2012 Mid-Year Securities Litigation and Enforcement Highlights

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Baker Hostetler

Marc D. Powers  Jonathan Nowakowski
Mark A. Kornfeld  Gabriel E. Drucker
Brian W. Song  Christopher B. Gallagher
Teresa C. Chow  Joshua B. Rog
Marco Molina
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By: Marc D. Powers, Mark A. Kornfeld, Brian W. Song, Teresa C. Chow, Marco Molina, Jonathan Nowakowski, Gabriel E. Drucker, Christopher B. Gallagher and Joshua B. Rog

Welcome to the 2012 Mid-Year Report from the Baker & Hostetler LLP Securities Litigation and Regulatory Enforcement practice team. The purpose is to provide periodic survey, apart from our team Executive Alerts on matters we believe of interest to sophisticated General Counsel, Chief Compliance Officers and Compliance Departments, Legal Departments and members of the securities and commodities industries at financial institutions and public companies.

We intend to issue this Securities Litigation and Enforcement Highlights Report on a regular basis mid-year and shortly after year end. We hope you find the information and commentary useful and welcome your comments and suggestions. We encourage you to contact any of the practice team members listed at the end of the Report.

I. Supreme Court Developments in Securities Litigation

On June 11, 2012, the Supreme Court granted certiorari in Amgen Inc. v. Connecticut Retirement Plans and Trust Funds ("Amgen"), a class action case on appeal from the Ninth Circuit that bears on Section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act") and Securities and Exchange Commission ("SEC") Rule 10b-5. The questions presented to the Supreme Court are 1) whether, in a misrepresentation case under Rule 10b-5, the district court must require proof of materiality before certifying a plaintiff class based on the fraud-on-the-market theory; and 2) whether, in such a case, the district court must allow the defendant to present evidence rebutting the applicability of the fraud-on-the-market theory before certifying a plaintiff class based on that theory.

First approved by the Supreme Court in Basic Inc. v. Levinson ("Basic"), the “fraud-on-the-market” doctrine alleviates the often insurmountable burden for each class member in a Rule 10b-5 case to individually prove reliance on the alleged misrepresentation in order to obtain class certification. It is based on the principle that the market price of a security traded in an efficient market reflects all public information, and the buyer is therefore presumed to have relied on the truthfulness of that information in purchasing the security.

1 Amgen Inc. v. Connecticut Retirement Plans and Trust Funds, 660 F.3d 1170 (9th Cir. 2011) ("Amgen").
4 Amgen, 660 F.3d at 1174.
In *Amgen*, Connecticut Retirement Plans and Trust Funds ("CRP") brought a Rule 10b-5 class action against Amgen Inc. and several of its officers (collectively, "Amgen"), alleging that Amgen failed to disclose safety information about two products used to treat anemia, thereby inflating the price of Amgen’s stock when CRP purchased it. Subsequent corrective disclosures allegedly caused Amgen’s stock price to drop, damaging CRP. The district court granted class certification after determining, among other things, that CRP successfully invoked the fraud-on-the-market presumption of reliance by alleging that Amgen’s stock traded in an efficient market and that Amgen’s alleged misstatements were public. The court also held that proof of the materiality of Amgen’s alleged misstatement was not required at the class-certification stage and declined to allow Amgen the opportunity to rebut CRP’s allegation of materiality. The Ninth Circuit affirmed the district court’s ruling on appeal.

It is expected the Supreme Court will resolve what is currently a split amongst the circuit courts regarding whether a class action plaintiff must prove materiality at the class certification stage in order to invoke the fraud-on-the-market presumption of reliance. The Ninth Circuit observed in *Amgen* that the First, Second, and Fifth Circuits have held that materiality is a required element that must be proven at the class certification stage in similar litigation. The Ninth Circuit, however, distinguished this legal conclusion by arguing that it is based on an incorrect reading of a footnote from *Basic*, which stated that materiality is essential, but—in the Ninth Circuit’s opinion—did not require class action plaintiffs to prove it is a precondition to class certification. Joining with the Seventh and Third Circuits, the Ninth Circuit held that because materiality is a merits issue most appropriate for trial or a motion for summary judgment, plaintiffs must only “plausibly allege—but need not prove” it at the class certification stage. Thus, according to the Ninth Circuit, rebuttal of materiality through proof of immateriality is a matter for trial or summary judgment but not appropriate at the class certification stage.

If the Supreme Court agrees with the First, Second, and Fifth Circuits and finds that plaintiffs must prove materiality in order to invoke the fraud-on-the-market presumption of reliance, class certification will increasingly be used by defendants, and could serve as an obstacle to plaintiffs seeking the Rule 10b-5 class certification.

Amgen’s and CRP’s briefs on the merits will be due on August 8, 2012 and September 20, 2012, respectively. Oral argument is set for November 5, 2012.

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5 *Id.* at 1172 – 1773.
6 *Id.* at 1174.
7 *Id.* at 1177.
8 *Id.* at 1172.
II. Civil Securities Cases Tried to Verdict

Although still somewhat uncommon, there has been a recent surge in the number of securities cases going to trial in lieu of settlement. The increase in litigation has two likely sources: more complex cases stemming from the 2008 financial crisis and a related increase in lawsuits filed against individual executives. The SEC has also been under increasing pressure from lawmakers, judges and investors who claim that the SEC has failed to hold Wall Street accountable. In a congressional hearing in March, SEC Chairman Mary L. Schapiro stated that the agency has plans to focus more resources and personnel on the trial unit. Accordingly, all signs point to the upward trend continuing for the foreseeable future.

Coquina Investments v. Rothstein

On January 18, 2012, a jury in the Southern District of Florida returned a $67 million verdict against Toronto-Dominion Bank (“TD Bank”) over claims that it was complicit in a Ponzi scheme. The suit was brought by Coquina Investments, Inc. (“Coquina Investments”), an investment firm based in Corpus Christi, Texas.

