, No. 11-cv-1900 (S.D.N.Y. Mar. 18, 2011). The SEC has moved to dismiss the complaint.

Potential Scope of Future Investigations and Actions

While the SEC will undoubtedly continue to focus on preventing Ponzi schemes perpetrated by hedge funds and will continue to pursue insider trading by funds, it is already branching out into new areas with respect to its scrutiny of fund managers.

More Sweeps

Fund managers should be prepared to get caught up in more general sweeps. As noted above, the SEC announced that it was undertaking a sweep of all funds that consistently beat market

indices. While sweeps consume tremendous resources and are not all that frequent, it appears clear that the SEC is nonetheless committed to conducting at least some selective sweeps in the hedge fund area, just as it has conducted similar sweeps in other areas. This would not be surprising given that the SEC faces increasing pressure to discover frauds before they blow up. In determining the scope of these sweeps, the SEC will likely compile a list of “risk factors” and will then seek information from funds that exhibit any number or combination of these factors.

In addition to suspiciously stable or high returns, other things the SEC may consider to be “risk factors” or red flags include an overly complex, novel, or opaque investment strategy; funds that use small or not-well-known outside auditors or administrators; and funds associated with individuals who already have a track record with the SEC.

Quant Funds

Another recent first for the SEC in the hedge fund area was an action against an investment adviser that used quantitative trading models. *In the Matter of AXA Rosenberg Group LLC*, File No. 3-14224 (SEC Feb. 3, 2011) (Corrected Order Instituting Administrative Cease-and-Desist Proceedings). The action was based on an alleged coding error in one of the models and the attempts by the adviser to cover up and conceal that error. Specifically, the SEC alleged that the adviser (1) omitted to disclose the error and its impact on client performance, (2) attributed the model’s poor performance to market volatility rather than the error, and (3) misrepresented the model’s ability to control risks. In settling the action, the adviser agreed to refund over \$200 million in losses incurred as a result of the error, to pay a \$25 million penalty, and to undertake various other compliance and record-keeping obligations.

It appears that this case may be only the beginning of the SEC’s focus on “quant” trading. Part of the SEC’s interest in this area is to determine whether quant trading strategies can disrupt markets, an interest that stems from a concern with the level of disclosure provided to investors about quant trading. Jean Eaglesham & Jenny Strasburg, “Big Fine over Bug in ‘Quant’ Program,” *Wall St. J.*, Feb. 4, 2011.

More Focus on Disclosures

In recent SEC investigations into hedge fund managers, there has been more of a focus on the disclosures those managers are making to potential investors. Previously, this has not been much of a focus for the SEC, probably because allocation of resources issues, if nothing else, made the SEC less prone to police disclosures made to accredited and sophisticated investors. But the SEC now has additional resources and will soon be receiving more information from more fund managers through Dodd-Frank’s registration and reporting requirements, which open the door for these types of investigations commonly (and, until now, primarily) experienced by public companies with respect to their public filings (i.e., their Ks and Qs). The SEC will also likely be paying closer attention to funds’ calculations of their returns, including diving into complex valuation and accounting issues, just as it has traditionally delved into these areas with respect to the reported revenues and other financial information of public companies.

Whistleblowers

Finally, it looks as if there will be an uptick in whistleblower-initiated investigations into hedge funds. While the final rules implementing the whistleblower provisions of the Dodd-Frank Act were just promulgated, passage of the act alone resulted in the SEC receiving what it describes as higher quality tips, as sophisticated individuals now have more of an incentive to come forward. Press Release, SEC, SEC Adopts Rules to Establish Whistleblower Program (May 25, 2011).

The primary sources for tips concerning hedge funds are generally former employees of fund managers and, surprisingly, potential investors. With respect to the latter, there have been recent examples of potential investors going through the due diligence process, deciding not to invest and then passing along the due diligence materials (along with scant analysis as to why things look suspicious) to the SEC. There is little downside for investors engaging in this type of activity because the whistleblower rules allow them to submit anonymous tips (they only need to identify themselves to the SEC upon collecting their bounty), and they may prevent disclosure of their identity even if they do not submit the tip anonymously. *See* 17 C.F.R. § 240.21F7. On the other hand, there is a significant upside given the potential for whistleblower bounties if the fund is actually investigated by the SEC.

In any event, the whistleblower provisions undoubtedly provide incentive to ex-employees and potential investors to run to the SEC with any real or imagined irregularities, which should prompt cautious fund managers to reexamine their ability to control the information flow accordingly. In this respect, the whistleblower provisions may result in harming potential investors in funds because managers will either be more selective with respect to the investors with which they speak or will limit the amount of information they provide in the due diligence process for fear that something may be taken out of context and used against them as part of a whistleblower tip.

Handling SEC Investigations

A myriad of issues can arise during an SEC investigation. This section focuses on just two approaches that should be considered when dealing with investigations of fund managers and investment advisers: taking steps prior to an investigation to ensure that an investigation imposes as little cost as possible and ensuring that an investigation does not disrupt ongoing business activities.

A primary goal for every fund manager or investment adviser is (or should be) to get through an SEC investigation as inexpensively and quickly as possible. The single largest factor affecting the cost and length of an investigation is the production of documents to the SEC. Thus, the more quickly and efficiently documents can be produced, the less fund managers will spend on attorney fees in connection with such productions, and the more quickly the investigation will proceed. So, even prior to any signs of an investigation, fund managers should review their document retention policies, ensure that those policies comply with all applicable laws and regulations, including the Advisers Act (if applicable), and ensure that the fund's documents are



retained in compliance with such policies and in an organized fashion that will allow for a speedy, efficient review of documents that are responsive to an SEC subpoena or document request.

On the second point, an SEC investigation poses several potential disruptions to ongoing fund operations beyond the time and energy that key personnel must spend in searching for and gathering documents and (potentially) providing testimony. For example, the SEC may begin contacting the fund's investors as part of its investigation. Another example is determining whether the fund should, or must, disclose the SEC investigation to current investors, potential investors, or both. Each one of these circumstances can pose potentially tricky situations, and there is no one-size-fits-all approach to addressing them; rather, they must be addressed case by case, preferably with the assistance of competent legal counsel. It is important for managers to keep these important issues in mind right from the start of any investigation and to be prepared to address them with their counsel.

Conclusion

There is no mystery as to why the SEC has intensified its focus on hedge fund managers. On the other hand, this increased focus on hedge fund managers is a striking departure from the SEC's prior practice, which involved conserving its resources in areas where sophisticated (and wealthy) investors had the means to seek their own private remedies and presumably understood the risks before investing in the first instance. For example, as recently as 2008, the SEC's settlements with various broker-dealers on auction rate securities sales carved out sophisticated or larger investors from those investors who could receive relief from the broker-dealers through the settlement order. But it now appears that SEC investigations and enforcement actions are entering a new era in which hedge funds are seen not just as investment vehicles for sophisticated investors but as key players in the stability and integrity of the public markets. Whether this perception is accurate is open to debate, but what does seem clear is the fact that fund managers will face increased scrutiny in the coming years.

