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WHAT'S INSIDE

SECURITIES FRAUD

Software security developer accused of illegally selling products in Iran

A global data security software company violated federal securities laws by failing to disclose to investors that a European subsidiary sold its products to a third-party distributor that possibly resold them in Iran, a recently filed shareholder lawsuit says.

Rossbach v. VASCO Data Security International Inc. et al., No. 15-CV-06605, complaint filed (N.D. Ill. July 28, 2015).

The complaint, filed in the U.S. District Court for the Northern District of Illinois, says VASCO Data Security International Inc. lacked adequate internal controls, resulting in the potential Iran sales and a decrease in the company's stock price.

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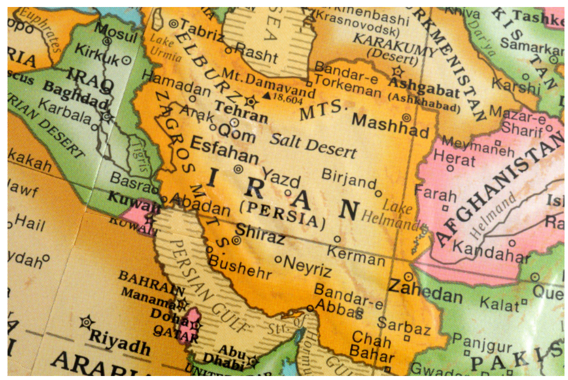

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E pluribus unum: Individual liability in securities fraud cases

By Adam Augustine Carter, Esq., and R. Scott Oswald, Esq.
The Employment Law Group

The popular definition of securities or banking fraud, as magnified by the 2008 financial crisis, is a massive-scale fraud perpetrated by a well-known institution.

Large institutional fraud is prone to capture national attention, while individual liability actions — with the occasional "Madoff" exception — are not.

Regardless of whether corporations are people, securities or banking fraud always starts with an individual (or set of individuals) who are determined there is more value in breaking the rules than there is in following them.

Corporations are, after all, just collections of individuals acting in concert.

When individuals decide to engage in fraud, they create liability not only for themselves but for other individuals in their organization.

This commentary reviews common approaches individuals use to hide behind their organizations and how enforcement authorities pursue those individuals.

It also discusses the approaches the Securities and Exchange Commission and the Federal Deposit Insurance Corp. use in reviewing and assessing frauds against individuals.

The result is a clearer picture of the tools at the disposal of enforcement authorities to bring justice to corporations and individuals.

PIERCING THE CORPORATE VEIL

The first place an individual suspected of fraud might think to hide is behind their organization.

Enforcement authorities, however, are not without the ability to "pierce the corporate veil," holding individuals liable for fraud and deceit perpetrated by a corporation.

When individuals decide to engage in fraud, they create liability not only for themselves but for other individuals in their organization.

For example, in the highly relevant jurisdiction of New York, "a court may pierce the corporate veil where: (1) the owner exercised complete domination over the corporation with respect to the transaction at issue, and (2) such domination was *used to commit a fraud or wrong* that injured the party seeking to pierce the veil."[1]

While the exact statement of the law on corporations varies from state to state, this approach is largely consistent across the country.

And, of course, New York law is relevant in the realm of securities matters.

FIDUCIARY RESPONSIBILITIES

Those dealing in securities often work with the money and assets of others.

These funds include individual clients' funds, public investors' funds, shareholders' funds and depositors' funds.

Handling these assets invokes fiduciary responsibilities and the requisite duty of care.

The SEC has made this fiduciary approach even stronger in the realm of investment advising.

In *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180, 194 (1963), the U.S. Supreme Court read into Section 206 of the Investment Advisors Act, 15 U.S.C. § 80b-6, a fiduciary responsibility applicable to registered investment advisors.

The decision makes clear that those advising on the purchase and sale of securities are subject to a lower pleading standard for fraud and are held to a high standard of fiduciary responsibility.

The high court said:

> Nor is it necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be, to establish all the elements required in a suit against a party to an arm's-length transaction. Courts have imposed on a fiduciary an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation" to employ reasonable care to avoid misleading his clients.

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In the banking context, fiduciary obligations pertain more to the safety and soundness of the institution and protection of the depositors, as well as the FDIC as the insurer of those deposits.

When dealing with publicly traded corporations, directors owe a duty of loyalty not to receive unfair benefits to the detriment of the corporation or its shareholders. They also have a duty not to usurp corporate opportunities.

THE GROUP PLEADING DOCTRINE

Once inside the corporate artifice, frauds are often perpetrated by groups of individuals working in concert.

Nonetheless, group anonymity may be insufficient to avoid individual liability for acts of fraud.

Individuals named in complaints only as part of a group have sought to use the elevated pleading standards for fraud set by Federal Rule of Civil Procedure 9(b) to avoid individual liability.

Under the "group pleading" doctrine, a plaintiff alleging securities fraud can sidestep the general pleading rule that fraudulent statements need to be linked directly to the party accused of the fraudulent act.[2]

A plaintiff can use this type of pleading only against individuals who are directly involved in the company's everyday business.

Additionally, a plaintiff must allege that the defendant was sufficiently responsible for the statements, meaning that the defendant caused the statements to be made and knew or should have known that the statement would be used to communicate with investors.

The 4th U.S. Circuit Court of Appeals has characterized "group pleading" as a doctrine that "serves as a presumption that may be invoked in favor of a plaintiff."[3]

To explain, the 4th Circuit defers to the 5th Circuit, which stated, "'Group pleading' allows a plaintiff to rely on a presumption that statements in company generated documents represent the collective work of those individuals directly involved in the company's daily management."[4]

THE SEC AND SUPERVISORY LIABILITY

The SEC also has authority to bring actions against individuals, and it may not be limited to those actually perpetrating the fraud.

Individuals who suspect fraud among their subordinates, or those who aid and abet fraud, may also be liable.

In particular, Section 15(b)(6) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o, authorizes the SEC to take action against an individual associated with a securities broker-dealer for "failure to supervise."

Such a failure occurs when a supervisor fails to prevent a securities violation by one of his subordinates.

Notably, the SEC does not take these actions against compliance personnel. Instead, it has focused on business line personnel.

> In the banking context, fiduciary obligations pertain more to the safety and soundness of the institution and protection of the depositors, as well as the FDIC as the insurer of those deposits.

Compliance personnel are implicated when they have "the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue."[5]

The SEC does not assume a compliance professional is a supervisor, but it will take into account whether that same individual has supervisory authority over employees or matters beyond the compliance area.

Ultimately, Exchange Act compliance responsibility in the broker-dealer context is retained by corporate officers and senior management.[6] The SEC does allow for supervisors to claim an affirmative defense if they made a reasonable effort to supervise and had no reason to suspect wrongdoing.

This defense is subject to the bounds of reasonableness and must actively root out fraud.

The defense will not stand if the supervisor ignored wrongdoing, if "red flags" existed or if the supervisor knew or should have known about other indicia of problems.

Exchange Act Section 15(b)(4)(E) provides an affirmative defense to potential liability for failure to supervise if a firm established procedures and a system for applying those procedures that would reasonably be expected to prevent and detect, insofar as practicable, a violation. The supervisor must have reasonably discharged his duties pursuant to the procedures and system, without reasonable cause to believe they were not in compliance.

THE SEC AND 'AIDING AND ABETTING'

Individuals may be held liable not only for affirmative fraud but also for aiding and abetting fraud under the SEC's jurisdiction.

In *IIT v. Cornfield*, 619 F.2d 909, 922 (2d Cir. 1980), the 2nd U.S. Circuit Court of Appeals laid out the three elements of an "aiding and abetting" claim:

> (1) the existence of a securities law violation by the primary (as opposed to the aiding and abetting) party; (2) "knowledge" of this violation on the part of the aider and abettor; and (3) "substantial assistance" by the aider and abettor in the achievement of the primary violation.[7]

Naturally, the details of these claims against individuals are highly case-specific.

The overarching takeaway is that it is not enough for someone in the securities world to simply keep his head down, put on blinders and steer just clear of fraud.

Supervisors need to be vigilant, and even those providing tangential assistance in service of fraud are implicated in SEC proceedings.

THE FDIC AND INDIVIDUAL LIABILITY

When a financial institution fails and the FDIC becomes its receiver, the agency has authority to investigate and take action against individuals who may have had a prominent role in causing the institution's failure.[8]

Anyone who had enough control and influence to play a significant role in the institution's failure — including officers, directors, attorneys, accountants, appraisers and brokers — can be a defendant in these cases.

Typically, these suits stem from an individual's failure to satisfy the duties of loyalty and care.