The case arises out of a complex Ponzi scheme that Scott W. Rothstein (“Rothstein”), formerly a disbarred attorney, orchestrated from 2005 to November 2009 as chairman and Chief Executive Officer (“CEO”) of the now-defunct Florida law firm of Rothstein Rosenfeldt Adler, P.A. (“RRA”). As part of his Ponzi scheme, Rothstein offered investors the opportunity to purchase structured settlements, which he claimed came from the settlement of lawsuits with high-profile defendants for large sums of money. Rothstein and RRA held several bank accounts at TD Bank, which purportedly held settlement payments and investor funds. Rothstein claimed that certain RRA clients wished to sell their interest in their structured settlements for an immediate lump sum payment. The structured settlements, however, turned out to be fictitious.

The trial focused on the bank’s responsibility to know its customers and to detect fraud under the Bank Secrecy Act and its anti-money-laundering provisions.

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11 Id.
12 Id.
15 Id.
16 Id.
17 Id.
18 Paul Brinkmann, Jury returns $67 Verdict Against TD Bank In Rothstein Related Case, SOUTH FLORIDA BUSINESS JOURNAL, January 18, 2012.
According to Coquina Investments’ complaint, Rothstein used the bank to make payments to investors that supposedly came from the settlements and to provide documents to conceal the truth from investors. Coquina Investments alleged that TD Bank knew Rothstein was stealing client money from bank accounts and that TD Bank employees, in particular the former regional Vice President Frank Spinosa, lied to them about the safety of their money and helped Rothstein deceive investors.  

The bank countered by accusing Coquina Investments of ignoring obvious signs of fraud. An expert hired by TD Bank stated that the bank conducted “reasonable due diligence” regarding dozens of alerts generated by computer systems concerning Rothstein’s accounts.

The jury ultimately awarded Coquina Investments $32 million in compensatory damages and $35 million in punitive damages, providing a verdict not commonly seen against banks accused of aiding a Ponzi scheme. TD Bank is currently facing three other suits by groups of investors with similar claims, including a $200 million lawsuit set for trial in March 2013 in Broward County Circuit Court.


On June 14, 2012, a federal jury in the U.S. District Court for the Eastern District of Louisiana rejected claims that WestPAC Resources (“WestPAC”), a company co-owned by actor Kevin Costner (“Costner”) that markets oil-cleaning devices, violated the securities laws and committed fraud by hiding details of an impending deal with British Petroleum (“BP”) when plaintiffs Spyridon C. Contogouris (“Contogouris”) and Stephen Baldwin (“Baldwin”) sold their stake in the company.

Costner financed and supervised the development of technology which could separate oil from water. After the 2010 Gulf of Mexico oil spill, Costner and WestPAC entered into an agreement with plaintiffs to market the oil-separating devices. Subsequently, WestPAC entered into an agreement with BP to sell 32 of the oil-separating devices to BP for approximately $52 million. Before the WestPAC-BP deal was completed or publicly announced, plaintiffs sold their shares of the joint venture at what they argue was a much lower price than they would have received had they sold after the agreement was entered.

19 Id.
20 Id.
21 Id.
22 Id.
23 Id.
27 Id.
 Plaintiffs alleged at trial that they were entitled to a portion of BP’s initial deposit as Costner and his business associates defrauded plaintiffs by not informing them of the contract with BP before they liquidated their stock. WestPAC’s attorneys countered that plaintiffs were not entitled to any portion of the contract because they sold their shares when the deal with BP was uncertain and far from finalized.

Contogouris was seeking close to $17 million from Costner and his business partner, Patrick Smith. The jury, which deliberated for less than two hours, found for the defendants and awarded no damages to plaintiffs.

III. Recently Filed Rule 10b-5 Cases Relating to the 2008 Financial Crisis

The SEC continues to bring Rule 10b-5 enforcement actions relating to conduct that occurred at the onset of the global financial crisis in late 2007 and 2008. On May 17, 2012, while testifying before the United States House Committee on Financial Services regarding the SEC’s settlement practices, Director Robert Khuzami (“Khuzami”) reported that 75% of the SEC’s financial crisis-related enforcement actions against individuals (including CEOs, CFOs, and other high-ranking executives of companies) were filed as litigated actions. This suggests that settlements were available, but rejected by the SEC as inadequate in these cases. Two examples of SEC cases filed in the first half of 2012, which are currently active, are S.E.C. v. Goldstone, and S.E.C. v. BankAtlantic Bancorp, Inc.

SEC v. Larry A. Goldstone, Clarence G. Simmons, III, and Jane E. Starrett

In this action filed in the District Court for the District of New Mexico on March 13, 2012, the SEC charged the CEO Larry A. Goldstone (“Goldstone”), Chief Financial Officer (“CFO”) Clarence G. Simmons, III (“Simmons”), and Chief Accounting Officer (“CAO”) Jane E. Starrett (“Starrett”) of Thornburg Mortgage Inc. (“Thornburg”) with hiding the company’s deteriorating financial condition at the onset of the financial crisis in late-February and early March 2008. As a result of the Thornburg executives’ fraudulent scheme, the company lost 90% of its value in two weeks. The SEC’s claims for relief include Rule 10b-5 fraud (against all defendants), control person liability (against Goldstone and Simmons) and aiding and abetting Thornburg’s fraud (against all defendants).