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The Potential for Mandatory Settlement Classes in Broker-Dealer Suits

By Daniel F. Wake

Early this year, a federal district court judge in the Northern District of Texas temporarily restrained hundreds of Financial Industry Regulatory Authority (FINRA) arbitrations from proceeding while the court considered whether to force those arbitration claimants to participate in a class action settlement. *See, e.g., Billitteri v. Secs. Am., Inc.*, No. 3:09-cv-01568-F (N.D. Tex. Feb. 18, 2011) (Order Granting Plaintiffs' Motion for Temporary Restraining Order). Ultimately, the court lifted the injunction and allowed the arbitrations to proceed, but numerous arbitrations in a related case remain enjoined while a class-wide settlement is considered. Although its success is not yet known, this dramatic tactic sheds light on the prospects for a broker-dealer to run the difficult gamut of barring arbitration proceedings to settle a competing class action. The U.S. Supreme Court's recent decision in *AT&T Mobility, LLC v. Concepcion*, 131 S. Ct. 1740 (Apr. 27, 2011) may also bear on those prospects.

Background of Claims Against Securities America and Capital Financial

Securities America, Inc., was a wholly owned subsidiary of Ameriprise Financial, Inc. Securities America sold nearly \$750 million of securities in private placements issued by Provident Royalties and Medical Capital Holdings. The Securities and Exchange Commission (SEC) later sued both issuers for fraud, alleging that they used new investor funds to pay earlier investors, i.e., a Ponzi scheme. A series of class actions against Securities America followed in which the plaintiffs alleged, among other things, that there were numerous misrepresentations in the private placement memoranda pursuant to which the securities were offered. Ameriprise was sued for control person liability.

At the same time, hundreds of putative class members opted to pursue their arbitral claims before FINRA. Thus, investors had their choice: cast their lot with the putative classes and their counsel, or pursue their individual claims in arbitration. By the same token, Securities America and Ameriprise were required to defend themselves in all of the various class actions and numerous arbitrations.

On February 16, 2011, plaintiffs in one of the class actions entered into a settlement agreement with Securities America by which Securities America agreed to pay approximately \$21 million to settle all claims relating to Provident Royalty and Medical Capital. (Ameriprise separately agreed to pay approximately \$27 million.) By "all claims," Securities America intended to settle *all claims*, including those of the investors who were pursuing their claims in arbitration. In effect, the settling parties (the class representative plaintiffs and Securities America) proposed a hostile takeover and settlement of the arbitration claims.

As of the date of the putative class settlement, many arbitration hearings had been scheduled, including some that were set to begin within days. Accordingly, the settling parties requested immediate injunctive relief to temporarily restrain the pending FINRA arbitration hearings from commencing while the court considered the settling parties' request for preliminary approval of the class action settlement. In the face of what promised to be fierce resistance from the arbitration claimants and their counsel, the settling parties constructed an argument to persuade the district court both that it had jurisdiction to enjoin arbitrations all over the country *and* that it should exercise that jurisdiction to do so.

A Mandatory Settlement Class That Sweeps in the Arbitration Claimants

The key to the settling parties' effort was obtaining certification of the settlement class pursuant to Rule 23(b)(1)(B) of the Federal Rules of Civil Procedure—a mandatory “limited fund” certification. Rule 23(b)(1)(B) allows certification of a class if, among other requirements,

separate actions by or against individual class members would create a risk of . . . adjudications with respect to individual class members that, as a practical matter, would be dispositive of the interests of the other members not parties to the individual adjudications or would substantially impair or impede their ability to protect their interests.

Where all plaintiffs are pursuing a “limited fund,” the earliest of separate actions may deplete the limited fund to the detriment of the separate actions that follow. To ensure all claimants to the limited fund share equally in that fund, and unlike the more common Rule 23(b)(3) certification in which class members choose whether to participate in a class settlement, members of a Rule 23(b)(1)(B) class are not given the choice to exclude themselves from the settlement or to pursue their separate claims. Participation is mandatory. *See* Fed. R. Civ. P. 23(b)(1)(B) advisory committee note (“[A]n adjudication as to one or more members of the class will necessarily or probably have an adverse practical effect on the interests of other members . . . when claims are made by numerous persons against a fund insufficient to satisfy all claims.”).

The settling parties argued there was a practical limit to how much money could possibly be recovered from Securities America, no matter how great the aggregated claims of all investors may be. The settling parties asserted that Securities America had limited assets, that those limited assets would be depleted by defense costs and payment of awards in the earliest arbitration cases, and thus, that those investors who proceeded first in arbitration would unfairly enjoy recoveries that would be unavailable to those proceeding later. In sum, by exhausting Securities America's limited assets, the settling parties argued, adjudications by the claimants with early arbitration hearings would “substantially impair or impede [other class members'] ability to protect their interests.”

A second component to the settling parties' theory was their assertion of the All Writs Act, which provides that federal courts “may issue all writs necessary or appropriate in aid of their



respective jurisdictions and agreeable to the usages and principles of law.” 28 U.S.C. § 1651(a). The settling parties argued that a district court may use the All Writs Act to enjoin other proceedings (including FINRA arbitrations pending in any location) in which the limited fund at issue in a proposed settlement over which the court presides would be depleted.

Initial Success Enjoining Arbitrations

U.S. District Court Judge Royal Ferguson in Dallas issued a temporary restraining order to enjoin certain imminent arbitration proceedings against Securities America while he evaluated the settling parties’ motion to preliminarily approve the class action settlement. Judge Ferguson ruled as follows:

[T]he Court’s exercise of its authority under the All Writs Act will preserve the funds available to the Settling Defendants for the proposed Settlement Agreement from being depleted by the costs to defend the arbitration and potential arbitration awards until the Court determines whether to grant preliminary approval of the partial class action settlement. . . .

Billitteri, No. 3:09-cv-01568-F (N.D. Tex. Feb. 18, 2011).

Judge Ferguson temporarily enjoined three specific FINRA arbitration hearings that were scheduled to commence within two weeks after the hearing on the temporary injunction and before the date set by the court for a hearing on the motion for preliminary approval of the limited fund class settlement. When the settlement hearing date was postponed by approximately two weeks, the plaintiffs requested and received a second order temporarily restraining the commencement of five additional arbitration hearings that were scheduled to begin before the new settlement hearing date. The court relied on the same rationale used in the first temporary restraining order, that of preventing the limited settlement fund from being depleted before the proposed settlement could be preliminarily evaluated. *See Billitteri*, No. 3:09-cv-01568-F (N.D. Tex. March 7, 2011) (Order Granting Plaintiffs’ Motion for Temporary Restraining Order Extension).

