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ARTICLES

The Broad Implications of *Blackstone* in Securities Fraud Litigation

By Vincent Paul Schmeltz III

On February 10, 2011, the U.S. Court of Appeals for the Second Circuit handed down a decision that promises to shape the debate in securities fraud litigation for the next several years. In the case, *Litwin v. Blackstone Group, L.P.*, 634 F.3d 706 (2d Cir. 2011), the plaintiffs alleged that the Blackstone Group had violated sections 11 and 12(a)(2) of the Securities Act of 1933 by failing to disclose the anticipated future impact of certain known trends on portions of its business. The plaintiffs alleged, among other things, that Blackstone had an affirmative duty to disclose the purportedly material impact of certain business trends under Item 303 of Regulation S-K. 17 C.F.R. § 229.303(a)(1)–(3) (2011). The district court dismissed the plaintiffs' complaint largely because the undisclosed trends would not have had a material impact on Blackstone's overall financial condition. *Blackstone*, 634 F.3d at 713–15.

The Second Circuit reversed, holding that Item 303 creates an affirmative duty to disclose management's analysis of the future impact of known trends on its business when it is reasonable to believe such an impact may be material. *Id.* at 716. The court went on to hold that it was "reasonable" to believe that such trends would have a material impact on Blackstone's future financial results. *See, e.g., id.* at 719 (concurring with plaintiffs' allegation that the material information Blackstone was required to disclose was "the manner in which those then-known trends, events, or uncertainties might reasonably be expected to materially impact Blackstone's future revenues"). As a result, the Second Circuit reinstated the plaintiffs' complaint, and the case is slowly moving through discovery. On September 7, 2011, the trial court agreed to postpone an initial conference regarding electronic discovery until "after the Supreme Court acts on [Blackstone's] [petition](#)" for a writ of certiorari (Case No. 1:08-cv-03601-HB, Docket No. 55). On October 3, 2011, the United States Supreme Court denied Blackstone's petition for a writ of certiorari. *See, e.g.,* Pete Brush, [High Court Turns aside Blackstone Cert Bid in IPO Case](#), *Law360*, Oct. 3, 2011.

Ordinarily, companies have no general obligation to "disclose [their] expectations for the future to the investing public." *See Kowal v. MCI Commc'ns Corp.*, 16 F.3d 1271, 1277 (D.C. Cir. 1994) (citing Regulation S-K, Item 303, Instr. 7, 17 C.F.R. § 229.303 (1993)). *Blackstone* confirms that Item 303 creates a duty to disclose certain forward-looking information and, under sections 11 and 12(a)(2) of the Securities Act, makes that duty actionable by private claimants. This holding alone is significant because it exacerbates a circuit split over the question of whether Item 303 creates a duty to disclose that is actionable by private claimants. As noted by the court in *In re Thornburg Mortgage, Inc. Securities Litigation*, No. CIV 07-0815 JS/WDS,

2011 WL 2429189, *28 (D.N.M. June 2, 2011), “some courts have held that a registrant’s violation of Item 303 of Regulation S–K can give rise to liability under the federal securities laws” (collecting cases). Of the cases on the other side of the issue, which refuse to impose a per se duty to disclose based on Item 303, the most notable is *Oren v. Stafford*, 226 F.3d 275, 287–88 (3d Cir. 2000), written by now Justice Samuel Alito.

But *Blackstone* also is significant insofar as it seems to set a standard for materiality that is lower than the standard set by the U.S. Supreme Court in *Basic v. Levinson, Inc.*, 485 U.S. 224 (1988), and lower than guidance issued by the Securities and Exchange Commission (SEC). SEC Interpretation: Management’s Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Release Nos. 33-6835; 34-26831; IC-16961; FR-36 (May 18, 1989). Indeed, after concluding that Item 303 created a duty to disclose, the Second Circuit held that “all Item 303 requires in order to trigger a disclosure obligation [is] a known trend that Blackstone reasonably expected would materially affect its investments and revenues.” *Blackstone*, 634 F.3d at 721. Although this arguably sets the standard for when a registrant must disclose a known trend, the Second Circuit also applied this “reasonabl[e] expect[ation]” standard to determine whether information was material. *Id.* at 719.

Whether a trend may reasonably be expected to have a material impact, however, is not the standard for actionable materiality set forth by the Supreme Court in *Basic v. Levinson, Inc.*, 485 U.S. 224, 238–39 (1988) (setting out the probability/magnitude test for determining when disclosure of uncertain future events may be necessary). *Basic* provides that, to determine whether a future event should be disclosed, a registrant must balance the probability that the event will occur against the anticipated magnitude of the event. *Id.* On the other hand, under *Blackstone*, a private litigant can sue based on omitted information when it is simply reasonable to conclude that the event might occur and might have a material impact on the registrant.

Finally, *Blackstone* held that the materiality of the impact an event may have on a company can be judged based on a single segment, rather than the entire financial position, of the company. *Blackstone*, 634 F.3d at 719–20. Yet, this holding seems to be at odds with SEC interpretive releases that provide guidance as to what must be disclosed under Item 303. Under such guidance, the impact of a trend to a particular segment need only be reported when that impact is material to the condition of the firm as a whole—not merely to that segment. *See, e.g.*, SEC Interpretation, *supra*. In short, *Blackstone* seems to lower the bar by allowing plaintiffs to plead the materiality of a known trend without having to plead facts suggesting how the known trend had an impact on anything more than one segment of the reporting company.

Blackstone’s Facts and Holding

The Blackstone Group, L.P., became a public company through an initial public offering (IPO) on June 21, 2007. *Blackstone*, 634 F.3d at 709–10. With \$88.4 billion in assets managed in four business segments, Blackstone had two of the largest funds ever raised in both the real estate sector (\$20 billion) and the private equity sector (\$33.1 billion). In its offering documents,



Blackstone represented to its investors that its status as a private equity leader “imbued the Blackstone brand with value that enhances all of [its] different businesses and facilitates [its] ability to expand into complementary new businesses.”

As an asset manager, Blackstone generated revenue in the form of a management fee based on total assets under management and performance fees based on the profits generated from invested capital. Blackstone’s fee agreements provided that it could have to give back performance fees if its investments did not perform as expected. Even though these fees were its primary sources of revenue, the plaintiffs alleged that, at the time of its IPO, Blackstone insiders knew, but failed to disclose, that “two of Blackstone’s portfolio companies as well as its real estate fund investments were experiencing problems” that could affect its fees. *Id.* at 710.

The first of the two portfolio companies was a monoline financial guarantor involved in writing credit default swaps (CDSs) for collateralized debt obligations (CDOs) and residential mortgage-backed securities (RMBS), which have since become known as the “weapons of mass destruction” that fractured AIG and ended Lehman Brothers. *Id.*; see also Jerome A. Madden, [*A Weapon of Mass Destruction Strikes: Credit Default Swaps Bring Down AIG and Lehman Brothers*](#), *Bus. L. Brief*, Fall 2008. Blackstone’s stake in this company was \$331 million, representing 0.4 percent of its total \$88.4 billion under management and 1 percent of the \$33.1 billion in its private equity business segment. *Blackstone*, 634 F.3d at 711. In 2007, prior to Blackstone’s IPO, it was clear that CDOs and RMBSs based on subprime mortgages were facing large losses, which would result in losses for the issuers of CDSs. *Id.* at 710–11. Accordingly, plaintiffs alleged, Blackstone should have disclosed that these market trends could have a material impact on its investment in the monoline financial guarantor—an investment that Blackstone later had to write down by \$122 million.

The second of the two portfolio companies was a semiconductor company that manufactured, among other things, the 3G wireless chips for Motorola phones. Blackstone allegedly had a \$3.1 billion investment in this company, or 3.5 percent of Blackstone’s total assets under management and 9.7 percent of the assets in its private equity segment. Prior to the IPO, this portfolio company announced that Motorola, which was its largest customer, had begun to reduce its orders. Plaintiffs alleged that this “trend” was known, would have a material impact on Blackstone’s investment, and, as a result, should have been disclosed in the registration statement for Blackstone’s IPO.

Finally, Blackstone’s real estate segment, which “constitute[d] 22.6% of its total assets under management,” allegedly had significant exposure to the residential real estate market. Due to the deterioration in the residential real estate market, plaintiffs alleged that “it was foreseeable that Blackstone would have performance fees clawed back.” Accordingly, plaintiffs alleged, Blackstone had an affirmative obligation to disclose the impact of this known trend on its real estate investments.

Analyzing the facts as alleged about the two portfolio companies, the district court held, among other things, that the omitted information was quantitatively immaterial, as the impact of each portfolio company on Blackstone's overall business was less than 5 percent and, with respect to the real estate portfolio, that "[t]he omission of generally known macro-economic conditions [i.e., the deterioration of the residential real estate market] is not material because such matters are already part of the 'total mix' of information available to investors." The Second Circuit disagreed.

Concluding that the "primary issue before [the court was] whether Blackstone's Registration Statement and Prospectus omitted material information that Blackstone was legally required to disclose," the court analyzed the extent to which Item 303 of SEC Regulation S-K, 17 C.F.R. § 229.303(a)(3)(ii), required Blackstone to make the disclosures the plaintiffs alleged were necessary. The court then concluded, without reference to any case law, that plaintiffs had adequately alleged "a presently existing trend, event, or uncertainty" and that the "sole remaining issue [was] whether the effect of the 'known' information was 'reasonably likely' to be material for the purpose of Item 303 and, in turn, for the purpose of Sections 11 and 12(a)(2)."

Accordingly, the court then analyzed the question of whether the various omissions were material. Initially, the court set out the legal standard for materiality, focusing primarily on rebutting the district court's use of a quantitative analysis and a 5 percent threshold. Then, with respect to the two portfolio companies, the court analyzed "whether, and to what extent, the particular known trend, event or uncertainty might have been reasonably expected to materially affect Blackstone's investments." To this end, the court concluded that, because the information was "require[d]" to be disclosed by Item 303 and was "material in the eyes of a reasonable investor," it must be disclosed. The court then held that the district court erred by analyzing the materiality of each portfolio company investment to Blackstone's overall financial results—concluding instead that information that could be materially adverse to an important business segment would merit disclosure under Item 303 of Regulation S-K.

