BLB&G Bernstein Litowitz Berger & Grossmann LLP

The Advocate

FOR INSTITUTIONAL INVESTORS

Spring 2013

Unfinished Business

What's in Store for Financial Reform in the Next Term?

Trouble After the RMBS Bubble

Banks Face a Flood of Civil Litigation

Holding Accountants Accountable

Can Private Litigation Force Auditing Reforms?

A Conversation with Harvey Pitt

Former SEC Chair Reflects on the Agency

Up Against Big Banks, SEC Settles For Less

Banks Have Little to Fear from Weak Enforcement

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Inside Look

With a sluggish economy, beltway gridlock and instability around the globe, a newly reelected President Obama faces a wide variety of domestic and foreign policy issues. Not least among his worries is managing the evolving regulatory landscape of the financial sector. Our cover story in this issue of *The Advocate* —"Unfinished Business: A Look at Wall Street, America's Financial Markets and The Obama Administration's Second Term," by BLB&G Partner John Rizio-Hamilton and BLB&G Associate Michael Blatchley, chronicles the enforcement efforts of the SEC and other regulatory agencies over the last four years and outlines what may lie ahead for the government and the industry.

In addition, we are extraordinarily pleased to have several esteemed guest authors in this issue. In particular, we are privileged to be able to share with our readers the insights of former SEC Chairman Harvey Pitt, who recently spoke with BLB&G Partner Mark Lebovitch to shed light on his experiences at the agency, what he sees as the current challenges it faces, and what he thinks needs to happen to improve the functioning of the securities markets and strengthen investor confidence. We are also delighted to feature in this issue a detailed and heartfelt critique of the auditing profession by one of its own — and one of the country's leading industry commentators — Francine McKenna. In "Can Private Litigation Redeem the Accounting Profession?," Ms. McKenna shares the trademark candor and passion always on display at her blog and her columns for *Forbes* and *American Banker*.

We are also happy to reprint here in our pages a related essay by one of legal media's finest journalists, Susan Beck of *The American Lawyer*. In light of this issue's focus on the future of financial sector regulatory enforcement, we include her cogent analysis "Bank of America Settlement and JPMorgan Case Highlight SEC's Tepid Response," contrasting the SEC's response to securities law violations related to the subprime credit crisis with the remarkable results which private litigation is obtaining for investors.

For a more comprehensive look at what some of those private subprime litigation victories look like, BLB&G Associate Ross Shikowitz has compiled "Trouble After the Bubble," a look at some of the pending lawsuits, and major milestones and developments in ongoing cases involving mortgage-backed securities.

As always, you will find a compilation of the most significant recent developments in securities litigation, regulation and corporate governance in our regular "Eye on the Issues" column, compiled by firm Associate Stefanie Sundel.

Please note that we always make the current issue of *The Advocate* (as well as all past issues) available on our website at www.blbglaw.com, and if you need any help in tracking down prior issues or essays please do not hesitate to contact us.

The Editors

The Advocate
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Unfinished Business

A Look at Wall Street, America's Financial Markets and The Obama Administration's Second Term

By John Rizio-Hamilton and Michael Blatchley

President Obama faces many pressing issues in the wake of his reelection this past November, not least of which is ensuring the effectiveness of his financial reforms and continuing America's role as a leading financial market. The administration has achieved some notable successes in improving the transparency and integrity of the U.S. securities markets, including the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. In addition, the SEC and other agencies have obtained numerous monetary recoveries and other settlements in enforcement actions. However, many investor advocates believe the Obama administration did not do enough to protect investors in its first term.

Continued on next page.

When President Obama took office in January 2009, the financial environment cried out for an aggressive enforcement policy and presented an opportunity to demonstrate that the grave consequences of financial fraud would not go unpunished.

The First Term: Some Notable Enforcement Successes, But a Mixed Record Overall

When President Obama took office in January 2009, the country was embroiled in a financial meltdown of historic proportions caused by years of high-risk lending practices and inflated asset valuations on Wall Street. Such an environment cried out for an aggressive enforcement policy and presented an opportunity to demonstrate that the grave consequences of financial fraud would not go unpunished. Against this backdrop, the Obama Administration scored some victories for investors in the years following the onset of the financial crisis.

For example, in April 2010, the SEC brought fraud charges against Goldman Sachs for failing to disclose to investors in a mortgage-related security known as a "CDO," or collateralized debt obligation, that the underlying assets of the security had been selected by an outside entity that was simultaneously shorting the security. Goldman paid $550 million to settle the charges in July 2010—the largest penalty ever assessed against a financial services firm in the SEC's history—and, in a rare move, admitted that its disclosures were misleading. In July 2010, the SEC obtained another large settlement against a Wall Street bank, as Citigroup paid $150 million to settle charges that it misled investors about its exposure to toxic subprime mortgage-related securities. In parallel proceedings, two former Citigroup executives paid $180,000 of their personal funds to settle similar charges. Finally, in October 2010, Angelo Mozilo, the former CEO of Countrywide Financial, agreed to pay $67.5 million to settle the SEC's fraud charges that he misled investors about Countrywide's lending practices and financial condition — the largest SEC settlement ever paid by a corporate executive.

Other aspects of the Obama Administration's enforcement record are more mixed. The Administration has not achieved success in criminally prosecuting senior executives of financial institutions who played a culpable role in the subprime crisis. The Department of Justice ("DOJ") brought criminal charges against two Bear Stearns hedge fund managers, Ralph Cioffi and Matthew Tannin, for misleading investors about the fund's financial condition, but they were acquitted in 2009. In the wake of that acquittal, the DOJ has not brought criminal charges against any of the senior executives of the firms at the epicenter of the financial collapse, such as Lehman Brothers, AIG, and Bear Stearns, for misleading statements and omissions about those companies' financial condition. In addition, the criminal investigation against Countrywide CEO Mozilo — who is considered by some to have been personally responsible, in some measure, for the subprime mortgage crisis — was quietly dropped without much explanation following his civil settlement with the SEC. Instead, the DOJ has elected to focus on insider trading cases, typically against employees of

hedge funds. Although the Administration has achieved some significant success in this area — including obtaining the conviction of Raj Rajaratnam, founder of the Galleon Group, in May 2011 — the very different stance taken against individuals such as Mozilo and Dick Fuld, the former CEO of Lehman Brothers, has raised questions for some investors.

Overall, the SEC has been criticized by many for not acting as aggressively as it could have during the past four years. In 2009, the agency sued Bank of America for misleading shareholders in connection with the shareholder vote on its merger with Merrill Lynch, contending that the Bank failed to disclose a secret agreement allowing Merrill to pay up to $5.8 billion in bonuses regardless of its financial condition. Despite evidence indicating that the Bank's senior executives were aware of the agreement, the SEC pursued only negligence claims against the Bank rather than suing any individuals for fraud. Further, the SEC initially proposed to settle the action for just $33 million — a proposal that the presiding federal judge, Judge Jed Rakoff of the Southern District of New York, rejected as inadequate in a withering opinion, calling it "a contrivance designed to provide the S.E.C. with the façade of enforcement and the management of the Bank with a quick resolution of an embarrassing inquiry — all at the expense of the sole alleged victims, the shareholders." In 2010, the SEC expanded the case to include the Bank's failure to disclose massive losses that Merrill was suffering prior to the shareholder vote, and increased the proposed settlement amount to $150 million. Although there was evidence that the Bank's most senior executives were aware of the losses, the SEC again decided to bring only negligence claims against the Bank. Judge Rakoff approved the settlement but remained highly critical of it, calling it "better than nothing" and "half-baked justice at best."

Judge Rakoff similarly rejected the SEC's October 2011 settlement with Citigroup, where the bank agreed to pay $285 million to settle charges alleging (like the case against Goldman Sachs) that Citigroup sold complex mortgage-related securities to investors while misleading them about the fact that Citigroup had taken a large short position on the security's underlying assets. Judge Rakoff explained that the proposed settlement "leaves the defrauded investors substantially short-changed." The SEC has appealed Judge Rakoff's decision; however, even if the SEC's appeal is successful, Judge Rakoff's criticism of the Citigroup settlement was yet another significant blemish in the SEC's recent track record.