The temporary restraining order and the extension order specifically enjoined only those eight arbitrations that were most imminent. However, the settling parties’ motion for preliminary approval of the settlement with Securities America made clear that they intended for the court’s preliminary approval to include injunctive relief against *all* of the hundreds of parallel arbitration proceedings around the country, which would require those claimants to participate in the limited fund settlement.

For that reason, the hearing for preliminary approval of the settlement was suddenly of great interest to many. For instance, several of the attorneys handling certain of the FINRA arbitrations represented multiple clients and thus had very large investments at risk in the settling parties’ gambit to enjoin those pending arbitration matters. Many of those parties intervened or objected,

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or both, to the proposed limited fund settlement certification and its compulsory participation. Because there was little precedent for extending the limited fund concept to a broker-dealer in particular, both the plaintiffs' bar and the broker-dealer community were intrigued to see whether the case would create a road map for future such actions through which broker-dealers might contain maximum exposure for a large liability while avoiding becoming insolvent or bankrupt in the process.

Determining the "Upper Limit" of the Fund

The purported \$21 million limited fund in *Billitteri* consisted of two primary components. First, Securities America would pay an amount equal to its "net capital" as determined for regulatory purposes. Second, it would contribute a portion of its future earnings, 1 percent of its projected gross revenues for the following three years. Thus, the plan fully intended that Securities America would remain in business. The settling parties described the \$21 million sum as the upper limit of what could reasonably be recovered from Securities America, no matter how many judgments might ultimately be entered against it and no matter how large those judgments might be. Indeed, they claimed it was *more* than could reasonably be recovered in the present, because Securities America was committing part of its *future* revenues, which, by definition, would not be available to creditors if it simply ceased operations and was liquidated.

Among other arguments, the objectors claimed that \$21 million was not, in truth, the limit of what claimants could recover from Securities America but merely a figure agreed to by Securities America and the representative plaintiffs. Like those supporting the mandatory certification, the objectors based their arguments on *Ortiz v. Fibreboard Corp.*, 527 U.S. 815, 144 L. Ed. 2d 715 (1999), in which the Supreme Court addressed when a limited fund could be derived from a going-concern business.

The Court in *Ortiz* identified the paradigm limited-fund case as one presenting a fixed fund for recovery against liquidated claims that, in the aggregate, exceed the fixed fund. Classic examples include claims asserted against a finite bank account or against the fixed proceeds of an insurance policy. *Ortiz*, 527 U.S. at 834. In contrast, when the aggregated claims against a going concern appear certain to exceed the entire value of that going concern (however the value may be defined), there *is* no preexisting, readily ascertainable fixed fund against which the claims can be compared. In such cases, absent the entity filing for bankruptcy or otherwise being liquidated, the question is, how can a court determine whether a recovery fund is truly "limited" and, more important, how can the court determine where that limit lies? In addition, in what manner and to what extent should a court take into account that there may be registered representatives, officers and directors, parent companies, or other control persons who may arguably also be liable to the class and who might be in a position to supplement the "limited" fund?

The obvious danger of approving a Rule 23(b)(1)(B) certification when the fund is not "fixed" on its face (like a surety bond) is that the defendant will understate its ability to satisfy judgments; the class representatives and class counsel will accept the understatement, either in

good faith or to be more immediately compensated; and other injured parties will be forced into the settlement with no opportunity to challenge the undersized fund or separately pursue their claims. Thus, evaluating the limited fund is a critical due process question “because certification of a mandatory settlement class, however provisional technically, effectively concludes the proceeding save for the final fairness hearing.” *Ortiz*, 527 U.S. at 849. The issue arose in *Ortiz* in the context of a mass tort asbestos case, which presented issues of future, unrealized personal injuries not present in a typical securities case, where injuries are economic and can be precisely determined. In all other respects, however, the limited fund analysis from *Ortiz* is applicable to a securities case, and the Supreme Court unquestionably left the door open in *Ortiz* for a firm to seek to force claimants to settle based on its purported maximum ability to satisfy judgments if the settlement proponents can carry their burden.

But the burden is heavy. *Ortiz* held that proponents of a mandatory limited fund settlement in the case of a going concern must prove, inter alia, that the fund available for settlement, as well as the claims against that fund, are “set definitely at their maximums.” *Id.* at 838. To do so, the proponents must present “evidence on which the district court may ascertain the limit and the insufficiency of the fund, with support in findings of fact following a proceeding in which the evidence is subject to challenge.” *Id.* at 849. This showing must prove the settlement is at the “upper limit” of the fund, and the Court suggested an independent valuation may be necessary. *Id.* at 850, 853. Although it may not be clear what *must* be shown to establish a limited fund, it is clear that the settling parties’ own untested assessment of how much the defendant can pay for a global release will *not* suffice. Rather, applicants for certification under Rule 23(b)(1)(B) “must show that the fund is limited by more than the agreement of parties.” *Id.* at 821. A mandatory class was not certified in *Ortiz* for failure to meet these and other requirements.

The Mandatory Securities America Settlement Class Is Not Certified . . .

At an evidentiary hearing in a courtroom in Dallas crowded with objectors, on March 18, 2011, the settling parties failed to show that Securities America’s proposed limited fund of \$21 million was set “definitely at [its] maximum.” At least in some respects, the size of the fund appeared to be limited more by “the agreement of the parties” than by a proven ceiling of Securities America’s ability to pay. The objectors argued that there is no magic to the regulatory concept of “net capital” for purposes of a Rule 23(a)(1)(B) certification. And, while the settling parties may have believed that adding 1 percent of Securities America’s gross revenues for the next three years to the settlement fund made the settlement more attractive, the objectors argued there was no certainty to that formula either. Such a formula begged the question: How was it that 1 percent of gross revenues necessarily defined the “upper limit” of the fund—why not a different percentage, or a different formula entirely, concerning future income?

Ultimately, the court failed to approve the Rule 23(b)(1)(B) limited fund class certification on which the preliminary settlement was based and, accordingly, refused to give preliminary approval to the settlement. As a result, the injunction against the pending arbitration hearings was lifted.

In the end, the Securities America decision will not likely add a further gloss to the issue of a mandatory settlement class. After the proposed settlement was rejected, the dispute proceeded rapidly toward an apparent resolution. Securities America and its parent, Ameriprise Financial, agreed to pay \$80 million to settle the class action and, separately, \$70 million to settle the multiple arbitrations. Apparently, the proposed \$21 million fund was not so limited after all, at least where there was a healthy parent company facing alleged control person liability, and its resources were added to the kitty. Thus, although the high-profile Securities America class action certainly raised awareness of the possibility of extending limited fund mandatory settlements to broker-dealers, the settling parties in that case never quite got there.