The FDIC defines three main categories of these cases:

- Individuals who engaged in dishonest conduct or approved/allowed inappropriate insider transactions.
- Individuals responsible for the institution's failure to adhere to applicable laws and regulations, the institution's own policies or other agreements and authorities impacting safety and soundness.
- Individuals who failed to establish and monitor sound underwriting policies, approved loans that they knew or should have known were problematic, or ignored warnings from advisors and regulators.

There are a number of regulatory guides the FDIC recommends to individuals to help them fulfill their duties. These resources can assist in avoiding the FDIC's ire for failure to follow applicable codes, rules and best practices.

They include "Pocket Guide for Directors" (FDIC 1988); "The Director's Book" (OCC 1987); FHLBB, Memorandum No. R 62, reprinted at 52 Fed. Reg. 22,682 (1987); and "The Director's Guide: The Role and Responsibilities of a Savings Institution Director" (FHLB-SF, 1988).

INDIVIDUAL LIABILITY FOR RETALIATION

The facts in *Wiest v. Lynch*, 15 F. Supp. 3d 543 at *567–68 (E.D. Pa. 2014), provide an excellent case study for the application of Sarbanes-Oxley retaliation claims to individuals.

The plaintiff in that case named four individuals as defendants in his SOX retaliation suit. While the allegations against three of the individuals were insufficient to defeat a motion to dismiss, the court allowed claims against the fourth to proceed.

U.S. District Judge Gene E.K. Pratter of the Eastern District of Pennsylvania went to great pains articulating that the allegations against this fourth individual defendant were "just barely" sufficient to meet the pleading standard.

This decision is helpful in understanding individual liability for retaliation claims because it clearly states a minimum pleading threshold.

One's status as a corporate officer is not enough to trigger liability for retaliation. Nor is being accused of actually participating in the fraud.

Jeffrey Wiest alleged that the defendants were known or suspected to have been involved in engineering or furthering the suspected fraud.

Only one was alleged to have actually known about Wiest's reports on the fraud, and this was the only defendant who remained after the motion to dismiss.

This shows how retaliation claims exist separately from the whistleblowing reports that serve as their source.

The allegation that most commonly leads to liability is that the individual knew of the whistleblower's protected activity, regardless of whether the whistleblowing was meritorious or the alleged fraud was substantiated.

While participation in the fraud may create a valuable factual predicate to demonstrate the motive for retaliation, someone completely uninvolved in fraudulent activity — but aware of the plaintiff's protected disclosures — is more likely to be individually liable.

CONCLUSION

We still live in a world heavily defined by the 2008 financial crisis, which means continued scrutiny of high financial crimes.

Those working in the modern financial sector need to be aware that their institutions are under the prosecutorial microscope.

Brokers, bankers, advisers, lawyers, and everyone else with even a modicum of control over the organization should know that they are not ensconced within impenetrable corporate walls.

When fraud occurs, individuals may be implicated not only by active participation but also by passive acquiescence. WJ

NOTES

1 *Blum v. Spaha Capital Mgmt.*, 44 F. Supp. 3d 482, 496 (S.D.N.Y. 2014) (emphasis added) (quoting *MAG Portfolio Consultant GMBH v. Merlin Biomed Grp.*, 268 F.3d 58, 63 (2d Cir. 2001)); *see also Grammas v. Lockwood Assocs.*, 95 A.D.3d 1073, 1075 (N.Y. App. Div., 2d Dep't 2012).

2 *SEC v. Landberg*, 836 F. Supp. 2d 148, 156 (S.D.N.Y. 2011).

3 *Dunn v. Borta*, 369 F.3d 421, 433–34 (4th Cir. 2004).

4 *Schiller v. Physicians Res. Group Inc.*, 342 F.3d 563, 569 n. 4 (5th Cir. 2003); *see also Decker v. Glen-Fed Inc. (In re GlenFed Inc. Sec. Litig.)*, 60 F.3d 591, 593 (9th Cir. 1995).

5 John H. Gutfreund, Exchange Act Release No. 31554 (Dec. 3, 1992).

6 *Sheldon v. SEC*, 45 F.3d 1515, 1517 (11th Cir. 1995)

7 *See also SEC v. Landberg*, 836 F. Supp. 2d 148, 157 (S.D.N.Y. 2011) (citing *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47–48 (2d Cir. 1978); *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 94–97 (5th Cir. 1975); *Marbury Mgmt. v. Kohn*, 470 F. Supp. 509, 515 (S.D.N.Y. 1979)).

8 *New FDIC Guidelines Issued to Clarify the Responsibilities of Bank Directors and Officers* (FIL-87-92), 1992 WL 714954 (Dec. 3, 1992).

Supreme Court preserves decision limiting bankruptcy trustees' powers to avoid securities-related transfers

By Richard Levy Jr., Esq.
Pryor Cashman

On June 22, the U.S. Supreme Court summarily denied two petitions for *certiorari*[1] that sought review of the unanimous decision of a panel of the 2nd U.S. Circuit Court of Appeals in the Bernard L. Madoff Investment Securities liquidation proceeding. The panel decision in *Picard v. Ida Fishman Revocable Trust (In re Bernard L. Madoff Investment Securities LLC)* significantly limited the scope of a trustee's clawback remedies.[2]

By applying the text of Section 546(e) of the Bankruptcy Code[3] to the facts alleged in hundreds of avoidance complaints filed by the federally appointed trustee in the broker's liquidation case, the 2nd Circuit's ruling — now beyond review — significantly limited the avoidance remedies of a trustee in a Securities Investor Protection Act liquidation proceeding. By extension, this ruling now limits the avoidance remedies of a bankruptcy trustee in any case involving transfers made by or to a stockbroker and other market participant covered by the statute.

BACKGROUND

In 2008, Irving H. Picard was appointed as the trustee under the SIPA to oversee the liquidation of Bernard L. Madoff Investment Securities LLP. In late 2010, the SIPA trustee invoked his avoidance powers — borrowed from the Bankruptcy Code[4] — to commence more than 1,000 adversary proceedings seeking avoidance of transfers by Madoff Securities (as actual fraudulent transfers under federal and state law, constructive fraudulent transfers under federal and state law, and preferences under bankruptcy law).

More that 600 of those suits targeted the broker's former customers (so-called innocent customers), none of whom were asserted by the SIPA trustee to have any knowledge or involvement in the alleged Ponzi scheme perpetrated by Madoff Securities.

> The 2nd Circuit ruling limits the avoidance remedies of a bankruptcy trustee in any case involving transfers made by or to a stockbroker.

In its *Fishman* decision in 2014, the 2nd Circuit affirmed an earlier decision of the U.S. District Court for the Southern District of New York that held the trustee in a SIPA stockbroker liquidation case may not avoid as fraudulent transfers or preferences certain securities-related transfers.[5] Applying the safe harbor under Section 546(e) of the Bankruptcy Code, the 2nd Circuit agreed that the SIPA trustee may avoid payments made during the two years immediately preceding the start of the liquidation case, but only as actual fraudulent transfers if they were made with the requisite intent.

Denying the petitions for review filed by the trustee and the Securities Investor Protection Corp., the Supreme Court let stand in all respects the 2nd Circuit's decision on the application of the Section 546(e) safe harbor. The denial left the trustee only with his claims for avoidance of actual fraudulent transfers under the Bankruptcy Code.

This brings to a close the litigation of that issue as it affected more than 1,600 customers named as defendants in more than 600 clawback actions commenced by the trustee in 2010. Moreover, it protects from avoidance more than $1.8 billion in transfers made to those customers and their subsequent transferees.[6]

MADOFF SECURITIES' TRANSFERS ARE PROTECTED AS PAYMENTS

Picard and the SIPC had asked the Supreme Court to review the 2nd Circuit's ruling that the trustee could not avoid and recover any transfers made to Madoff customers more than two years before Madoff's collapse. It further sought review of the ruling that the trustee could only reach transfers made within the two-year period if they were fraudulent — that is, made with the intent to defraud creditors.

The 2nd Circuit concluded that transfers made more than two years before the start of the bankruptcy case were covered by the safe harbor in Section 546(e) of the Bankruptcy Code. That section payments that either were made by a stockbroker "in connection with securities contracts" or were securities "settlement payments."

Although Picard and the SIPC argued that the statute should not apply to an alleged "Ponzi scheme" in which no actual securities trades occurred, the 2nd Circuit (building upon its broad ruling four years earlier in *Enron*[7]) held that the plain language of the statute governed the case and thus limited the trustee's clawback remedies.