Item 303 Creates a Duty to Disclose—or Does It?

Ever since the Supreme Court announced that, "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak," *Chiarella v. United States*, 445 U.S. 222, 230 (1980), the plaintiffs' class action securities bar has sought to build a compelling case for the actionable omission—to impose a duty to speak on those who have not spoken. In addition, a registrant has no duty to make financial projections, and forward-looking statements about future events are largely optional, making it even more difficult for a plaintiff to succeed in imposing a duty to speak on a company that has not spoken. *See, e.g., In re Lyondell Petrochemical Co. Secs. Litig.*, 984 F.2d 1050, 1052–53 (9th Cir. 1993) (recognizing that the SEC does not require that a company disclose financial projections). Enterprising plaintiffs' counsel have argued, with mixed success, that Item 303 of Regulation S-K, which requires disclosure of known trends that are reasonably likely to have a material impact on a registrant's financial statements, represents the promise of just such a duty. *In re Barclays Bank PLC Secs.*



Litig., No. 09 Civ. 1989 (PAC), 2011 WL 2150477, at *2 (S.D.N.Y. May 31, 2011). *Blackstone* appears to vindicate them.

But did *Blackstone* really reinvigorate a regulation that gives rise to duty of disclosure for private litigants? Perhaps, but a principled argument remains that, absent factual allegations suggesting that it was *probable* that the known trend would have a *significant* impact on a registrant, the failure to disclose the impact of the known trend does not give rise to a private right of action under section 10(b) of the Securities Exchange Act or sections 11 and 12(a)(2) of the Securities Act.

To begin with, one could argue that Item 303 does not give rise to an actionable “duty to disclose” for purposes of a private right of action. As noted above, a registrant does not typically have a duty to make forward-looking statements. *Kowal v. MCI Commc’ns Corp.*, 16 F.3d 1271, 1277 (D.C. Cir. 1994). Item 303 creates an exception to the general rule when it is “reasonable” for a registrant to conclude that a known trend could have a material impact on its financial statements. Yet, as the following discussion makes plain, this is a lower standard for disclosure than that imposed by case law on private causes of action under section 10(b) of the Securities Exchange Act or sections 11 and 12(a)(2) of the Securities Act. Accordingly, it is arguable that Item 303 cannot give rise to a per se duty to disclose for purposes of those private causes of action.

Item 303 of Regulation S-K requires a registrant’s management to describe “known trends or uncertainties” that it “reasonably expects will have a material . . . impact” on the registrant’s financial statements. 17 C.F.R. § 229.303(a)(1)–(3) (2011). According to Instruction 3 to Regulation S-K, the Item 303 requirement that a party disclose prospective information is focused on “material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.” *Id.*

The SEC has offered guidance as to what events and uncertainties need to be disclosed. According to the SEC, disclosure of any known “trend, demand, commitment, event or uncertainty is required *unless* a company is able to conclude either that it is not reasonably likely that the trend, uncertainty or other event will occur or come to fruition, or that a material effect on the company’s liquidity, capital resources or results of operations is not reasonably likely to occur.” Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations, Release Nos. 8350, 48960, 33-8350 & 34-48960, 81 SEC Docket 2905, 2003 WL 22996757, at *11 (Dec. 19, 2003) (emphasis added). In other words, if management cannot determine that it is “not reasonably likely” that a trend will somehow affect it, “it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, *on the assumption that it will come to fruition.*” Commission Statement about Management’s Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8056 (Jan. 22, 2002) (emphasis added).

In short, Item 303 requires a registrant to disclose a known trend unless it can *rule out* the “reasonable” likelihood that the trend will occur at all or will have a material impact on it. “This disclosure threshold is lower than ‘more likely than not.’” *Id.* at *4. It also is lower than the “probability/magnitude test for materiality approved by the Supreme Court in *Basic v. Levinson*.” SEC Interpretation, *supra*; see also *SEC v. Conaway*, 698 F. Supp. 2d 771, 821 (E.D. Mich. 2010) (describing the *Basic v. Levinson* standard of materiality as “more stringent” than that found in Item 303). Indeed, under *Basic*, materiality “will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.” 485 U.S. 224, 238–39 (1988).

In *Basic*, the Supreme Court used this balancing test to determine when a merger discussion would need to be disclosed. Beyond peradventure, it is not unreasonable to presume the merger could happen once merger discussions begin. And, although this would constitute a known trend that could have to be disclosed under Item 303, there would be no similar duty under the *Basic* balancing test. In fact, under the balancing test set out by the Supreme Court, for forward-looking information to be deemed material, it would have to be more probable than “reasonable” that the future event would occur.

For this reason, it was arguably erroneous for *Blackstone* to have concluded, without analysis of whether information would have to be disclosed under *Basic v. Levinson*, that Item 303 gives rise to an actionable disclosure obligation. In fact, in *Oren v. Stafford*, the Third Circuit held that Item 303 does not per se impose a duty to disclose for purposes of a private securities fraud claim. 226 F.3d 275, 287–88 (3d Cir. 2000) (Alito, J.) (collecting cases). In reaching this conclusion, the court was persuaded by the following analysis: “Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5. Such a duty to disclose must be separately shown.” *Id.* The Ninth Circuit, on the other hand, sides with *Blackstone*, at least in cases under sections 11 and 12(a)(2). *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1296 (9th Cir. 1998).

Ultimately, as long as *Basic* remains good law (and the Supreme Court’s recent decision regarding materiality in *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011) did not disturb *Basic*’s holding), a registrant should be able to make a principled argument that, unless a plaintiff has pleaded factors demonstrating a *probability* that an event will actually have an impact on that registrant, Item 303 alone cannot make an omission actionable.

Does *Blackstone* Simplify Pleading Materiality?

Even if one assumes, as the *Blackstone* court did, that Item 303 imposes a duty to disclose information, that still does not mean that such a duty gives rise to a private right of action under section 10(b), section 11, or section 12(a)(2). Indeed, the doctrinally correct approach to analyzing this issue may be to concede that Item 303 can impose a *duty* to disclose and then to

go on to analyze whether the omitted information is material for purposes of a private securities fraud claim under the probability/magnitude test in *Basic*. See, e.g., Donald C. Langevoort & G. Mitu Gilati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 Vand. L. Rev. 1639, 1644 & 1647–54 (2004). That is not the approach taken by *Blackstone*.

To begin with, in several instances, the *Blackstone* court appears to have concluded that, because the information should have been disclosed under Item 303, it was material. See, e.g., 634 F.3d at 720. But, as noted above, establishing that it is not *unreasonable* to presume an event will have an impact on a business is not the same as establishing some *probability* that it will have an impact on a business. And, under *Basic*, a plaintiff ought to have to plead facts suggesting that it is probable that a trend will have an impact on a business before the trend and its impact can be said to be material. See *In re Verifone Secs. Litig.*, 11 F.3d 865 (9th Cir. 1993) (holding that Item 303 could not “be imported as a surrogate for straight materiality analysis under [section] 10(b) and Rule 10b-5”).

Next, *Blackstone* concluded that, because information was potentially material to one segment, it was sufficiently material to merit disclosure under section 11 and section 12(a)(2). However, as the SEC’s interpretation of Item 303 makes plain, segment reporting is only appropriate when the impact on the segment would have a material impact on—or help a party gain a greater understanding of—the business as a whole:

Companies also should focus on an analysis of the consolidated financial condition and operating performance, with segment data provided where material to an understanding of consolidated information. Segment discussion and analysis should be designed to avoid unnecessary duplication and immaterial detail that is not required and does not promote understanding of a company’s *overall financial condition* and operating performance.

81 SEC Docket 2905, 2003 WL 22996757, at *9 (Dec. 19, 2003) (emphasis added).

Ultimately, *Blackstone*’s revenue was based on the fees it generated from managing assets. None of the alleged omissions had an impact on *Blackstone*’s ability to generate fees—or even meaningfully moved the needle as to how much it would generate in fees. As a result, the omitted information (the impact of the credit market on residential real estate holdings or one portfolio company’s loss of a major client) did not reveal *anything* about *Blackstone*’s overall financial condition and operating performance. Accordingly, it was unduly permissive for the Second Circuit to analyze the materiality of omitted information on a segment-by-segment basis, rather than looking at whether or not the segment-related information was needed in order to “promote understanding of [*Blackstone*’s] overall financial condition and operating performance.” The Chamber of Commerce of the United States of America filed an [amicus brief](#) in support of *Blackstone*’s petition for a writ of certiorari, which makes additional arguments as



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to why the Second Circuit's segment analysis is out of step with *Basic v. Levinson* and *Matrixx Initiatives v. Siracusano*.

In the wake of *Blackstone*, registrants may find themselves making defensive disclosures that confuse, rather than help, investors. As the SEC said in 2010, the obligation to disclose known trends that are “reasonably likely to shape future periods” requires management to analyze “important trends and uncertainties relating to liquidity [that] might include, for example, difficulties accessing the debt markets.” Commission Guidance on the Presentation of Liquidity and Capital Resource Disclosures in Management’s Discussion and Analysis, Release Nos. 33-9144, 34-62934, FR-83 (Sept. 28, 2010). This could include the credit downgrades that followed Standard & Poor’s downgrade of the United States’ credit rating. One way or the other, *Blackstone* is likely to leave a mark on securities fraud cases and securities filings for the next several years. See, e.g., Pete Brush, [Blackstone IPO Case Could Yield More PE Disclosures](#), *Law360*, Oct. 4, 2011.

