

I N S I D E T H E M I N D S

Managing Securities Fraud Claims

*Leading Lawyers on Case Assessment,
Enforcement Trends, and Best Practices for an
Evolving Regulatory Environment*



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First Printing, 2009

10 9 8 7 6 5 4 3 2 1

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Understanding Key Trends in Securities Enforcement

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Trends in Securities Enforcement: A New Economic and Regulatory Landscape

Recent developments in the economic and regulatory environment have transformed the manner in which investors and the Securities and Exchange Commission (SEC) approach securities regulations and enforcement. In response to the market distress that began in 2008, regulators made radical changes in the way in which they enforce the law, which, in turn, have had an impact on how public companies, broker-dealers, placement agents, and investment funds and their advisers make decisions. Three areas illustrate the nature and extent of the trends: the manner in which hedge funds restrict redemptions, the accuracy of statements that hedge funds provide to investors, and the response of the Reserve Fund to its net asset value per share falling below \$1.

Amendment of Investment Fund Partnership Agreements

Turmoil in the capital markets and serial redemption requests has caused investment fund advisers to close their gates and suspend redemption requests. This action preserves cash, protects the best interests of clients, and is preferable to the other alternative: liquidation. However, neither option represents an optimal outcome for investors, especially if the assets are illiquid securities that are difficult to value.

Recently, hedge funds have scrambled to amend their limited partnership agreements because they faced liquidation if all pending redemption requests were honored. A new case reveals, however, that steps to amend a limited partnership agreement may not be the most prudent course of action. If done carelessly, amendments to limited partnership agreements to avoid liquidation can result in fraud claims being brought against the fund and its management.

In mid-February 2009, the Honorable Ellen Bree Burns of the U.S. District Court for the District of Connecticut issued a ruling in *Umbach v. Carrington Investment Partners*, No. 3:08 CV 484, 2009 WL 413346 (D. Conn. Feb. 18, 2009) permitting a hedge fund investor to pursue fraud claims against a hedge fund and its management related to amendments to the hedge fund's

limited partnership agreement that altered the way investors could redeem their interests in the fund.

According to the court's ruling, the hedge fund did three things that, when taken together, led the court to conclude that the plaintiff could proceed with his fraud-related claims:

1. The hedge fund failed to follow written procedures for amendments to the agreement and instead proposed three different amendments in rapid succession.
2. Before the final vote, the hedge fund distributed three amendments that contained certain materially different terms and thereby provided less than the required twenty days between the distribution of the third amendment and the voting deadline.
3. The hedge fund circulated e-mails stating it had support for the amendments from other investors, thereby putting additional pressure on individual investors to accept the final amendment.

In the eyes of Judge Burns, these facts provided the backdrop against which the plaintiff could proceed with his fraud-based case against the hedge fund's management.

Judge Burns did note that protecting the hedge fund from a market downturn was a legitimate interest, but the ruling sends a decidedly cautionary message. Hedge fund advisers must be careful how they seek to protect the fund in the current economic climate, and management must follow proper procedures if it seeks to amend the hedge fund's partnership agreement. When amending a hedge fund's agreement, management should communicate clearly with investors and refrain from actions that might be viewed as putting undue pressure on investors to approve an amendment. According to Judge Burns, even an e-mail that suggests there is strong support for the amendment could cause a problem if the statement is untrue or if management did not investigate the support for the amendment before sending the e-mail.

Nothing in the court's ruling prevents hedge funds from passing an amendment regarding redemptions or relying on any other permissible means of protection. For example, hedge funds may still include clauses in

their agreements giving the hedge fund discretion to deny redemption requests for certain reasons. Of course, this discretion—in light of the ruling in *Umbach v. Carrington Investment Partners*—must be exercised judiciously to avoid a lawsuit. With the dislocation in the capital markets, liquidity issues, and the inability of funds to meet redemption requests, it has become commonplace for hedge fund investment advisers to close the gates of the fund and to suspend redemptions to satisfy their fiduciary duties to the funds' entire investor base. But how they go about doing so, including in some cases rushing to amend their limited partnership agreements to avoid redemptions and/or liquidation, has created a number of issues that should be considered carefully before acting.