The Supreme Court's denial of review means that former Madoff Securities customers named as defendants by Picard, who dealt with the broker under standard brokerage contracts and who knew nothing of their broker›s conduct, are protected from having

Richard Levy Jr. is a partner of **Pryor Cashman** in New York, where he is co-chair of the firm's bankruptcy and creditors' rights practice group. He argued the appeal discussed in this commentary in the 2nd U.S. Circuit Court of Appeals on behalf of the former customers of Madoff Securities, and he was counsel of record for the customers in related U.S. Supreme Court proceedings. Levy and Pryor Cashman continue to represent numerous Madoff Securities customers in pending litigation with Irving H. Picard, the Securities Investor Protection Act trustee appointed for the liquidation of Madoff Securities.

to give back any account withdrawals made more than two years before the collapse of Madoff's firm.

Section 546(e) precludes bankruptcy trustees from avoiding transfers that are "made in connection with securities contracts" *or* that constitute "settlement payments" relating to securities. Any transfer that is made more than two years before the bankruptcy case and that satisfies *either* category qualifies for the statutory protection. Thus, under *Fishman*, where alleged avoidable transfers fall within either of the protected categories, a trustee's avoidance powers will reach only transfers that occurred within the two years preceding the filing of the bankruptcy case *and* that were made by the transferor with an actual intent to hinder, delay or defraud creditors — even if they are securities-related transfers.

But qualifying transfers made outside of the two-year period will be protected from challenge by the statute. Thus, both the text of Section 546(e) and the 2nd Circuit's decision permit a trustee to continue to prosecute the two-year actual fraudulent transfers but bar all other avoidance claims under state or federal laws if the transfers fall within the safe harbor.

THE EFFECT OF THE DECISION

When applied to the requisite securities-related transfers, Section 546(e) by its terms will bar all of a SIPA trustee's clawback claims except for the two-year actual fraudulent transfer claims under Section 548(a)(1)(A). By limiting the trustee's avoidance powers to the two-year remedy for actual fraudulent transactions, the court's ruling has the direct effect of prohibiting the SIPA trustee for Madoff Securities from utilizing the typically longer reach-back remedies under state fraudulent transfer laws otherwise available for non-securities-related transfers. In the Madoff Securities case, for example, New York has six-year fraudulent-transfer statutes.

Left wholly intact by the Supreme Court, the *Fishman* decision places beyond the SIPA trustee's reach an aggregate of more than $1.8 billion in challenged transfers by Madoff Securities to former customers and subsequent transferees.

The *Fishman* decision will significantly impact trustees and transferees in other bankruptcy settings where challenged transfers fall within the safe harbor under Section 546(e). In *Fishman*, the 2nd Circuit became the latest of several federal appeals courts to hold that, by its plain terms, Section 546(e) applies to qualifying transfers even in the context of massive frauds characterized as a "Ponzi schemes."[8] However, it is the first federal circuit court to hold that the safe harbor applies even if the stockbroker allegedly did not make any real securities trades for its customers.

> More that 600 lawsuits targeted the broker's former customers (so-called innocent customers) who did not have any knowledge of the alleged Ponzi scheme perpetrated by Madoff Securities.

Notwithstanding the trustee's allegations of the existence of a Ponzi scheme perpetrated by Madoff and the lack of securities trading, *Fishman* held that a sufficient contractual relationship existed between the broker and the customers based on their account documents and the broker's promises to the customers. Accordingly, the payments were made "in connection with" those contracts. Therefore, they were protected against avoidance even where the broker failed to perform its obligations, such as by failing to trade for the customers' accounts or misappropriating the customers' funds or securities.

The court also held that the broker's transfers to the customers were protected as securities "settlement payments." Again, despite the alleged absence of underlying securities trades, the 2nd Circuit concluded that each payment was made in response to a customer's request for a withdrawal from its account, i.e., a request to dispose of securities from the customer's account. The payments thus settled a securities transaction between the broker and customer, even though the stockbroker did not actually execute a trade but instead stole money from other clients to fund the payment.

Now that the Supreme Court has declined to review the *Fishman* decision, the 2nd Circuit's ruling is likely to have far-reaching implications. Importantly, the decision shrinks the scope of a SIPA trustee's power to pursue avoidance claims in SIPA liquidation cases. But the decision will also prevent trustees in ordinary bankruptcy cases from avoiding transfers that satisfy the safe-harbor categories of Section 546(e) —even if there was no underlying securities transactions but the parties otherwise were engaged in relationships that involved securities contracts or settlement payments.

Although the decision directly binds only the lower federal courts within the 2nd Circuit (New York, Connecticut and Vermont), it is likely to be cited as a strong precedent. This is because the 2nd Circuit is viewed as a particularly influential federal tribunal based on its heavy concentration of corporate and commercial disputes.

Despite its breadth, the holding in *Fishman* does not eliminate all of the Madoff trustee's clawback remedies. Nor does it extinguish all avoidance remedies of other bankruptcy trustees. The 2nd Circuit's ruling does not affect a bankruptcy or SIPA trustee's ability to seek avoidance of transfers made by stockbrokers in the two years immediately preceding the commencement of the bankruptcy case, if the broker made the transfers with an actual intent to hinder, delay or defraud creditors. Those claims remain in play against the customer-defendants covered by the *Fishman* decision.

Moreover, *Fishman* provides no immediate protection to any clawback targets alleged by a trustee to have known of the debtor's fraud or to have blinded themselves to it.[9] In the Madoff Securities context, those targets generally include feeder funds and financial institutions as well as individuals who had close relationships with Madoff over long periods of time.

Under pertinent case law not involved in the *Fishman* ruling, such targets (unlike the "innocent" customers covered by the 2nd Circuit ruling) likely will be unable to obtain dismissal at the pleading stage of claims for avoidance of transfers made more than two years before the bankruptcy case. This is because of the fact-intensive nature of issues regarding actual knowledge of or willful blindness to a debtor's fraud. A defendant faced with such allegations by a trustee may have to litigate the action through to summary judgment motion practice or even trial to defeat the claims. WJ

NOTES

[1] *Sec. Inv'r Prot. Corp. v. Ida Fishman Revocable Trust (In re Bernard L. Madoff Inv. Sec. LLC),* 135 S. Ct. 2858 (2015); *Picard v. Ida Fishman Revocable Trust (In re Bernard L. Madoff Inv. Secs. LLC),* 135 S. Ct. 2859 (2015).

[2] *Picard v. Ida Fishman Revocable Trust et al*. (In re Bernard L. Madoff Inv. Sec. LLC), 773 F.3d 411 (2d Cir. 2014).

[3] Section 546(e) provides, in relevant part, "The trustee may not avoid a transfer that is a … settlement payment, as defined in section 101 or 741 of this title, made by … a … stockbroker … or that is a transfer made by … a … stockbroker … in connection with a securities contract, as defined in section 741(7) [the Bankruptcy Code] … that is made before the commencement of the case, except under section 548(a)(1)(A) of [the Bankruptcy Code]." 11 U.S.C. § 546(e).

[4] See SIPA § 8(c)(3), 15 U.S.C. § 78fff-2(c)(3).

[5] *Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC,* 476 B.R. 715, 722, 730 (S.D.N.Y. 2012) (Rakoff, J.). Accord, Picard v. Katz (In re Bernard L. Madoff Inv. Sec. LLC), 462 B.R. 447 (S.D.N.Y. 2011) (Rakoff, J.), certification for interlocutory appeal denied, 466 B.R. 208 (S.D.N.Y. 2012), settlement approved and action dismissed, No. 11-cv-3605 (S.D.N.Y. June 1, 2012) (ECF Nos. 192-93). The District Court approved the limited consolidation of all pending actions by the trustee against "innocent customer" defendants for purposes of facilitating an appeal of the Section 546(e) issue, and it certified its dismissal of the affected claims as final judgments under Federal Rule of Civil Procedure 54(b) from which the trustee and SIPC appealed to the 2nd Circuit.

[6] See Trustee's Ninth Interim Report, *In re Bernard L. Madoff Inv. Sec. LLP,* 44 n.7 (Bankr. SD.N.Y. Apr. 30, 2013) (ECF No. 5351) ("[I]f [the District Court's] interpretation of Section 546(e) is upheld, the trustee will be prohibited from pursuing preference and state law fraudulent conveyance claims totaling approximately $1.8 billion, but will remain able to pursue avoidance actions seeking the return of approximately $1.5 billion in fraudulent conveyances occurring within the two years prior to the BLMIS bankruptcy filing."). In his Supreme Court petition, the trustee asserted that allowing the 2nd Circuit decision to stand could affect his ability to recover up to $4 billion in claims but did not explain the basis of that figure.

[7] *Enron Creditors Recovery Corp. v. Alfa S.A.B. de C.V.,* 651 F.3d 329, 334 (2d Cir. 2011).