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28 See Leslie Snadowsky, Kevin Costner Defeats Stephen Baldwin in Court, supra, June 14, 2012.
29 Id.
30 On July 19, 2012, U.S. District Court Judge Martin Feldman denied Plaintiffs’ motion for a new trial, stating that previously excluded documentary evidence about alleged ‘bad acts’ by Smith was irrelevant. See Eriq Gardner, Stephen Baldwin Denied New Trial Against Kevin Costner, THE HOLLYWOOD REPORTER, July 20, 2012. Attorneys for Plaintiffs have indicated that they are considering further appeals. See id.
According to the SEC’s complaint, Thornburg was a publicly-traded, single-family mortgage lender and one of the nation’s largest mortgage companies. In addition to its lending business, Thornburg purchased and held adjustable rate mortgage (“ARM”) securities and securitized ARM loans, which, in turn, served as collateral for loans utilized by Thornton to finance its mortgage business and investment activities. Thornton was subject to margin calls by its lenders if the value of its collateral/ARM securities fell below designated thresholds.33

Starting in August 2007, Thornburg started to receive unprecedented levels of margin calls due to extraordinary disruptions in the housing and financial markets, and a sudden decline in mortgage-backed securities prices. Despite being in violation of at least three lending agreements by failing to make on-time margin call payments, Thornburg executives hid this fact and the company’s critical liquidity crisis from its investors and outside auditor, reasoning that more than $400 million in market value losses relating to its ARM securities were merely temporary. With the cooperation and forbearance of its lenders, Thornburg scrambled to meet outstanding margin calls just hours before the filing of its annual report.

Within hours of filing its 2007 Form 10-K, however, Thornburg received additional margin calls that far exceeded its available liquidity. By the time Thornburg filed an amended 2007 Form 10-K on March 11, 2008—which included a going concern qualification and an impairment charge of $427.8 million on its income statement related to its ARM securities—its stock price had plummeted over 90% from its closing price on February 28, 2008. Thornburg filed for Chapter 11 bankruptcy relief on May 1, 2009.34

The Thornburg executives moved to dismiss the SEC’s complaint under Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim characterizing the SEC’s claims as, among other things, unfounded and inadequate, and, based on “twenty twenty hindsight” regarding complex accounting judgments made at a time of extraordinary market turmoil. The motions to dismiss were heard on July 30, 2012.

— SEC v. BankAtlantic Bancorp, Inc. and Alan B. Levan

In this action filed in the Southern District of Florida on January 18, 2012, the SEC charged the holding company for one of Florida’s largest banks (“Bancorp”) and its CEO Alan B. Levan (“Levan”) with making misleading statements in public filings and in earnings calls about growing problems in one of its significant loan portfolios (the “Portfolio”) in 2007. Bancorp and Levan were also charged with accounting fraud for minimizing the bank’s losses on their books by improperly recording loans they were trying to sell from the

33 Id.
34 Id.
Portfolio in late 2007. The SEC’s claims for relief include, Rule 10b-5 fraud (against all defendants), and aiding and abetting Bancorp’s Rule 10b-5 fraud (against Levan).  

According to the SEC’s Complaint, the Portfolio consisted primarily of loans on large tracts of land targeted for single-family housing and condominiums that were distressed in 2007 due to the borrowers’ inability to meet their loan obligations and the general decline in Florida’s real estate market. Some loans were kept current only by extending the loan terms or replenishing their interest reserves with principal increases. Starting from close of first quarter 2007 (and continuing thereafter), many loans were downgraded to “non-passing” status reflecting the bank’s serious concerns about their viability. Levan was well-aware of these issues through his position on the bank’s committee that approved the extensions and principal increases.

Nonetheless, Bancorp’s public filings for the first half of 2007, which were signed by Levan, failed to disclose the known downward trend in the Portfolio and only generally mentioned the deterioration of the Florida real estate market. During earnings calls for first and second quarter of 2007, Levan also knowingly made misleading statements concerning the credit quality of loans in the Portfolio. When Bancorp finally disclosed the problems with the Portfolio in a Form 8-K filing on October 26, 2007, which announced a large unexpected net loss, its share price plummeted 37%.

Bancorp and Levan moved to dismiss the SEC’s Complaint under Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim, advocating that 1) Bancorp’s public filings and earnings calls contained adequate disclosures regarding the Portfolio, and 2) no misrepresentations were made about the “held for investment” status of the loans as no decision was alleged to have been made to actually sell the loans. On May 29, 2012, the Court rejected defendants’ arguments, and denied Bancorp and Levan’s motion to dismiss.

IV. Investment Adviser/ Investment Company Cases

So far, 2012 has proven that the SEC is committed to investigating the trading practices of hedge funds as well as enforcing the Foreign Corrupt Practices Act (“FCPA”). Additionally, the U.S. Court of Appeals for the Second Circuit provided some clarity to the extraterritorial reach of the United States securities laws. Below is a discussion of a few of the important cases from the first half of 2012:

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36 Id.
37 Id.
38 Id.
In *Absolute Activist Value Master Fund, Ltd. v. Ficeto* (“Absolute Activist”), the Second Circuit spoke to the extraterritorial reach of the securities laws following the Supreme Court’s landmark 2010 decision in *Morrison v. National Australia Bank Ltd. et al* (“Morrison”). In *Morrison*, the Supreme Court held that “Section 10(b) [of the Exchange Act] applies only to transactions in securities listed on domestic exchanges and domestic transactions in other securities,” noting that “[w]ith regard to securities not registered on domestic exchanges, the exclusive focus [is] on domestic purchases and sales.”

The plaintiffs in *Absolute Activist* were nine Cayman Island hedge funds (collectively the “Plaintiff Funds”) that alleged that their investment manager, Absolute Capital Management Holdings Limited (“ACM”), their U.S. broker-dealer, Hunter World Markets, Inc. (“Hunter”), and several officers and employees of ACM and Hunter (collectively the “Defendants”) fraudulently traded securities in a “pump-and-dump” scheme, “causing the funds to suffer losses of at least $195 million.” The defendants were alleged to have purchased billions of shares of U.S.-based penny stock companies whose shares “were quoted on the Over-the-Counter Bulletin Board or by Pink OTC Markets, Inc.” The defendants then artificially inflated the price of those shares by trading and re-trading the shares among the Plaintiff Funds in order to generate commissions and “to sell previously locked-up shares and exercise warrants to obtain additional shares, which they then sold to the [Plaintiff] Funds for a windfall.” The Second Circuit was asked to “determine whether foreign funds’ purchases and sales of securities issued by U.S. companies brokered through a U.S. broker-dealer constitute ‘domestic transactions’” pursuant to the Supreme Court’s decision in *Morrison*.