Accuracy of Hedge Fund Statements to Investors

New SEC rules provide insight into how the SEC may bring certain enforcement actions against investment advisers. The SEC adopted Rule 206(4)-8 in July 2007, under the Investment Advisers Act of 1940. Pooled Investment Vehicles, 17 C.F.R. § 275.206(4)-8 (2007). It did so in response to the opinion by the U.S. Court of Appeals for the D.C. Circuit in *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), which created uncertainty regarding the obligations that investment advisers to pooled investment vehicles have to the pools' investors. The purpose of Rule 206(4)-8 was to make it clear—in light of, or perhaps despite, *Goldstein*—that the SEC has the power to bring enforcement actions against investment advisers for making false or misleading statements to investors or prospective investors in pooled investment vehicles.

Rule 206(4)-8: Power to Bring Enforcement Actions against Investment Advisers for Making False or Misleading Statements

Because Rule 206(4)-8 does not require a showing of scienter; i.e., intent by the adviser to deceive, manipulate, or defraud, or a connection to a sale of securities, the unanswered question has been: What kind of *negligently* false or misleading adviser conduct will the SEC use new Rule 206(4)-8 to prohibit? 17 C.F.R. § 275.206(4)-8.

SEC actions are providing some early answers. On March 2, 2009, the SEC instituted an administrative proceeding against M.A.G. Capital LLC, a Los

Angeles-based registered investment adviser, and David F. Firestone, its president and sole owner, for allegedly taking warrants from three funds that it advises without compensating the funds for those warrants. The funds had purchased the warrants and other securities in private investment in public equity (PIPE) transactions. In a PIPE investment, hedge funds or other investors purchase securities directly from a publicly traded company in need of a cash infusion, and the public company agrees to register those shares at a later date. As part of these transactions, M.A.G. allegedly took, as compensation for itself and not its investors, warrants that were being paid for by its investors.

In the administrative proceeding, the SEC alleged that M.A.G. did not adequately disclose that the warrants were being paid for by the funds, and that M.A.G. was not compensating the funds for these warrants. Examiners allegedly had previously informed Firestone that M.A.G. had failed to make adequate disclosure to the funds' investors. M.A.G. tried to address the issue by revising the disclosure distributed to investors, which stated, in bold, that with respect to due diligence fees, “[t]he amount of the due diligence fee may be payable in the form of cash, warrants to purchase common stock of the Portfolio Company or other securities.” However, this revised disclosure still failed to satisfy the SEC, which concluded that the disclosure did not sufficiently alert the funds that the warrants M.A.G. took were being paid for by the funds and that M.A.G. was not compensating the funds for these warrants.

Heightened Scrutiny of Investor Communications

While the SEC relied on the old rule in the proceeding (because the alleged conduct pre-dated the Rule 206(4)-8's implementation), the disclosures (or non-disclosures) at issue involved the investors of the funds—precisely the audience the SEC wanted the power to protect and for which it promulgated new Rule 206(4)-8. 17 C.F.R. § 275.206(4)-8. The new SEC administrative proceeding indicates the kind of heightened scrutiny the SEC may apply in its investigations and prosecutions regarding communications with investors, for example, alleging inadequate disclosure even when the adviser made an effort to provide investors with the required information. It seems unlikely that M.A.G. intended to mislead or defraud its investors; rather, M.A.G. was attempting to correct a perceived shortcoming by

sending a notice to its investors, which highlighted language in bold. Nevertheless, the SEC pursued M.A.G. for this allegedly negligent attempt to make disclosures.

The proceeding indicates that the SEC intends to scrutinize communications between fund advisers and fund investors more carefully than it used to. To this end, the SEC recently indicated that its examination staff would contact fund investors directly. The direct contact is designed to verify that the fund manager provides the same information to both the investors and SEC staff regarding such topics as account balances, adviser compensation, and fund performance. This enforcement behavior appears to be in line with new Rule 206(4)-8—the SEC believes it has the authority to investigate an adviser’s statements to fund investors and to prosecute even negligent misrepresentations and/or omissions. 17 C.F.R. § 275.206(4)-8.

Statements Regarding Fund Performance

A recent enforcement case highlights yet another area in which the SEC may seek to apply a heightened scrutiny and negligence standard: fund performance. The SEC has initiated actions against advisers for reporting misleading results to hedge fund investors by engaging in a practice known as portfolio pumping. In a case against San Francisco investment adviser MedCap Management & Research LLC, the SEC alleged that MedCap made extensive quarter-end purchases of a thinly traded penny stock in which the fund was heavily invested, more than quadrupling the stock price and allowing MedCap to report artificially inflated quarterly results to fund investors.