[8] See, e.g., Grede v. FCStone, LLC, 746 F.3d 244, 251-54 (7th Cir. 2014) (applying Section 546(e)'s "deliberately broad" text to shield from clawback "settlement payments" made "in connection with a securities contract"); Grayson Consulting Inc. v. Wachovia Sec. (In re Derivium Capital LLC), 716 F.3d 355, 366 (4th Cir. 2013) (rejecting argument that there should be an "exception" to Section 546(e) for Ponzi schemes). See also Wyle v. Howard, Weil, Labouisse, Freidrichs Inc. (In re Hamilton Taft & Co.), 114 F.3d 991, 997 (9th Cir. 1997) ("[The ethical nature of the transaction is irrelevant to our determination of the legal issues involved. … [The prior version of] Section 546(e) [then in force] explicitly excepts fraudulent transfers that are completed within one year of the filing of the bankruptcy petition. Because the reverse repo transaction at issue here was completed over two years before the filing of [the debtor's] bankruptcy petition, the trustee cannot invoke the fraud exception to Section 546(e).").

[9] See *Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLP, No.* 12 MC 115, *2013 WL 1609154, at *4* (S.D.N.Y. Apr. 15, 2013) (Rakoff, J.) ("If the allegations adequately allege that a defendant had actual knowledge of Madoff's scheme, such a transferee stands in a different posture from an innocent transferee, even as concerns the application of Section 546(e). … [T]he burden is on the trustee to prove that a transferee does not meet what the language and purpose of Section 546(e) require. … [T]o do this, the trustee must show, at a minimum, that the transferee had acquittal knowledge that there were no actual securities transactions being conducted"); *Picard v. Merkin (In re Bernard L. Madoff Inv. Sec. LLC)*, 515 B.R. 117, 138 (Bankr. S.D.N.Y. 2014) (Bernstein, J.) ("If, however, an initial (or subsequent) transferee had actual knowledge of Madoff's Ponzi scheme, he cannot avail himself of the Section 546(e) safe harbor, and the trustee can avoid and recover preferences and actual and constructive fraudulent transfers to the full extent permitted by state and federal bankruptcy law."). But the standard of proof for a trustee to escape the application of Section 546(e) is high: "'[A]ctual knowledge' implies a high level of certainty and absence of any substantial doubt regarding the existence of a fact." *Picard v. Merkin,* 515 B.R. at 139.

Judge calls strike out on ex-Lehman employees' ESOP suit; appeal filed

Ex-Lehman Bros. employees who claimed company stock plan fiduciaries recklessly continued to buy Lehman stock despite the investment bank's imminent failure in the 2008 financial collapse struck out again in Manhattan federal court July 10.

In re Lehman Brothers ERISA Litigation, No. 1:08-cv-05598, 2015 WL 4139978 (S.D.N.Y. July 10, 2015).

According to the U.S. District Court for the Southern District of New York docket, however, the plaintiffs filed an appeal to the 2nd U.S. Circuit Court of Appeals five days later. The July 15 filing marks the second time they have appealed the dismissal of their suit.

U.S. District Judge Lewis A. Kaplan on July 10 dismissed a third amended complaint by Lehman's employee stock option plan beneficiaries. He said that after filing several versions of the complaint they still had not adequately alleged that their plan managers — many of whom were officers and directors — disloyally put Lehman's interests ahead of the investors'.

Before it filed the largest bankruptcy in U.S. history in September 2008, Lehman was the fourth-largest financial services firm in the nation and a leader among investment banks in borrowing to invest in subprime mortgage loans and exotic and risky securities based on them.

The consolidated complaint alleged the ESOP fiduciaries violated their duty under the Employee Retirement Income Security Act to manage the plan prudently because as the subprime securities market imploded, they had to know Lehman was not a "suitable and appropriate" investment for an employee stock plan.

The suit claimed the plan managers were part of a scheme to conceal material information that would have caused employee investors

REUTERS/Alex Grimm

to demand the withdrawal of their funds had they known the danger of investing in Lehman stock that depended on the value of mortgage-backed securities.

At the very least, the complaint said, the plan fiduciaries breached their duty to investigate Lehman's alleged overreliance on volatile subprime-mortgage-based securities and the danger that posed to a stock in which the ESOP was heavily invested.

However, Judge Kaplan found that the plaintiffs failed to back their claims with particularized allegations.

As in previous dismissal rulings, the judge found that most of the plaintiff's allegations amounted to claims that the defendant fiduciaries should have used their positions as Lehman officers and directors to detect that rough waters lie ahead for the company and warn the plan participants.

Plan managers have no such duty, Judge Kaplan said in the July 10 ruling.

To sustain such a claim, he said, "a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than help it."

As to the alleged duty to investigate Lehman's deteriorating financial condition, the judge said the complaint still does not explain "how plaintiffs' hypothetical investigation would have uncovered the alleged inside information" so that the fiduciaries could have warned the plan participants — if they had a duty.

Besides, a rapid divestiture of Lehman stock by the ESOP "would have accelerated Lehman's collapse and reduced the plan's value," he added.

The plaintiffs did not even prove the fiduciaries violated a duty to monitor the health of the stock in which the ESOP invested, Judge Kaplan said in dismissing all claims. WJ

Attorneys:
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Defendants: Jonathan K. Youngwood and Janet A. Gochman, Simpson Thacher & Bartlett, New York; Todd S. Fishman, Allen & Overy, New York

Related Court Document:
Opinion: 2015 WL 4139978

See Document Section B (P. 29) for the opinion.

PIMCO funds urge court to dismiss AIG suit

Dozens of Pacific Investment Management Co. funds have argued in a recent Manhattan federal court filing that a lawsuit filed by American International Group to stop their California state court action against the insurance giant must be thrown out.

American International Group Inc. v. Pacific Investment Management Co., No. 15-CV-03339, motion to dismiss filed (S.D.N.Y. July 10, 2015).

AIG's complaint, filed in the U.S. District Court for the Southern District of New York, seeks a determination that PIMCO filed suit beyond the applicable three-year statute of repose.

The PIMCO funds say the court should toss the insurance company's complaint because U.S. District Judge David O. Carter of the Central District of California recently granted the funds' motion to remand their suit to state court. *Pac. Inv. Mgmt. Co. et al. v. AIG Inc.*, No. 15-CV-0687, 2015 WL 3631833 (C.D. Cal. June 10, 2015).

AIG violated federal securities laws by misrepresenting the size of its swap portfolio and the rising costs associated with its swap business during the crisis, the PIMCO funds claim.

The funds had opted out of an approved $970.5 million settlement between AIG and other investors in an earlier Manhattan federal court action. *In re AIG Inc. 2008 Sec. Litig.*, No. 08-CV-4772, *consolidation order issued* (S.D.N.Y. Mar. 20, 2009).

According to the funds' state court complaint, AIG began providing billions of dollars of swaps — a kind of financial insurance against default risk — tied to the subprime market to several financial institutions in the mid-2000s.

AIG received periodic payments during the life of a swap from a debt security issuer in exchange for providing insurance on the securities to their purchaser. If the underlying financial security defaulted, AIG was obligated to buy it from the purchaser at face value.

Pursuant to some swap contracts, if AIG's or the underlying security's credit rating fell below a certain threshold, AIG had to post cash collateral as assurance it could fulfill its obligations, the suit said.

When the housing market collapsed, the swap counterparties requested reimbursements and collateral totaling billions of dollars, resulting in the federal government rescue of AIG in September 2008 because of its precarious financial condition.

The company's stock dropped 97 percent as news of the insurance giant's swap exposure and the government rescue hit the market, the PIMCO funds claim.

AIG violated federal securities laws by misrepresenting the size of its swap portfolio and the rising costs associated with its swap business during the crisis, the complaint says.

Several investors sued the company, and in March 2009 the complaints were consolidated in the Southern District of New York as *In re AIG Inc. 2008 Securities Litigation*. The PIMCO funds were members of the consolidated cases, but they opted out when AIG and the lead plaintiffs reached a settlement approved in March by U.S. District Judge Laura Taylor Swain.

AIG's suit, meanwhile, seeks a determination that the California suit is untimely.

The funds purchased AIG securities between October 2006 and May 2008; thus, the applicable three-year repose period began to run after the last offering in May 2008 and expired in May 2011, the insurance giant claims.

REUTERS/Brendan McDermid

The funds are asking the District Court to dismiss AIG's suit, saying the court does not have jurisdiction over the action and the complaint is an "end run" around the Securities Act of 1933's anti-removal provision, 15 U.S.C. § 77v, and an "illegitimate" use of the Declaratory Judgment Act, 28 U.S.C. § 2201.