. . . But the Mandatory Capital Financial Settlement Class Is Still an Open Question

Notably, however, the same issues have played out almost simultaneously in a separate proposed settlement with Capital Financial in the same courtroom. Capital Financial sold Provident Royalty and Medical Capital securities, just as Securities America did, but on a much smaller scale. A class action was filed against Capital Financial, just as one was filed against Securities America. Likewise, certain investors pursued arbitration claims rather than participate in the class action, though on a smaller scale than in Securities America's case. And when the class representatives reached a settlement with Capital Financial, the settling parties sought a similar, mandatory, non-opt-out limited fund certification.

For all the attention given the outcome of the Securities America case, however, the settling parties in Capital Financial proceeded further down the road to barring parallel arbitration proceedings. Going one significant step further than in the Securities America case, the court granted preliminary approval of the proposed limited fund settlement *and* preliminarily enjoined all arbitration actions against Capital Financial. *See Billitteri*, No. 3:09-cv-01568-F (N.D. Tex. Jan. 25, 2011) (Order Preliminarily Certifying Mandatory Class for Settlement Purposes). A hearing on *final* approval of the class action limited fund settlement, which would include a *permanent* injunction against competing arbitrations, was held in April 2011. Only then did things bog down.

At that hearing, the court expressed several concerns about approving a mandatory limited fund settlement but did not rule it out. The court continued the hearing on final confirmation to give the parties an opportunity to address those concerns, which included some of the same issues vetted in the Securities America proceedings. Those issues included, among others, the parent company's participation in the limited fund, the contribution by and release of individual brokers, and a determination with confidence that the fund is set at its upper limit. Thus, at a minimum, the concept of a mandatory certification remains viable in that case. In the meantime, the injunction against Capital Financial arbitrations remains in place. When the issue is next revisited, however, the parties and the court may have yet another development to take into account, as discussed below. As it happens, this will occur sooner than later, as the court has scheduled a second fairness hearing on the settlement and attorney fees issues for August 10, 2011.

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AT&T Mobility, LLC v. Concepcion

While the limited fund determination may be the most critical and difficult step in fashioning a mandatory certification of class claims against a broker-dealer, another essential step is applying the All Writs Act to enjoin competing arbitrations that would interfere with that settlement. The objectors to the proposed settlements with Securities America and Capital Financial argued that even if a limited fund can be established for a broker-dealer, the All Writs Act cannot be used to frustrate arbitration, which is legislatively favored through the Federal Arbitration Act (FAA).

On April 27, 2011, the U.S. Supreme Court issued its decision in *AT&T Mobility, LLC v. Concepcion*, 131 S. Ct. 1740. The case involved customer agreements that provided for arbitration of disputes with AT&T but specifically barred customers from bringing any proceeding in a class or representative capacity. The Ninth Circuit affirmed a district court ruling that the class action waiver was unconscionable under California law and thus unenforceable.

The Supreme Court reversed, in yet another nod to the FAA. The 5–4 opinion held that the act’s principal purpose is to ensure that private arbitration agreements are enforced according to their terms. *Id.* at 1748. The Court held that invalidating an arbitration provision merely because it contains a class action waiver would interfere with arbitration proceedings and is thus preempted by the FAA. *Id.* at 1753.

Whether *Concepcion* specifically affects the application of the All Writs Act to enjoin arbitration claims, as is possible in the Capital Financial proceedings, remains to be seen. *Concepcion* involved a state common-law rule and public policy that interfered with a federal statute’s mission to promote arbitration. In contrast, employing the All Writs Act to enjoin FINRA arbitrations pits one federal statute against another, which does not present the same federal/state issue of preemption presented in *Concepcion*. Nevertheless, *Concepcion* strongly confirms the favored status of arbitration.

Concepcion may also reflect a hostility on the part of the current Supreme Court majority toward class actions in general. (For example, last year’s decision in *Stolt-Nielsen S.A. v. AnimalFeeds Int’l Corp.*, 130 S. Ct. 1758, 1763, 176 L. Ed. 2d 605 (2010) restricted class action arbitrations.) Thus, even if a limited fund can be proven in the Capital Financial case to satisfy the many demands of *Ortiz*, such a decision would not only impede arbitration but also, in effect, promote securities class actions, and the current tide appears to be against both propositions.

Conclusion

Depending on who is asked, allowing a broker-dealer to settle all claims on a mandatory basis pursuant to a limited fund, the size of which is at least initially determined by litigants, and then to continue in business, is one of three things: (1) the fairest possible result for all involved, (2) a circumvention of bankruptcy rules, or (3) a vast and improper curtailment of arbitration rights. The substantial effort and energy put into litigating this issue in these recent cases illustrate both the difficulty in obtaining, and the enormous impact of, a Rule 23(b)(1)(B) certification. Suffice



it to say that the issue may remain high on the agenda in large broker-dealer litigation pending further consideration and elaboration by the courts.

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Standing in Mortgage-Backed Securities Class Action Litigation

By Lawrence Zweifach, Jennifer H. Rearden, and Darcy C. Harris

Over the past several years, courts have been inundated with securities class actions concerning complex financial products known as “mortgage-backed securities” (MBS). In these cases, courts have been called upon to apply to these uniquely structured securities principles that were developed in litigation involving far less complicated fixed income and equity products. The complex nature of MBS has thus given rise to significant challenges for litigants and novel questions for the courts.

This article discusses the current state of the law concerning standing in MBS class action litigation. As discussed below, this issue in particular has required courts to engage in careful analyses of the intricate architecture of these instruments to resolve motions directed at the standing of a party to serve as the named plaintiff in an MBS class action.

Mortgage-Backed Securities

MBS are created in the first instance when a financial institution purchases a large group of mortgage loans from banks or other lenders, or “originators,” that originally provided the loans. The loans are then securitized by being deposited into a trust and grouped together into several different collections, or pools. *See, e.g., N.J. Carpenters Health Fund v. DLJ Mortg. Capital, Inc.*, No. 08 Civ. 5653 (PAC), 2010 WL 1473288, at *1 (S.D.N.Y. Mar. 29, 2010). These pools are then further divided into tranches, with different investment characteristics and a different risk profile for each tranche. *See, e.g., In re Wells Fargo Mortg.-Backed Certificates Litig.*, 712 F. Supp. 2d 958, 961 (N.D. Cal. 2010). Subsequently, the financial institutions sell interests in the trust tranches in the form of MBS in an offering with documentation that identifies the underlying loans. *See, e.g., In re IndyMac Mortg.-Backed Secs. Litig.*, 718 F. Supp. 2d 495, 499 (S.D.N.Y. 2010). The holders of the MBS are entitled to a portion of the revenue stream generated by the principal and interest payments on the underlying mortgage loans. Each tranche constitutes a separate security, with a separate Committee on Uniform Security Identification Procedures (CUSIP) identifier.