The SEC has also had some mixed results at trial during President Obama's first term. In August 2012, the SEC brought charges against a Citigroup trader, Brian Stoker, for his role in misleading investors about the fact that Citigroup had taken a short position against a CDO that it had structured and marketed to investors. After a trial in the Southern District of New York, a jury cleared Stoker of all civil fraud charges. In November 2012, the SEC achieved a partial verdict against the senior executives of the Reserve Fund — Bruce R. Bent, and his son, Bruce R. Bent II — who the SEC alleged committed fraud in issuing false statements to investors when the

The Administration has not achieved success in criminally prosecuting senior executives of financial institutions who played a culpable role in the subprime crisis.

President Obama nominates former federal prosecutor Mary Jo White as SEC Chief. (Getty Images)

On January 24, President Obama nominated former federal prosecutor Mary Jo White — the first-ever female U.S. attorney for the Southern District of New York—as his next SEC Chairman.

Reserve Fund "broke the buck," or fell below $1 per share, in September 2008. After a trial, the jury found for the SEC on a count alleging that Bruce R. Bent II acted negligently and on another count alleging that the parent company had violated the securities laws with scienter.

An Uncertain Enforcement Agenda Over The Next Four Years

Because the leadership of the SEC and the DOJ — the Administration's two principal securities enforcement agencies — is in flux, the enforcement agenda for President Obama's second term is not entirely clear, but is taking shape. In mid-December, SEC Chairman Mary Schapiro announced that she was stepping down, and on January 24 President Obama nominated former federal prosecutor Mary Jo White — the first-ever female U.S. attorney for the Southern District of New York — as his next Chairman. Ms. White's background in enforcement and record of success may send a signal that she plans to hold Wall Street accountable for wrongdoing. That said, she would be coming to the post from her position as counsel to major Wall Street banks such as Bank of America and Morgan Stanley.

SEC enforcement chief Robert Khuzami also stepped down. Khuzami was named head of enforcement in 2009 following widespread public criticism of the agency's failure to detect the Madoff scheme. Khuzami was the architect of the SEC's enforcement strategy following the financial collapse, and dramatically reshaped the enforcement division by eliminating bureaucracy, expanding investigators' powers and creating specialized units to police Wall Street. However, his ties to Wall Street, including through his prior employment as general counsel of Deutsche Bank, have been noted by some who have criticized the SEC's failure to bring more enforcement actions against the senior executives and large financial institutions that were responsible for the financial crisis.

George Canellos, a longtime SEC prosecutor, has stepped in as acting interim enforcement chief, but it is uncertain whether he will remain the SEC's top enforcement officer under White. The reshuffling of top positions at the agency has raised larger questions about the SEC's enforcement agenda during President Obama's second term and renewed calls for the administration to ensure the agency's independence from Wall Street. When former Citigroup and Bank of America lawyer Sallie Krawcheck was recently floated as a potential successor to Schapiro, critics immediately claimed her past employment would hamper the SEC's ability to effectively police Wall Street. Similarly, the candidates that the next SEC chairman considers to lead the enforcement division will give investors insight into the agency's forthcoming approach to enforcement, and whether the agency will be more aggressive than it has been in the past.

One sign that the administration appears to remain committed to pursuing financial crisis-related cases is the Department of Justice's recent filing of civil fraud charges against Standard & Poor's for allegedly awarding knowingly inaccurate credit ratings to numerous RMBS and CDO securities from 2004 through 2007. While it is uncertain whether the new lawsuit against S&P marks a shift in en-

forcement focus, many have heralded the lawsuit as a constructive, if belated, step in seeking accountability from those responsible for the financial crisis.

Preventing the Next Financial Crisis Through the Dodd-Frank Wall Street Reform and Consumer Protection Act

Beyond enforcement, the Obama administration's most enduring impact on investor protections and the integrity of the securities markets will ultimately depend on the success of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. By far the most significant and far-reaching financial reform legislation passed since the Great Depression, Dodd-Frank spans 848 pages and targets numerous regulatory failings that contributed to the financial crisis. The Act created several federal agencies, including the Financial Stability Oversight Counsel, which is charged with monitoring and addressing systemic risks to the financial system, and the Consumer Financial Protection Bureau, an agency designed to promote fairness and transparency in mortgages, credit cards and other consumer financial products. The Act also created new sets of rules for major financial industry participants and made significant improvements to the regulation of the securities markets. These reforms have already begun to remedy some of the most glaring regulatory loopholes that were exploited by financial institutions, rating agencies, and other market participants in the lead up to the financial crisis.

For example, the Act attempts to strengthen investors' ability to hold rating agencies accountable for inaccurate and/or fraudulent ratings. For example, Dodd-Frank established that rating agencies can be held civilly liable as "experts" for providing materially inaccurate ratings in public securities offerings, and made it easier for investors to allege claims for fraud. However, as discussed below, putting these measures into practice has proved difficult at best, and some of the Act's new rules are still not being enforced.

The Act also provided investors with additional protections designed to limit risk-taking by financial institutions. Chief among them is a measure that provides shareholders with a "say-on-pay" vote indicating whether they support their companies' executive-compensation packages. Many believe the say-on-pay measure played a key role in the abrupt resignation of former Citigroup CEO Vikram Pandit,

Beyond enforcement, the Obama administration's most enduring impact on investor protections and the integrity of the securities markets will ultimately depend on the success of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

The signing of the Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010 marked a historic occasion, but much of the law remains unwritten. (Getty Images)

At a news conference on the one-year anniversary of the passage of the Dodd-Frank Act, House Republicans prepared to "score" the bill. (Getty Images)

Despite its lofty aims, the Obama administration's hallmark financial reform legislation has also been criticized for failing to achieve its drafters' primary goals.

which followed Citigroup shareholders' rejection of his proposed compensation plan.

Dodd-Frank also includes numerous provisions that strengthen regulatory oversight and encourage greater transparency. These measures include:

- Increased protections and incentives for whistleblowers to report illegal or fraudulent conduct. The SEC issued its first award under the whistleblower protection this past year, and awarded the whistleblower 30 percent of the SEC recovery (the maximum award recoverable).

- Several measures to help shine a light on the so-called "shadow banking system"—the web of non-bank financial institutions (like hedge funds and private equity advisors) that were virtually unregulated in the lead up to the financial crisis. Dodd-Frank requires that these entities register with the SEC and provide information about their trading.

- Requirements that certain transactions that had previously been largely unregulated in the derivative markets be conducted on central clearing systems or through exchanges, and that participants in these transactions have sufficient financial resources to cover their obligations.

- Provisions that provide the Commodity Futures Trading Commission ("CFTC") and SEC with authority to regulate the over-the-counter derivatives market, which was an area that was previously considered a regulatory black hole. Indeed, the lack of such systems and controls are blamed by many for enabling AIG to secretly accumulate disastrous derivative wagers on mortgage-related securities that ultimately led to its multi-billion dollar government bailout.

Falling Short: Regulatory Reform Stunted by Wall Street

Despite its lofty aims, the Obama administration's hallmark financial reform legislation has also been criticized for failing to achieve its drafters' primary goals. For example, the Dodd-Frank Act failed to provide for "aiding and abetting" liability to enable private investors to hold underwriting banks, auditors and law firms accountable when they actively participate in fraud—a remedy that the U.S. Supreme Court had previously limited in prior court decisions. Dodd-Frank also failed to explicitly restore investors' rights to bring federal securities law claims in cases involving foreign-based securities transactions, an area that was significantly altered by the U.S. Supreme Court's decision in *Morrison v. Australia National Bank*.

Critics also point to Dodd-Frank's failure to effectively address the "Too-Big-To-Fail" problem — i.e., the perception that large financial institutions are too important to the global financial system to be effectively punished when they violate the law. For example, the government recently decided not to criminally indict HSBC, even though the bank admitted to its role in enabling drug traffickers to launder hundreds of billions of dollars, as well as to knowingly allowing hundreds of millions of dollars to move through the U.S. financial system on behalf of banks in countries subject to U.S. sanctions, including Iran, Cuba, and Sudan. The head of the DOJ's criminal division acknowledged that the decision not to criminally indict HSBC was based at least in part on a concern that the government did not "want to make a decision that is going to have all kinds of horrible collateral consequences"—in other words, HSBC was too important to the economy to prosecute.

But while many rightly criticize Dodd-Frank for not going far enough in promoting investor protections, arguably the biggest challenge to the bill's supporters is the simple fact that much of the law literally remains unwritten. Congress left some of the most difficult issues to be solved by regulators, who are charged with writing the vast majority of its implementing rules. Indeed, Dodd-Frank imposed nearly 400 rulemaking requirements on federal enforcement agencies and required the SEC and other regulatory bodies to complete dozens of studies. As of December 2012, regulators had finalized only 133 of the 398 regulations they were tasked with crafting in 2010. The process of writing the rules that Congress left to these regulators has invited intense lobbying by the financial services industry, which has spent millions of dollars in ensuring Dodd-Frank's implementing regulations are interpreted as favorably to their interests as possible.