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Courts Should Use Caution in Certifying RMBS Suits as Class Actions

By Frances S. Cohen, Krystal N. Bowen, and John D. Pernick

Recent decisions from the Southern District of New York have reached inconsistent conclusions on class certification in suits brought by residential mortgage-backed securities (RMBS). Early in 2011, in *New Jersey Carpenters Health Fund v. Residential Capital*, 272 F.R.D. 160 (S.D.N.Y. Jan. 18, 2011) (Baer, J.), the court refused to certify a class of RMBS investors, but just months later on June 15, 2011, a second judge allowed a substantially similar case to proceed as a class action. *See Pub. Emps.' Ret. Sys. of Miss. v. Merrill Lynch & Co., Inc.*, (*MissPERS*), 2011 U.S. Dist. LEXIS 93222 (S.D.N.Y. Aug. 22, 2011) (Rakoff, J.). *See also N.J. Carpenters Health Fund v. DLJ Mortg. Capital*, No. 08 Civ. 5653, 2011 U.S. Dist. LEXIS 92597 (S.D.N.Y. Aug. 16, 2011) (Crotty, J.) (certifying a similar investor class). The Second Circuit has certified an appeal from the decision in *Research Capital* that promises further guidance.

Close review of these issues suggests that—particularly in light of the Second Circuit decision in *In re Initial Public Offering Securities Litigation (IPO)*, 471 F.3d 24 (2d Cir. 2006), *reh'g denied*, 483 F.3d 70 (2d Cir. 2006)—courts should rarely permit such suits to proceed as class actions. In a garden-variety “stock drop” case, public shareholders often have similarly limited access to independent information about management decisions; the small size of individual holdings means that the cases would not proceed except as a class action; and the homogenous nature of the equity (generally common stock) allows common issues to predominate. In contrast, many RMBS purchasers at initial public offering were sophisticated, largely institutional investors with access to myriad sources of information. In litigation, the plaintiffs are diverse groups that include investment advisers and securitizers who are themselves defendants in other RMBS investor suits, as well as passive investors. The actions often combine multiple offerings—the certified class in *MissPERS*, for example, involved purchasers in 19 separate offerings—further complicating common proof and requiring an evaluation of different plaintiffs’ knowledge over time. *MissPERS*, 714 F. Supp. 2d at 475.

The varying holdings, disparate access to information, and particularized risk and return tolerances mean that, on issues such as reliance and knowledge, common questions will rarely predominate and that a class action will not be a superior mechanism to resolve a dispute. *See* Fed. R. Civ. P. 23(b). Particularly in light of the “rigorous analysis” of the merits of claims and defenses now required at class certification, a district court should proceed with caution before certifying a class of RMBS investors. *See IPO*, 471 F.3d at 26.

Sophisticated Purchasers with Extensive Market Knowledge

The typical RMBS is structured as a special purpose entity that issues pass-through certificates



backed by collateralized mortgage obligations. The securities were “tranching,” allowing investors to purchase different classes of debt, such as super-senior, senior, or mezzanine debt, depending on their individual investment style and appetite for risk and return. RMBS offerings were often sold at initial public offerings through intermediaries who retained positions in the securities themselves, as did the sponsors. Investors in some instances hedged holdings with short positions in the same security or its related tranches, demonstrating a highly refined assessment of market risk.

Information relating to the collateral was broadly available to investors from different sources. Since the promulgation of Reg AB, effective January 1, 2006, the Securities and Exchange Commission (SEC) has required registration statements to include detailed information concerning the type of mortgage collateral, the geographic location, the credit characteristics of borrowers, debt-to-income ratios, loan-to-value ratios, and the nature of unusual mortgage products such as “NINA” loans (made with “no income, no asset” verification), balloon loans, and interest-only products. Reg AB requires publication of detailed “static pool” information tracking performance data for the underlying collateral. Thus, in connection with investment decisions, investors had detailed access to the performance profile of the collateral in past securitizations issued on the same registration shelf.

Investors often used complex computer modeling tools, such as Intex, to predict expected performance and to compare collateral with other securitizations. Some, themselves in the business of packaging RMBS, had direct access to the originators and were able to ask their own questions about underwriting practices and loan products.

Ratings agencies, including Moody’s, Standard & Poor’s, and Fitch, independently rated each securitization, using models that applied different analytical weights to collateral characteristics and other information obtained from the sponsors. The agencies published frequent bulletins assessing the risks associated with various products, borrower characteristics, market trends, and geographic concentration.

Not surprisingly, in light of this cornucopia of information, although securitizations failed across the board, investors’ results were highly idiosyncratic. Trade books about the market crash by Gregory Zuckerman, *The Greatest Trade Ever* (Crown 2009), and Michael Lewis, *The Big Short: Inside the Doomsday Machine* (W.W. Norton & Company 2010), among others, detail the success of some investors in using this same publicly available information to short the market. As reported, these investors did not have access to inside information; rather, they read the available information differently than other investors.

The size of many of the investors’ holdings, in the billions of dollars, has meant that some investors have preferred to proceed as single plaintiffs without invoking the class action machinery. These individual suits demonstrate that, unlike the shareholders in a typical stock drop case, many investors have the means and the incentive to pursue individual actions.

Individualized Knowledge Relevant as a Matter of Law

What should this extensively available market knowledge mean for class certification? In *IPO*, the leading Second Circuit case, the court reversed class certification because differences among putative class members as to subjective elements such as reliance (relevant in “new issue” 10b-5 cases) and knowledge (a defense in section 11 and 12(a)(2) cases) signified that plaintiffs could not meet Rule 23(b)’s requirements of “predominance” and “superiority.” In *IPO*, some class members were “fully aware of the obligation” allegedly undertaken by defendants to purchase shares in the aftermarket in exchange for IPO allocations, thereby inflating the aftermarket price. “[W]idespread knowledge” will “precipitate individual inquiries” as to whether individual class members had full, or even partial, knowledge of the scheme that would predominate over common issues. 471 F. 3d at 59.

This ruling apparently settled the relevance of plaintiffs’ knowledge to certification of a class on section 11 and 12(a)(2) claims. Following the Second Circuit’s decision in *IPO*, the U.S. District Court for the Southern District of New York, in *Residential Capital*, declined to allow section 11 and 12(a)(2) claims asserted by purchasers of four RMBS offerings to proceed as a class because individual issues of knowledge would predominate. 272 F.R.D. at 168–69. However, in *MissPERS*, the court nonetheless questioned the relevance of individualized knowledge to the predominance inquiry. Suits alleging violations of the securities laws, and “especially of Sections 11 and 12(a)(2) are,” the court observed, “especially amenable to class action resolution,” and the proof “depends, more than anything else, on establishing that certain statements and omissions common to all the offerings were material misrepresentations. 2011 U.S. Dist. LEXIS 93222, at *6–7. Potential defenses, “to the extent that they are viable at all, can largely be resolved through generalized proof.” *Id.* at *7. The court was “unpersuaded” that individualized inquiries into the knowledge of the plaintiffs would be required; because a plaintiff’s knowledge is a defense, and not an element of the claim, it was not relevant to the class certification inquiry. *Id.* at *59.

Whether *MissPERS* is consistent with *IPO*, or would be upheld on appellate review, is hardly free from doubt. *MissPERS* offered two reasons to distinguish *IPO*, neither particularly compelling. First, it cited a brief footnote from the *IPO* opinion on rehearing, 483 F.3d at 73 n.1—which the *MissPERS* court saw as “not trivial,”—stating that knowledge is an affirmative defense that need not be pled as an element of a section 11 or section 12(a)(2) action. It neither contradicts nor retreats from the explicit holding in *IPO* that knowledge is relevant to certification on such claims. *IPO*, 471 F.3d at 59. Surely, if the Second Circuit had intended to retreat from its holding, it would have said so explicitly.

Second, the *MissPERS* court relied on dicta to the effect that “[c]ourts generally focus on liability issues in deciding whether the predominance requirement is met, and if the liability issue is common to the class, common questions are held to predominate over individual questions.” 2011 U.S. Dist. LEXIS 93222, at *66–67 & n.26 (citing *Dura-Bilt Corp. v. Chase Manhattan*

Corp., 89 F.R.D. 87, 93 (S.D.N.Y. 1981) and *In re Marsh & McLennan Cos., Inc. Sec. Litig.*, 2009 U.S. Dist LEXIS 120593 (S.D.N.Y. 2009) (quoting *Dura-Bilt*). The cited cases, however, do not rule out consideration of defenses as part of the predominance inquiry. Moreover, to the extent that *Dura-Bilt* is inconsistent with *IPO*, the court offers no reason to disregard the Second Circuit decision. The Second Circuit is more likely to find the rationale in *Residential Capital* consistent with the legal rule stated in *IPO*.

Individual Issues Predominate

In *IPO*, the Second Circuit concluded that “[t]he claim that lack of knowledge is common to the class is thoroughly undermined by the Plaintiffs’ own allegations as to how widespread was knowledge of the alleged scheme.” 471 F.3d at 58. The court detailed the evidence: The plaintiffs themselves referred to the “industry-wide understanding” that those who agreed to purchase in the aftermarket received allocations. *Id.* at 59. The scheme was broadly known to “thousands” of initial IPO allocants, “who were required to purchase in the aftermarket” and were “fully aware of the obligation that is alleged to have artificially inflated share prices.” The requirements would have been known not only to those receiving allocations, “but also to many thousands of people employed by the institutional investors.” *Id.* MSNBC and CNBC reported on the aftermarket purchase requirements in 1999; in 2000 the practice was the subject of an SEC Staff Legal Bulletin and a report in *Barron’s* discussing the bulletin. *Id.*

In the RMBS cases, as well, the central question will be what did investors know about underwriting practices when they made their purchases? In *Research Capital*, the court concluded that the principles applied in *IPO* were equally relevant to the residential mortgage market: “Where a defendant shows that broad knowledge of the alleged wrongful conduct existed ‘throughout the community of market participants . . . this widespread knowledge’ would precipitate individual inquiries as to the knowledge of each member of the class.” 272 F.R.D. at 168, quoting *IPO*. The court denied class certification, “persuaded” that “different putative class members have different levels of knowledge regarding the underwriting guidelines and practices based on their respective levels of sophistication and time of purchase.” *Id.* The court relied *both* on documentary evidence imputing knowledge to a specific investment adviser and on broader market knowledge, for example, that certain RMBS purchasers knew that loan originators “were ‘loosening and lowering’ underwriting guidelines.” *Id.*

The *MissPERS* court took a starkly different view of similar facts. The knowledge attributed to the plaintiffs was too “generalized” and did “not rise to the level” of *IPO* or other cases denying certification. 2011 U.S. Dist. LEXIS 93222, at *64. For example, in *MissPERS*, the court placed little weight on contemporaneous acknowledgments by an investment adviser in the plaintiff class that originators’ appraisals were a “little lofty” and that it had witnessed “the outright degradation of underwriting standards.” *Id.* at *69.