The Plaintiff Funds argued that the location of the broker-dealer or the identity of the security should be indicative of whether the securities transaction is domestic, while the Defendants maintained that the identity of the buyer and seller and whether the defendants in a particular action engaged in some conduct in the U.S. should determine whether a transaction was domestic. The Second Circuit rejected these arguments and held that “to sufficiently allege a domestic securities transaction in securities not listed on a domestic exchange . . . a plaintiff must allege facts suggesting that irrevocable liability was incurred or title was transferred within the United States.” The Court then granted leave to the Plaintiff Funds to amend their complaint to plead additional facts to support their claim that the transactions took place in the United States.

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39 677 F.3d 60 (2d Cir. 2012).
41 *Absolute Activist Value Master Fund Ltd.*, 677 F.3d 60, 63 (2d Cir. 2012).
42 Id.
43 Id. at 64.
44 Id. at 62.
45 Id. at 68.
This case is important because while this area of law is sure to evolve as other circuit courts weigh in using *Morrison* as their guide, foreign funds must now be aware that their location overseas does not relieve them of potential liability under U.S. securities laws.  

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**SEC v. Garth R. Peterson**

In April 2012, the SEC brought a case against Garth R. Peterson, a former Managing Director in Morgan Stanley’s real estate investment and fund advisory business, alleging violations of the FCPA, the Securities Exchange Act of 1934 (the “Exchange Act”), and the Investment Advisers Act of 1940 (the “Advisers Act”). Specifically, Peterson was charged with violating the anti-bribery and internal controls provisions of the FCPA, Sections 13(b)(5) and 30A of the Exchange Act, and with aiding and abetting violations of the anti-fraud provisions of the Advisers Act.

Peterson, who worked in Morgan Stanley’s Singapore office, had the responsibility to “evaluate, negotiate, acquire, manage and sell real estate investments on behalf of Morgan Stanley’s advisers and funds.”  

Peterson had developed a personal friendship and secret business relationship with a Chinese government official who ran Yongye Enterprise (Group) Co., a Chinese state-owned entity that could influence the success of Morgan Stanley’s real estate investments in Shanghai. The SEC alleged that from at least 2004 to 2007, Peterson not only paid himself and the Chinese official $1.8 million in finder’s fees that were otherwise owed to third parties, but that he also structured a deal, negotiating for both sides, in which he, the Chinese official, and an attorney were able to acquire a Shanghai real estate interest from one of Morgan Stanley’s funds.

While the SEC brought a civil action and the U.S. Department of Justice (the “DOJ”) brought a criminal action against Peterson, neither filed a case against Morgan Stanley. The SEC noted that “a Morgan Stanley compliance officer specifically informed Peterson in 2004 that employees of Yongye, a Chinese state-owned entity, were government officials for purposes of FCPA,” and that Peterson received some 35 FCPA compliance reminders, and still committed the violations. Furthermore, in their own press release, the DOJ explained that “[a]fter considering all the available facts and circumstances—including that Morgan Stanley constructed and maintained a system of internal controls,” and because the company “voluntarily disclosed this matter and has cooperated throughout the department’s investigation,” the DOJ declined to bring a case against Morgan Stanley related to

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46 “The fact that these [defendants] are located outside the United States does not aid the Morrison argument.”  
SEC v. ICP Asset Management LLC (June 21, 2012 Memorandum Opinion Judge Kaplan) (analyzing Morrison arguments under the Investment Advisers Act, rejecting defendants’ arguments that (i) because Section 206 of the Investment Advisers Act does not contain an affirmative intention to give extraterritorial effect, that claims predicated on fraud must only be directed at domestic clients, and (ii) the focus is not upon place where fraud allegedly originated but upon location of the client), citing SEC v. Gruss, 2012 WL 1659142 (S.D.N.Y. May 9, 2012).


Peterson’s conduct. Still further, Morgan Stanley also immediately terminated Peterson for his actions.

Ultimately, Peterson settled with the SEC and, in addition to being barred for life from the securities industry, Peterson agreed to a court order in which he is to disgorge $254,589. This settlement is still subject to court approval. This case is proof of the SEC’s continued commitment to enforcing the FCPA and that swift remedial and personnel action can be an advantage for other broker-dealers in dealing with the Government when an employee of theirs goes rogue.

V. Insider Trading Cases

The SEC and DOJ continue to press investigations and prosecution of insider trading in the securities industry. Since 2009, the DOJ has brought insider trading charges against 66 Wall Street executives, analysts, research providers, and traders—60 have either pled guilty or were later convicted. Additionally, the SEC has been successful and tougher in its civil enforcement actions that accompany the criminal proceedings, beginning with the SEC’s January 2012 announcement that it would no longer allow defendants to neither admit nor deny charges brought against them if they admit to or are later convicted of criminal wrongdoing. Since then, the Government has achieved some high-profile legal victories based, in large part, on its years-long investigation into insider trading in the securities industry. Below is a sample of some of these notable cases.