One particularly illustrative example of Wall Street's lobbying efforts has been the financial industry's campaign against the so-called "Volcker Rule," a measure aimed at restricting federally-insured depository banks from engaging in "proprietary trading" (i.e., a bank trading its own money for profit). Proprietary trading by federally-insured banks has long been a concern because of the perception that such banks are essentially making bets with taxpayers' money. As with many other Dodd-Frank provisions, the law left the drafting of some of the key components of that legislation to regulators — including the task of defining exactly what would be considered prohibited "proprietary trading" under the statute. Regulators, pushed by industry lobbyists led by JPMorgan and its CEO Jamie Dimon, were poised to consider an exemption for certain kinds of trading that Wall Street banks argued were "risk mitigating" activities that should be allowed under the Volcker Rule, and not proprietary trading. The danger of Wall Street banks attempting to influence this legislative process became apparent in May of last year when JPMorgan announced a multi-billion trading loss arising from the very type of proprietary trading that JPMorgan tried to convince Congress to exempt from the Volcker Rule as a "risk mitigating" activity.

In other instances, industry participants have thwarted reform through sheer resist-

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Challenge & Opportunity for the SEC

A Conversation with Former SEC Chair Harvey Pitt

Harvey L. Pitt served as the twenty-sixth Chairman of the United States Securities and Exchange Commission from 2001 until 2003. In that role, Mr. Pitt was responsible, among other things, for overseeing the SEC's response to the market disruptions resulting from the terrorist attacks of 9/11, for creating the SEC's "real time enforcement" program, and for leading the Commission's adoption of dozens of rules in response to the corporate and accounting crises generated by the excesses of the 1990s. For nearly a quarter of a century before becoming the SEC's Chairman, he was a senior corporate partner in the international law firm Fried, Frank, Harris, Shriver & Jacobson. A founding trustee and the first President of the SEC Historical Society, Mr. Pitt is a leading expert and frequent commentator on the U.S. securities markets and regulatory environment. He participates in a wide variety of bar and continuing legal education activities to further public consideration of significant corporate and securities law issues.

Mr. Pitt is the Chief Executive Officer of the global business consulting firm Kalorama Partners, LLC and its law firm affiliate, Kalorama Legal Services, PLLC.

BLB&G Partner Mark Lebovitch recently had the opportunity to interview Chairman Pitt about his time as head of the agency, and about the SEC's role in today's regulatory landscape.

"The SEC's real strengths are its role, history, and the high quality of the people it attracts. The Commission's mandate is to protect investors and facilitate capital formation. When performing those functions at its historically high levels, it becomes an important instrument for economic growth."

Q ***Mark Lebovitch: Thank you for your time, Mr. Chairman. For starters, how did you begin with the SEC?***

Chairman Harvey Pitt: My professional career began in 1968 as an entry-level attorney in the SEC's Office of General Counsel. We counseled, litigated, drafted legislation and rules, helped develop SEC policies, and guided the Agency's performance of its substantive mandates. After starting in the GC's Office, I was Legal Assistant to Commissioner Francis M. Wheat, an Editor of the SEC's Institutional Investor Study, Chief Counsel of the Division of Market Regulation (now Trading & Markets) and, after seven years, I became the first career SEC General Counsel, serving three years.

Q ***What were your best and worst experiences as an SEC attorney?***

Working as an attorney at the SEC was enormously gratifying. One highly positive aspect was receiving immediate and broad responsibility for significant matters. That was also one of the most frightening aspects—I wasn't necessarily always ready for the responsibility I received! Perhaps my "best" experience was serving as Chairman Ray Garrett's Chief of Staff. Ray was brilliant and a fabulous mentor, both professionally and personally; I tried to embrace the wisdom he constantly dispensed.

My worst experience was arguing *SEC v. Sloan*, 436 U.S. 103 (1978), in the Supreme Court. In the absence of adequate information about publicly traded securities, the SEC could suspend trading "for a period not exceeding ten days." From its creation, the SEC interpreted those seven words as if there were ten — that is, "for a period not exceeding ten days at a time." Samuel Sloan was defrocked as a securities broker for insufficient net capital, caused by holding shares of a security the SEC suspended, ten days at a time, for over a year! Sloan challenged his expulsion, arguing the Commission unlawfully nullified the value of the suspended security by suspending trading beyond the initial ten days. When the case reached the Supreme Court, the Solicitor General wouldn't argue the case, so I did, and lost 9-0 to a non-lawyer who didn't even have his own lawyer! I argued several other cases in the Supreme Court as SEC GC, with better results, leading Harold Williams—the third Chairman I served as GC—to remark at my farewell reception that I had never lost a Supreme Court case I argued myself, where the other side was represented by counsel!

Q ***What was your biggest surprise during your tenure as Chairman?***

My biggest surprise was how political, vitriolic and ill-informed Congressional and journalistic criticism of the SEC (and especially its Chairman) was. I naively believed that, if we did the right things substantively, our efforts would be credited. In the face of one crisis after another, starting with 9/11 (where there was praise, not criticism), followed by Enron, Arthur Andersen, faulty analyst research, etc., most politicians and journalists weren't interested in helping us solve problems, but only in capitalizing on, and blaming others for, them.

Q ***What would you say are the SEC's top strengths and weaknesses?***

The SEC's real strengths are its role, history, and the high quality of the people it attracts. The Commission's mandate is to protect investors and facilitate capital formation. When performing those functions at its historically high levels, it becomes an important instrument for economic growth. Our freedoms are a direct result of an economic system that facilitates private enterprise and concomitantly ensures that those who commit funds to our capital markets are protected from sharp practices and fraud. The SEC has always successfully attracted the highest quality professionals to carry out its important mission.

Conversely, the SEC is plagued by continually expanding mandates without concomitant resource increases, efforts of many Congressmen to treat the Commission as if it were an institutional piñata, and its deserved reputation as "over-lawyered." Since 2002, Congress passed Sarbanes-Oxley, Dodd-Frank and JOBS, each exponentially increasing Agency burdens, without providing means to fulfill them. The Commission is substantially behind in adopting required rules, despite herculean efforts. Simultaneously, the Commission is constantly attacked, both by Congress and the press. No agency is perfect, but the SEC gets most things right, yet receives little or no recognition. Its few missteps result in excessive attacks. Finally, the Agency must wean itself from its over-dependence on legal analysis, and start looking at things from an economic point of view.

Q ***What do you see as the most significant opportunities and threats the SEC faces today?***

The SEC can modernize the way we regulate financial services, and make regulation relevant to current market realities. The statutory framework it administers — especially after recent legislative efforts—

reflects a quilt-patch system, designed and developed nearly eighty years ago. That system based regulation on what enterprises did at birth, rather than the functional services and products enterprises currently offer. Functional regulation — where comparable services are regulated comparably — is crucial. While it will require creativity, the SEC needs to embrace functional regulation and mold the statutes it administers to the realities of today's markets.

> ***"One threat the SEC faces is lack of resources. In an era of financial restraint, the only viable solution is to give the SEC the same ability to fund its own operations that a number of the banking agencies have."***

One threat the SEC faces is industry's increasing reliance on technology. We've seen repeated technological snafus create capital markets havoc. Neither the Commission, self-regulators, nor the financial services industry effectively anticipate how current technology creates problems;

Chairman Pitt talks with the Senate Banking Committee Chair Paul Sarbanes during a Capitol Hill hearing about accounting and investor protection issues. (Getty Images)

"Sarbanes-Oxley disproves that good governance can simply be legislated. There are certainly solid principles and models that can assist boards in performing their oversight functions, but if SOX had really improved corporate governance, Dodd-Frank wouldn't have been necessary!"

all lack early warning systems for technological problems, and all lack viable methodologies for responding to problems that do arise. Another threat is the SEC's lack of resources. In an era of financial restraint, the only viable solution is to give the SEC the same ability to fund its own operations that a number of the banking agencies have. The SEC polices increasingly complex markets; it will never effectively oversee markets it does not understand. Because SEC self-funding is unlikely, it must rely on self-regulation for industries it oversees.

