SECURITIES

An Advertising Supplement to the Orange County Business Journal • April 2, 2012

To Judge or Not To Judge: Stage Is Set In SEC v. Citigroup

by David J. Darnell, Senior Attorney, Callahan & Blaine

Many have called him a hero and advocate of truth. To others, his maverick ruling is a significant departure from established precedent.

On November 28, 2011, Judge Jed S. Rakoff from the U.S. District Court in New York rejected a proposed settlement by the SEC of a securities lawsuit against Citigroup for $285 million. In his order, Judge Rakoff repeatedly cited the SEC's complaint, which accused Citigroup of creating a billion-dollar fund in which it knowingly dumped mortgage-backed securities on misinformed investors. The SEC suit alleged Citigroup structured and marketed this fund as an attractive investment and even touted that the assets had been hand-picked by an independent advisor, but in reality Citigroup knew these assets had negative projections and it was Citigroup who selected them for this portfolio. Adding insult to injury, Citigroup took a short position on the very same holdings. By betting that the assets would perform poorly, Citigroup realized net profits of approximately $160 million while, at the same time, investors who bought into their fund lost more than $700 million.

Despite the serious accusations, the SEC asked Judge Rakoff to sign off on a consent judgment against Citigroup. Under the terms of the proposed settlement, though Citigroup would neither admit nor deny any wrongdoing, it would change its review and approval process for mortgage-related security offerings and also be enjoined from further violations. In addition, Citigroup would pay a total of $285 million consisting of disgorgement of $160 million, prejudgment interest of $30 million and a civil penalty of $95 million. This prompted Judge Rakoff to set a hearing to ascertain whether such a settlement is "fair, reasonable, adequate and in the public interest." To this end, the judge asked the SEC to respond to questions such as:

Over the past few months, Judge Rakoff's ruling has sparked considerable debate over SEC consent judgments and the role of the judiciary in reviewing and confirming such settlements.

Why should the Court impose a judgment in a case in which the SEC alleges a serious securities fraud but the defendant neither admits nor denies wrongdoing?

What is the total loss to the victim's as a result of Citigroup's actions? How was this determined?

How was the amount of the proposed judgment determined?...What reason is there to believe this proposed penalty will have a meaningful deterrent effect?

Why is the penalty in this case to be paid in large part by Citigroup and its shareholders rather than by the "culpable individual offenders acting for the corporation?"

In response, the SEC argued that judicial review in these cases is both limited and deferential. In other words, a reviewing court is not to substitute its judgment for that of the parties or ask whether this is the best possible settlement that could have been obtained. Instead, the SEC argued a reviewing court should take a "deferential posture" to the agency's determination of what is fair, adequate and reasonable. The SEC also reversed its prior position by asserting that "the public interest" is not part of the applicable standard of judicial review, but even if it were, the Court should still defer to the agency's recommendations.

Apparently, Judge Rakoff did not take kindly to the SEC's arguments. In a scathing opinion, after describing the egregious nature of the SEC's charges, the judge noted:

"Although this would appear to be tantamount to an allegation of knowing and fraudulent intent ("scienter," in the lingo of securities law), the SEC, for reasons of its own, chose to charge Citigroup only with negligence, in violation of Sections 17(a)(2) and (3) of the Securities Act, 15 U.S.C. § 77(q)(a)(2) and (3)."

Judge Rakoff also flatly rejected the suggestion that "the SEC is the sole determiner of what is in the public interest." While acknowledging that the law requires substantial deference to the views of an administrative agency, he pointed out that the Court must still exercise its independent judgment and be satisfied that it is not being used as a tool to enforce an agreement that is unfair, unreasonable, inadequate, or in contravention of the public interest. And in this case, because the proposed settlement "does not provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified under any of these standards," the Court refused to approve it, noting that it would not be a "mere handmaiden to a settlement privately negotiated on the basis of unknown facts, while the public is deprived of ever knowing the truth in a matter of obvious public importance."