In light of new Rule 206(4)-8 and the fairly recent pronouncement that it intends to send examiners directly to investors, the SEC will request information regarding fund performance and account balances directly from investors. 17 C.F.R. § 275.206(4)-8. The SEC also is scrutinizing the way funds have been computing their net asset values and the way they have been representing those values to their investors to determine whether fund advisers are—whether intentionally or negligently—misrepresenting fund performance. The SEC’s aggressive activities may have significant investor relationship implications for fund managers, and recent

enforcement actions provide insight into what to expect from the SEC in the current environment. For example, fund managers now have to be concerned with the prospect that the SEC's direct communication with an investor will—whether justified or not—make the investor uneasy about or even doubt the fund manager's honesty, competence, or past advice.

Focus on the Reserve and the Effect of Breaking the Buck

The Reserve Primary Fund, the first money market fund to “break the buck” as a result of the economic meltdown, has also gained the attention of the SEC. On May 5, 2009, the SEC commenced an enforcement action against the principals of The Reserve Primary Fund. The SEC alleges that the principals of this once highly regarded fund-committed fraud as they sacrificed the interests of their investors in an ill-fated effort to save the fund following the bankruptcy of Lehman Brothers. The complaint, which alleges violations of the Securities Exchange Act § 17(a), 15 U.S.C. § 77q (2000), Securities Exchange Act § 10(b), 15 U.S.C. § 78j (2000), and the Investment Advisers Act § 206, 15 U.S.C. § 80b-6 (1988) claims that the defendants failed to provide key material information to the investors of the Primary Fund, the board, and rating agencies after the bankruptcy of Lehman Brothers on September 15.

The Primary Fund is one of a series of money market funds composing the Reserve Fund, whose president co-founded the first money market fund in the early 1970s. Money market funds traditionally have served cautious investors seeking to preserve their principal while also earning dividends: the funds maintain a net asset value (NAV) of at least \$1 per share, and investors redeeming shares recoup their principal at 100 cents on the dollar plus profits earned by the fund on its investments.

At the time the problems arose at the Primary Fund, it was almost unheard of for a money market fund's NAV to drop below \$1—an event described as “breaking the buck.” This phenomenon had happened only once before, in 1994, with a relatively small fund. But it happened again in September 2008 with the Reserve Primary Fund when, on September 15, 2008, Lehman Brothers filed for Chapter 11 bankruptcy protection; the Primary Fund's investment in Lehman commercial paper became nearly worthless; and a number of investors decided to redeem all or some of their Primary

Fund shares. The events of the next forty-eight hours would set the Primary Fund on a fast track toward liquidation and litigation.

When redemption requests began pouring into the Primary Fund on September 15, it honored some of them. That afternoon, the Primary Fund announced that, due to its small exposure to Lehman debt holdings, the Fund's NAV would not be negatively impacted. However, the next day the Primary Fund announced that its holdings of Lehman debt securities had been valued at zero effective as of 4 p.m. on September 16, and informed investors that redemption requests submitted before 3 p.m. on September 16 would be honored at \$1 per share. Redemption requests made after the cutoff would be honored at the reduced NAV of \$0.97 per share. Not surprisingly, this set off a flurry of redemption requests before 3 p.m. These requests were not honored at \$1 per share. By late September, the Reserve Fund's Board of Trustees had decided to liquidate the assets in the Primary Fund and make *pro rata* distributions to investors. The first round of distributions, totaling \$26 billion, took place in late October. In late November, the Reserve Fund announced that it had miscalculated the Primary Fund's NAV on September 16; the proper value per share from 11 a.m. to 4 p.m. was ninety-nine cents, not \$1.

The SEC's complaint alleges that during the critical period following Lehman's bankruptcy, when the Fund was overwhelmed by redemption demands, the defendants made a series of false and misleading statements, including claims that there was sufficient capital to maintain the NAV and that the Reserve Fund was liquid and could honor the redemption requests. Because of these misrepresentations, the SEC alleges, the process the board used to set the NAV for the Fund up to 4 p.m. on September 16 was flawed, and this harmed some investors.