Q ***What would you say is the most significant corporate governance problem you see today?***

Many directors — while intending to perform at the highest level — don't understand how to do their jobs. This is exacerbated by Sarbanes-Oxley, which seems to have substituted a "check-the-box" mentality for serious rigor. Outside advisors contribute when they deem themselves beholden to those who hire them, rather than to the community of interests reflected by the corporation. Frequently, this lack of true rigor manifests itself in two extremes—when things seem to being going well, these board members are compliant and unquestioning; when trouble strikes, they adopt adversarial postures. Neither extreme is conducive to good governance. Boards should try to maximize a collaborative approach with management, but always maintain healthy skepticism, to protect crucial shareholder interests.

Sarbanes-Oxley disproves that good governance can simply be legislated. There are certainly solid principles and models that can assist boards in performing their oversight functions, but if SOX had really improved corporate governance, Dodd-Frank wouldn't have been necessary!

Q ***How would you change how corporations are managed?***

I have a number of thoughts on that:

- There's too much emphasis today on form and process, over substance, vis-à-vis governance. Independent board members should organize themselves to be responsive to management initiatives while also setting their own agendas.
- Many companies have unduly large boards, making it impossible for those boards to function effectively. Smaller boards can be far more effective.
- Too much burden is placed on audit committees; separate committees — for governance, legal compliance and risk management — should be the norm.

- In many instances, management treats board members as if they were "rubber stamps," presenting them with conclusions, rather than explicating the process that produced a particular recommendation.

- At some companies, board meetings are like "show-and-tell" sessions, where management asserts everything is fine, and doesn't provide meaningful insights into the reasoning that led management to the positions they are recommending their boards embrace.

Q ***You have taken a public stance against mandatory auditor rotation. What do you recommend instead?***

Those promoting mandatory rotation have a valid concern—ensuring auditor independence. Unfortunately, any rote obligation to change auditors after X years won't ensure greater independence, will substitute less knowledgeable auditors for audit firms steeped in a company's business, and may do more harm than good. Studies indicate serious frauds often occur in the first 2-3 years of an audit firm's retention. I believe audit committees must ensure the independence and high performance of their outside auditors. By giving audit committees the tools to fulfill that obligation, true independence will result—audit committees should be obligated to perform a *de novo* review of existing auditors every 5-7 years. This consideration should be searching and extensive, not cursory. Audit Committees should have access to PCAOB quality review data, to assess how exacting their outside accounting firm has been.

This regime would permit replacement of outside auditors more frequently than a rote service term limit, but would require affirmative evidence that the outside auditors are performing at the highest professional level. It would produce meaningful rotation of audit firms based on quality and independence, rather than a rote system that would prevent audit committees from exercising their independent judgment about the quality and independence of audits their company receives from its outside audit firm.

Q ***What do you see as the most significant obstacle to restoring investor confidence today?***

Investor confidence is a function of many variables, only some of which are within the control of regulators and the private sector. Among the hurdles we face are:

- A lack of real and immediate transparency on the part of public companies, market venues, self-regulators and regulators;

- "Reverse laissez faire" by the business community — inertia that causes businesses to wait for government to opine whether what they're doing is wrong, why it's wrong, and how to fix it;

- A sense businesses don't really care about their customers and clients (after they've parted with their money); and

- An overarching concern regulators are almost always a day late, a dollar short, and devoid of creativity.

These are all things that can be fixed, if the will to do so exists. ◆

> ***"At some companies, board meetings are like "show-and-tell" sessions, where management asserts everything is fine, and doesn't provide meaningful insights into the reasoning that led management to the positions they are recommending their boards embrace."***

Eye on the issues

By Stefanie J. Sundel

Wall Street Critic Elizabeth Warren Joins Senate Banking Committee

Newly elected Senator Elizabeth Warren (D-MA), a Harvard Law School professor with expertise in bankruptcy and personal finance, has joined the Senate Banking Committee. Senator Warren was instrumental in the establishment of the Consumer Financial Protection Bureau which was created to protect Americans from unfair lending practices and bring transparency to financial products. She has been a vocal critic of Wall Street, writing last year that there had been "little action when it comes to holding large financial institutions accountable for breaking the law," and that it is "time [to] stop talking about accountability and start demanding it from those who broke the system."

> *Sources: http://www.banking.senate.gov/public/ ; http://money.cnn.com/ ; http://www.politico.com/*

President Nominates Tough-As-Nails Prosecutor to Chair the SEC

On November 26, 2012, the SEC announced that Mary Schapiro would step down as SEC Chair effective December 14, 2012. On January 24, 2013, President Obama nominated Mary Jo White to be the next SEC Chair. Ms. White — who received a B.S. in psychology from the College of William and Mary and a law degree from Columbia Law School — is currently a lawyer at Debevoise & Plimpton and previously served as the first-ever female U.S. attorney for the Southern District of New York from 1993 to 2002. As a federal prosecutor, Ms. White built a reputation as a tough-as-nails prosecutor with an expertise in pursuing white-collar crimes and financial fraud cases. Her background in enforcement and record of success send a signal about the importance of holding Wall Street accountable for wrongdoing. As one White House official noted, President Obama specifically chose Ms. White to head the SEC so that "Wall Street is held accountable and middle-class Americans never again are harmed by the abuses of a few."

> *Sources: SEC Press Release 2012-240, Nov. 26, 2012; The White House Office of the Press Secretary Statements, Nov. 26, 2012 & Jan. 24, 2013.*

New Study: Private Securities Suits Deter Fraud Better Than SEC

A groundbreaking new empirical study on the "merits of private and public anti-fraud enforcement in fostering deterrence" suggests that private class action lawsuits brought by investors are superior to SEC investigations in targeting fraud. Comparing SEC investigations with securities class actions from 2004 through 2007, the study—conducted by two securities law professors at the University of Michigan Law School and NYU School of Law—found that private suits provide at least as much deterrent value, if not more, than public enforcement actions. While the study found that cases with the highest probability of obtaining investor recoveries are those in which there is an SEC investigation and a parallel class action, the study's "surprising result" is that a stand-alone private class action is more likely than a stand-alone SEC investigation to result in a settlement — and a larger settlement — as well as top executive resignations.

> *Sources: SEC Investigations & Sec. Class Actions: An Empirical Comparison, Stephen J. Choi & Adam C. Pritchard*

Legislative Proposal: Merging the SEC and the CFTC

After a year-long investigation into the collapse of former brokerage firm MF Global, the House Committee on Financial Services' Subcommittee On Oversight & Investigations released a 100-page report (the "House Report") urging Congress to consider merging the SEC and the Commodity Futures Trading Commission ("CFTC"). Based on a review of documents produced by the SEC and the CFTC addressing each agency's oversight of MF Global, the House Report concluded that there is "no record of meaningful communication between the [two] regulators," and that their failure to coordinate meant both agencies missed several opportunities to share critical information that might have prevented MF Global's demise. The House Report further concluded that the "inability of these agencies to coordinate regulatory oversight efforts or to share vital information" should compel Congress to consider whether investors and commodities customers would be better served if the SEC and the CFTC merge into a single agency.

Within weeks of the House Report, Former Congressman Barney Frank (D-MA) introduced a bill called the Markets and Trading Reorganization Act, which seeks to combine the functions of the SEC and the CFTC into a single independent regulator, the Securities and Derivatives Commission ("SDC"). The SDC would comprise five commissioners appointed by the U.S. President with Senate approval, and would be divided into three divisions (markets & trading, issuers & financial disclosures, and enforcement). On November 29, 2012, the Markets and Trading Reorganization Act was referred to the House Committee on Financial Services for its consideration.

> *Source: Staff Report Prepared For Representative Randy Neugebauer, Chairman, Subcommittee On Oversight & Investigations Committee On Financial Services, Nov. 15, 2012; H.R. 6613*

"Say-On-Pay-Vote" Suits Gain Traction

Two years after Congress enacted Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which requires public companies to conduct an advisory shareholder vote on executive compensation plans, a growing number of investors have filed suits to enjoin shareholder votes where a proxy statement fails to adequately disclose executive compensation proposals. Such suits are being filed as class actions and typically assert claims against directors for fiduciary-duty breaches or violations of Section 14 of the Securities Exchange Act of 1934. At least twenty-two of these "say-on-pay-vote" suits have been filed since 2010, with eighteen filed in 2012 (and nine in October 2012 alone). Some of these cases have already proven successful, with two court orders enjoining shareholder meetings and five settlements prior to companies' annual meetings.