Judge Rakoff also strongly critiqued the SEC's "long-standing policy – hallowed by history, but not by reason – of allowing defendants to enter into Consent Judgments without admitting or denying the underlying allegations…" Specifically, the judge noted that such settlements, coupled with only modest penalties, are "frequently viewed, particularly in the business community, as a cost of doing business imposed by having to maintain a working relationship with the regulatory agency, rather than as any indication of where the real truth lies." Judge Rakoff further commented that in this case, "[i]f the allegations of the Complaint are true, this is a very good deal for Citigroup; and, even if they are untrue, it is a mild and modest cost of doing business." For these reasons, the judge seriously questioned what the SEC is getting from this settlement "other than a quick headline."

Accordingly, Judge Rakoff held that even after giving the fullest deference to the SEC's view, this proposed settlement, which "asks the Court to impose substantial injunctive relief, enforced by the Court's own contempt power, on the basis of allegations unsupported by any proven or acknowledged facts whatsoever, is neither reasonable, nor fair, nor adequate, nor in the public interest." To conclude otherwise and apply "judicial power that does not rest on facts is worse than mindless, it is inherently dangerous." Thus, instead of rubber stamping the settlement, the Court directed the parties to prepare for trial.

Not happy with this ruling, the SEC and Citigroup filed petitions and appeals to set aside Judge Rakoff's order, as well an emergency motion to stay the pending trial in the underlying action and to expedite the SEC's appeal. On March 15, 2012, the motion panel for the Second Circuit Court of Appeal granted a stay of the lower court proceedings and also scheduled oral arguments on the appeal for this coming September.

While the motion panel's decision is not binding on the appellate panel that will ultimately decide the merits, in issuing the stay the panel did consider whether the SEC and Citigroup made a strong showing that it they were likely to succeed on the merits. On this issue, the panel perceived several problems. Specifically, the opinion prejudges that "Citigroup had in fact misled investors, and assumes that the SEC would succeed at trial in proving Citigroup's liability." Responding to the judge's criticisms of the SEC's settlement policy, the panel stated "it is not the proper function of the federal courts to dictate to executive administrative agencies what policies will best serve the public interest." Further, while it claimed to have given the "fullest deference" to the SEC's view, the panel observed that "there is no indication in the record that the Court in fact gave deference to the SEC's judgment on any of these questions." It thus concluded "it is doubtful whether the court gave the obligatory deference to the SEC's views in deciding that the settlement was not in the public interest." Finally, the panel questioned Judge Rakoff's view that the public interest is disserved with "neither admit nor deny" settlements as requiring such an admission would in most cases "undermine any chance for compromise."

Despite the motion panel's decision, it is important to remember that the merits of the appeal have not actually been considered or decided. In fact, the appellate briefs have not even been submitted. Nevertheless, some commentators view the motion panel's decision as a precursor of what is to come.

Over the past few months, Judge Rakoff's ruling has sparked considerable debate over SEC consent judgments and the role of the judiciary in reviewing and confirming such settlements. At its core, the debate raises bigger questions about the judiciary's position in shaping public policy and highlights divergent perspectives on the issue. Based on the SEC's accusations against Citigroup, one can certainly understand why many people have sided with Judge Rakoff and his efforts to seek out the truth. Yet on a grander scale, unrestrained judicial activism can lead to greater instances of inequitable or inconsistent rulings and oftentimes blurs the line between our executive, legislative and judicial branches. The underlying debate on these issues will no doubt continue regardless of what happens to Judge Rakoff's ruling. In fact, when the appeals court chimes in later this year, we will likely hear even more comment and opinion on the subject.

David J. Darnell

David J. Darnell is a senior attorney with Callahan & Blaine who specializes in complex business, contract and commercial matters, as well as disputes involving fraud and other intentional torts. Mr. Darnell and other attorneys at Callahan & Blaine have obtained outstanding results for clients in some of the most difficult and complex litigation matters. For example, Mr. Darnell recently obtained a $15.5 million settlement for his client in a case involving claims of illegal dividends and breach of fiduciary duty against corporate officers and directors. For more information on Mr. Darnell and Callahan & Blaine, please feel free to visit the firm's website at www.callahan-law.com or call 714.241.4444.