— Rajat Gupta

Perhaps the case attracting the most attention for insider trading in the first half of 2012 was the Government’s prosecution of Rajat K. Gupta (“Gupta”). The Government brought its action in conjunction with its successful prosecution of Raj Rajaratnam (“Rajaratnam”), the one-time executive of one of the most profitable hedge fund advisory firms in the world. Rajaratnam was found guilty of fraud and conspiracy on May 11, 2011, and was subsequently sentenced to 11 years in prison and fined $10 million in October 2011. The Government alleged that Gupta provided Rajaratnam with material non-public information concerning a large investment by Berkshire Hathaway Inc. (“Berkshire”) in The Goldman


For this conduct, Gupta faced criminal charges of securities fraud and conspiracy.\textsuperscript{55} Gupta was alleged to have used his membership of Goldman Sachs and The Procter & Gamble Company (“Procter & Gamble”) to feed Rajaratnam sensitive non-public information regarding the financial condition of those companies.\textsuperscript{56} Rajaratnam, in turn, used this non-public information to make several trades for his hedge fund, Galleon Management, LP (“Galleon”), at a profit.\textsuperscript{57} Gupta maintained significant investments at Galleon at all relevant times.\textsuperscript{58}

On June 15, 2012, after a short deliberation, the jury in the criminal action found Gupta guilty on all but two counts of insider trading.\textsuperscript{59} This verdict against Gupta is significant for the fact that, unlike the case against Rajaratnam—which had tape recordings of telephone conversations—the Government’s case against Gupta consisted entirely of circumstantial evidence.\textsuperscript{60} The jury relied on phone records, trading logs, instant messages, and e-mail correspondence to support the inference that Gupta supplied Rajaratnam with non-public information.\textsuperscript{61} The Government also relied on the testimony of Anil Kumar (“Kumar”), a former McKinsey & Company partner who shared confidential information with Gupta and Rajaratnam.\textsuperscript{62} This marked another significant high-profile victory for the Government in its ongoing investigation into insider trading in the securities industry.\textsuperscript{63}

\textsuperscript{57} Id.
\textsuperscript{60} Id.
\textsuperscript{61} Id.
\textsuperscript{62} Id.
\textsuperscript{63} Kumar was a key witness for the Government in the Gupta and Rajaratnam trials. His testimony corroborated the Government’s allegations and undermined the defendants’ defense that Gupta and Rajaratnam had minimal business connections with one another. Even though Kumar admitted to essentially the same conduct charged against Gupta and Rajaratnam, his cooperation with the Government resulted in a sentence of only two years’ probation along with a $2 million repayment of illicit profits gained as a result of his insider trading. Kumar is an excellent case study of the upside of Government cooperation. See Azam Ahmed, No Jail Time for Cooperating Witness in Galleon Case, N.Y. TIMES, July 19, 2012, http://dealbook.nytimes.com/2012/07/19/no-jail-time-for-cooperating-witness-in-galleon-case/?src=twrhp.
\textsuperscript{64} The Government’s extensive investigation into the Galleon insider trading scandal has also resulted in litigation against Douglas F. Whitman (“Whitman”), the founder of Whitman Capital. On February 10, 2012, the Government accused Whitman of trading on inside information given to him by at least one tipster who is at the center of the insider trading allegations against Gupta and Rajaratnam. This litigation is ongoing. See Ben Protess & Peter Lattman, Fund’s Chief Is Charged in Case Tied to Galleon, N.Y. TIMES, February 10, 2012, http://dealbook.nytimes.com/2012/02/10/california-fund-manager-arrested-on-insider-trading-charges.
On February 17, 2012 the SEC brought charges against John Kinnucan (“Kinnucan”) and his expert consulting firm Broadband Research Corporation (“Broadband Research”) for insider trading. Specifically, the SEC complaint includes charges of violations under Section 10(b) and Rule 10b-5 thereunder and seeks disgorgement of profits and the payment of civil penalties. This came one day after agents of the Federal Bureau of Investigation (“FBI”) arrested Kinnucan for using his position at Broadband Research to receive material non-public information from insiders and subsequently disseminate it to his clients. The criminal complaint includes securities fraud and conspiracy charges.

Kinnucan gained notoriety in 2010 for refusing to cooperate with FBI agents in its ongoing insider trading investigation of Kinnucan’s hedge fund clients. Shortly after a conversation with FBI agents, Kinnucan wrote a letter to his clients wherein he disparaged the efforts of the FBI and warned his clients of the Government’s insider trading investigation. After his letter went viral, Kinnucan granted dozens of interviews where he continually attacked the government’s investigation and denied any wrongdoing on the part of his clients.

The Government’s investigation continued, however, and outed Kinnucan’s practice of funneling corporate secrets to his clients from 2008 to 2010. The SEC complaint alleges that Kinnucan used Broadband Research to gain the trust of securities industry insiders and collect material non-public information regarding securities. Once Kinnucan obtained this information he sold it to investment adviser clients for tens of thousands of dollars a quarter. It is estimated that Kinnucan generated hundreds of thousands of dollars for Broadband Research through this illegal conduct.

Kinnucan pleaded guilty on July 25, 2012 to charges of conspiracy to commit securities fraud and two counts of securities fraud.

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67 Id.
68 Id.
69 Id.
70 Id.
73 Id.
74 Id.
This case is a significant and symbolic victory for the Government in its years-long investigation and prosecution of insider trading in the financial industry. Prior to his arrest, many hedge fund industry insiders branded Kinnucan a hero for his refusal to cooperate with the Government in 2010.  

--- Diamondback Capital and Level Global Investors

In January 2012, the SEC brought charges against two multi-billion dollar hedge fund advisory firms as well as several of their employees in an alleged $78 million insider trading scheme. The allegations were that a well-connected group of traders at Diamondback Capital Management LLC (“Diamondback Capital”) and Level Global Investors LP (“Level Global Investors”) caused their respective firms to trade on inside information relating to Dell, Inc. (“Dell”) and Nvidia Corporation (“Nvidia”). For their roles in this scheme, the SEC charged each defendant under the anti-fraud provisions and sought disgorgement of defendants’ gains along with additional financial penalties. Additionally, federal prosecutors brought criminal charges against all seven of the individual defendants in the SEC action.