> *Sources: http://www.pacer.gov; http://www.dandodiary.com*

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Eye on the issues

FDIC: "Problem" Institutions Decline, Banks Post Highest Quarterly Earnings Since 2006

According to the FDIC's latest Banking Profile for the quarter ended September 30, 2012, insured depositary institutions continued to improve and the number and percentage of "problem" institutions (determined by a composite rating based on regulators' evaluation of financial and operating criteria) declined. Reduced expenses from loan losses and rising noninterest income helped institutions' earnings reach $37.6 billion — the highest quarterly earnings posted in six years since 2006. FDIC Chairman Martin Gruenberg said that this was another quarter of "steady recovery" with "[s]igns of further progress" in a "number of indicators, such as loan growth, asset quality and profitability," leading to "fewer expected bank failures."

> *Sources: FDIC Quarterly Banking Profile, Third Quarter 2012; FDIC Release, Dec. 4, 2012*

Steven A. Cohen's Hedge-Fund Affiliates Pay Historic Penalty for Insider Trading

Steven A. Cohen

On November 20, 2012, federal prosecutors criminally and civilly charged Mathew Martoma, a portfolio manager with hedge-fund giant Steven A. Cohen's SAC Capital Advisors L.P. ("SAC"), in one of the most lucrative insider-trading schemes ever. Martoma is accused of reaping a $276 million windfall by trading on nonpublic information about the poor results of an Alzheimer's drug trial before the negative news was announced in July 2008. Martoma allegedly obtained the inside information from a physician who helped run the clinical trial. The government alleges that SAC sold large positions in the two pharmaceutical companies that sponsored the Alzheimer's drug trial (Elan Corp. plc and Wyeth), and also bet that their stocks would go down. On March 15, 2013, the SEC announced a $600 million settlement with SAC's affiliate, CR Investors, in the largest-ever settlement of an insider trading action. Another SAC affiliate also agreed to pay $14 million to resolve a separate insider-trading ring that illegally traded technology stocks. George S. Canellos, the SEC's acting Enforcement Director, described these settlements as "historic penalties."

> *Sources: SEC v. Intrinsic Investors, LLC, 12-cv-8466 (S.D.N.Y. filed Nov. 20, 2012) (VM); United States v. Martoma, 12-MAG- 2985 (S.D.N.Y. filed Nov. 20, 2012); WSJ, Mar. 15, 2013*

PCAOB Finds Problems With Eight Largest Accounting Firms' Audits

On December 10, 2012, the Public Company Accounting Oversight Board ("PCAOB") — which regulates the audit industry — released a report identifying widespread problems with the major accounting firms' audits. In 22 percent of all audits, the PCAOB found that the eight largest accounting firms surveyed in 2011 did not obtain sufficient evidence to support their opinions that a company's internal controls over financial reporting were effective. The PCAOB noted that audit deficiencies primarily included the failure to identify and test controls addressing the risk of a material misstatement; the failure to sufficiently test the design and effectiveness of management-review controls; and the failure to test system-generated data and reports. Despite these findings, the PCAOB has stated that, "in the case of most deficiencies identified," it has decided "to encourage and facilitate auditors' improvement through the inspection dialogue" rather than "by invoking formal disciplinary authority."

> *Source: PCAOB Observations From 2010 Inspections Of Domestic Annually Inspected Firms Regarding Deficiencies In Audits Of Internal Control Over Financial Reporting*

After *Citizens United:* The Next Chapter In The Fight Over Corporate Political Spending

The United States Supreme Court's 2010 decision in *Citizens United v. Federal Election Commission* removed restraints on corporations' political expenditures. The ruling included a note in Justice Kennedy's majority opinion that "shareholders" can keep corporations in check by determining whether political spending "advances the corporation's interest in making profits." On January 2, 2013, for the first time ever, New York State Comptroller Thomas P. DiNapoli did just that by filing a shareholder suit on behalf the New York State Common Retirement Fund ("NYSCRF") in the Delaware Chancery Court against mobile-technology giant Qualcomm Inc.to compel disclosures about Qualcomm's political spending.

According to DiNapoli, "[w]ithout disclosure, there is no way to know whether corporate funds are being used in ways that go against shareholder interests." Indeed, in August 2012, the Fund and other members of the Council of Institutional Investors requested data on political expenditures from 430 companies in the S&P 500, including Qualcomm. Other companies complied, but Qualcomm rebuffed all requests. The Fund's suit alleged that Qualcomm's refusal violated Delaware's corporate law code, which permits shareholders to review a company's books and records.

In what DiNapoli calls a "significant milestone in greater transparency in corporate political spending," on February 22, 2013, Qualcomm agreed to adopt a new "Political Contributions and Expenditures Policy." Qualcomm's new policy requires it to post all political contributions on its website, and Qualcomm will also continue to refrain from making contributions to "federal independent expenditure-only committees" (more commonly known as "Super PACs").

BLB&G served as counsel to NYSCRF in this matter.

> *Sources: NYSCRF v. Qualcomm Inc., C.A. No. 8170-CS (Del. Ch.); Office of the NY State Comptroller - News Releases, Jan. 3, 2013 & Feb. 22, 2013*

DOJ Sues S&P Over Falsely Inflated Mortgage-Bond Ratings

On February 4, 2013, the United States Department of Justice ("DOJ") filed a 119-page lawsuit against Standard & Poor's Financial Services LLC ("S&P"), alleging that S&P rigged bond ratings for its own gain. The lawsuit seeks more than $5 billion for violations of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, and is the first federal enforcement action against the ratings industry since the financial crisis. The DOJ specifically alleges that S&P defrauded investors in mortgage-related securities between September 2004 and October 2007, by falsely representing that S&P's ratings reflected true, independent, and objective opinions. The DOJ further alleges that S&P intentionally "adjusted and delayed" updates to its rating criteria and models, and downplayed and disregarded credit risks in order to increase revenues. According to United States Attorney General Eric Holder, "this alleged conduct is egregious — and it goes to the very heart of the recent financial crisis."

Upon news of the DOJ lawsuit, shares of McGraw-Hill Companies Inc., S&P's parent company, sold off dramatically — as did S&P's main competitor, Moody's Corporation, due to speculation the DOJ may sue other major agencies that rated mortgage-related securities. Although rating agencies have long been under scrutiny for giving rosy ratings to win fees — with the Financial Crisis Inquiry Commission calling them "essential cogs in the wheel of financial destruction" and "key enablers of the financial meltdown" — they have generally shielded themselves from liability by citing First Amendment free-speech protection. Indeed, while the DOJ lawsuit relies on a treasure trove of internal reports and sardonic emails among S&P analysts, S&P maintains that the DOJ's claims are "meritless." S&P now faces related suits filed by the Attorneys General from sixteen states and the District of Columbia, and is scheduled to respond to the DOJ lawsuit by May 6, 2013.

> *Sources: U.S. v. McGraw-Hill Cos., Inc., No. 2:13-cv-00779 (C.D. Cal. filed Feb 4, 2013); S&P's Response to the DOJ Complaint, Feb. 5, 2013; Financial Times, Feb. 5, 2013; Financial Crisis Inquiry Commission Report*

Can Private Litigation Redeem The Accounting Profession?

By Francine McKenna

It's never been easy to bring lousy auditors to justice, but in the last 35 years, it's become harder than ever.

The law was supposed to restore confidence in the integrity and independence of the auditing profession, and reduce the number and severity of corporate and accounting frauds like the ones at Enron and WorldCom. And for a time it appeared that the auditing profession may have found religion. But, ultimately, Sarbanes-Oxley failed to make corporate accounting and disclosure frauds a thing of the past. Indeed, frauds have exploded in recent years, making it clear that the accounting industry is failing the markets.

Auditors of public companies are supposed to perform a public duty. The auditor's true clients, according to statute, are shareholders, not company executives. There is an inherent conflict in the way we pay for an audit, however. Similar to the conflict that ratings agencies have, shareholders have very little say in how the relationship between the company and its audit firm is managed because their proxy votes are only advisory. The company, through the Audit Committee of the Board of Directors, hires, pays, and evaluates an "independent" audit firm and its work. Auditors risk losing clients when they object to deliberate accounting manipulation or possible illegal acts favored by client management. Perversely, auditors more often keep their jobs even when shareholders sue them repeatedly for lapses that allowed fraud and failure to occur.