"AIG's attempt to substitute this court for California state court is an improper invocation of the Declaratory Judgment Act in order to circumvent the federal removal statute and the Securities Act's removal bar, and to evade a remand order issued by a sister federal court," the funds' motion to dismiss says. WJ

Related Court Documents:
Motion to dismiss: 2015 WL 4512460
AIG complaint: 2015 WL 1928724
PIMCO complaint: 2015 WL 1531249

Standard & Poor's tells 2nd Circuit to squash attempt by German bank to revive suit

Standard & Poor's has argued in an appellate brief that a trial judge properly dismissed a lawsuit accusing it of giving false credit ratings to commercial paper and debt notes issued by a now-defunct structured investment vehicle.

IKB Deutsche Industriebank AG v. McGraw Hill Financial Inc., No. 15-1387, appellees' brief filed (2d Cir. July 23, 2015).

In its brief to the 2nd U.S. Circuit Court of Appeals, S&P says U.S. District Judge Jed S. Rakoff of the Southern District of New York correctly determined that IKB Deutsche Industriebank sued the company too late. *IKB Deutsche Industriebank AG v. McGraw Hill Fin.*, No. 14-CV-3443, 2014 WL 4376202 (S.D.N.Y. Sept. 2, 2014).

According to IKB's lawsuit, the German bank purchased $574 million worth of commercial paper and capital notes — both highly rated by S&P — issued by the structured investment vehicle Rhinebridge. IKB Credit Asset Management GmBH, a subsidiary of IKB, managed Rhinebridge.

Structured investment vehicles issue short-term debt and use the sales proceeds to purchase long-term assets such as mortgage-backed securities. Commercial paper is a short-term, fixed-interest debt instrument, and capital notes are a low-priority debt instrument.

Rhinebridge raised money from investors by selling commercial paper and capital notes. It used the proceeds from the commercial paper and notes to buy mortgage-backed securities and collateralized debt obligations, the suit claims.

An MBS is a financial instrument tied to pools of mortgage loans, and a CDO is an instrument made up of mortgage-backed securities and other debt securities.

S&P highly rated the CDOs and MBS as well as the commercial paper Rhinebridge issued, the suit says.

IKB said it relied on the ratings S&P gave the CDOs and MBS when deciding which investments to make on behalf of Rhinebridge and when it decided to invest its own money in Rhinebridge's paper and notes.

IKB had notice of the allegations when it and S&P were sued by King County, Washington, over the same structured investment vehicle Oct. 2, 2009, he said. *King Cnty. v. IKB Deutsche Industriebank et al.*, No. 09-CV-08387, 2009 WL 3239032, *complaint filed* (S.D.N.Y. Oct. 2, 2009).

Although New York has a six-year limitations period, the judge explained, the state's "borrowing statute" uses the shortest limitations period available — in this case Germany's time limit.

> Shortly after IKB invested $547 million in S&P-rated paper and notes in 2007, the notes were downgraded from "investment grade" to "junk," causing IKB to lose its entire investment, the bank says.

Shortly after IKB invested $547 million in Rhinebridge paper and notes in 2007, the notes were downgraded from "investment grade" to "junk," causing IKB to lose its entire investment, the bank says.

S&P asked the court to dismiss the suit, contending it was filed beyond the German three-year limitations period.

Judge Rakoff agreed and expanded his reasoning in a memorandum opinion, saying the German three-year limitations period barred the suit. *IKB Deutsche Industriebank AG v. McGraw Hill Fin.*, No. 14-CV-3443, 2015 WL 1516631 (S.D.N.Y. Mar. 26, 2015).

To file within the German three-year limitations period, IKB needed to sue by Oct. 22, 2012. Instead, it waited until 2014, the judge said in his opinion.

The bank is now asking the 2nd Circuit to reverse the dismissal, arguing the trial court misapplied German law.

The German limitations period would start not when the King County complaint was filed, but when discovery in that case began in 2010, the brief argues. A 2013 agreement between S&P and IKB — which was made within the three-year limitations period — then tolled the time limit, the IKB asserts.

S&P counters in its brief that Judge Rakoff accurately applied German law.

"The German statute of limitations began to run no later than Dec. 31, 2009, because IKB admits … that it had actual knowledge of the King County complaint and the facts alleged therein prior to that date," the brief says. WJ

Related Court Documents:
Appellees' brief: 2015 WL 4511378
Appellant's brief: 2015 WL 3830566

REUTERS/Wolfgang Rattay

REUTERS/Brendan McDermid

IKB Deutsche Industriebank says it purchased $574 million worth of commercial paper and capital notes — both highly rated by S&P — issued by the structured investment vehicle Rhinebridge. The notes were soon downgraded from "investment grade" to "junk," causing IKB to lose its entire investment, the bank says.

S&P shareholder asks Supreme Court to review fraud suit

A Standard & Poor's shareholder is urging the U.S. Supreme Court to examine the dismissal of a lawsuit accusing the credit ratings agency of artificially increasing its stock price by giving false ratings to certain financial instruments before the global financial crisis.

Boca Raton Firefighters and Police Pension Fund v. Bahash et al., No. 15-88, petition for cert. filed (U.S. July 20, 2015).

In its petition for *certiorari*, the Boca Raton Firefighters and Police Pension Fund says the 2nd U.S. Circuit Court of Appeals incorrectly threw out its 2008 suit and failed to reinstate the complaint when new evidence demonstrated the company and its top executives' knew the ratings were inflated.

The pension fund claims the Justice Department disclosed the information when it filed its own suit in February 2013 in California federal court, accusing S&P of inflating credit ratings to the detriment of federally insured financial institutions. *United States v. McGraw-Hill Cos.*, No. CV-13-00779, *complaint filed* (C.D. Cal. Feb. 4, 2013).

ALLEGATIONS AGAINST S&P

The claims in the case arise from S&P's alleged inflation of credit ratings for structured financial instruments leading up to the recent global financial crisis. Shareholders say the agency's stock price was artificially high and dropped when it became public that S&P's inflated ratings played a role in the recession.

The company acts as an intermediary between issuers of debt instruments and investors. It analyzes various securities from issuers and rates them according to risk.

Investors in the instruments rely on S&P's ratings and use them to gauge the riskiness of securities for purchase. The ratings spare investors the costs associated with analyzing the instruments' credit risk themselves.

> The 2nd Circuit's "overly broad puffery definition threatens to usurp the fundamental concept that materiality is inherently fact-specific and context-sensitive," the petitioner argues.

Boca Raton argues the information was not available to it in 2008.

The ratings agency in February settled with the Justice Department, 19 states and the California Public Employees' Retirement System for agreeing to pay $1.5 billion. *United States v. McGraw-Hill Cos. et al.*, No. 13-CV-0779, *joint stipulation for dismissal filed* (C.D. Cal. Feb. 4, 2015).

S&P did not admit to any wrongdoing in agreeing to settle.

S&P represented to investors that its rating system was objective and independent, the complaint said.

According to the suit, the company was inflating its ratings in favor of debt issuers to gain a greater market share. The securities performed badly, hurting investors in the securities and causing a drop in S&P's share price, hurting its shareholders.

Several shareholders then filed suit, alleging violations of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t(a).

S&P moved to dismiss the consolidated claims, and U.S. District Judge Sidney H. Stein of the Southern District of New York granted the motion in March 2012, holding that the statements were "puffery" and not actionable. *Reese v. McGraw-Hill Cos.*, No. 08-CV-7202, 2012 WL 9119573 (S.D.N.Y. Mar. 30, 2012).

NEW INFORMATION

In 2013, the Boca Raton pension fund moved to amend its complaint based on new evidence in the Justice Department lawsuit, but Judge Stein denied the motion. He said they were not entitled to the "extraordinary remedy" of relief from a final judgment because the new information would not have changed his earlier ruling. *Reese v. McGraw-Hill Cos.*, No. 08-CV-7202, 2013 WL 5338328 (S.D.N.Y. Sept. 24, 2013).

The new information was too similar to the plaintiffs' old allegations, the judge said.

The 2nd Circuit affirmed Judge Stein's ruling in a summary order last September. *Reese v. Bahash et al.*, 574 Fed. Appx. 21 (2d Cir. 2014).

Boca Raton is now appealing both decisions, saying it adequately alleged S&P knowingly defrauded shareholders.

Additionally, the Supreme Court should review the case because the 2nd Circuit's "overly broad puffery definition threatens to usurp the fundamental concept that materiality is inherently fact-specific and context-sensitive," the pension fund argues. WJ

Related Court Document:
Petition: 2015 WL 4450645

7th Circuit freezes out alleged fraud victim from disgorged profits

An alleged fraud victim cannot receive the disgorged profits from a penny stock fraud because he was not a victim of that scheme, even though he says he was cheated by the same penny stock fraudster, the 7th U.S. Circuit Court of Appeals has ruled.