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It is common for several MBS offerings to be made under a single shelf registration statement and base prospectus filed with the Securities and Exchange Commission (SEC). The single registration statement and base prospectus contain general statements and disclosures; additional, specific details are contained in the supplemental prospectus for each offering. Each individual MBS offering is accompanied by a distinct prospectus supplement with details regarding the specific loans underlying that offering. *See, e.g., In re Lehman Bros. Secs. & ERISA Litig.*, 684 F. Supp. 2d 485, 488 (S.D.N.Y. 2010).

Each MBS offering is made by a specific trust and is based on the specific set of loans held by that trust. *See, e.g., N.J. Carpenters Health Fund v. Novastar Mortg., Inc.*, No. 08 Civ. 5310 (DAB), 2011 WL 1338195, at *1 (S.D.N.Y. Mar. 31, 2011). A security certificate in one MBS offering is typically backed by a completely different set of loans than a security certificate in another MBS offering. Similarly, each tranche is based on a specific loan pool, and two tranches of a single offering may be backed by completely different loans in two different loan pools. Loan pools may differ in a number of respects, including the origination channels for the underlying mortgage loans and the types of underlying mortgage loans (e.g., prime jumbo versus sub-prime, residential versus commercial, fixed rate versus adjustable rate versus hybrid adjustable rate versus negative amortization, conforming balance versus nonconforming balance). And a single pool of loans may comprise a mix of loan types and origination channels that is not seen in any other pool.

As a result of these structural differences among tranches, each tranche is distinguished by different investment characteristics and a different risk profile based on, for example, its original principal balance, interest rate, payment right and priority, and credit enhancement rights. *See, e.g., N.J. Carpenters Vacation Fund v. Royal Bank of Scotland Grp., PLC*, 720 F. Supp. 2d 254, 258 (S.D.N.Y. 2010) (noting that MBS “are often divided into groups (‘tranches’) based on the relative riskiness of the underlying loans, the order in which the Certificates are paid out, and their corresponding interest rates”). Each MBS tranche also has a separate credit rating.

MBS Class Action Litigation

Allegations in MBS class actions typically are brought under sections 11 and 12(a)(2) of the Securities Act of 1933. 15 U.S.C. §§ 77k, 77l(a)(2). In general, plaintiffs asserting claims under these provisions have alleged that the MBS offering documents contained untrue statements and material omissions. Because several MBS offerings are made under a single shelf registration statement, class actions often include claims based on every offering covered by a common registration statement, notwithstanding that the named plaintiff purchased MBS only in a subset of those offerings. These claims, however, typically do not allege that the untrue statements and material omissions are in the common shelf registration statement; rather, they allege that the misstatements and omissions are in the individual prospectus supplements accompanying each offering. *See, e.g., In re Morgan Stanley Mortg. Pass-Through Certificates Litig.*, 2010 WL 3239430, at *5 (S.D.N.Y. Aug. 17, 2010); *Pub. Employees’ Ret. Sys. of Miss. v. Goldman Sachs Grp., Inc.*, 2011 WL 135821, at *7 (S.D.N.Y. Jan. 12, 2011).

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Constitutional Standing

To establish constitutional standing under Article III, a plaintiff must demonstrate that it has personally suffered an injury in fact that is fairly traceable to a defendant's alleged misconduct and is likely to be redressed by a decision in the plaintiff's favor. *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560–61 (1992). “That the suit may be a class action . . . adds nothing to the question of standing, for even named plaintiffs who represent a class must allege and show that they personally have been injured, not that injury has been suffered by other, unidentified members of the class to which they belong and which they purport to represent.” *Lewis v. Casey*, 518 U.S. 343, 357 (1996) (internal quotation omitted).

Although the Supreme Court has held that, in certain limited circumstances, a determination on standing can be postponed until after class certification has been decided (e.g., *Ortiz v. Fibreboard Corp.*, 527 U.S. 815 (1999); *Amchem Prods. v. Windsor*, 521 U.S. 591 (1997)), the majority of courts in the MBS context have held that standing is a threshold question, antecedent to class certification. See, e.g., *Pub. Employees' Ret. Sys. of Miss. v. Merrill Lynch & Co., Inc.*, 714 F. Supp. 2d 475, 480–81 (S.D.N.Y. 2010).

It is firmly established that a plaintiff cannot satisfy the injury-in-fact requirement with respect to MBS that it did not purchase. Every court to address standing in the context of multiple MBS offerings has held that plaintiffs lack standing to challenge MBS offerings in which they themselves did not purchase securities. See *Me. State Ret. Sys. v. Countrywide Fin. Corp.*, 722 F. Supp. 2d 1157, 1163–64, n.6 (C.D. Cal. Nov. 4, 2010) (collecting cases). This is because, “[a]s part of their case, Plaintiffs would have to show that the practices of which they complain occurred with respect to the mortgages in which they invested, and thereby caused injury.” *City of Ann Arbor Employees' Ret. Sys. v. Citigroup Mortg. Loan Trust Inc.*, 703 F. Supp. 2d 253, 260 (E.D.N.Y. 2010). But if plaintiffs “did not invest in any such pool of mortgages, they can make no such showing.” *Id.*

As courts have explained, “the harm Plaintiffs may have suffered based on misstatements in the Offering Documents for the Certificates they purchased has no bearing on any harm suffered by other investors based on alleged misstatements in other offering documents with details about other offerings that Plaintiffs did not purchase.” *Royal Bank of Scotland*, 720 F. Supp. 2d at 265. If the plaintiffs did not purchase securities in a given offering, they have not suffered any injury stemming from that offering and thus have no standing with respect to securities issued in that offering.

Indeed, most of the factual allegations in MBS class actions “are unique to each of the offerings: the downgrade in credit ratings, the particular guidelines used by the mortgage originator for that pool of loans, and the default and delinquency rates all differ based on the particular offering.” *Pub. Employees' Ret. Sys. of Miss.*, 2011 WL 135821, at *7. As a district court in the Eastern District of New York explained:

Ultimately, Plaintiffs must be able to prove falsity with respect to statements, or omissions regarding the mortgages in which they purchased interests. Those statements will inevitably require reference to particular pools of mortgages contained in particular securities. If Plaintiffs did not purchase those securities, they lack standing to make any claim of injury flowing from false statements referring to lending practices of particular institutions. In sum, Plaintiffs lack Constitutional standing, because they cannot trace their injuries to Defendants' conduct.

City of Ann Arbor, 703 F. Supp. 2d at 260.

Defendants in MBS cases have argued that just as a plaintiff's allegations are unique to each MBS offering because each offering comprises a separate, distinct group of mortgage loans, the same allegations are also unique to each MBS tranche. Each tranche, the argument goes, can be backed by a separate, distinct pool of loans, with different principal amounts, interest rates, credit ratings, credit risk attributes, types of loan products, monthly payment rights, and credit enhancement rights. Consequently, any alleged misrepresentation regarding the loan pool underlying one tranche could not injure (and would be wholly irrelevant to) an investor who purchased only a tranche backed by a different pool of loans. Thus, defendants argue, without such injury, there can be no constitutional standing under Article III.