Legislators with short memories also conveniently forgot how Arthur Andersen lost its independence and objectivity at Enron because of the hundreds of millions it earned from consulting to its audit client. Unfortunately, company executives, and the audit committees that serve

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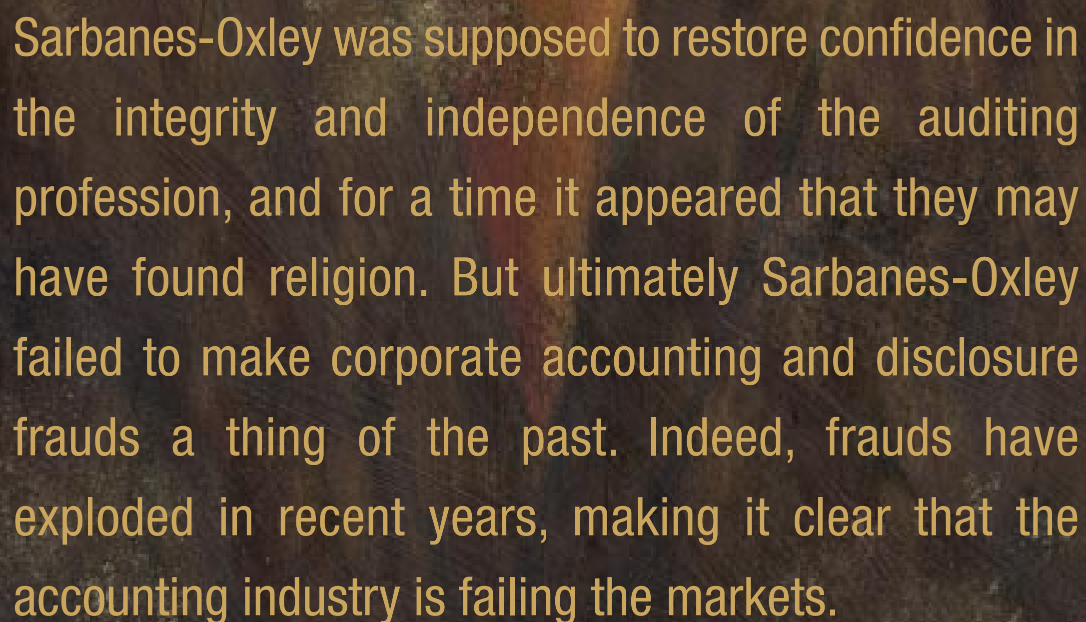

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them, have regained the upper hand in the auditor-company relationship.

At the same time, the Supreme Court has made it harder and harder for private investors to hold auditors accountable. Notwithstanding these obstacles, today the Big Four audit firms — Deloitte, KPMG, Ernst & Young, and Pricewaterhouse-Coopers — are under intense scrutiny by regulators and institutional investors for consulting practices that have again grown so large that they again have threatened audit quality. In fact, it is the institutional investor community that may hold the key to redeeming the accounting profession.

The Challenges to Accounting Accountability

It has never been easy to bring lousy auditors to justice, but in the last thirty-five years it has become harder than ever. In 1975, the U.S. Supreme Court decided in *Ernst & Ernst v. Hochfelder* that securities litigation requires an allegation of "'scienter' — an intent to deceive, manipulate, or defraud." The "scienter" requirement is notoriously difficult to meet in an auditor liability case without a whistleblower or a "smoking gun." Because Congress's 1995 Private Securities Litigation Reform Act ("PSLRA") prohibited investors from discovery without getting past a motion to dismiss, many cases against auditors are, therefore, dismissed before the first witness can be deposed or the first document requested. In addition, in a series of decisions that culminated in the 2008 opinion in *Stoneridge Investment Partners v. Scientific-Atlanta*, the Supreme Court sharply curtailed the ability of investors to bring cases against auditors for "aiding and abetting" securities fraud even where there is definitive proof that an auditor actively conspired with a company to commit fraud.

All hope to bring auditors to justice for securities fraud is not lost, however. Theoretically, where auditors issue public statements themselves (like certifying a company's public financial statements), plaintiffs can attempt to satisfy the requirement of auditor scienter. To do so, the auditor must be "reckless." The "reckless" standard established by the Supreme Court's 1975 *Ernst* decision requires more than just a misapplication of accounting or auditing principles. Plaintiffs must prove that the auditing was so deficient that the audit amounted to "no audit at all" or "an egregious refusal to see the obvious, or to investigate the doubtful," or that the accounting judgments which were made were such that no reasonable auditor would have made the same decisions if confronted with the same facts.

Proving that an audit amounted to "no audit at all" is increasingly difficult these days, because companies are refusing to restate their past audited financials. Instead, when companies misstate financial information, intentionally or not, they are using a "revision" approach more and more to fix it without filing a Form 8-K with the SEC or formally restating and refiling prior financials. Fewer formal restatements means it is harder for shareholders to bring any case, let alone one against a third-party such as auditors, because without a formal restatement it's difficult to quantify the harm to investors prior to discovery. When a case can be filed, auditors, and their lobbyists, have

made it very difficult to prevail. As a result, auditors are left off the list of class action defendants or dropped once judges signal acceptance of the common, but professionally embarrassing, auditor defense: "We were duped, too."

Making matters worse, if audit firms paid for failure at all, it was typically a fraction of what other defendants paid. There's a rule of thumb heard repeatedly in settlement discussions: Big Four firms won't pay more than 10% of what the company paid.

Meaningful Prosecutions on the Rise

Auditors have only sparingly been named as defendants in securities cases, including in the recent financial crisis lawsuits. But that is beginning to change. In March of 2010, the Lehman Bankruptcy Examiner used the word "fraud" in his report and implied that Ernst & Young, Lehman's auditor, was complicit in Lehman's misconduct.

While securities cases have recently been brought against auditors, such cases are rarely, if ever, going to trial. Especially since Andersen's high-profile demise, the Big Four global audit firms settle securities litigation before trial both because they fear a judgment large enough to threaten their solvency and because they don't want their mistakes aired in public. Indeed, if there is substance to a claim, or negligence or complicity by an audit partner and his firm, the case usually settles before any facts are made public.

For example, New Century Financial was a subprime mortgage originator that failed early in the crisis. The bankruptcy trustee and private investors in a class action suit both sued auditor KPMG successfully. The cases settled in spite of — or perhaps because of — very specific examples of reckless auditor behavior documented by the New Century bankruptcy examiner. Thus, the allegations against KPMG will never be heard in open court.

Similarly, in 2011, Price Waterhouse India, Price Waterhouse International Ltd. and PwC U.S. settled for $25.5 million for the massive Satyam accounting fraud, a $1 billion scam that involved falsified bank confirmations. Shareholders alleged the auditor was "reckless" in carrying out its duties. Price Waterhouse India also paid $7.5 million in fines to the Public Company Accounting Oversight Board, the audit regulator, and the SEC who alleged Price Waterhouse India had aided and abetted the Satyam fraud and there had been "no audit at all." In 2012, Deloitte agreed to pay $19.9 million to settle claims for its work at JPMorgan Chase & Co. (JPM)'s Bear Stearns unit after plaintiffs successfully argued "no audit at all" allegations.

If a Big Four audit firm ever does go to trial again for a major fraud, we may finally close the "expectations gap," the infamous gulf between what investors think auditors do and what auditors actually do, and say they do. There are a few cases where this remains a possibility:

- There's a trial scheduled to start in June 2013 against Deloitte as auditor for Taylor, Bean & Whitaker (TBW), another financial crisis era mortgage originator fraud where plaintiffs allege there was "no audit at all."

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- PwC is the last defendant standing in a class action for the Colonial Bank failure, pending a decision soon on a motion to dismiss.

- In the class action case related to the Lehman failure, Ernst & Young is one of two remaining defendants. Barring a last minute settlement, we may finally see some of the facts of that case given a public airing.

This willingness to hold auditors liable for their role in the crisis, and in several of the non-crisis related corporate frauds that have occurred since, did not come soon enough to change the law or judges' minds. Attempts to restore private plaintiffs' right to allege aiding and abetting by auditors, specifically an amendment introduced by Senator Arlen Specter in 2010 during the Dodd-Frank financial reform bill debates, failed.

Shareholders Can Reform the Accounting Industry

Investor action can be a powerful tool to effect change in boardrooms and at the Big Four accounting firms. What can investors do when auditors behave more like lapdogs of management than watchdogs?

1 Pay attention to the proxy. Support corporate governance initiatives such as "tender or explain" for long-term relationships between auditors and companies. When auditors serve the same client for decades there's bound to be a negative impact on independence and objectivity.