Litigation against the Reserve Fund

Not surprisingly, the SEC is not the only one to commence an action against The Reserve Fund. Investors have initiated more than thirty lawsuits against the Reserve Fund, the Primary Fund, and related entities, asserting various claims to damages ranging from breach of contract under the Primary Fund's prospectus to securities fraud. State securities regulators in

Colorado and Massachusetts have filed suit, as well. The private actions fall into two broad categories:

1. Institutional investors who submitted redemption requests while the NAV was properly calculated at \$1 per share. These investors assert that, pursuant to the prospectus, they are entitled to a full return of their investments at \$1 per share because they properly submitted redemption requests before the Primary Fund broke the buck. The Primary Fund did not honor approximately \$21.1 billion in redemption orders falling into this category.
2. Individual and class actions brought by investors who submitted redemption requests after the NAV was calculated below \$1 per share.

In response to investor lawsuits being filed in federal courts in New York and elsewhere, the Judicial Panel on Multi-District Litigation recently granted the Primary Fund's request to hold consolidated pretrial proceedings in the U.S. District Court for the Southern District of New York for all actions pending in federal court. Additional investors have filed suit in state court in New York and elsewhere; the Primary Fund sought removal of these actions to federal court, but the investors' motions to remand are pending.

Establishment of the "Special Reserve"

In response to the lawsuits, the Reserve Fund's liquidation plan called for the retention of a "Special Reserve" comprising investors' money in the Primary Fund, to cover legal and accounting fees associated with defending the Primary Fund against civil suits and paying damages resulting from these suits. On February 26, 2009, the Primary Fund announced that \$3.5 billion would be set aside in the Special Reserve, noting that up to \$100 million of that total might be devoted to the Primary Fund's legal expenses.

The liquidation plan called for a series of interim distributions to all investors on a *pro rata* basis, regardless of when investors submitted their redemption requests. In other words, investors who submitted redemption requests on September 15 (when the NAV was properly calculated at \$1) and investors who submitted redemption requests after 11 a.m. on September 16 (when the NAV was ninety-nine cents or ninety-seven cents)

would receive the same *pro rata* distributions. The February 26, 2009, announcement set the interim *pro rata* distributions at up to \$0.9172 per share.

Other Strategic Considerations

More than ever these recent developments demonstrate the importance of keeping abreast of current trends and the areas of focus by the SEC and other regulatory bodies. Perhaps more significantly, it is critical to analyze new developments with an eye toward anticipating the SEC and other regulators' motives and what recent actions by the SEC and other regulators say about how they may act in the future. Only by doing this can attorneys properly advise clients on how the behaviors and decisions of today could prove critical tomorrow.

DLA Piper LLP's Securities Litigation practice includes the representation of public companies, officers and directors, broker/dealers, placement agents, and investment funds in class action and derivative suits, SEC investigations and enforcement proceedings, FINRA investigations, enforcement proceedings and arbitrations, and criminal investigations and prosecutions by federal and state prosecutors. The practice has involved a wide variety of substantive areas, including most recently insider trading, public company options granting, Reserve Fund litigation, Auction Rate Securities, and a host of issues impacting investment advisers including breach of fiduciary duties by failing to fully disclose, diversify, or conduct the requisite due diligence in connection with investments, suspending or restricting investor redemptions, and with respect to placement agents, pension fund kick-back investigations and related litigation.

Perrie M. Weiner is international co-chairman of DLA Piper's securities litigation practice, is a managing partner of the Century City, C.A. office, and a member of the firm's Executive and Policy Committees. Mr. Weiner represents private equity funds including hedge funds, broker-dealers, and issuers (including their officers and directors) in SEC and FINRA (formerly NASD) enforcement proceedings, white collar criminal proceedings, and individual and class action securities fraud and related claims. He has a national practice, with scores of litigation victories, pending cases and publications widely reported in *Time*, *Business Week*, *Forbes*, *The Wall Street Journal*, *New York Law Journal*, *Los Angeles Daily Journal*, *Los Angeles Times*, *Los Angeles Money Management Executive*, *PIPEs Report*, *HedgeWorld* and *The*

Economist, among others. Mr. Weiner also represents private and public companies in a variety of industries, in both national and international business disputes.