But how different were those facts from the evidence that led the courts to reject class certification in *Residential Capital* and *IPO*? The evidence in the RMBS cases suggests that—to

the extent the issues with the mortgages were caused by disregard of the underwriting standards and not a systemic collapse of the housing market—plaintiffs had extensive information on this subject.

Differential Knowledge, Class Member Conflicts, and Needless Complexity

Several factors counsel that class actions are not be a “superior” vehicle for the adjudication RMBS investor suits. Among other things, the plaintiffs include many different participants in the RMBS market. These divergent roles raise inevitable conflicts. The issue is not that sophisticated institutional investors may never be class action plaintiffs; rather, the fact that the RMBS plaintiffs are a diverse pastiche with a broad spectrum of knowledge of the mortgage market inevitably raised complex issues of individual proof. As the *Residential Capital* court found, many putative class members included “sophisticated investors with significant experience in asset-backed securities market,” including major investment banks that another plaintiff had named as defendants in other litigation and alleged that they knew of originators’ “systematic disregard” for underwriting guidelines. 272 F.R.D. at 169. Several major hedge fund plaintiffs each had “tout[ed] their expertise in mortgage backed securities” and government-sponsored entity plaintiffs had themselves “issued trillions of dollars of residential mortgage backed securities,” suggesting they knew something about underwriting practices. *Id.*

The *MissPERS* court distinguished *IPO*, observing that no class member actually participated in the alleged conduct, and concluded without explanation that “[i]t is irrelevant that members of the class have been sued in connection with their own MBS offerings.” 2011 U.S. Dist. LEXIS 93222, at *68. However, it is surely pertinent that the class included mortgage securitizers familiar with the originators’ underwriting standards and practices.

The threat that these disparate issues will predominate led the court in *Residential Capital* to conclude that class treatment was not a superior form of adjudication. Although “[c]lass treatment is particularly appropriate where it allows groups of claimants to bundle into a single action common claims that are too small to pursue individually,” the court concluded “[t]hat purpose is not served where, as here, the proposed class consists of large institutional and sophisticated investors with the financial resources to pursue their own claims.” 272 F.R.D. at 170. A heterogeneous assortment of putative class members, thus, may not be “sufficiently cohesive” to warrant class-based adjudication. *Id.*

Conclusion

Suits by RMBS investors pose special challenges for management as class actions. RMBS offerings were sold to a relatively small group of largely institutional investors, with different roles in the market and ample access to a smorgasbord of information. As a result, proof regarding their individualized knowledge threatens to make these actions a judicial management quagmire. It remains to be seen whether, and in what form, the decisions on class certification in *Residential Capital* and *MissPERS* will withstand future challenge. If the cases go forward as class actions, the courts will need to develop procedural mechanisms to permit full discovery of



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the individualized issues. Because many of these cases have proceeded as individual suits, there are ample reasons to deny certification and to allow the cases to proceed individually.

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Why Courts Should Favor Certification of MBS Actions

By Julie Goldsmith Reiser

Institutional investors have brought more than 20 class actions against issuers, underwriters, and others who sold trillions of dollars worth of purportedly investment-grade mortgage-backed securities (MBS) for violations of the Securities Act of 1933. These strict liability claims seek to hold the defendants accountable for stating that underwriting guidelines published in offering documents were followed when, in fact, those guidelines were routinely disregarded. Such deviations from the guidelines caused default rates to increase exponentially and the value of the MBS to plummet. Virtually all the certificates being challenged in these actions have been downgraded from “investment grade” to “junk” status.

Federal courts now are considering whether these putative Securities Act class actions meet the requirements of Federal Rule of Civil Procedure 23(b)(3). Class certification motions have been filed but not yet decided (at the time of this writing) in the following MBS actions: *City of Ann Arbor Employees’ Retirement System v. Citigroup Mortgage Loan Trust, Inc.*, No. 08-cv-1418 2008 WL 3891221 (E.D.N.Y. Aug. 11, 2008); *Massachusetts Bricklayers & Masons Funds v. Deutsche Alt-A Securities, Inc.*, No. 08-cv-3178 (E.D.N.Y.); *Tsetereli v. Residential Asset Securitization Trust 2006-A8*, No. 08-cv-10637 (S.D.N.Y.); *In re IndyMac Mortgage-Backed Securities Litigation*, No. 09-cv-4583 (S.D.N.Y.). Class certification briefing will commence shortly in *Fort Worth Employees’ Retirement Fund v. JPMorgan Chase & Co., Inc.*, No. 09-cv-3701 (S.D.N.Y.) in December 2011.

The following MBS cases have not yet had class certification briefing and are in various stages of litigation, including on appeal of dismissal orders: *In re Lehman Brothers Securities and ERISA Litigation*, No. 09-md-2017 (S.D.N.Y.); *In re Bear Stearns Mortgage Pass-Through Certificates Litigation*, No. 08-cv-8093 (S.D.N.Y.); *In re Morgan Stanley Mortgage Pass-Through Certificates Litigation*, No. 09-cv-2137 (S.D.N.Y.); *Genesee County Employees’ Retirement System v. Thornburg Mortgage, Inc.*, No. 09-cv-300 (D.N.M.); *Plumbers Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, No. 08-cv-10446 (D. Mass.); *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, No. 08-cv-10783 (S.D.N.Y.); *New Jersey Carpenters Health Fund v. Novastar Mortgage, Inc.*, No. 08-cv-5310 (S.D.N.Y.). Finally, class certification was stipulated as part of a settlement that has received preliminary approval in *In re Wells Fargo Mortgage-Backed Certificates Litigation*, No. 09-cv-1376 (N.D. Cal.), and a class certification stipulation was granted in *Maine State Retirement System v. Countrywide Financial Corp.*, No. 10-CV-00302 (C.D. Cal. Oct. 13, 2011).

The central issue in these cases is whether differing levels of investor sophistication should defeat class certification. While the first district court to consider the question concluded that

individual issues predominated and a class was not the superior way to adjudicate the matter, three federal district courts have since disapproved of the rationale underlying that opinion. In so doing, the majority have correctly refused to treat investor sophistication as a basis for differentiating among class members to defeat class certification. Not only is the logic behind the majority position sound, but also as a practical matter, class treatment of Securities Act claims produces the most efficient resolution of these actions for the parties and the courts.

The Federal Court Split in MBS Class Certification Decisions

January 2011 saw the first class certification opinion issued in an MBS action: *New Jersey Carpenters Health Fund v. Residential Capital, LLC.*, [272 F.R.D. 160 \(S.D.N.Y. Jan. 18, 2011\)](#). See also *N.J. Carpenters Vacation Fund v. Royal Bank of Scotland Grp., plc*, 272 F.R.D. 160 (S.D.N.Y. Jan. 18, 2011). In *Residential Capital*, Judge Harold Baer Jr. denied class certification after concluding that certain MBS purchasers were “sophisticated” in their knowledge of housing market trends and loan default rates. Relying on the Second Circuit’s decision in *In re Initial Public Offering Securities Litigation (IPO)*, 471 F.3d 24, 44 (2d Cir. 2006), Judge Baer concluded that the defendants were entitled to test individually whether each class member knew that statements in the offering documents were misleading at the time of purchase. (An issuer is strictly liable pursuant to section 11 of the Securities Act of 1933 for any materially false or misleading statement made in offering documents for a registered security. Yet, a defendant is entitled to present an affirmative defense that a plaintiff knew of the specific untruth or omission at issue at the time of acquisition to avoid liability. 15 U.S.C. § 77k(a)). The need for individual proof, Judge Baer concluded, defeated the predominance and superiority prongs required to certify a class action pursuant to Rule 23(b)(3). Every court that has considered class certification in the MBS context has found that Rule 23(a)’s elements of numerosity, commonality, typicality, and adequacy are satisfied. Instead, differences among courts have arisen in the context of Rule 23(b)(3) and “[whether] questions of law or fact common to class members predominate over any questions affecting only individual members, and [whether] a class action is superior to other available methods for fairly and efficiently adjudicating the controversy.” Fed. R. Civ. P. 23(b)(3).

Significantly, the *Residential Capital* decision did not find that *any* putative class member actually had knowledge of the falsity of statements in the offering documents nor did any of the evidence cited by the court indicate knowledge. Instead, Judge Baer wrote that he was persuaded “that different putative class members have different levels of knowledge regarding the underwriting guidelines and practices based on their respective levels of sophistication and time of purchase.” 272 F.R.D. at 168–69. The *Residential Capital* decision also expressed concern that some class members’ experience in issuing MBS—albeit unrelated to those at issue in the case at hand—“gives rise to a reasonably reliable inference that they possessed at least some knowledge of underwriting practices.” *Id.* at 169. The Second Circuit granted the lead plaintiffs’ motion for an interlocutory appeal of this decision under Rule 23(f), and the appeal is currently being briefed.