The alleged scheme began when Sandeep Goyal (“Goyal”), a former Dell employee obtained quarterly earnings information and other performance data regarding Dell. Goyal tipped analysts at Diamondback Capital who, in turn, traded on this information for profit. Goyal also shared this information with Level Global Investors employees who also traded on the information for a profit. In return for his profitable inside information, Goyal received up to $175,000 in soft payments from Diamondback Capital. The SEC alleged that Diamondback Capital netted nearly $4 million on this non-public information while Level Global Investors reaped profits totaling approximately $57 million that same year.

The SEC also alleged that the defendants obtained non-public information regarding Nvidia’s revenues, gross profit margins, and other financial information from an investment adviser in 2009. Then, allegedly, traders at Diamondback Capital and Nvidia traded on this information for profits of $73,000 and $15.6 million, respectively.

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78 Id.
82 Id.
83 Id.
84 Id.
85 Id.
86 Id.
87 Id.
The SEC brought these allegations as a result of its ongoing investigation into suspected insider trading practices at hedge fund advisory firms, which resulted in a raid of Diamondback Capital and Level Global Investors, among others, in November 2010. Several of the fund's employees named in the complaint were subsequently arrested for their role in this scheme. Five days after the initiation of the SEC action, Diamondback Capital and the SEC agreed on a settlement plan wherein Diamondback Capital would forfeit $6 million in ill-gotten gains and pay a civil penalty of $3 million. The SEC cited to Diamondback Capital's "substantial assistance" as one of the mitigating factors surrounding the terms of the settlement. Notably, however, the settlement did not include any language that Diamondback Capital neither admits nor denies any wrongdoing in this case.

Several of the individuals charged in the criminal complaint have pleaded guilty in the criminal action and are cooperating with the Government.

VI. Settlements in Class, Derivative and Enforcement Actions

The first half of 2012 has seen an increase in the number of settlements with the SEC, but a decline in class action settlements. According to a June 27, 2012 report issued by NERA Economic Consulting ("NERA") the SEC is on pace to settle with more defendants in fiscal year 2012 than in any year since fiscal year 2005. Conversely, NERA is also projecting the lowest level of class action settlements since 1999, with only 49 cases having settled through June 2012. We highlight some of the noteworthy settlements from this period below:

89 Id.
90 Id.
93 Id.
On June 25, 2012, Judge Frederic L. Block of the Eastern District of New York approved SEC settlements with two former Bear Stearns Asset Management portfolio managers, Ralph Cioffi and Matthew Tannin. In November 2009, a federal jury acquitted Cioffi and Tannin of conspiracy and securities and wire fraud in the first criminal trial stemming from the collapse of the sub-prime mortgage market. In the parallel civil action, the SEC alleged that Cioffi and Tannin, who co-managed two of the firm’s largest hedge funds, misrepresented the extent to which the funds had invested in securities backed by subprime mortgages, the level of investor redemptions, and their own holdings in the investment pools. The total loss to investors was estimated at $1.6 billion.

The parties announced a proposed settlement on February 13, 2012, whereby both men agreed, without admitting or denying the SEC’s allegations, to a consent judgment in which Cioffi agreed to pay $700,000 in disgorgement and $100,000 in penalties and agreed to an administrative order that bars him from participating in the securities industry for 3 years. Tannin agreed to pay $200,000 in disgorgement and $50,000 in penalties and agreed to an administrative order that bars him from participating in the securities industry for 2 years. Judge Block, questioned the court’s role in evaluating the proposed settlement and described the penalties and disgorgement as “chump change.” Ultimately, Judge Block noted that the court was “constrained to accept the settlement,” noting “the limited powers that Congress has afforded the SEC to recoup investor losses- as well as obstacles that it has placed in the path of litigation by the private bar- and invites Congress to consider whether more should be done by the government to come to the aid of victims of Wall Street predators.”

On June 6, 2012, the State of Michigan Retirement Systems, the lead plaintiff in a securities class and derivative action litigation alleging that Bear Stearns and numerous former executives made misleading statements about the investment bank’s financial health and exposure to the subprime market, announced that it reached a $275 million settlement, which ended all claims against Bear Stearns. The consolidated class action complaint was filed on February 27, 2009. The plaintiffs alleged that Bear Stearns had "secretly abandoned any meaningful effort to manage the huge risks it faced" from subprime and other mortgage-related securities. Such exposure contributed to the collapse of two in-

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house hedge funds in the middle of 2007. The settlement is one of the top 40 largest settlements since the passage of the Private Securities Litigation Reform Act.\(^\text{101}\)

--- **In re: Lehman Brothers Equity/Debt Securities Litigation**

On May 24, 2012, Judge Lewis A. Kaplan approved a $90 million securities class action settlement between Lehman Brothers Holdings, Inc. (“Lehman”) executives and a proposed class of Lehman investors.\(^\text{102}\) The plaintiffs sued the Lehman executives for allegedly misleading them about Lehman’s exposure to subprime mortgages prior to its collapse in 2008, claiming billions of dollars in damages. Judge Kaplan previously delayed approving the settlement because he required additional information regarding the assets of the Lehman executives before deciding whether the settlement, which would be covered entirely by Lehman’s insurance for its directors and officers, was fair to the proposed class.\(^\text{103}\)

--- **In re: Morgan Stanley & Co. Inc. Auction Rate Securities Derivative Litigation**

On February 9, 2012, Morgan Stanley announced an unusual settlement where no money would go to shareholders. Instead, Morgan Stanley would implement extensive reforms, changing how it sells certain financial products, including a mandatory program to retrain its financial advisors.\(^\text{104}\) The derivative actions, brought in New York and Delaware by an institutional investor, stem from Morgan Stanley’s alleged involvement in the manipulation of the market for auction rate securities, blaming its officers and directors for the resulting $35 million in federal and state penalties Morgan Stanley paid, and its agreement to repurchase $6.4 billion in the securities.