RUTAN

RUTAN & TUCKER, LLP

The JOBS Act: A New Era in Raising Private Capital?

by Larry Cerutti, Partner; and Ike Chidi, Associate; Rutan & Tucker LLP

Among the many evidences of recent instability in the U.S. capital markets is the dramatic decline in the number of initial public offerings (IPOs) over the last 10 years. This decline may be an indication that the traditional IPO model is no longer suitable for many of today's smaller companies or startups. With burdensome disclosure and reporting requirements, IPOs are both time consuming and costly. As the U.S. continues to face a challenging economic climate, many believe new sources of early stage funding are critical to re-energizing the Nation's economy.

Increasing the Potential Investor Pool

On March 27, 2012, the House passed Senate Amendment No. 1884 (S.AMDT 1884) to the House and Senate approved Jumpstart Our Business Startups Act (JOBS) Act (H.R. 3606). Given President Obama's support for the JOBS Act, it is expected that he will sign the JOBS Act into law soon. Designed to address the decline in IPOs, the JOBS Act intends to facilitate capital raising through several reforms to the federal securities laws and regulations. One such reform will permit "crowdfunding" offerings, wherein groups of individuals pool money to help fund small businesses. The crowdfunding provisions of the JOBS Act are aimed at providing ordinary investors with the opportunity to own a piece of the next Google, Facebook or LinkedIn. In addition, through the relaxation of certain existing private offering criteria, the JOBS Act will allow issuers more flexibility in raising private capital.

Current federal securities laws restrict the manner by which issuers can raise capital through private placement offerings which are exempt from the registration requirements of the Securities Act of 1933. For example, under Rule 506 of Regulation D, a "safe harbor" for the private offering exemption found in Section 4(2) of the Securities Act, an issuer can raise an unlimited amount of capital, if among other offering limitations, (i) the issuer does not use general solicitation or advertising to market the securities, and (ii) the issuer limits selling its securities to an unlimited number of "accredited investors" (e.g., a person with a net worth of more than $1,000,000 or with an individual net income of $200,000 in each of the two most recent years) or no more than 35 sophisticated "non-accredited" investors. However, once the JOBS Act is signed into law, the Securities and Exchange Commission will be required to adopt changes to Regulation D permitting general solicitation and general advertising in connection with Rule 506 offers and sales of securities provided the purchasers of such securities are accredited investors. In addition, the new crowdfunding provisions will broaden the potential investor pool by eliminating several other existing restrictions contained in the federal securities laws, provided that participants meet certain prescribed guidelines. As a result, issuers will be able to attract accredited investors and "crowdfund" by directly soliciting a broader base of investors through the internet or other means.

Offering Exemption Section 4(6) and Section 4A

Under Section 4(6) of the Securities Act, the JOBS Act will create a new statutory exemption to the registration requirements of Section 5 of the Securities Act for transactions involving the offer or sale of securities, provided that: (i) the aggregate amount sold in reliance on the exemption in a 12-month period is $1,000,000, and (ii) the maximum investment per investor within any 12-month period is (a) the greater of $2,000 or 5% of the investor's annual income or net worth (if either the investor's annual income or net worth is less than $100,000); and (b) 10% of the investor's annual income or net worth, not to exceed a maximum amount of $100,000 (if either the investor's annual income or net worth is equal to or more than $100,000).

The JOBS Act will also create a new Section 4A of the Securities Act, setting forth additional requirements for "issuers" and "intermediaries." New Section 4A will require issuers to make certain financial disclosures and support the accuracy of information provided to investors. For example, (i) issuers seeking to raise less than $100,000 will need to provide tax returns and a financial statement certified by a company official; (ii) issuers seeking to raise between $100,000 and $500,000 will need to provide financial statements that are reviewed by an independent public accountant; and (iii) issuers seeking to raise over $500,000 will need to provide audited financial statements. In addition, Section 4A will require that issuers and intermediaries:

- warn investors of the speculative nature of investments in startups, including illiquidity;
- warn investors that they are subject to resale restrictions;
- take reasonable measures to reduce the risk of fraud;
- provide the Securities and Exchange Commission with continuous investor-level access to the intermediary's website;
- require each potential investor to answer questions demonstrating understanding of the investment risks; and
- not offer investment advice.