The first opinion to reject the rationale of *Residential Capital* was *In re Washington Mutual Mortgage Backed Securities Litigation*, No. C09-37 MJP, 2011 WL 1789975, at *2 (W.D. Wash. May 9, 2011). There, Judge Marsha Pechman refused to permit absent class member discovery sought in connection with the defendants' opposition to class certification. In issuing a protective order, Judge Pechman criticized the inference that class member sophistication could defeat class certification, writing that the *Residential Capital* opinion "nowhere explains why this individualized knowledge rendered class certification improper." *Id.* Notably, although absent class member discovery was not permitted in *In re Washington Mutual*, it was, however, permitted in *Maine State Retirement System. v. Countrywide Financial Corp.*, No. 10-cv-00302 (MJP) (C.D. Cal. 2010) and *In re IndyMac Mortgage-Backed Securities Litigation*, No. 09-cv-4583 (LAK) (S.D.N.Y. 2009). Judge Pechman ruled that such analysis was properly considered following a class-wide liability determination. *Washington Mutual*, No. C09-37 MJP, 2011 WL 1789975, at *2. Judge Pechman has since granted class certification in this action. *Id.*, Docket No. 345 (W.D. Wash. Oct. 21, 2011).

The next two courts to consider the propriety of certifying a class of MBS purchasers soundly rejected *Residential Capital's* comparison between the MBS actions and *IPO*. First, Judge Paul A. Crotty issued a detailed opinion granting class certification in *New Jersey Carpenters Health Fund v. DLJ Mortgage Capital (HEMT)*, No. 08 Civ. 05653(PAC), 2011 WL 3874821, at *7 (S.D.N.Y. Aug. 16, 2011): "The factual contentions here that some class members may have had knowledge of the misstatements or omissions do not rise to the level found in *IPO*," where class members had actually *participated* in the challenged conduct. Shortly thereafter, Judge Jed S. Rakoff certified a class of MBS purchasers against Merrill Lynch and distinguished *IPO* because "[t]here is no allegation in this case that any class member actually participated in the conduct described in the Amended Complaint." *Pub. Emps.' Ret. Sys. of Miss. v. Merrill Lynch & Co.*, No. 08 Civ. 10841(JSR), 2011 WL 3652477, at *19 (S.D.N.Y. Aug. 22, 2011). *See also Washington Mutual*, No. C09-37 MJP (W.D. Wash. Oct. 21, 2011) ("Plaintiffs' general knowledge of the mortgage industry or their ability to have reviewed loan data is not sufficient to show that any named Plaintiff is subject to a unique defense or one that it is likely to become a focus of this litigation."). Judge Rakoff wrote: "Defendants note that the head of PIMCO's mortgage desk told the Wall Street Journal in May 2005 that he 'assume[d] that appraisals [were] a little lofty.' This generic statement does not come close to suggesting that PIMCO had any knowledge of appraisal inflation in the Offering Documents at issue here." *Id.*

Virtually all Securities Act class actions would be uncertifiable if courts uniformly adopted the *Residential Capital* standard. Institutional investors that rely on professional investment managers represent nearly 75 percent of all investors in the largest U.S. corporations. Nevertheless, applying the logic of *Residential Capital*, defendants would be able to challenge asset manager sophistication in an effort to defeat certification in virtually all Securities Act class actions, claiming that individual issues predominated. This is problematic for three reasons: (1) There is no bright line level of "sophistication" that warrants the denial of class certification; (2) sophistication is irrelevant to the "actual knowledge" requirement that creates a defense to

Securities Act liability; and (3) such a result would be entirely at odds with the Supreme Court's recognition that "[p]redominance is a test readily met in certain cases alleging . . . securities fraud[.]" *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 625 (1997).

Instead of treating investors' sophistication as a basis for denying class certification, the *Merrill Lynch* decision, like the *HEMT* opinion before it, sensibly concluded that generalized proof of common issues and defenses made class certification appropriate. Establishing the falsity of statements in offering documents is and should be "a classic basis for a class action." 2011 WL 3652477, at *1. Further, as Judge Rakoff wrote, "the potential defenses to liability in this case, to the extent they are viable at all, can largely be resolved through generalized proof." *Id.*

Superiority of Class Certification in MBS Actions

After concluding that Rule 23(b)(3)'s predominance test was met, the *HEMT* and *Merrill Lynch* courts explored whether a class-wide adjudication was superior to other alternatives. Judge Crotty noted in the *HEMT* opinion that "[t]he goal of class actions is to achieve economies of time, effort and expense, and promote uniformity of decision as to persons similarly situated, without sacrificing procedural fairness." 2011 WL 3874821, at *8 (internal quotations and citation omitted). In the MBS actions, efforts to achieve efficiencies and fairness militate in favor of class certification from the perspective of plaintiffs, defendants, and the judiciary.

Recently, in the *Maine State Retirement System v. Countrywide Financial Corp.* MBS litigation, the parties stipulated to class certification following two rulings on motions to dismiss that addressed issues of standing. Stipulation Concerning Class Certification, *Me. State Ret. Sys. v. Countrywide Fin. Corp.*, 10-CV-00302-MRP (C.D. Cal. Sept. 30, 2011). The reasoning behind the stipulation sheds light on the costs and time involved in seeking and opposing class certification. In their stipulation, the parties stated that further litigation regarding class certification issues would be "significantly time-consuming and expensive for the Parties and non-parties, and potentially could require the Court to become involved in disputes with one or more third parties in connection with their compliance with subpoenas for class-certification-related information." *Id.* at 3. Thus, defendants stipulated to the certification of a class rather than expending more resources on taking the depositions of a number of nonparties that had potentially discoverable information, including absent class members, investment managers, and investment consultants. If defendants had been successful in defeating class certification, not only would they have borne the costs of taking and, in many instances, compelling documents and testimony, but also it would have been a Pyrrhic victory because defeating certification would increase their litigation costs by requiring them to defend a large number of individual actions. Certification allowed defendants to reduce their litigation costs and preserve the possibility of a settlement that would be all-encompassing for the proposed class of investors.

For plaintiffs, the advantages of being able to litigate Securities Act claims on a class-wide basis are widely recognized. Plaintiffs have more leverage and bargaining power where defendants' potential liability is greater; moreover, by aggregating their claims, plaintiffs are better able to

match the resources available to defendants. Class actions also overcome so-called collective action problems in which claims may not be sufficiently large for investors to pursue them independently notwithstanding the fact that defendants' conduct gives rise to liability as to all purchasers. For example, in the *Residential Capital* case, more than 1,500 investors purchased the certificates at issue. Those investors were geographically distributed throughout the country and beyond, and some investors' losses were in the low thousands of dollars. This situation epitomizes the concept of a "negative value suit" in which the amount at stake is insufficient to justify an individual action. Finally, class-wide litigation typically limits the cost and burden of discovery to just the representative plaintiffs if affirmative defenses vis-à-vis particular plaintiffs are unable to derail class certification.

For the judiciary as well, a class-wide determination is advantageous, and in two ways. First, it would further the effective enforcement of the Securities Act, which is designed to enforce the duties of an issuer to disseminate accurate information by penalizing those who fail to do so. *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969). Second, as Judge Rakoff noted in *Merrill Lynch*, "[t]here is a fundamental fact that trying this [MBS action] as a class action, as opposed to multiple individual actions (joinder of which would present its own difficulties), cannot help but result in a huge savings of judicial resources. No one familiar with modern federal dockets can minimize the importance of such savings." *Merrill Lynch & Co.*, 2011 WL 3652477, at *21–22 (internal citations omitted). *See also Washington Mutual*, No. C09-37 MJP (W.D. Wash. Oct. 21, 2011) ("It is beyond dispute that having all claims of the class litigated at once will serve judicial economy and efficiency").

Conclusion

The MBS actions and, in particular, Securities Act claims are ideally suited to be resolved through the class mechanism. Allowing the defense of investor sophistication to defeat class certification is an inadequate proxy for whether those investors had actual knowledge of the falsity of the statements and, if used to defeat class certification, unnecessarily increases the costs of litigation for all parties and the court. In contrast, determining whether offering documents contain materially false or misleading statements on a class-wide basis creates efficiencies while still affording defendants procedural fairness and the opportunity to demonstrate that a purchaser had actual knowledge of the falsity of the statements following a liability determination. This is the correct and most efficient path for courts and the parties to follow.

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Keywords: securities litigation, mortgage backed securities, Residential Capital, class certification

Can an Arbitrator Order Prehearing Discovery from a Nonparty?

By Lisa M. Eddington and Howard S. Suskin

In arbitration proceedings conducted by the Financial Industry Regulatory Authority (FINRA) and other securities self-regulatory organizations, issues often arise as to the permissible scope of discovery. When parties to an arbitration seek judicial enforcement of arbitrators' discovery subpoenas, courts have not always agreed on what the Federal Arbitration Act (FAA) allows. One particular issue on which the courts are divided is whether an arbitrator may order pre-hearing discovery from a nonparty and whether the courts are authorized under the FAA to enforce such subpoenas. This article discusses the current split among the courts on this topic.

Currently, the courts are divided regarding the proper interpretation of section 7 of the FAA and, specifically, whether that section grants an arbitrator the authority to order pre-hearing discovery from nonparties. The Sixth and Eighth Circuits have held that implicit in the power to order the production of documents from a nonparty at a hearing is the power to order pre-hearing document production from a nonparty. The Second and Third Circuits disagree, finding that section 7 of the FAA unambiguously limits an arbitrator's subpoena power to instances in which the nonparty has been called to appear before the arbitrator. Although generally following the Second and Third Circuits, the Fourth Circuit has suggested that an exception might be appropriate upon a showing of special need or hardship.

In reaching their decisions, the circuits have viewed the goals of arbitration differently. On the one hand, some have reasoned that the efficiency of the arbitration process may be reduced if, especially in complex cases, parties are not afforded the opportunity to review and digest relevant evidence prior to an arbitration hearing. On the other hand, some courts have reasoned that allowing pre-hearing discovery from nonparties will lessen the incentive to limit the scope of discovery and strengthen the incentive to engage in costly and time-consuming fishing expeditions.