**VII. Commodities and Futures Cases**

The first half of 2012 has had many noteworthy lawsuits related to commodities and futures trading. While the collapse of commodities brokerage MF Global last year has compromised confidence in the futures industry, the Commodity Futures Trading Commission (“CFTC”) reacted to the collapse by taking a hard-lined approach in its oversight. The CFTC brought one of its largest cases ever in the Royal Bank of Canada wash-trading case, and is currently investigating the alleged cotton futures market manipulation by Louis Dreyfus Commodities, one of the most prominent market manipulation cases in a decade. Both of these cases are discussed below.


In April 2012, the CFTC charged Royal Bank of Canada (“RBC”), a Canadian bank and financial services firm, with conducting a several hundred million dollar wash trading scheme “of massive proportions,” using sham futures trades to reap tax benefits.\footnote{Commodity Futures Trading Commission v. Royal Bank of Canada (S.D.N.Y. Apr. 2, 2012) (Complaint ¶1).}

The lawsuit alleges that from at least June 2007 to May 2010, RBC coordinated these “wash trades” with two subsidiaries, and that the trades were negotiated noncompetitively and not at arm’s length, as required by the law.\footnote{Id. at ¶ 1, 3, 31, 47, 66.} Both the Commodity Exchange Act and Commission Regulations require trades to be executed openly and competitively, and prohibit trading practices that undermine the price discovery process that futures markets provide, such as wash sales and fictitious sales.\footnote{Id. at ¶ 6, 17.} A bank is allowed to trade with its subsidiaries, provided it is done in an “arm’s length” manner, with independent supervision and checks on potential wrongdoing.\footnote{Ben Protess, Regulator Accuses R.B.C. of ‘Massive’ Trading Scheme, N.Y. TIMES, April 2, 2012, http://dealbook.nytimes.com/2012/04/02/regulator-accuses-rbc-of-massive-trading-scheme.}

The CFTC, however, claims the trading was orchestrated by a small group of senior RBC personnel and executed in a “riskless manner” and not at arm’s length, with the ultimate purpose of guaranteeing that the profits and losses of each counterparty “washed to zero.”\footnote{Id. at ¶ 4, 5, 23-25} Thus, the positions were offset, eliminating the possibility that RBC would suffer a loss on the investments, while giving the appearance of being the result of independent decisions by the subsidiaries, and allowing RBC to take advantage of Canadian tax benefits from holding certain public companies.\footnote{Id. at ¶ 7, 57-66, 79-83.}

The CFTC further accused RBC of misleading and making false statements to OneChicago, the electronic futures exchange where the trades were executed, and CME Group, the entity that exercised the regulatory compliance function for OneChicago.\footnote{Commodity Futures Trading Commission v. Royal Bank of Canada (S.D.N.Y. Apr. 2, 2012) (Complaint ¶2,3, 31, 47).} Specifically, the complaint alleges that RBC responded to a CME Group inquiry by asserting that its trading with its subsidiaries was done at arm’s length. The complaint also alleges that RBC concealed the fact that the trading strategy was created and arranged by a group of senior RBC personnel acting on RBC’s behalf.\footnote{Id.} RBC, however, claims they proactively sought
guidance from regulators before the trades were made and there was no objection. 113 RBC, in a statement, asserted the trades were “fully documented, transparent, and reviewed by both the CFTC and the exchanges, and for the next several years were monitored by them; it is absurd to now claim these trades were fictitious or wash sales.” 114 The lawsuit is the largest wash-sale case the CFTC has ever filed, and one of the agency’s largest ever, with some seeing it as demonstrating the expanded oversight powers granted to it under Dodd-Frank. 115

— Louis Dreyfus Price Manipulation Case

On June 29, 2012, Mark Allen, a former leader of Glencore International PLC’s cotton trading team, filed a lawsuit in the Southern District of New York against three units of Louis Dreyfus Commodities BV (“Dreyfus”), alleging Dreyfus unlawfully inflated cotton prices and manipulated the cotton futures market for futures contracts expiring in May and June of 2011. 116 Allen alleges he lost $57,000 because he was forced to pay artificially high prices for cotton. 117 Allen lost his job at Glencore in November 2011 after the trading firm lost more than $300 million in the market. 118 The suit is filed as a proposed class action on behalf of all traders who may have lost money from the alleged manipulation. 119 Allen alleges that in artificially manipulating cotton prices Dreyfus violated provisions of both the Commodity Exchange Act and the Sherman Antitrust Act. 120

The lawsuit states that physical cotton was trading at lower prices in the cash market than the futures market, but that Dreyfus refused to buy it. 121 The plaintiffs allege that Dreyfus, in not acting in an economically rational manner, overpaid to purchase cotton by taking delivery on May and June 2011 futures contracts. 122 The complaint states that Dreyfus and his affiliates took delivery of more than 99% of all cotton futures deliveries on the

114 Id.
117 Allen v. Term Commodities et. al. (S.D.N.Y. June 29, 2012) (Complaint ¶11)
119 Allen v. Term Commodities et. al. (S.D.N.Y. June 29, 2012) (Complaint).
120 Id. at ¶12.
122 Allen v. Term Commodities et. al. (S.D.N.Y. June 29, 2012) (Complaint ¶34).
InterContinental Exchanges during the period, which had the effect of manipulating and distorting the prices in the cotton futures market by pushing the prices up.\textsuperscript{123}

The CFTC has already opened a probe into the trading.\textsuperscript{124} It is being called one of the highest-profile commodity market-manipulation suits in more than a decade.\textsuperscript{125} Price manipulation lawsuits are unusual among traders, and regulators are hesitant to bring them because they can be difficult to prove.\textsuperscript{126}

\textbf{VIII. Recent SEC Policy and Regulatory Developments}

The first half of 2012 has not been as prolific on the regulatory front as last year since the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, but there have been two developments of note. Recently, the SEC promulgated a final rule related to investment adviser performance compensation, reflecting a reform envisioned by Dodd-Frank. Additionally, Chairman Mary L. Shapiro delivered testimony to the Senate Committee on Banking, Housing and Urban Affairs regarding the state of the money market mutual fund industry and highlighted potential reforms to that industry to avoid potential catastrophic market losses in the event of critical market conditions.