2 Vote your proxy. When auditors are sued or suspected of negligence or complicity in frauds or accounting manipulation, don't allow your broker to reelect them. Attend the annual meeting and voice your concerns.

3 Support activist investor and corporate governance initiatives to actively monitor companies that spend more with their auditors on tax and consulting services than the audit. Put pressure on the SEC and PCAOB to discipline auditors for breaking the rules on prohibited services by an auditor.

4 Board directors, and especially Audit Committee members, should monitor the work of the audit firm closely. Don't take the auditor's word that it's independent. Don't allow the CFO to make all decisions or be the only one to debate accounting issues. Ask your auditor about PCAOB inspection results and push back on excuses for poor quality.

5 When frauds occur, pursue valid claims against the audit firms all the way to trial if necessary. Hire a great lawyer who will fight as hard as the auditors do to successfully overcome the traditional obstacles to auditor litigation. If you stay the course, you'll likely recover your losses.

When investors force auditors to play their statutory role in the regulatory infrastructure — and stop being handmaidens to management — frauds can be stopped earlier and losses mitigated. Shareholders pay the accounting industry billions of dollars to keep their portfolio companies honest and open. They deserve more bang for their auditing buck. ◆

About the Author

Ms. McKenna is a freelance writer and C.P.A. with more than twenty-five years of experience in consulting and professional services, including tenure at two Big Four auditing firms in the U.S. and abroad. She is a columnist for both *Forbes* ("Accounting Watchdog") and *American Banker* ("Accountable"), and prior to that was a weekly columnist at GoingConcern.com. Her other writing credits include *Financial Times, Accountancy Age, Accountancy Magazine, The Columbia Journalism Review, Boston Review, the FEI Blog*, and various other financial, media, and technology blogs.

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Trouble After the Bubble

Banks Face a Flood of Litigation as RMBS Investors Fight Back

By Ross Shikowitz

Efforts by investors and other institutions to recover massive losses due to Wall Street Banks' securitization practices are finally bearing fruit.

In the lead up to the financial crisis — as Deutsche Bank was creating and selling off billions of dollars in residential mortgage-backed securities ("RMBS") — its head of RMBS trading, Greg Lippmann, repeatedly derided those same RMBS as "crap" and "pigs." In fact, Deutsche Bank made a huge profit by betting that these same RMBS would fail by taking massive short positions on these securities. According to Lippmann, "he was short 1 billion dollars of this stuff and was going to make 'oceans' of money." By the end of 2007, Deutsche Bank's "short" position had grown to $10 billion. Similarly, the head of Goldman Sachs' mortgage desk, Daniel Sparks, explained that Goldman Sachs' RMBS team had "worked their tails off to make some lemonade from some big old lemons." Former Bear Stearns analyst Matt Van Leeuwen reported that "Bear traders pushed [its] analysts to get loan analysis done in only one to three days. That way, Bear could sell them off fast to eager investors." One Bear Stearns deal manager had even nicknamed a Bear Stearns RMBS deal a "SACK OF S**T."

None of this was disclosed to the institutional investors that invested in millions and millions of dollars of these RMBS.

Well after the Wall Street banks made a killing through their undisclosed securitization practices, the government has — all too late — subjected those practices to

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One of the first types of actions to be filed on behalf of investors in RMBS were class actions that asserted strict liability and negligence claims under the Securities Act of 1933, which provides liability for those that make false statements in a registration statement. Several of these cases have already resulted in substantial settlements for investors.

scrutiny. In January 2011, the Congressionally-established Financial Crisis Inquiry Commission published a report showing that the third-party due diligence providers employed by Wall Street banks consistently alerted the banks to widespread and critical problems with the loans that they were purchasing, yet the banks securitized and sold them as RMBS to institutional investors regardless. Then, in April 2011, the United States Permanent Subcommittee on Investigations issued a report (the "Subcommittee Report") that chronicled the fraudulent practices of Deutsche Bank, Goldman Sachs, and Washington Mutual ("WaMu"). As revealed in the Subcommittee Report, Deutsche Bank senior traders such as Greg Lippmann knew the RMBS that Deutsche Bank created were destined to fail, announcing in internal emails at least as early as 2006 that "THIS STUFF HAS A REAL CHANCE OF MASSIVELY BLOWING UP." In 2006, Lippmann was paid $47 million in total compensation—an amount greater than Deutsche Bank paid to the rest of its senior management combined.

Similarly, the Subcommittee Report found that Goldman Sachs "instructed its sales force to sell mortgage related assets, including high risk RMBS and CDO securities that Goldman Sachs wanted to get off its books...to promote its own interests at the expense of investors." In fact, Goldman Sachs CEO Lloyd Blankfein personally reviewed the efforts of the Goldman Sachs sales force to sell RMBS that company executives believed would fail, asking "are we doing enough right now to sell off cats and dogs in other books throughout the division?" As noted by Senator Carl Levin upon the publication of the Subcommittee Report, "[t]he report pulls back the curtain on shoddy, risky, deceptive practices on the part of a lot of major financial institutions....The overwhelming evidence is that those institutions deceived their clients and deceived the public."

Even though these government inquiries have revealed widespread and devastating misconduct, they have done little to directly recover funds for investors. In fact, the RMBS Working Group — a joint federal-state task force to investigate the securitization practices of Wall Street banks, "hold wrongdoers accountable, help victims, and stop similar fraud from happening in the future" — was not instituted until January 2012. Indeed, while Wall Street's own excesses and outright fraudulent practices are surely to blame for RMBS-related losses, they were enabled and even fostered at the time by widespread failures in governmental oversight and financial regulation. As just one example detailed in the Subcommittee Report, WaMu's regulator, the Office of Thrift Supervision ("OTS"), utterly failed to stop WaMu's risky lending practices before it tumbled into bankruptcy in one of the largest bank failures in history. According to the Subcommittee Report, the OTS identified over 500 serious deficiencies at WaMu from 2004-2008 arising out of the bank's lending and appraisal practices, yet never forced WaMu to improve its operations. Such failures allowed WaMu's securitization of high risk loans to continue unabated throughout the subprime boom. As Senator Levin noted, Wall Street banks "were aided and abetted by deferential regulators" and others "who had conflicts of interest."

The massive losses suffered by investors and other institutions as a result of Wall Street banks' securitization practices have led to a flood of civil litigation. One of the first types of actions to be filed on behalf of investors in RMBS were class actions that asserted claims under the Securities Act of 1933 ("Securities Act"), which provides liability for those that make false statements in a registration statement. Several of these cases have already resulted in substantial settlements for investors. For example, the RMBS class actions against Merrill Lynch and Wells Fargo settled for $315 million and $125 million, respectively. Investors in Deutsche Bank RMBS have resolved their claims ($32.5 million), as have investors in Goldman Sachs RMBS ($26.6 million), and Citigroup RMBS ($25 million). Many of the most significant RMBS class actions, however, are still pending against various Wall Street banks, including JPMorgan, Bear Stearns, and Morgan Stanley.

Institutional investors have also been successful in bringing direct actions asserting fraud-related claims against various Wall Street banks. Fraud claims are generally considered attractive to litigants because they often have a relatively long statute of limitations and allow for punitive damages. However, fraud claims are also generally believed to be more difficult for institutional investors to plead and prove because they typically require showing that, among other things, defendants acted with a reckless state of mind. Nevertheless, over the last few years, RMBS investors have achieved significant success asserting fraud claims in RMBS actions, including in recent cases brought against Countrywide, JPMorgan, Morgan Stanley, Deutsche Bank, Goldman Sachs, Merrill Lynch, and Credit Suisse.

Insurance companies that insured the RMBS securitization trusts' payments to investors have also achieved favorable results by suing Wall Street banks for fraud and breach of contract. These insurers, which include MBIA, Assured Guaranty, Syncora, and Financial Guaranty, have alleged that Wall Street banks fraudulently induced them to provide billions of dollars of insurance on RMBS by misrepresenting the quality of the securitized loans. In one of the most closely watched RMBS cases involving an insurer, MBIA sued Countrywide for over $4.5 billion in losses. Motions for summary judgment are fully briefed in that case and, should MBIA's claims survive, the judge will set a trial date. Claims brought by insurers have also resulted in significant settlements, with Assured Guaranty and

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Insurance companies that insured the RMBS securitization trusts' payments to investors have also achieved favorable results by suing Wall Street banks for fraud and breach of contract, alleging that the banks fraudulently induced them to provide billions of dollars of insurance on RMBS by misrepresenting the quality of the securitized loans.