Securities and Exchange Commission v. Custable et al., No. 15–1442, 2015 WL 4529304 (7th Cir. July 23, 2015).

The appellate panel said Brad Hare failed to intervene in the action at the trial stage, precluding him from requesting a portion of the disgorged profits from Frank Custable.

The Securities and Exchange Commission also gave the disgorged profits to the U.S. Treasury because there was not a lot of money and there were many victims, the panel said.

According to the 7th Circuit's opinion, the SEC filed civil charges against Custable and others in 2003, accusing them of penny stock fraud that began in 2001.

Penny stocks are valued at less than $5, and the fraud involves pumping up the cheap stocks to inflated rates and selling shares to investors.

The Justice Department filed a separate criminal case against Custable, halting the civil proceedings, and he pleaded guilty to the fraud in 2009. He was sentenced to nearly 22 years in prison. *United States v. Custable et al.*, No. 05-CR-00340, *defendant sentenced* (N.D. Ill. June 9, 2009).

REUTERS/Jim Young

The civil case resumed, and Custable settled the charges, agreeing to disgorge his profits of $6.4 million. Only $500,000 was recovered, however.

The SEC decided to give the disgorged profits to the Treasury because of the large number of victims, the small amount recovered and the length of time since the fraud.

Hare asked U.S. District Judge Sharon Johnson Coleman of the Northern District of Illinois, who is overseeing the SEC case, for a portion of the profits, claiming Custable defrauded him in a separate incident.

Judge Coleman denied Hare's request in February, ruling that the disgorged profits involved only the penny stock fraud. *SEC v. Custable et al.*, No. 03-CV-02182, *minute entry issued* (N.D. Ill. Feb. 5, 2015).

Hare appealed, arguing that he is more entitled than the Treasury to the disgorged profits.

> The man failed to intervene in the action at the trial stage, precluding him from requesting a portion of the disgorged profits, the appeals court said.

The 7th Circuit agreed with Judge Coleman.

First, the panel said Hare did not intervene in the case. Then, it determined Hare was not entitled to the profits anyway because he was not a penny stock victim, and the SEC was entitled to pay the profits to the Treasury. WJ

Related Court Document:
Opinion: 2015 WL 4529304

Shareholders want Chinese battery firm's numbers before stock buyback

Shareholders of a publicly traded China-based battery manufacturer have filed a complaint to enforce their right to inspect the company's books and records in anticipation of a stock buyback program.

Duchesneau et al. v. Advanced Battery Technologies Inc., No. 11226, complaint filed (Del. Ch. June 29, 2015).

More than a dozen investors say in the complaint filed in the Delaware Chancery Court that Advanced Battery Technologies Inc., a Delaware corporation with facilities in China, has failed to file any reports with the Securities and Exchange Commission since 2011, making it impossible to determine if the company's offer price would be fair or acceptable.

Advanced Battery's common stock is registered with the SEC and trades on the Nasdaq small-cap market exchange. The complaint says the company announced the planned stock repurchase program last November.

The plaintiffs say they have no idea of the true value of their stock. The only financial data Advanced Battery has provided in the last four years has been some limited information posted on its website in May 2013, but even that was not up to U.S. accounting standards, according to the complaint.

Lead plaintiff Louis Duchesneau and others say that between June 15 and 17 they served Advanced Battery's service agent in Delaware with demands to inspect the books under 8 Del. C. § 220. The complaint notes valuation is a proper purpose for inspection under that section of law.

To that end, the plaintiffs sought figures for annual revenue, income before taxes, earnings per share, cash and cash equivalents, and total assets and total liabilities between January 2011 and the present, as well as quarterly figures for each of those categories going back one year from the date of the demand.

> The company has not made any SEC filings since 2011, according to shareholders attempting to determine the health of their investments.

The company allegedly failed to respond within five business days, effectively constituting a refusal to produce the requested documents under Section 220.

The plaintiffs now seek a judgment in their favor and an order compelling Advanced Battery to produce the requested documents, as well as an award for the costs of bringing suit and any other relief the court deems proper.

The complaint notes that the Chancery Court has already ordered Advanced Battery to produce books and records in a similar matter filed by another shareholder and that the plaintiffs here are not seeking anything beyond the scope of inspection in that action. *Southpaw Credit Opportunity Master Fund LP v. Advanced Battery Techs.*, No. 9542-ML, *order confirming master's final report issued* (Del. Ch. Mar. 27, 2015),

Despite the court's prior order in *Southpaw*, ABAT has not produced any of the requested records, and the plaintiff in that case is preparing a contempt motion against the company, according to the complaint. WJ

Attorney:
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Related Court Document:
Complaint: 2015 WL 4094737

Trade group challenges CLO risk retention rule

The Securities and Exchange Commission and the Federal Reserve abused their discretion when they implemented a credit risk retention rule for collateralized loan obligations as a part of the 2010 Dodd-Frank Wall Street reform law, a loan market advocacy group says in a recent court filing.

Loan Syndications and Trading Association v. Securities and Exchange Commission et al., Nos. 14-1240 and 14-1304, reply brief filed (D.C. Cir. July 10, 2015).

The Loan Syndications and Trading Association says in a reply brief opposing dismissal in the District of Columbia U.S. Circuit Court of Appeals that the agencies rule is arbitrary and capricious and will hurt the economy by restricting lending. In addition, the group says, the agencies' brief did not address the LSTA's complaint about the rule.

The LSTA filed a lawsuit asking the appellate panel to invalidate the rule. The District of Columbia Circuit oversees challenges to agency rules.

Collateralized loan obligations are financial instruments backed by loans made to corporate borrowers. The loans are pooled together by CLO managers and placed into trusts or special purpose vehicles that then issue certificates to investors.

There are two types of CLOs: open market CLOs and balance sheet CLOs.

Open market CLOs pool loans from different institutions or the secondary market, while balance sheet CLOs originate from one source.

The credit risk retention rule is an interagency rule that requires securitizers to retain 5 percent of the underlying assets to an asset-backed securities offering. CLO managers are considered securitizers under the rule.

The Federal Reserve, SEC, Office of the Comptroller of the Currency, Federal Deposit Insurance Corp., Department of Housing and Urban Development, and Federal Housing Finance Agency adopted the rule in late 2014.

According to the LSTA, open-market CLO managers are not securitizers, and securitizers are responsible for transferring assets to third parties.

An open-market CLO manager does not transfer loans because it never originates or possesses them, the association says. Rather it acts as the CLO's agent, buying loans on the CLO's behalf, it adds.

CLOs are safer than other derivative instruments and should not be hindered by restrictive lending rules, the trade group says in its brief.

"The agencies provide no reason to doubt that CLOs' superior performance shows the superiority of CLOs managers' practices and shows that the structure of open-market CLOs does in fact provide strong, useful incentives to managers," the brief says.

The regulators counter in their brief that the rule will help to prevent a future financial crisis.

Open-market CLO managers do transfer loans, and the LSTA "relies on an unnaturally narrow interpretation of the term 'transfer,'" the SEC and Federal Reserve say in response.

The agencies say their definition of a securitizer is entitled to deference.

In addition, they say that Congress directed them to require that securitizers retain 5 percent risk and did not exempt CLO managers from this requirement.

REUTERS/Jonathan Ernst

Moreover, the agencies add, they gave managers options for retraining risk, lessening their economic burden.

In its reply brief, the LSTA says the agencies "sidestep the key issues."

The regulators do not justify the high level of credit risk the rule requires or address the petitioner's arguments that they failed to offer alternatives to lessen the rule's burden on market participants, the LSTA asserts.

Finally, the agencies' rule-making approach "was inconsistent with basic administrative law obligations to address comments, to articulate reasons for rejecting alternatives, to rationally assess costs and benefits, and to ground agency decisions in the record," the reply brief says. WJ

Related Court Documents:
Reply brief: 2015 WL 4154129
Respondents' brief: 2015 WL 3622789
Petitioner's brief: 2015 WL 3622788

Legal expense cost containment: Applying legal process outsourcing to financial services

By Deirdre Oren Byrne
Integreon

Financial services firms are under siege. So says Jamie Dimon, CEO of JPMorgan Chase & Co., the biggest U.S. bank as measured by assets. "We have five or six regulators coming at us on every issue," Dimon said in January.[1] And he is not being overly dramatic; his firm's legal "spend" — all its legal expenses — nearly tripled in 2014 from a year earlier.[2] The reason, Dimon states bluntly, is regulators.

There is no doubt that in the post-"too big to fail" era, regulatory scrutiny has increased exponentially. In its well-intentioned efforts to ensure that the country does not face another financial meltdown, Congress has not only tightened regulations, but has also vastly expanded the number of regulatory bodies scrutinizing the banks. Chief among the regulators to which Dimon referred are the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Department of Justice, and a private self-regulatory body called the Financial Industry Regulatory Authority, commonly known as FINRA.