Section 7 of the Federal Arbitration Act

The key provision governing discovery from nonparties in arbitrations is found in section 7 of the FAA, which provides in pertinent part as follows:

The arbitrators . . . or a majority of them, may summon in writing any person to attend before them or any of them as a witness and in a proper case to bring with him or them any book, record, document or paper which may be deemed material as evidence in the case [I]f any person or persons so summoned to testify shall refuse or neglect to obey said summons, upon petition the United States

district court for the district in which such arbitrators, or a majority of them, are sitting may compel the attendance of such person or persons before said arbitrator or arbitrators, or punish said person or persons for contempt in the same manner provided by law for securing the attendance of witnesses or their punishment for neglect or refusal to attend in the courts of the United States.

The Sixth and Eighth Circuits' Implicit Power

In *American Federation of Television and Radio Artists, AFL-CIO v. WJBK-TV (New World Communications of Detroit, Inc.)*, 164 F.3d 1004 (6th Cir. 1999), a party sought to enforce a subpoena that directed a nonparty to appear and produce documents prior to the arbitration hearing. The Sixth Circuit looked to section 7 of the FAA for guidance in deciding whether the district court had authority to enforce the subpoena under section 301 of the Labor Management Relations Act and found that section 7 “implicitly include[d] the authority to compel the production of documents for inspection by a party prior to the hearing.” *Id.* at 1009. The court, however, did not reach the question of whether the arbitrator may subpoena a third party for a discovery deposition relating to a pending arbitration proceeding. *Id.* at 1009 n.7.

Similarly, in *In re Security Life Insurance Co. of America*, 228 F.3d 865 (8th Cir. 2000), a third party was subpoenaed to produce documents prior to an arbitration hearing. The Eighth Circuit held that “implicit in an arbitration panel’s power to subpoena relevant documents for production at a hearing is the power to order the production of relevant documents for review by a party prior to the hearing.” *Id.* at 870–71. In reaching its decision, the court reasoned that “[a]lthough the efficient resolution of disputes through arbitration necessarily entails a limited discovery process . . . this interest in efficiency is furthered by permitting a party to review and digest relevant documentary evidence prior to the arbitration hearing.” *Id.* at 870.

The Second and Third Circuits' Restricted Power

In *Hay Group, Inc. v. E.B.S. Acquisition Corp.*, 360 F.3d 404 (3d Cir. 2004), the court looked first to the text of section 7 in deciding whether a nonparty can be subpoenaed to produce documents prior to a hearing. The court found that the language unambiguously restricts an arbitrator’s subpoena power to situations in which the nonparty has been called to appear in the physical presence of the arbitrator and to hand over the documents at that time. *Id.* at 407. In reaching its decision, the court relied on the language requiring a nonparty “to bring” items “with him” as well as the word “and” in the first sentence of section 7. *Id.* The court noted that requiring document production to be made at an actual hearing may discourage parties from issuing large-scale subpoenas to nonparties because parties “will be forced to consider whether the documents are important enough to justify the time, money, and effort that the subpoenaing parties will be required to expend if an actual appearance before an arbitrator is needed.” *Id.* at 409. The court noted that if pre-hearing document production from nonparties were permitted, there is “more incentive to engage in fishing expeditions that undermine some of the advantages of the supposedly shorter and cheaper system of arbitration.” *Id.*

The Second Circuit in *Life Receivables Trust v. Syndicate 102 at Lloyd's of London*, 549 F.3d 210 (2d Cir. 2008), joined the Third Circuit in holding that section 7 does not authorize an arbitrator to compel pre-hearing document discovery from a nonparty. As in *Hay Group*, the court found the language of section 7 to be straightforward and unambiguous, noting that although “[t]here may be valid reasons to empower arbitrators to subpoena documents from third parties, [the court] must interpret a statute as it is, not as it might be . . .” *Id.* at 216.

The Fourth Circuit’s Showing of Special Need or Hardship

In *COMSAT Corp. v. National Science Foundation*, 190 F.3d 269, 275 (4th Cir. 1999), the Fourth Circuit generally took the approach that the Second and Third Circuits would later take, finding that the FAA does not grant an arbitrator the authority to order nonparties to appear at deposition or to demand pre-hearing document production from nonparties. Unlike the Second and Third Circuits, however, the court suggested, in dicta, that a court might, under unusual circumstances, compel the pre-hearing production of documents from a nonparty upon a showing of special need or hardship. *Id.* at 276. The court acknowledged that the rationale for constraining an arbitrator’s subpoena power is clear: A “hallmark of arbitration—and a necessary precursor to its efficient operation—is a limited discovery process.” *Id.* The court reasoned, however, that in a complex case, “the much-lauded efficiency of arbitration will be degraded if the parties are unable to review and digest relevant evidence prior to the arbitration hearing.” *Id.* The Fourth Circuit did not define “special need” but noted that, at a minimum, a party would be required to demonstrate that the information it seeks is otherwise unavailable. *Id.*

The Northern District of Illinois’s Recent Holding

Most recently, the Northern District of Illinois addressed this issue in *Alliance Healthcare Services, Inc. v. Argonaut Private Equity, LLC*, No. 11 C 3276, 2011 WL 3489807 (N.D. Ill. Aug. 9, 2011). In *Alliance*, nonparties received subpoenas calling for oral testimony and production of records before a member of the arbitration panel at a preliminary hearing. *Id.* at *1. The court recognized the split in the circuits over the arbitrator’s ability to order pre-hearing discovery from a nonparty. *Id.* at *2. However, relying in part on *Hay Group*, the court held that any rule against compelling nonparties to participate in discovery does not apply to a situation in which the nonparty is summoned to appear at a pre-hearing conference before any of the arbitrators and bring documents with him. *Id.* The court further found that nothing in the language of the FAA states that an arbitrator’s subpoena power can be invoked only at the time of the *final* hearing. *Id.*

Conclusion and Practical Considerations

The current split among the courts as to the scope of pre-hearing arbitration discovery undermines the national uniformity in the arbitration process that the FAA was designed to promote. Ultimately, the U.S. Supreme Court may be called upon to resolve the split among the circuits regarding the proper interpretation of the FAA, unless Congress steps in first and clarifies the FAA’s provisions. To date, however, none of the parties in the cases discussed



above have sought U.S. Supreme Court review. So, it may be a long time before the split is resolved.

Predicting how the Supreme Court would resolve the split is not easy. On the one hand, in strongly favoring enforcement of arbitration agreements, the Supreme Court has expressed its view that arbitration procedures afford parties a full and fair mechanism to resolve their disputes. For that reason, the inability of parties to enforce arbitrators' subpoenas against nonparties under the FAA might lead the Court to take an expansive approach in facilitating that discovery. On the other hand, the Supreme Court also has recognized that arbitration procedures, including the availability of discovery, are more limited than what is available under the Federal Rules of Civil Procedure. As a result, the inability of parties to conduct discovery from nonparties might not be of great concern to the Court.

As long as the lower courts are split, attorneys handling FINRA and other self-regulatory organization arbitrations need to be up-to-date about the law on this issue in the particular jurisdiction in which they are arbitrating. Parties seeking to enforce arbitrators' subpoenas may do so under section 7 of the Federal Arbitration Act only in the U.S. district court for the district in which the arbitrators, or a majority of them, are sitting. Seeking enforcement from another court where the nonparty may be located is not an option. Therefore, when a claimant has a choice of places in which to conduct the arbitration, knowing how that district's courts have weighed in on discovery from nonparties may be one factor to consider in selecting the arbitration forum, particularly if significant discovery from nonparties will be needed.

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Keywords: securities litigation, Federal Arbitration Act, circuit split, NDILL, FINRA

Is the Tide Turning Against the SEC in Favor of Finders?

By Ernest E. Badway and Daniel A. Schnapp

“Finders” or “business brokers” may be the unsung heroes of early-stage companies, or, as the U.S. Securities and Exchange Commission (SEC) believes, they may be unregistered broker-dealers. Finders raise capital for companies that might not otherwise have capital on their own or, more importantly, would not draw the attention of investment bankers, who by definition are licensed broker-dealers. Finders and those who employ them must be aware of the risks associated with their services and the requirements imposed on them by the federal securities laws. Companies or individuals who intend to use a finder—or those engaged as one—must be aware that certain activities require registration, the lack of which may bring about serious consequences.

Recently, the SEC’s enforcement of the broker-dealer registration requirements against finders was thrown into uncertainty in a case arising from the U.S. District Court for the Middle District of Florida, *SEC v. Kramer*, No. 8:09-cv-455-T-23TBM (M.D. Fla. Apr. 1, 2011). The decision in this case has caused uncertainty, requiring enforcement lawyers to consider alternatives. This article explores the background of the finder’s or business broker’s exemption, the no-action letters that attempted to construe the exemption, and the *Kramer* court’s rationale, before looking ahead to the next steps the SEC may take in an increasingly complex landscape involving broker-dealer registration and the raising of capital.

Who Needs to Register?

The broker-dealer registration requirements of the Securities Exchange Act of 1934 do not explicitly require finders to register with the SEC. Although some believe that labeling oneself as a finder means that registration is unnecessary, broker-dealers must register, including those who call themselves finders, when they act as broker-dealers. The SEC’s Enforcement Division has consistently undertaken investigations and litigation against those who claim to be finders but who are, in fact, seeking to evade the broker-dealer registration requirements. The SEC seeks severe penalties in those cases. However, the *Kramer* case shed light on the importance of analyzing broker-dealer registration requirements in the context of existing jurisprudence and, in so doing, dealt the SEC’s approach a stinging blow. An analysis follows.

Generally, a broker or dealer needs to register with the SEC. Section 3(a)(4) of the Securities Exchange Act states that a “broker” is “any person engaged in the business of effecting transactions in securities for the account of others.” Such brokers (and dealers) are required to be registered under section 15(a)(1) of the act, which makes it unlawful for “any broker or dealer . . . to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security . . . unless such broker or dealer is registered[.]” These registration requirements are significant. Broker-dealers must register with the SEC by filing an application on a Form BD,

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become a member of a self-regulatory organization such as the Financial Industry Regulatory Authority, as well as a member of the Securities Investor Protection Corporation. Further, broker-dealers are required to be licensed in the states where they conduct business as a broker-dealer, and certain individuals employed by broker-dealers must also pass certain exam qualification requirements, such as the Series 7 exam. Div. of Trading & Mkts., U.S. Secs. & Exch. Comm'n, *Guide to Broker-Dealer Registration* (Apr. 2008).