--- Final Rules

The Investment Adviser’s Act of 1940 permits investment advisers to charge a performance fee to certain “qualified clients,” based on net worth or value of assets under management. Effective May 22, 2012, the SEC has increased the dollar threshold for qualified client status\textsuperscript{127}. Also, the rule allows the SEC to adjust the dollar threshold every five years for inflation. Additionally, Dodd-Frank empowered the SEC to adjust the threshold of an “accredited investor” under the Securities Act of 1933. The new assets under management threshold and net worth baseline have been increased to $1 million and $2 million respectively. The purpose of these thresholds is to protect the investing public from predatory advisers and limit increased fees to sophisticated investors who presumably could withstand high losses.

Notably, the text of the rule states that Dodd-Frank does not require that the SEC specifically exclude the value of a person’s primary residence from the net worth calculus. After weighing the comments of a number of commentators, the SEC determined to exclude the primary residence in the net worth calculation, because the value of a person’s primary residence has too little to do with investment experience or risk tolerance.

\begin{itemize}
\item \textsuperscript{123} Id. at ¶44.
\item \textsuperscript{124} Id. at ¶138.
\item \textsuperscript{126} Id.
\end{itemize}
Congressional Testimony

On June 21, 2012, SEC Chairman Schapiro testified before the Senate Committee on Banking, Housing and Urban Affairs. Her testimony, “Perspectives on Money Market Mutual Funds,” provided a brief history of the money market mutual fund industry as well as potential directions that regulation of this industry could go. Chairman Schapiro highlighted the popularity of money market mutual funds for investors seeking “low risk, highly liquid investments and borrowers seeking short term funding” and testified that there was approximately $2.5 trillion in assets under management in domestic money market mutual funds. While money market mutual funds are specifically designed to withstand market volatility and small scale credit events, they are still subject to substantial runs when a fund’s sponsor also requires liquidity or a major credit event occurs. According to Chairman Schapiro, the financial crisis of 2008 presented a stark example of a critical market event and its impact on money market mutual funds. We do not know the full extent of the damage a run on money market mutual funds could have because the government bailed out the industry.

Historically, fund sponsors tended to pad money market mutual funds to prevent their funds from deviating from stable money market NAV of $1.00. The SEC’s fear is that once these funds “break the buck,” as falling to $0.9950 or below is known, investors could redeem at alarming rates. If redemptions were substantial enough, the fund sponsors would have to sell assets in other segments of the market, thus affecting the market price of those assets and potentially depriving investors of the liquidity that money market mutual funds provide.

Chairman Schapiro highlighted two specific reforms to help guard against potential meltdowns of money market funds for SEC staff to consider. The first potential reform would be to allow for fluctuation from $1.00 NAVs in money market mutual funds, which would be similar to NAVs with other mutual funds. This approach would require that money market funds sell shares according to market value rather than the set $1.00 value. The theory behind this reform was that exposure to market conditions would make fund sponsors more comfortable with responding to significant market factors, which could include selling assets.

The second potential reform is to require that money market funds maintain what Chairman Schapiro referred to as a “capital buffer.” This buffer would allow the funds to absorb small losses due to redemptions and market fluctuations, but would not be large enough to absorb much larger market events. This approach would be designed to allow funds some

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129 Id. at 1
130 Id. at 3
131 Id. at 6
flexibility and the ability to supplement selling securities to meet redemptions during critical market times.\textsuperscript{132}

\textit{Baker Hostetler is an AMLAW 100 law firm with eleven offices and over 825 attorneys which represents companies and individuals who face class and derivative securities litigation and enforcement investigations by the Securities and Exchange Commission, the Department of Justice, the Commodities Futures Trading Commission, the New York and other state attorneys general and regulators, the Financial Industry Regulatory Authority (FINRA), the New York Stock Exchange, and other federal and state regulators.}

Our Securities Litigation and Regulatory Enforcement Team has broad prior experience at regulatory organizations. Our partners include a former Branch Chief and Senior Counsel with the SEC’s Division of Enforcement, Regional Counsel with FINRA, Chief of the Securities Fraud Unit for the U.S. Attorney’s office and the Deputy Chief of Investigations at the New York District Attorney’s Office.

\textit{Baker Hostetler lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Baker Hostetler lawyer with whom you work or any of the following:}

\textsuperscript{132} \textit{Id.}
New York
Marc D. Powers  
National Practice Team Leader  212.589.4216  mpowers@bakerlaw.com
Mark A. Kornfeld  212.589.4652  mkornfeld@bakerlaw.com
Jimmy Fokas  212.589.4272  jfokas@bakerlaw.com
John W. Moscow  212.589.4636  jmoscow@bakerlaw.com
Andrew W. Reich  212.589.4222  areich@bakerlaw.com

Washington, D.C.
Jonathan R. Barr  202.861.1534  jbarr@bakerlaw.com
Gary D. Anderson  202.861.1604  ganderson@bakerlaw.com

Los Angeles
Michael R. Matthias  310.442.8802  mmatthias@bakerlaw.com

Columbus
Thomas L. Long  614.462.2626  tlong@bakerlaw.com
Mark A. Johnson  614.462-2698  mjohnson@bakerlaw.com

Denver
Richard B. Levin  303.764.4010  rlevin@bakerlaw.com
D.J. Poyfair  303.764.4099  djpoyfair@bakerlaw.com

Chicago
William K. Kane  312.416.6211  wkane@bakerlaw.com
Leah J. Domitrovc  312.416.6235  ldomitrovic@bakerlaw.com