The two courts that have directly addressed this issue so far have reasoned that the same principles underlying the denial of standing across offerings also apply to tranche standing: “[Y]ou can only represent the class of persons or entities that purchased . . . the certificate from the particular tranche from the particular trust that you purchased.” *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, No. 08 Civ. 10783 (MGC), at 8 (S.D.N.Y. Sept. 22, 2010) (oral argument on motion to dismiss the third amended complaint) (stating that “it must be the same tranche as yours” and noting that “the effects are very different in different tranches”). A court in the Central District of California likewise held that “Plaintiffs must establish that they have tranche-based standing as to the securities involved here.” *Me. State*, No. 10 Civ. 302 (MRP) (MAN), at 4 (C.D. Cal. May 5, 2011); *see also Mass. Bricklayers & Masons Fund v. Deutsche Alt-A Secs.*, 2010 WL 1370962, at *1 (E.D.N.Y. Apr. 6, 2010) (“The amended pleading . . . shall plead only those causes of action with respect to securities actually purchased by Plaintiffs. With respect to those Trusts, Plaintiffs shall specify in the pleading the tranches in which they invested.”).

Under these courts' analysis, the differences in loan pools collateralizing the different tranches of an offering demonstrate that a plaintiff who has not purchased in a given tranche has not suffered any cognizable injury with respect to that tranche; the alleged injury suffered by a purchaser of one tranche associated with one loan pool is fundamentally different from an alleged injury suffered by a purchaser of another tranche associated with a different loan pool. *See Me. State*, No. 10 Civ. 302, at *13 (C.D. Cal. May 5, 2011) (“The key to the standing issue is the significant differences between the underlying pools of mortgages.”). Accordingly, there can be no

constitutional standing as to tranches in which a plaintiff has not made a purchase. *See NECA-IBEW*, No. 08 Civ. 10783 (MGC), at 8; *Me. State*, No. 10 Civ. 302, at 13–15 (C.D. Cal. May 5, 2011).

Statutory Standing

To bring a claim under section 11 or 12(a)(2) of the 1933 act, a plaintiff must satisfy the separate standing requirements prescribed by that statute. A section 11 claim may be asserted only by “any person acquiring such security.” 15 U.S.C. § 77k(a). Similarly, a section 12(a)(2) claim may be asserted only by “the person purchasing such security.” *Id.* § 77l(a). In the context of MBS class action litigation, “[f]ederal courts have consistently dismissed ’33 Act claims related to offerings in which the plaintiffs did not actually make the purchase at issue for lack of statutory standing.” *Me. State*, 722 F. Supp. 2d at 1163, n.7 (citing cases).

Given that courts have consistently held that each MBS offering under consideration should be deemed a separate security, defendants have argued that the standing requirements under the 1933 act likewise apply to all tranches within an MBS offering. Thus, defendants have further argued that plaintiffs must establish that they actually purchased in each MBS tranche at issue to establish standing under the 1933 act. In its recent decision on this issue, the *Maine State* court confirmed this reasoning, stating, “the plain text of the Securities Act dictates that Plaintiffs must have acquired or purchased the security on which they sue[,] and] [i]t is undisputed that each [tranche] is a separate security.”

Conclusion

The unique structure of MBS has been the principal rationale for courts’ decisions on the issue of standing in MBS cases. As the financial services industry continues to create new and highly complex products through financial engineering, the courts will continue to be called upon to apply well-established principles to novel factual contexts in securities class action cases.

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Keywords: securities litigation, mbs, article iii, cusip, standing

Lessons from the Galleon Prosecution

By Mark S. Cohen, Jonathan S. Abernethy, and Elizabeth F. Bernhardt

The ground-breaking Galleon prosecution offers a number of lessons for white-collar practitioners. This first-ever use of wiretaps in an insider trading investigation is a game changer for prosecutors and the criminal defense bar. For Raj Rajaratnam, the 45 intercepted calls played for the jury were difficult proof to overcome, and in many ways, the government’s biggest win

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came at the pretrial stage, when the judge denied his motion to suppress. That motion and the judge's ruling are important and bear careful consideration by white-collar defense lawyers.

In addition, Rajaratnam's trial strategy is worthy of study. Conceding the facial importance of the government's wiretap evidence, the defense argued that Rajaratnam nonetheless had an innocent state of mind, in that the information he received was not material or nonpublic, and he based all of his trades on a "mosaic" of information. This approach enabled the defense to present a wealth of positive background information about Rajaratnam and his business.

Wiretapping in Insider Trading Cases Is Here to Stay

Notwithstanding the result in his case, white-collar practitioners in future insider trading cases should consider following Rajaratnam's lead in moving to suppress wiretaps. Rajaratnam and his codefendant Danielle Chiesi raised a number of forceful arguments in this regard, the first of which was that wiretaps are not permitted in insider trading investigations. Judge Richard J. Holwell rejected this argument.

The defense argued that because insider trading is not a predicate offense under Title III, the government's use of the wiretaps was improper. But the judge held that the government could use this evidence because it fell under a provision of Title III allowing the use of intercepted calls relating to crimes "other than those specified" in the order authorizing the wiretap. *See* 18 U.S.C. § 2715(5). As Judge Holwell stated, the test is whether the government lawfully and in good faith applied for the original wiretap to investigate enumerated Title III crimes, and "not as a subterfuge for gathering evidence of other offenses," and whether the communications relating to those "other offenses" were "incidentally intercepted." Because the prosecution in the Galleon case had not engaged in subterfuge but had candidly indicated it was investigating insider trading and because it also indicated that its investigation would uncover evidence of wire fraud and money laundering (both of which are predicate Title III offenses), the judge found that the use of wiretapped calls relating to insider trading was permissible. *United States v. Rajaratnam*, No. 09 Cr. 1184 (RJH), 2010 WL 4867402, at *3–4 (Nov. 24, 2010).

Significantly, the district court found that it did not matter that the government's main objective was to investigate securities fraud, holding that "when the government investigates insider trading for the bona fide purpose of prosecuting wire fraud, it can thereby collect evidence of securities fraud, despite the fact that securities fraud itself is not a Title III predicate offense." *Id.* at *6. Judge Holwell cited several cases from the Second and First Circuits that had allowed the use of wiretapped calls for non-Title III enumerated offenses when those calls were incidentally intercepted. *See In Re Grand Jury Subpoena Served on John Doe*, 889 F.3d 384, 387–88 (2d Cir. 1989); *United States v. Masciarelli*, 558 F.2d 1064, 1068–69 (2d Cir. 1977); *United States v. Marion*, 535 F.2d 697, 700–701 (2d Cir. 1976); *United States v. McKinnon*, 721 F.2d 19, 22–23 (1st Cir. 1983).