These burdens discourage many from registering, but to remain involved in capital-raising activities, individuals often may operate as finders or business brokers so as not to trigger the Securities Exchange Act's registration requirements. Although not defined under either federal or state securities laws, a finder has been described as "someone who finds, interests, introduces and brings parties together for a transaction that the parties themselves negotiate and consummate." *Ne. Gen. Corp. v. Wellington Advertising, Inc.*, 82 N.Y. 2d 158, 163 (N.Y. 1993). A finder essentially "fill[s] a void that is created by the lack of interest on the part of licensed brokerage firms and venture capital funds in smaller equity transactions." ABA Task Force on Private Placement Broker-Dealers to the SEC Advisory Committee on Small Public Companies; Letter from Gerald V. Niesar endorsing the *Report and Recommendations of the Task Force on Private Placement Broker-Dealers* (Sept. 12, 2005).

Accordingly, the initial step in analyzing a party's status as a finder or business broker is to determine whether the party is involved in effecting a securities transaction for another or merely introduces parties who then complete the transaction on their own. If the party engages in the later, no broker-dealer registration is required, while the former activity may require registration. However, registration is required only where a party's actions fall within previously delineated conduct proscribed by both the courts and the SEC.

Unfortunately, the SEC has not always taken a consistent approach in defining the type of conduct requiring registration. As detailed below, the SEC has followed a case-by-case approach, analyzing and then indicating whether such conduct requires registration when it is presented to it. However, the courts described in this article essentially have adopted a six-prong test to determine whether certain conduct would require registration.

The SEC's Evolving Approach to Finders and Business Brokers

Over the years, various individuals and entities have sought guidance from the SEC staff, through a series of no-action letters, on the appropriateness of certain activities described as falling within the purview of the work of a finder or business broker. No-action letters allow the SEC staff to evaluate a finder's proposed activities and to determine whether registration as a broker-dealer is required prior to the undertaking of any of the stated activities. In the absence of statutory authority, securities practitioners and industry insiders rely on these no-action letters to determine whether a proposed party would be required to register as a broker-dealer.

Often the difference between registration or not was based on the SEC's focus on whether the intermediary would earn compensation from its activities and the intermediary's level of participation in the transaction. For example, in 1972, the SEC staff issued a no-action letter at the request of Corporate Forum, Inc., Corp. Forum, Inc., SEC No-Action Letter, 1972 WL 9128 (Dec. 10, 1972). Corporate Forum's proposed activities included seeking out merger and acquisition candidates as well as conducting any financial analysis requested by its client. The SEC staff stated that it would not recommend enforcement action if Corporate Forum did not register as a broker-dealer and conducted these activities. The SEC staff seemed to emphasize Corporate Forum's lack of participation in negotiations between its client and the merger and acquisition candidates. *Id.* at *2.

However, the SEC staff has not always been consistent in its position. In another 1972 no-action letter, the SEC staff denied the relief sought by Fulham & Co., Inc., for similar proposed activities. The SEC staff indicated that Fulham & Co. needed to register as a broker-dealer because, apparently, Fulham & Co. intended to participate directly in the negotiations between the interested parties. Fulham & Co., Inc., SEC No-Action Letter, 1972 WL 9129, at *2 (Dec. 20, 1972).

Similarly, the SEC staff's no-action letter to the Russell R. Miller Corp. (RRM) continued to focus on participation (or lack thereof) in negotiations. Russell R. Miller & Co., Inc., SEC No-Action Letter, 1977 WL 10938 (Aug. 15, 1977). RRM proposed, in its capacity as a finder, to value potential targets for buyers and sellers but not to participate in any negotiations. *Id.* at *1–2. Intriguingly, the SEC staff issued a no-action letter in favor of RRM, even though RRM would receive a transaction-based fee. *Id.* at *2. Although payment of the fee would occur only upon consummation of a transaction, the SEC staff found it meaningful that RRM would not participate in negotiations or provide any input as to whether its fee would be paid in cash or securities. *Id.* at *3–4.

The SEC staff further elaborated on the finder's proper role in conjunction with potential compensation in other no-action letters. The SEC staff issued a no-action recommendation regarding the proposed activities of International Business Exchange Corporation (IBEC). Int'l Bus. Exch. Corp., SEC No-Action Letter, 1986 WL 67535, at *2 (1986). IBEC's activities included the advertising and sale of closely held entities where its role was limited to the transmission of documents between the interested parties along with avoiding participation in negotiations. *Id.* at *1. IBEC, essentially, would not advise either party as to the consideration used to consummate the transaction, and IBEC's fee would be based on the value of the transaction, determined prior to the time the parties agreed to the form of the consideration required to close the transaction. *Id.*

In a 1991 no-action letter involving Paul Anka, the entertainer, the SEC staff stated it would not recommend enforcement of the broker-dealer registration requirement against him. Paul Anka, SEC No-Action Letter (July 24, 1991). Although there were several factors present indicating

registration would be requested because Mr. Anka seemed to have been offered a contingent investment commission in exchange for providing a list of potential investors to a professional hockey team, the SEC staff granted no-action relief. Apparently, the SEC staff focused on the financial acumen of the potential investors in making this determination.

In later years, the SEC staff, nonetheless, went further in defining certain standards it would consider in determining finder or business broker status as opposed to requiring broker-dealer registration. The SEC staff issued a no-action recommendation regarding the proposed activities of Country Business, Inc. (CBI). Country Bus., Inc., SEC No-Action Letter, 2006 WL 3289777, at *1 (2006). CBI proposed “providing services that are more extensive than simply acting as a finder of potential purchasers of the business.” [Letter from Craig McCrohon, Counsel for Country Bus. Inc., to Catherine McGuire, Chief Counsel and Assoc. Dir., Div. of Mkt. Regulation](#), SEC, at 1 (Nov. 8, 2006). CBI intended to assist with the sale of closely held entities by, among other things, transmitting documents between the parties; valuing the assets of the business as a going concern; providing the seller with administrative support; and assisting the seller with the preparation of financial statements. *Id.* at 2. In granting the no-action relief, the SEC staff apparently relied on CBI’s proposal to avoid advising the interested parties on the form of consideration to be used in completing the transaction and to have its fee determined prior to a decision on the structure of the transaction. Country Bus., Inc., No-Action Letter, 2006 WL 3289777, at *1. Further, this fee would potentially be “a fixed fee, hourly fee, a commission, or a combination thereof, that is based upon the consideration received by the seller, regardless of the means used to effect the transaction, and will not vary according to the form of conveyance (i.e., securities rather than assets).” *Id.*

However, the SEC staff denied relief to Hallmark Capital Corporation based on its proposed activities, Hallmark Capital Corp., SEC No-Action Letter, 2007 WL 1879799, at *1 (2007), despite the fact that the activities were very similar to those described by CBI. Hallmark described itself as “a financial consultant and finder for small businesses that assists the owners of businesses in raising capital, facilitates mergers and acquisitions and provides strategic business consulting services.” *Id.* at *2. Although the SEC did not state in detail its reasons, the difference seemed to be that Hallmark’s fee was not fixed prior to a decision by the interested parties as to the structure of the transaction and that the fee had been set prior to the transaction as detailed in both the IBEC and CBI no-action letters. *Compare* Country Bus., Inc., No-Action Letter at 1, *and* Int’l Bus. Exch. Corp., SEC No-Action Letter, *with* Hallmark Capital Corp., SEC No-Action Letter. Seemingly, these differences would indicate that Hallmark would be acting more as a salesman where such compensation is normally tied to the transaction itself. In IBEC and CBI, the fee was akin to a “flat fee.”

This departure from the previous factors was solidified in March 2010, when the SEC staff issued a [response](#) to a no-action request from the law firm of Brumberg, Mackey & Wall, P.L.C. The Brumberg no-action letter moved closer to a one-issue checklist: Did the finder or business

broker receive transaction-based compensation? If so, broker-dealer registration would be required because that factor alone, according to the SEC, would trigger such requirements.

Brumberg sought to introduce potential investors to a renewable energy company. In return, Brumberg would receive a percentage of the funds raised from those investors. Brumberg claimed that it would not engage in any negotiations with investors; provide potential investors any information about the energy company that could be used as the basis for funding-related negotiations; be responsible for, or make any recommendation regarding, the terms, conditions, or provisions of any agreement for an investment; or provide any assistance to any potential investor regarding any transaction involving the financing of the energy company.

This seemingly innocuous description would have placed Brumberg in the long line of previous SEC no-action relief, such as we saw in IBEC and CBI. Not so for Brumberg because the SEC switched its focus, underscoring its transaction-based compensation approach. Now, according to the SEC staff, Brumberg's role of introducing potential investors to the company seeking financing constituted "pre-screening" potential investors to determine their eligibility to purchase securities, and "pre-selling" the company seeking financing. The SEC staff emphasized that the transaction-based compensation Brumberg sought to receive would provide Brumberg a strong incentive to engage in "pre-selling" or other sales activities such that Brumberg would need to register as a broker-dealer if it proceeded with the proposed arrangement. *Id.*

The Brumberg no-action letter would later serve as the basis for the SEC's arguments to the *Kramer* court, signifying that the method of compensation for a finder or business broker was the determinative factor for the SEC staff in deciding whether registration is required under the Securities Exchange Act.

The *Kramer* Decision

The decision in *SEC v. Kramer*, No. 8:09-cv-455-T-23TBM (M.D. Fla. Apr. 1, 2011), may be the beginning of the end for the SEC's transaction-based compensation approach. In *Kramer*, defendants Kenneth Kramer and Bruce Baker, neither of whom were registered brokers at the time, were business partners. Baker had facilitated a reverse merger on behalf of Skyway Communications Holding Corp. and continued to be compensated, pursuant to an agreement with Skyway, for his promotional efforts.