Furthermore, issuers using the exemption will be required to file with the Securities and Exchange Commission the names of officers, directors and holders of more than 20% of the issuer's shares. Intermediaries will be required to register as broker-dealers or as a new category of "funding portal," which has fewer regulatory burdens than those imposed on broker-dealers.

Exchange Act Registration and Restriction on Resale

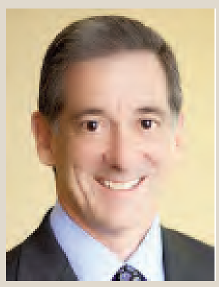
The JOBS Act will also exempt issuers from reporting obligations under the Securities Exchange Act of 1934. For example, securities purchased pursuant to Section 4(6) will not be considered "held of record," and therefore not trigger the registration requirements of Section 12(g) of the Exchange Act.

Furthermore, the crowdfunding provision will restrict the resale of securities acquired under the exemption such that they may not be transferred for a period of one year unless they are transferred to the issuer or an accredited investor.

What Now?

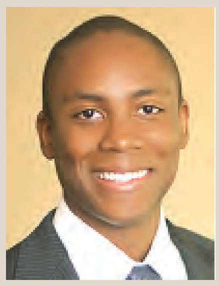
Although President Obama is expected to sign the bill soon, its provisions will still be subject to rulemaking by the Securities and Exchange Commission. Therefore, issuers should continue to comply with existing laws and regulations. Despite the JOBS Act's objectives, it is too early to tell what effects it might have on the U.S. capital markets, and to what extent it will facilitate capital raising by smaller companies and startups. What seems evident, however, is that the new crowdfunding exemption and other relaxed private offering criteria will increase the investor pool by permitting greater access to reach both accredited and non-accredited investors and expand opportunities to seek private capital.

Larry Cerutti



Mr. Cerutti leads Rutan & Tucker's Corporate Section and is a partner in the firm's Financial Practices Group. He has a diverse practice that is principally devoted to financing and acquisition transactions for public and private companies and represents corporate issuers in connection with public and private securities offerings, preparation of reports filed with the Securities and Exchange Commission, acquisitions and general corporate matters. He acts as counsel to investment banking firms in connection with capital raising activities. Mr. Cerutti also represents borrowers and lenders in secured lending transactions and a number of private emerging-growth companies on a day-to-day basis in all aspects of their business law requirements. Mr. Cerutti can be reached at lcerutti@rutan.com or 714.641.3450.

Ike Chidi



Mr. Chidi is an associate in Rutan & Tucker's Corporate & Securities Section, where his practice includes a wide range of corporate matters, including general corporate transactions, business organizations and securities transactions. Also, as a member of the firm's Financial Practices Group, he represents lenders and borrowers in a broad range of finance transactions, including term and revolving facilities, asset-based lending, receivables financing, mezzanine financings, loan workouts and debt restructurings. Mr. Chidi can be reached at ichidi@rutan.com or 714.662.4618.

PAUL HASTINGS

Changing Securities Litigation Landscape Poses New Challenges For Public Companies

by Howard M. Privette, Partner, Paul Hastings LLP

The past 15 years have seen major shifts in the enforcement of the federal securities laws. In the mid-1990s, shareholder class action lawsuits were the predominate form of securities litigation. The Securities and Exchange Commission (SEC) was a fairly benign regulator, and SEC civil enforcement actions were relatively rare. Securities-related prosecutions by the Department of Justice (DOJ) were rarer still.

Executives of that era were vexed by the volume and nature of shareholder class actions, which were often derided as “strike suits.” A corporation could be slapped with one of these lawsuits at the slightest hint of bad news, such as a quarterly earnings miss, or a setback in the development of a new product. Because shareholders often claimed market losses of tens of millions of dollars or more, these were “bet the company” cases. They were expensive and time-consuming to defend, and often more expensive to settle.