Their task areas often overlap, complicating the regulatory landscape. In an attempt to get ahead — or at least stay on top — of the required heightened reporting requirements, banks and other financial institutions have implemented or enhanced their own internal compliance programs and increased their regulatory burden. Internal checks and balances will go a long way toward ensuring compliance with the increasing demands, but at a huge cost.

ESCALATING LEGAL SPENDING

In addition to JPMorgan, Bank of America and Citibank, the second- and third-largest banks in size in terms of assets, are also seeing their legal spending escalate. Based on their annual reports, these three firms' costs for legal services increased between 2012 and 2014. Shockingly, the amount spent on lawyers, litigation and meeting the demands of regulators by the six largest U.S. banks has now reached a combined $51 million per day, which is enough to erase all 2012 earnings.[3]

Congress has not only tightened regulations but has vastly expanded the number of regulatory bodies scrutinizing banks.

Dimon is not the only CEO to see large legal bills. Michael Corbat, Citibank's CEO, reported that the bank's legal expenses were $2.7 billion per quarter in 2014.[4] Settlements extracted by regulators are also drastically affecting the bottom line: BofA agreed to a settlement with the Justice Department in August 2014 to the tune of roughly $17 billion.[5] And one thing the big banks can count on is that the trailing lawsuits arising from the residential mortgage-backed securities meltdown are not ending any time soon.

While the settlements may appear to be largely in the rear view mirror, the regulatory scrutiny and litigation are likely to proceed unabated. There are, however, strategies financial services firms can employ to contain costs while achieving both streamlined processes and uniformity of results.

HOW DID WE GET HERE?

The genesis of the new regulatory landscape can be traced to the Great Recession, which was precipitated in large part by the residential mortgage-backed securities debacle between 2000 and 2010. The falling profitability of banks can be directly linked not only to heightened regulatory scrutiny and resulting litigation but also to the ensuing settlements extracted by federal and state regulators.[6]

Commentators on both sides of the current political divide have opined that it was the largely unheralded 1999 repeal of the Glass-Steagall Act that caused the U.S. and global economic meltdowns.[7] The act, which encompasses four provisions of the Banking Act of 1933, was a concise and tightly drafted piece of legislation, separating the purview of banking activities into two discrete categories: commercial and investment. After 2008, Congress attempted to close the proverbial barn doors with a regulatory monster: the Dodd-Frank Wall Street Reform and Consumer Protection Act.

That act contains roughly 400 provisions, and it is estimated that only 40 percent of them have been implemented to date. It names a wide variety of regulatory agencies to scrutinize banks and financial services firms and enforce compliance. It also created the Financial Stability Oversight Council and empowered the creation of sub-agencies under the aegis of many of the existing regulatory bodies, such as the Federal Reserve.

Dodd-Frank, however, is only one of a number of stepped-up requirements in

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the new climate. Anti-fraud, anti-money laundering, "know your customer," "know your supplier" and a host of other new or expanded regulations are now a part of the everyday lives of legal and compliance officers and their outside counsel.

COST CONTAINMENT: THE LPO MODEL

A number of the large global investment banks are containing or reducing their legal expenses by using a legal process outsourcing partner. More will inevitably follow. The simple reason for this coming trend is that the numbers speak for themselves. With regard to the big three, annual legal spending more than doubled for JPMorgan Chase and Citibank, and it grew almost as much for BofA in from 2012 to 2013.

What exactly is legal process outsourcing, and how can it reduce legal spending? The LPO model is actually quite simple: Disaggregated support tasks traditionally performed by law firm paralegals and junior lawyers — or beleaguered internal counsel — are outsourced to attorneys in low-cost locations. In other words, it's a labor arbitrage model.

LPO can be delivered offshore (such as in India and the Philippines for the United States and Australia) or onshore in the United States, including by embedding resources in banks' offices under the supervision of internal counsel.

Delivery models can be combined when doing so improves "optics," or the way things look, for regulators and when a nimble "follow the sun" approach works best. This workflow process involves having tasks passed between work areas in different time zones to maintain continual effort. The follow-the-sun approach is good for large engagements with aggressive timelines, as teams across the globe hand the work off twice a day to the next facility coming online. As a result the project never sleeps.

An LPO engagement addresses the two factors of the regulatory compliance conundrum faced by banks. In the first instance, there is the need to implement systems, processes and reporting to comply with both the letter of the regulations as well as the often-higher criteria that such companies set internally. In the second instance, however, there is a concomitant need to manage the costs of compliance while standardizing and improving the processes to maximize results.

Outsourced attorneys and paralegals can perform a broad range of services. They can review documents for compliance and regulatory inquiries, in connection with third-party subpoenas and for internal forensic reviews of suspicious activity. Monitoring traders' activities, complying with anti-money laundering requirements, and knowing your customer activities all fall within the purview of LPO capabilities. Even tasks for retail banking operations, such as state-by-state review of documents like powers of attorneys and guardianship agreements, can be completed remotely using an LPO provider at tremendous cost savings and with vastly improved turnaround time.

> Large global investment banks are containing or reducing their legal expenses by using a legal process outsourcing partner.

LPO compliance capabilities include the execution of lower and mid-level tasks that clog up internal counsels' desks and are too costly and tedious to assign to external law firms. When a regulator comes knocking, an outsourcing partner can review millions of documents for disclosure quickly, efficiently and at a substantially reduced cost. Whether the purpose of the exercise is forensic (such as for an internal risk manager or compliance officer to understand the substance and gravity of an investigation) or simply to feed the regulatory beast, using a low-cost offshore or onshore provider can vastly increase turnaround time and slash legal expenses.

Other programs, such as those addressing emails for sales and trading operations, anti-money laundering and anti-fraud compliance are ongoing. Unlike the one-offs of the formal inquiries and subpoenas, these programs require process-driven systems that are implemented and supported on an all-day, everyday basis. LPO can also create custom solutions to fit these needs. Moreover, an LPO provider can offer third-party verification of regulatory compliance should an audit arise.

SUCCESS STORIES

The following case studies highlight a number of regulatory and internal compliance programs that were tailored to meet the banking industry's needs.

- A major global investment banking and sales and trading firm received a regulatory inquiry requiring the review and disclosure of more than 6 million documents over a period of 18 months. The project called for only attorney-client privilege review, but internal counsel also wanted documents sorted by importance in preparation for a potential lawsuit. A dedicated team was created both onshore and offshore to review the documents all day, every day, using a follow-the-sun protocol. The review got the results to the regulators with improved efficiency at a fraction of the cost of outside counsel's paralegals.
- A prestigious global investment bank faced an onerous backlog in its anti-money-laundering initiatives as well as daunting volumes of red-flagging, client investigation and documentation required by both internal and external compliance regulations. A large team of paralegals was embedded in an outsourcing provider's facility to provide support while supervised directly by the firm's anti-money-laundering team. By not "owning" these resources, the firm can ramp up or down as deadlines loom without the additional burden associated with using its own employees.
- A Fortune 50 global insurance and financial services company required European multi-country compliance legislation tracking as well as monitoring of regulations relating to 70 issues across 13 European jurisdictions. In addition, their database of nearly 1,000 summaries of key legislation concerning various legal issues (employment, tax, termination, anti-corruption and fraud, etc.) required a substantial update within a short timeframe. A team of experienced multi-lingual lawyers conducted legal research from Bristol, U.K. After thoroughly researching each subtopic, the team updated the summaries to ensure the body of law was up to date and that all changes to relevant

legislation had been duly referenced. The team used a standardized approach to each jurisdiction and monitored quality control to ensure consistency throughout the process, despite the differences in legal systems, languages and regulating bodies. The client reduced legal costs substantially while maintaining quality and consistency.