Kramer, Baker's partner, helped promote Skyway, and Skyway also compensated him directly if he introduced potential investors who ultimately invested in Skyway. *Id.* at 16–18. As a result, Kramer earned compensation for arranging a successful meeting between Skyway management and a broker interested in selling Skyway securities. Kramer also received compensation from Baker when Kramer's family, close friends, and business acquaintances bought shares in Skyway. Kramer had informed these individuals that Skyway was a good investment and encouraged them to read Skyway press releases and visit its website. *Id.* at 19–21.

Not surprisingly, given its previous no-action guidance, the SEC sued Kramer, alleging that he violated the act's broker-dealer registration requirement. However, noting that "the distinction between a finder and a broker . . . remains largely unexplored," the federal court entered judgment for Kramer. *Id.* at 29. The court explained that there is a six-factor test to determine whether a person or an entity is required to register as a broker-dealer. The six factors are as follows:

[A] person (1) works as an employee of the issuer, (2) receives a commission rather than a salary, (3) sells or earlier sold the securities of another issuer, (4) participates in negotiations between the issuer and an investor, (5) provides either advice or a valuation as to the merit of an investment, and (6) actively (rather than passively) finds investors.

Id. at 25 (citations omitted).

However, the court stated that these factors were not exclusive, and some factors, typically tied to broker-dealer activity, may be more likely to indicate broker-dealer conduct. In fact, the court cited another case, *SEC v. Bravata*, 2009 WL 2245649, at *2 (E.D. Mich. 2009), which stated that "the most important factor in determining whether an individual entity is a broker" is whether there is a "regularity of participation in securities transaction at key points in the chain of distribution." *Kramer*, No. 8:09-cv-455-T-23TBM, at *33. However, the court qualified its opinion in that certain nonexclusive factors also were to be evaluated to determine whether a finder engaged in broker activity, among them, whether the finder engaged in negotiating the terms or details of a transaction, offering advice or valuation information, and aggressively pursuing investors, in addition to receiving transaction-based compensation. *Id.* at *33–37.

In dealing with the SEC's position, the court emphatically concluded that "the Commission's proposed single-factor 'transaction-based compensation' test for broker activity . . . is an inaccurate statement of the law." *Id.* Further, the court criticized the SEC's reliance on no-action letters, pointing out that they have no binding legal authority and noting "[a]s this order exhaustively explains, an array of factors determine the presence of broker activity. In the absence of a statutory definition enunciating otherwise, the test for broker activity must remain cogent, multifaceted, and controlled by the Exchange Act." *Id.* at 37.

After this defeat, the SEC filed an appeal with the U.S. Court of Appeals for the Eighth Circuit in June 2011, and the appeal is sub judice.

Where Does the SEC Go from Here?

The *Kramer* decision rejected the SEC's transaction-based compensation approach as well as the SEC's attempt to impose on the courts its own no-action letters as interpretative guidance on the broker-dealer registration requirements. Although the SEC has appealed this decision, it is fair to expect that, at a minimum, the SEC should look inwardly to determine whether such an



approach, delineated through no-action letters, is a legitimate basis for imposing registration requirements. The *Kramer* court's analysis was far more (in its own words) "multifaceted" and flexible than the SEC's leanings, leaving those who seek to raise capital without much clarity.

Others have suggested in the past that the SEC may want to consider implementing a new rule or provide a simplified registration process for finders, who may perform limited broker-like services, *Guide to Broker-Dealer Registration, supra*, but the SEC has not been forthcoming. The SEC has also not sought guidance from Congress on this statutory "blank."

Given that the penalties for using an unregistered broker-dealer may be severe—among them, potential injunctions or civil and criminal liability, as well as restitution of fees and expenses and the denial of future applications for broker-dealer registration—greater clarity is needed to ensure proper compliance and to avoid potential enforcement action. The SEC seems to be ignoring this problem, hoping it will go away, but the Eighth Circuit may have other ideas.

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NEWS & DEVELOPMENTS

Delaware Court Dismisses Compensation Case Against Goldman Sachs

On October 12, 2011, the newly appointed Vice Chancellor Glasscock of the Delaware Chancery Court issued a decision in *In Re Goldman Sachs Group, Inc. Shareholder Litigation*, 2011 WL 4826104 (Del. Ch. Oct. 12, 2011) that ruled in favor of defendant Goldman Sachs’s motion to dismiss pursuant to Chancery Rule 23.1, which requires that a plaintiff plead particularized facts as demand futility in derivative suits.

The plaintiffs had challenged Goldman’s “pay for performance” compensation policies. The plaintiffs had argued, inter alia, that by tying pay to revenue, Goldman was incentivizing its employees to focus on short-term revenue increases at the expense of the very large attendant risks in the longer term. “The Plaintiffs contend that Goldman’s employees would do this by engaging in highly risky trading practices and by over-leveraging the company’s assets. If these practices turned a profit, Goldman’s employees would receive a windfall; however, losses would fall on the stockholders.” *Id.* at *1.

The Court dismissed these claims on the grounds that the plaintiffs had failed to meet Delaware’s demand-futility requirements—which require that a plaintiff “alleg[e] particularized facts that create a reasonable doubt that either (1) the directors are disinterested and independent or (2) “the challenged transaction was otherwise the product of a valid exercise of business judgment.” *Id.* at *6 (internal citations omitted).

As to the first prong, the court found that the majority of the board was independent and disinterested. As to the second prong, under which “the Plaintiffs must allege “particularized facts sufficient to raise (1) a reason to doubt that the action was taken honestly and in good faith or (2) a reason to doubt that the board was adequately informed in making the decision[.]” *Id.* at *12, the court again held for defendants. The court found that

[a]llocating compensation as a percentage of net revenues does not make it virtually inevitable that management will work against the interests of the stockholders . . . management and stockholder interests were aligned. Management would increase its compensation by increasing revenues, and stockholders would own a part of a company which has more assets available to create future wealth.

Id. at *19. Further, the court found that “[a]t most, the Plaintiffs’ allegations suggest that there were other metrics not considered by the board that might have produced better results. The

business judgment rule, however, only requires the board to *reasonably* inform itself; it does not require perfection or the consideration of every conceivable alternative.” *Id.* at *16.

The plaintiffs’ also claimed that the defendants had abdicated their oversight responsibilities by, among other things, failing to implement procedures to prevent risky and unlawful trades that were a result of Goldman’s compensation structure. As to these claims, the court applied the test articulated in *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch.1996), which held that “[p]laintiffs ha[ve] to show that the Board (a) . . . utterly failed to implement any reporting or information system or controls” . . . or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.” *Goldman*, 2011 WL 4826104 at *19 (internal citations omitted). The court also applied the demand-futility test for board inaction articulated in *Rales v. Blasband*, 634 A.2d 927 (Del.1993), requiring plaintiffs to plead particularized facts “creat[ing] a reasonable doubt that, as of the time the complaint [was] filed, the board of directors could have properly *exercised its independent and disinterested business judgment in responding to a demand.*” *Goldman*, 2011 WL 4826104 at *6. (emphasis added). Furthermore, “[u]nder *Rales*, defendant directors who face a *substantial* likelihood of personal liability are deemed interested in the transaction and thus cannot make an impartial decision.” *Id.* at 18.

The court held that the plaintiffs failed the *Rales* test because the defendants did not face a substantial likelihood of liability. The plaintiffs pointed to, inter alia, the collateralized debt obligation transaction with the famous investor, John Paulson, as an example of oversight failure. The court, however, found that the “transactions referenced by the Plaintiffs . . . are not sufficient pleadings of wrongdoing or illegality necessary to establish a *Caremark* claim—the only inferences that can be made are that Goldman had risky assets and that Goldman made a business decision, involving risk, to sell or hedge these assets.” *Id.* at 20. The court found that that there were no particularized pleadings that suggested that the defendants acted in bad faith or consciously disregarded their oversight risks.

As a result, “[t]he Plaintiffs ha[d] failed to allege facts sufficient to demonstrate that the directors were unable to properly exercise this judgment in deciding whether to bring these claims.” *Id.* at 23. The court did not have to therefore decide on Goldman’s Chancery Rule 12(b)(6) motion, under which pleading standards are significantly lower, to reach its decision.

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SDNY Questions SEC Settlement Practices in Citigroup Settlement

On October 27, 2011, Judge Jed. S. Rakoff, issued an order in *SEC v. CitiGroup Global Market, Inc.*, 1:11-cv-073897-JSR, DI 9 (S.D.N.Y. 2011), in which he continues to question Securities and Exchange Commission (SEC) settlement practices. In the order, Judge Rakoff listed numerous questions he intends to ask the parties when he holds a hearing on November 11, 2011 to finally approve the settlement the SEC reached with CitiGroup. Judge Rakoff, who has made comments critical of the SEC settlement practices in the past, intends to question the SEC as to why the court should approve a settlement where no wrongdoing is admitted, especially in light of the SEC's "statutory mandate to ensure transparency in the financial marketplace." *Id.* at 1. He asks, "[i]s there an overriding public interest in determining whether the S.E.C.'s charges are true? Is the interest even stronger when there is no parallel criminal case?" *Id.* The SEC has historically not required defendants to admit to any wrongdoing when reaching settlements.

He also asks "[h]ow was the amount of the proposed judgment determined? In particular what calculations went into the determination of the \$95 million dollar penalty? Why, for example, is the penalty in this case less than one fifth of the \$535 million dollar penalty assessed in [the recent case of] *SEC v. Goldman Sachs & Co.*?" *Id.* at 2. These probing questions are unusual in cases where the SEC is seeking settlement.

Thus, while the SEC has historically faced little difficulty in getting their settlements approved in federal court, and has rarely faced such probing questions from federal judges, it appears this settlement will be different. Judge Rakoff, who has been very critical of the SEC of late, will likely probe the SEC at the November 11, 2011, hearing. What effects it will have on SEC practices going forward remains to be seen.

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