Insider trading almost always involves the use of interstate wires (typically the telephone), as the district court acknowledged. For that reason, the district court's ruling appears to invite an end run around Title III. Based on the court's rationale, all the government need do in future insider trading investigations is claim to be investigating wire fraud (an enumerated Title III offense), even if it really is only focused on and ultimately only charges insider trading (a *non*-Title III offense)—as it did in Rajaratnam's case. The district court's reasoning may also be questioned on a more basic level: How can interceptions revealing evidence of insider trading be deemed "incidental" when insider trading is, in fact, the *focus* of the investigation? These questions will likely be at issue in Rajaratnam's appeal.

These issues are, of course, not limited to the Rajaratnam case. Emboldened by its success in the Galleon prosecution, the government is sure to bring many more insider trading cases using wiretaps, and other courts will have to decide whether similar interceptions are "incidental," and therefore proper, or whether they constitute an impermissible end run around the wiretapping statute. At least until further clarity is gained through the appeal of the Rajaratnam case and issuance of other court rulings, wiretapping in insider trading cases appears to be here to stay. Thus, defense lawyers would do well to consider a multi-pronged strategy, including following Rajaratnam's lead in attempting to exclude the wiretaps at the pretrial stage, while also preparing to defend against them at trial.

The Government May Be Vulnerable to Necessity Challenges to Wiretaps

There is at least one other pretrial challenge that white-collar practitioners should consider in future wiretap cases, drawing on the experience of the Galleon case. Rajaratnam moved to suppress on the grounds that, in its wiretap affidavit, the government had not provided "a full and complete statement as to whether or not other investigative procedures have been tried and failed or why they reasonably appear to be unlikely to succeed if tried." 18 U.S.C. § 2518(1)(c). This statutory requirement forms a fundamental tenet of Title III—that a phone may only be tapped out of necessity—and limits the use of this highly intrusive tactic to situations where traditional law enforcement techniques are insufficient to expose fully the criminal conduct at issue. Although the government need not "exhaust all conceivable investigative techniques before resorting to electronic surveillance," in its wiretap affidavit it "must provide some basis for concluding that less intrusive investigative procedures are not feasible." *Rajaratnam*, 2010 WL 4867402, at *14.

On this point, Judge Holwell took the government to task for recklessly failing to disclose in its wiretap application the numerous investigative procedures already employed—including the fact that the SEC had been investigating Rajaratnam for years, had collected over four million subpoenaed documents, and had interviewed and/or taken depositions of numerous Galleon employees, including Rajaratnam himself. The judge held a four-day hearing under *Franks v. Delaware*, 438 U.S. 154 (1978), which allows defendants challenging a wiretap to obtain an evidentiary hearing if they make "a substantial preliminary showing that the government recklessly or knowingly made a misleading statement or omission" in a wiretap affidavit. *United*

States v. Rajaratnam, No. 09 Cr. 1184 (RJH), 2010 WL 3219333, at *1 (Aug. 12, 2010). The *Franks* hearing established that the government had made a “glaring omission” in failing to disclose its use of these more traditional techniques, thereby depriving the judge who had approved the first wiretap application “of the opportunity to assess what a conventional investigation of Rajaratnam could achieve by examining what the SEC’s contemporaneous, conventional investigation of the same conduct was, in fact, achieving.” In the end, however, Judge Holwell concluded that when the government’s misstatements and omissions were corrected, the wiretap affidavit still established that it was necessary to tap Rajaratnam’s phone to reveal the full nature of the insider trading conspiracy. *Rajaratnam*, 2010 WL 4867402, at *15, 17, 21–24.

There are at least a few valuable takeaways from this ruling for white-collar practitioners. First, when presented with a motion challenging the necessity of a wiretap, judges are likely to look critically at the wiretap affidavit and may not tolerate the use of mere boilerplate language often found in such affidavits to the effect that “alternative investigative techniques have been tried or appear unlikely to succeed if tried.” *Id.* at *17. Second, recognizing that judges will closely scrutinize the necessity portion of an affidavit, the government is likely to provide more detail to try to avoid the type of lengthy *Franks* hearing that occurred in the Galleon case. Third, based on the court’s response to Rajaratnam’s necessity motion, in the future, the government should provide more discovery materials to defendants in insider trading cases involving wiretaps. Defendants must have a detailed accounting of all of the conventional investigative techniques that prosecutors and the SEC have used so that they can determine whether to move to suppress wiretaps on necessity grounds. And when the government is unwilling to give such expansive discovery, defense lawyers should move to compel it.

In light of the above, the government may indeed be vulnerable to necessity challenges in future insider trading cases. As Judge Holwell observed, “conventional [investigative] techniques have at least proven adequate” in prior insider trading investigations spanning decades. *Id.* at *22. Given the many ways insider trading has been investigated effectively in the past *without* the use of wiretaps, it is appropriate to speculate why this additional tool is now *necessary* for the government. Prosecutors cannot merely assert that wiretaps are helpful to investigate this crime, which often occurs over the phone. They must show more to justify the highly intrusive use of wiretaps. Regardless, however, of whether a necessity challenge ultimately results in suppression of a wiretap, at a minimum, defense lawyers should use the prospect of litigation over this issue to extract more complete pretrial disclosures about the full range of investigative techniques used by the government in insider trading investigations.

Rajaratnam’s Trial Strategy

At trial, the defense team did not dispute Rajaratnam’s receipt of some confidential information, nor deny his trading in the affected companies. However, the defense did dispute whether the confidential information Rajaratnam received was truly “material” and “non-public” and whether

he relied on this information to make specific trades. Thus, the defense made an issue of Rajaratnam's state of mind and intent when he traded.

As a direct result, a great deal of background evidence was admitted. For instance, the defense was able to introduce evidence that Galleon was staffed by teams of qualified, aggressive professionals, who traveled, interviewed executives, analyzed data, and conducted intensive research on companies in various sectors of the global economy—research that Rajaratnam scrutinized. The defense also presented evidence that Galleon kept careful records of all of its transactions, including trading, and that it had transparent procedures. The jury learned that Rajaratnam himself was disciplined, energetic, and decisive; that he was devoted to the interests of his investors; and that he consulted numerous sources of information before making trading decisions. In short, the jury learned that Galleon was a well-run, legitimate business. An expert defense witness testified that given the “mosaic” of publicly available information, a reasonable investor could have made the identical trading decisions that Rajaratnam made, all based on public sources.

Such evidence—sometimes called “reverse 404(b)” evidence—is usually excluded as irrelevant, collateral, or even forbidden “propensity” evidence. *See* Fed. R. Evid. 404(b) (“Evidence of other . . . acts is not admissible in order to . . . show action in conformity therewith”). But the strategy of placing a defendant's intent and state of mind (rather than his or her actions) at issue allows defense counsel to put this evidence before the jury and expand the context in which ostensibly inculpatory evidence is viewed. Rajaratnam's defense team did this repeatedly, reiterating in summation that the jury should consider “the complete picture of what happened and not the tiny sliver that the government” presented, “because the government's narrow view is very unfair.” Transcript of Record at 5320:22–23; 5321: 2–3, *United States v. Rajaratnam*, No. 09 Cr. 1184 (RJH).