- A Fortune 500 consulting company to the financial services industry wanted to set up compliance delivery for its clients around know-your-customer due diligence and profiling for screening purposes. The consultancy had a backlog of potential clients that required urgent screening and compliance services. A team of lawyers in Manila screened potential clients using a preapproved questionnaire and research conducted across several databases, including Dun & Bradstreet. Upon completion, the attorney team drafted individual memoranda providing a comprehensive profile of each individual potential client.
- A world-class financial services firm in the mortgage industry required a 50-state survey of U.S. mortgage banking regulations. The client had no internal processes to support the project, but a dual-shore solution utilizing both India and a low-cost onshore team created a standardized workflow to guarantee uniform results. The project was completed on time and on budget, with significant savings for the client.
- A Fortune 50 global investment bank's retail division was burdened by a backlog of nearly 1,500 powers of attorney while continuing to receive about 150 per day from states where it maintains retail locations. A dedicated team of paralegals in a low-cost, onshore facility performed compliance review and processing. Additionally, process management experts ensured that the compliance review was robust, efficient and consistent. Turnaround time for branch office legal review was reduced from six months internally to as little as two days.
- A client required an extensive compliance program, including know-your-customer and know-your-supplier aspects as well as legal research. The needed services included anti-corruption red flag transaction review, business partner due diligence, auditing any international subsidiaries to which authority had been delegated, legal librarian services for international knowledge management and international legal research. The solution involved managing the large volume of legislation and regulation associated with operating in a multi-jurisdictional, highly regulated business environment. The overall program included research on existing and pending rules and regulations, creating and filling folders at counsel's direction, and creating taxonomies (*i.e.* roadmaps) for search and retrieval.. The LPO team acted as a virtual extension of the client's international legal team. Innovation in legal processes, the leveraging of technology and collaborative work by onshore and offshore teams added extra value.

SUMMARY

Engaging an LPO partner is a low-risk/high-reward solution for banks and other financial services firms that need to make a real dent in their skyrocketing legal expenses in an environment of escalating regulatory scrutiny.

There are factors inherent in engaging an LPO provider that all clients — not just financial institutions — must be aware of, with the chief among them being supervision. The American Bar Association, Standing Committee on Ethics and Professional Responsibility, in Formal Opinion 08-451 (2008), gives the nod to legal outsourcing so long as law firms and general counsels' offices employ rigorous due diligence and supervision procedures, which are laid out in the opinion.

Above all, the compliance conundrum is ultimately and always the responsibility of the financial institutions. The importance of engagement in the entire process, from working with the LPO partner to design and build the solution, to reviewing the work product and providing continuous feedback, cannot be overstated. But as long as such safeguards are implemented, an LPO partner is an extremely effective tool that can be used to tamp down spiraling legal costs while ensuring regulatory compliance. WJ

NOTES

[1] Tanya Agrawal & David Henry, *JPMorgan hit by legal costs, Dimon says banks 'under assault,'* Reuters, Jan. 14, 2015, http://www.reuters.com/article/2015/01/14/us-jpmorgan-results-idUSKBN0KN19C20150114

[2] JPMorgan's legal spending increased from $1.1 billion in 2013 to $2.9 billion in 2014. All information on legal costs from banks' annual reports can be found at http://www.annualreports.com/companies?ind=s4.

[3] Donal Griffin & Dakin Campbell, *U.S. bank legal bills exceed $100 billion*, Bloomberg, Aug. 28, 2013, http://www.bloomberg.com/news/articles/2013-08-28/u-s-bank-legal-bills-exceed-100-billion.

[4] Dakin Campbell, *Citigroup expenses bring total to $13 billion on Corbat's watch*, Bloomberg, Dec. 9, 2014, http://www.bloomberg.com/news/articles/2014-12-09/citigroup-sees-3-5-billion-of-costs-at-year-end-ceo-says-1-.

[5] Jacob Davidson, *Bank of America Is Paying Up for the Mortgage Mess, But Who Will Get the Money?* Time, Aug. 29, 2014, http://time.com/money/3177343/bank-of-america-mortgage-settlement/.

[6] By August 2014, the Justice Department reported it had recovered almost $37 billion. Some commentators, says the New York Times, think it is not enough. Peter Eavis & Michael Corkery, *Bank of America's $16 Billion Mortgage Settlement Less Painful Than It Looks*, N.Y. Times, Aug. 21, 2014, http://dealbook.nytimes.com/2014/08/21/bank-of-america-reaches-16-65-billion-mortgage-settlement/?_r=0.

[7] *See, e.g.*, James Rickards, *Repeal of Glass-Steagall Caused the Financial Crisis*, U.S. News & World Rep., August 2012, http://www.usnews.com/opinion/blogs/economic-intelligence/2012/08/27/repeal-of-glass-steagall-caused-the-financial-crisis; Robert Weissman, *Reflections on Glass-Steagall and Maniacal Deregulation*, Common Dreams (Nov. 12, 2009), http://www.commondreams.org/views/2009/11/12/reflections-glass-steagall-and-maniacal-deregulation.

Iran

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The suit was filed by VASCO shareholder Linda Rossbach on behalf of all those who purchased the company's stock between Feb. 18, 2014, and July 21, 2015.

A VASCO representative declined to comment on the suit.

The company sells data security software worldwide, specializing in two-factor and digital signature authentication software. It is headquartered in Switzerland and has subsidiaries in Illinois and Belgium.

According to Rossbach's lawsuit, VASCO disclosed in a Form 8-K filed with the Securities and Exchange Commission on July 21 that its European subsidiary sold its products to the third-party distributor.

The distributor might have sold the products to parties in Iran, possibly including parties subject to U.S. economic sanctions, the regulatory filing said.

The company told investors its audit committee initiated an ongoing internal investigation to review the sales with the help of outside counsel. VASCO also said it stopped shipping its products to the distributor pending the results of the investigation, the complaint says.

It further reported working on the sales issue with the U.S. Treasury Department, Office of Foreign Assets Control and the U.S. Department of Commerce, the suit says.

On this news, the software developer's stock price dropped 86 cents, or about 3 percent, the complaint says.

Rossbach claims VASCO did not have a proper mechanism in place to prevent federal laws violations, despite assurances in previous regulatory filings that it had adequate internal controls.

VASCO's misrepresentations about its internal controls and failure to disclose the possible Iran sales caused the stock price to artificially rise, and then drop when the truth emerged, harming its investors, the suit says.

The complaint alleges violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t(a), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 8 240.10b-5, against VASCO, CEO T. Kendall Hunt and CFO Clifford Brown.

Rossbach is seeking class certification, unspecified damages, and reasonable costs and expenses. WJ

Attorneys:
Plaintiff: Patrick V. Dahlstrom and Louis C. Ludwig, Pomerantz LLP, Chicago; Jeremy A. Lieberman and J. Alexander Hood II, Pomerantz LLP, New York

Related Court Document:
Complaint: 2015 WL 4540355

See Document Section A (P. 21) for the complaint.

NEWS IN BRIEF

ISDA LOOKS BACK AT DODD-FRANK AFTER 5 YEARS

The International Swaps and Derivatives Association Inc. released a report July 20 analyzing the impact of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act five years after it was signed into law. Congress enacted Dodd-Frank to increase transparency, reduce risk in the financial markets and prevent a future global crisis. According to the report, significant progress has been made but challenges remain. ISDA CEO Scott O'Malia said in a statement that the derivatives markets especially have made progress achieving the goals put forth by policy makers. Before joining ISDA, O'Malia was a commissioner of the Commodity Futures Trading Commission. The report said a large portion of Dodd-Frank devoted to derivatives has been implemented. Central clearing, trade execution requirements and reporting obligations are all currently in use, the ISDA said. Legislators and regulators, however, should continue working on harmonizing cross-border rules and identifying reporting obligation redundancies, the report says. The report is available at http://bit.ly/1LBmst1.

GLOBAL REGULATOR WORKING ON FOREIGN EXCHANGE CODE OF CONDUCT

The Bank for International Settlements announced in a July 24 statement the formation of the Foreign Exchange Working Group to develop and strengthen code-of-conduct standards and principles for the foreign exchange markets and their participants. BIS said it is an international organization that helps central banks and regulators collaborate to promote financial stability. BIS hopes the code will be implemented globally by national regulators with consideration given to local circumstances. The FXWG will work with a newly established Market Participants Group that will include participants from the buy and sell sides of the foreign exchange markets and members of the foreign exchange market infrastructure. The statement indicated a May 2017 target date for competing the code and principles.

TREASURY TOUTS SUCCESS OF SMALL-BUSINESS CREDIT PROGRAM

Small businesses kept or created 141,000 jobs in 2014 through involvement in the Treasury Department's State Small Business Credit Initiative, according to a new Treasury Department report on the initiative. The SSBCI allows states to apply for federal money for programs that work with private lenders to provide greater credit access to small businesses. In a July 9 statement, the Treasury said its report found that participating states spent $864 million in federal program funds in 2014, leading to more than $6.4 billion in private lending and investment to small firms. The SSBCI, created under the Small Business Jobs Act in 2010, has an initial allotment of $1.5 billion in federal money. The statement said President Obama has requested an additional $1.5 billion in funding in his fiscal year 2016 budget. The Treasury report is available at http://www.treasury.gov/resource-center/sb-programs/Documents/Final%20-%20SSBCI%20Annual%20Report%202014%2007.09.15.pdf.

Related Court Document:
Order: 2015 WL 3946506

CASE AND DOCUMENT INDEX