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Bank of America Settlement and JPMorgan Case Highlight SEC's Tepid Response

By Susan Beck

In the BofA case, don't forget that the SEC was initially willing to settle its case against BofA for a measly $33 million.

Reprinted courtesy of The *American Lawyer — The Litigation Daily,* October 3, 2012.

BLB&G served as Co-Lead Counsel for the investor Class in *In re Bank of America Securities Litigation.*

In the last week we've seen some flashy headlines about lawsuits stemming from the financial crisis. On Friday, Bank of America Corp. announced that it had agreed to pay $2.43 billion to settle a shareholder suit over allegedly inadequate disclosures it made when it acquired Merrill Lynch & Co. in 2009. Then on Tuesday New York Attorney General Eric Schneiderman brought a sweeping lawsuit accusing J.P. Morgan Chase Bank of deceiving investors in mortgage-backed securities before the financial crisis. (The suit focuses on the activities of Bear Stearns & Co. Inc., which JPMorgan acquired.)

Sounds like good news for those concerned about tough enforcement of our securities laws, right?

Wrong.

The problem is that both of these events highlight the weak, tepid response of the federal agency that should stand at the front lines of enforcing those laws. I'm talking about the Securities and Exchange Commission.

In the BofA case, don't forget that the SEC was initially willing to settle its case against BofA for a measly $33 million. That case — which alleged that the bank improperly failed to disclose that Merrill executives would be paid up to $5.8 billion in bonuses — was famously upended when Manhattan U.S. District Judge Jed Rakoff refused to approve the settlement, calling $33 million a "trivial penalty" in this September 2009 ruling. The SEC and the bank later came back with a $150 million deal, which included the settlement of charges that BofA concealed the full extent of Merrill's losses before the shareholder vote on the merger. An exasperated Rakoff called that penalty "modest"— especially in light of the expanded charges —- and queried why no individuals were charged. But he reluctantly signed off on the pact in February 2010, writing: "While better than nothing, this is half-baked justice at best."

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The SEC can't recoup investor losses. Instead, the agency is limited to seeking disgorgement of ill-gotten gains and statutory financial penalties. SEC Chairman Mary Shapiro last year asked Congress to give her agency the power to impose bigger penalties; legislation has been introduced, but not yet voted on.

Now it's true that the SEC, unlike the shareholder plaintiffs, can't recoup investor losses, so it's unfair to compare the two settlements side-by-side. Instead, the agency is limited to seeking disgorgement of ill-gotten gains and statutory financial penalties. (SEC Chairman Mary Shapiro last year asked Congress to give her agency the power to impose bigger penalties. Legislation has been introduced, but not yet voted on.) Measuring ill-gotten gains in the context of a disclosure case is a tricky matter. But by settling for $150 million, the SEC may have underestimated the strength of this case. After all, in the shareholder litigation, Manhattan U.S. District Judge P. Kevin Castel brusquely rejected most of BofA's defenses in pretrial rulings. And he also refused to dismiss BofA's top officers and directors, who were never even sued by the SEC.

The SEC declined to comment.

The JPMorgan matter raises a slightly different question. Why was this case brought by the New York AG, and not by the SEC or Justice Department under our federal securities laws? Investor deception should be right down the SEC's alley. Instead, the charges were filed under New York's nebulous Martin Act. Although this lawsuit was the product of an effort by the Residential Mortgage-Backed Securities Working Group, a newly-formed state and federal task force that includes the SEC and the DOJ, the SEC is standing far in the background here.

I do wonder if the SEC feels its hands are tied by assurances that it gave JPMorgan in 2008 when it acquired Bear Stearns. As I reported in an article for *The American Lawyer*, JPMorgan's general counsel Stephen Cutler reached out to then-enforcement director Linda Thomsen with a bold request before that deal. Cutler, a former SEC director of enforcement who had been Thomsen's boss, tried to get her to ensure that JPMorgan wouldn't be sued for Bear Stearns's misdeeds. Although Thomsen, who is now a partner at Davis Polk & Wardwell, didn't give Cutler exactly what he wanted, she did take the unusual step of giving some vague assurances in writing, which upset some of her staff who were investigating Bear Stearns. (Cutler declined to comment for that article and Thomsen did not respond to requests for comment.)

Unfortunately the New York AG doesn't have the greatest track record when it comes to aggressively litigating another hallmark financial crisis case. As I noted in an earlier column, "Whatever Happened to the NY AG's Case Against BofA?," the AG's case against Bank of America and former CEO Ken Lewis and former CFO Joe Price has all but stalled in state court since it was filed with great fanfare in February 2010.

Let's hope this case is pursued with more urgency.

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Unfinished Business

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ance. For example, the credit rating agencies essentially nullified some of the Act's new rules by simply refusing to provide their ratings on new securities offerings. The rating agencies' boycott essentially froze the asset-backed securities market in July 2010, prompting the SEC to issue a "no action" letter indicating that it would not enforce the rule.

Financial services companies and their lobbyists have also had considerable success in challenging Dodd-Frank's implementing rules in court. In one case, the Washington, D.C. Circuit Court of Appeals threw out an SEC final rule implementing a Dodd Frank provision that allowed institutional investors to nominate board members. The Court held that the SEC's rule could not stand because the agency's cost-benefit analysis had not taken into account how much it would cost companies to protest investor nominations. Critics of the D.C. Circuit's decision claim that the Court simply ignored the SEC's extensive review of the empirical evidence of the law's benefits. Nevertheless, the SEC did not appeal the decision, and instead issued new guidelines based on the D.C. Circuit Court's ruling that many critics argue embrace that court's business-friendly approach. The result of the Court's ruling is to compound the already formidable influence the financial industry has had in shaping the final outcome of Dodd-Frank.

Looking Ahead: Finalizing Dodd-Frank in Obama's Second Term

While many of Dodd-Frank's final rules have yet to be written, the strongest chances for the law's success will depend on the administration's effectiveness in navigating a combative rule-making process, and the political will of investors and their advocates in Congress. One clear opportunity for the administration will be to fill the three current vacancies on the eleven-member D.C. Circuit, which hears all appeals arising from direct challenges to SEC regulations. While the administration's efforts to fill those vacancies were scuttled in Obama's first term, there will be an opportunity to try again over the next four years.

Also looking ahead, many believe that the election of investor advocates to Congress this past November — including of Massachusetts Senator Elizabeth Warren, who conceived the Consumer Financial Protection Bureau — will have a positive influence on the ultimate outcome of Dodd-Frank.

But investor advocates in Congress face a daunting task. With industry lobbying in full force, public pension funds and other institutional investors are the last line of defense in maintaining the integrity of our capital markets. The institutional investor community will have to continue pressing President Obama and those in Congress to stand up to Wall Street, and to push for meaningful reforms that will have a real impact on the safety and integrity of the securities markets.

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Trouble After The Bubble

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Syncora settling their claims against Countrywide for $1.1 billion and $375 million, respectively.

Perhaps the most widely reported RMBS cases have arisen out of so-called "put-back" claims, where a large group of investors (typically, 25 percent of the holders of a given RMBS) collectively petition an issuer of RMBS, either privately or through litigation, to repurchase defectively originated mortgages. These cases have also resulted in significant settlements. For example, Bank of America settled such claims for $8.5 billion with a group of more than 20 investors including PIMCO, MetLife, and BlackRock, as well as the Federal Reserve Bank of New York. Residential Capital resolved similar claims with RMBS investors for approximately $8.7 billion upon filing for bankruptcy. (Both settlements are pending court approval.)

One of the most significant developments in this history of RMBS litigation occurred in early February, when Assured Guaranty won at trial its breach of contract action against Flagstar Bank. The trial, which included twelve days of testimony, was conducted as a "bench trial" before Judge Jed S. Rakoff in the Southern District of New York, and led to a recovery of over $90 million for Assured. The evidence included the testimony of one of Assured's experts, who testified that over 600 of the 800 loans reviewed suffered from serious problems and never should have been issued in the first place. The evidence also showed that Flagstar included in the RMBS many of the very same loans that

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it internally referred to its fraud investigation unit. While it is impossible to predict with absolute certainty how this result will affect the hundreds of other pending RMBS-related actions, several commentators believe that Assured's victory is a watershed event that may lead to the eventual settlement of numerous other actions.

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