Mr. Weiner is listed in Who's Who in America and in the Legal 500 US as one of the leading litigation lawyers in the US by corporate counsel. In addition, Mr. Weiner was named a Southern California Super Lawyer in 2004 (one of only 16 securities litigators who made that list), and again every year since then, ranking him among the top 5% of all attorneys in Southern California, in peer surveys conducted by Law and Politics and Los Angeles magazines. Mr. Weiner was named in the Who's Who in American Law, 2005-2006. From 2004 to 2007, the Los Angeles Daily Journal cited him as one of California's Top Mega-Rainmakers, in the \$10 Million Club. In 2006, Securities Law360 ranked Mr. Weiner among the top 10 securities litigators in the United States (see "Securities Law360 Names Weiner Among Top 10 Legal Superstars"). In 2007, he was named to Lawdragon's 500 Leading Lawyers in America. In 2008, Lawdragon named him to its list of 100 Lawyers You Need to Know in Securities Litigation.

In 2006, Mr. Weiner received the prestigious 2006 Burton Award for Legal Achievement for the article "Litigation Strategies: Managing Litigation Risk and Addressing Investor Concerns." The Burton Award, regarded as the "Pulitzer prize of the legal profession," is dedicated to the enrichment and refinement of writing in the legal profession. The awards are presented by the Burton Foundation, a nonprofit cultural and academic organization devoted to promoting the legal profession, in association with the Library of Congress. "Litigation Strategies" originally appeared in PIPES: A Guide to Private Investments in Public Equity, published in December 2005. In 2007, Mr. Weiner received a Highly Commended Award from the Emerald Literati Network for the article "Recent developments in hedge fund enforcing and regulation by the SEC under the leadership of Chairman Cox suggest that he may not be the free market advocate everyone once thought he was." The article originally appeared in the Journal of Investment Compliance in 2006.

Mr. Weiner is an author, speaker, and commentator on cutting-edge securities litigation issues. He was a keynote speaker at the PIPES Conferences in 2004 -2008 held in New York, as well as at the PIPES Europe Conference held in London, England, in June 2006. Mr. Weiner was a featured interviewee on CNBC's December 12, 2006 broadcast of its On The Money segment entitled, "Hedge Fund Limits." He was recently quoted in Extreme Value Hedging: How Activist Hedge Fund Managers Are Taking on the World by Ronald D. Orol, released in October 2007.

Mr. Weiner attended Loyola Law School Los Angeles (J.D., 1985) and the University of California at Los Angeles (B.A., summa cum laude, 1982). He served as a Judicial Extern to the Honorable Ralph J. Geffen, U.S. District Court, Central District of California (1985) and as a Judicial Law Clerk to the Honorable John R. Kronenberg, U.S. District Court, Central District of California (1986-87).

Acknowledgement: *The author would like to acknowledge **Joshua Briones** for his work on the chapter. Mr. Briones, a litigation associate in the Los Angeles office of DLA Piper LLP, focuses his practice on complex commercial litigation, contract disputes, and alternative dispute resolution. He regularly counsels clients on issues relating to records retention.*

Mr. Briones also has international litigation experience. He represents foreign companies doing business in the United States in commercial and regulatory disputes. He has prepared several cases for trial in state and federal courts for cases originating outside the United States, including conducting discovery under international treaties, addressing international conflict of laws issues, and obtaining dismissals under the forum non conveniens doctrine.

Mr. Briones is on the Hiring Committee for DLA Piper's Los Angeles office and is also a member of Diversity Committee. He attended UCLA School of Law (J.D.), and in 2007 was appointed to a three-year term on the board of directors of the UCLA School of Law Alumni Board of Directors. The board assists in the development of the full potential of UCLA School of Law, including working on diversity issues, the endowment, and student and faculty recruitment, and governs the activities and policies of the Law Alumni Association, numbering more than 13,000 graduates of the school. Mr. Briones also attended San Diego State University (B.A.), and received his LL.M. from New York University School of Law.

The author would also like to acknowledge the contributions of Caryn Schechtman, Edward Totino, and Nicolas Morgan.



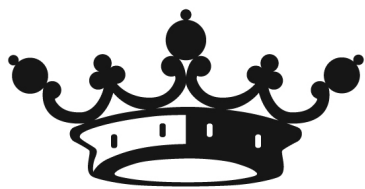
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