This approach makes for a logical strategy when the government has evidence of specific, apparently illegal acts, and the authenticity of the evidence cannot easily be challenged. In such cases then, it is possible for a defendant to admit the *actus reus* but still assert that his intent was innocent. If a defendant admits his actions, intent may be the only thing at issue at the trial.

Several federal circuit courts have approved the introduction of relevant background evidence, including “good acts,” in such situations. For instance, in the seminal case *United States v. Shavin*, 287 F.2d 647, 653–54 (7th Cir. 1961), the Seventh Circuit held that contemporaneous honest transactions “shed light upon” the defendant's “intent and purpose” and could be used to show “lack of criminal intent.” *See also United States v. Garvin*, 565 F.2d 519 (8th Cir. 1977) (finding reversible error in the exclusion of defendant's truthful statements where he asserted a good-faith defense); *United States v. Hayes*, 219 F. App'x 114, 117, 2007 WL 708984 (3d Cir. Mar. 8, 2007) (reversing a conviction because the trial judge erroneously excluded evidence of defendant's “good acts,” such as his policies and directives to subordinates, when this evidence was relevant to whether defendant was a conspirator); *United States v. Sheffield*, 992 F.2d 1164



(11th Cir. 1993) (holding evidence of defendant’s custom and practice was admissible to disprove his intent to embezzle); *United States v. Thomas*, 32 F.3d 418 (9th Cir. 1994) (reversing conviction because testimony from the satisfied customers, who were not cited in the indictment, was excluded from trial, and only the dissatisfied customers were permitted to testify); *United States v. Quattrone*, 441 F.3d 153, 188 (2d Cir. 2006) (holding that defendant could introduce “evidence of events” during the two-year period between the underlying events and his statement to the government, because events over these two years had “a tendency to make more or less probable the fact that [he] was simply mistaken when he spoke”).

The Galleon defense team should be credited with contextualizing Rajaratnam’s actions and showing the jury a more rounded picture, including good behavior at odds with criminality.

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NEWS & DEVELOPMENTS

The Supreme Court Curtails Rule 10b-5's Reach

In *Janus Capital Group, Inc. v. First Derivative Traders*, issued June 13, 2011, the Supreme Court held that a person makes a statement within the meaning of section 10(b) and Rule 10b-5 only if the person has “ultimate authority over the statement.” A person who lacks ultimate authority—even a person “significantly involved” in preparing a statement or who publishes a statement on behalf of another—does not make the statement. The decision confirms that no private right of action exists under Rule 10b-5 against secondary actors (advisors, auditors, bankers, lawyers) who only help to draft or disseminate a statement made by another.

The plaintiffs alleged that Janus Capital Management, an advisor to Janus mutual funds, violated Rule 10b-5 by causing the funds to issue prospectuses containing misstatements. The district court dismissed. But the Fourth Circuit reversed, holding that Janus Capital Management made the alleged misstatements “by participating in the writing and dissemination of the prospectuses.”

Reversing, the Supreme Court held that “the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not ‘make’ a statement in its own right.” Drawing a “clean line” between those who are potentially liable under Rule 10b-5

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and those who are not, the Court held that a person who “creates” or “prepares or publishes a statement on behalf of another” does not “make” the statement.

The “ultimate authority” rule follows from *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), where the Court held that no private right of action exists against those who aid and abet a violation of section 10(b). *Central Bank’s* holding would be “substantially undermine[d]” if a person without ultimate authority could be liable for a statement. If those persons were “primary violators . . . then aiders and abettors would be almost nonexistent.”

Janus Capital Management lacked ultimate authority over the statements in the prospectuses because it was legally separate and independent from the funds it advised. The funds, not Janus Capital Management, were legally obligated to, and did, issue the prospectuses. Further, the prospectuses did not attribute to Janus Capital Management any alleged misstatement. Therefore, Janus Capital Management did not make the alleged misstatements for Rule 10b-5 purposes.

Following *Central Bank* and *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) (holding that no private right of action exists against a person whose undisclosed, deceptive acts facilitated another’s fraud), *Janus* affirms the Court’s commitment to construing narrowly the implied private right of action under Rule 10b-5.

The decision was written by Justice Thomas for a five-justice majority.

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Supreme Court: “Loss Causation” Not Required at Class Certification

A unanimous U.S. Supreme Court has held that plaintiffs do not have to prove loss causation to obtain class certification in federal securities-fraud cases. The decision, [Erica P. John Fund, Inc. v. Halliburton Co.](#), issued June 6, 2010, overturns a unique Fifth Circuit rule requiring plaintiffs to prove loss causation at the class-certification stage to invoke the rebuttable presumption of reliance that the Supreme Court adopted in *Basic v. Levinson*, 485 U.S. 224 (1988). The decision does not address and, therefore, leaves intact, a defendant’s ability to rebut *Basic’s* presumption of reliance by showing that a misrepresentation did not inflate the share price at the time of the relevant transaction.

In *Basic*, the Supreme Court held that because “the market price of shares traded on well-developed markets reflects all publicly available information,” plaintiffs may raise a rebuttable presumption that they relied on a misrepresentation when they bought or sold shares at the price



set by the market. To invoke the rebuttable presumption, plaintiffs must show that the market for the shares was efficient. Before *Halliburton*, the Fifth Circuit also required plaintiffs who sought to invoke the presumption to prove loss causation at the class-certification stage. *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007).

In *Halliburton*, plaintiffs tried to invoke the presumption of reliance not by showing that the fraud inflated Halliburton's share price, but by showing that the share price corrected because the fraud was revealed. The court declined to certify a class. Applying *Oscar*, the court held that plaintiffs could not invoke *Basic*'s presumption of reliance because they failed to prove loss causation. The Fifth Circuit affirmed.

Vacating the Fifth Circuit's ruling, the Supreme Court held that reliance and loss causation are distinct elements, and the facts necessary to establish loss causation have "no logical connection to the facts necessary to establish" the rebuttable presumption of reliance. Reliance focuses on "facts surrounding the investor's decision to engage in a transaction," whereas loss causation "requires a plaintiff to show that a misrepresentation that affected the integrity of the market price *also* caused a subsequent economic loss." Defendants might show that facts other than the revelation of the fraud caused economic loss, thereby undercutting loss causation. But those facts have "nothing to do with whether an investor relied on the misrepresentation in the first place."

By conflating reliance and loss causation at the class-certification stage, the Fifth Circuit imposed a condition on class certification that was inconsistent with *Basic*. The Court declined to address other aspects of *Basic*, its presumption, or when and how defendants may rebut the presumption. These issues remain for further development by the lower courts.

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