In late 1995, Congress responded with the Private Securities Litigation Reform Act (“PSLRA”). Passed over President Clinton’s veto, the PSLRA made a number of changes to the federal securities laws that were intended to cut back on unmeritorious suits. The PSLRA provided a number of new protections, such as a “safe harbor” for forward-looking statements (such as earnings projections). These changes produced intense courtroom battles over the interpretation and application of the PSLRA.

These battles may have reached their zenith in 2005, when the Supreme Court decided the *Dura Pharmaceuticals* case. In *Dura*, the Court held that shareholders have a strict burden to plead and prove that claimed stock losses were actually caused by fraudulent activity, rather than other causes such as industry or market volatility. Since that decision, the principles enunciated in *Dura* have been used with some success to restrict the economic threat posed by these class action lawsuits.

Nearly two decades after the PSLRA, however, its proponents might be surprised to learn that the annual number of shareholder class action filings remains remarkably steady. In 2011, for example, there were 188 securities class actions filed, an increase from the 176 filed in 2010, and just below the post-PSLRA average of 194. (The annual number of cases averaged only 176 in the five years prior to the PSLRA.) And not only have class action filings continued unabated, today’s executives must deal with a far more complex and threat-filled securities enforcement environment than their predecessors ever did.

Unanticipated corporate bad news, accompanied by a stock price drop, is still a common recipe for the filing of a shareholder class action. However, the past decade has seen an explosion of new corporate governance regulation, and reinvigorated government enforcement of the securities laws. Following accounting debacles at companies like Enron and Worldcom at the start of the new century, Congress passed a different kind of securities reform, the Sarbanes-Oxley Act of 2002 (SOX). More recently still, there has been a spate of new rule-making under the auspices of 2010’s Dodd-Frank Act.

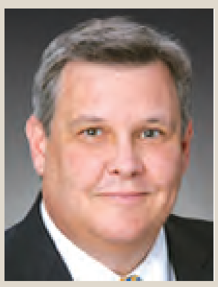
One aspect of Dodd-Frank is a program to reward whistleblowers who report violations to the SEC. In just six *weeks* after the rules took effect in August 2011, the SEC reported it had 334 new tips. On top of that, the SEC reported that it commenced a record number of 735 enforcement actions during the fiscal year ended September 30, 2011. In the same year, the SEC obtained orders for more than $2.8 billion in civil penalties and disgorgement. Likewise, the DOJ has stepped up its efforts to impose criminal penalties for securities violations. There are numerous examples today of corporations and executives facing criminal charges and prison sentences in such cases.

Recent years have also seen a surge in shareholder derivative lawsuits. Unlike class actions, derivative actions are not brought on behalf of the shareholders themselves. Instead, a shareholder brings the case on behalf of the corporation, ostensibly to redress harm to the corporation from conduct that may not have had a material impact on the stock price. These cases usually involve claims against officers and directors for allegedly causing or allowing wrongful conduct to occur at the corporation. In addition to any direct harm that the conduct caused the corporation, alleged damages often include costs of defending and settling government actions arising from that conduct. These cases were the primary vehicle for shareholder claims in stock option “backdating” cases, for example, and have remained popular ever since.

As the first quarter of 2012 draws to a close, there are several areas that bear particular attention.

Howard Privette

Howard Privette is a securities litigation partner with Paul Hastings LLP. He regularly defends securities class actions and derivative suits, and also represents clients in relation to SEC and DOJ matters. He has rare trial experience among securities defense counsel in both civil and criminal cases. Most recently, he successfully defended the former Chairman and CEO of Homestore.com in one of the few securities class actions to go to trial in the post-PSLRA era, a result recognized as one of the “Top Verdicts of 2011.” Mr. Privette can be reached at 213.683.6229 or howardprivette@paulhastings.com.



Mergers and Acquisitions

Always a source of shareholder litigation, mergers and acquisitions are spinning off class actions and derivative lawsuits at a record pace. For example, approximately 24% of all federal securities class actions filed in the eighteen months ended December 2011 were based on mergers and acquisitions.

The Foreign Corrupt Practices Act (“FCPA”)

Passed in the mid-1970s, this anti-corruption statute lay largely dormant until the past few years. Now, globalization of business has increased the focus of the SEC and the DOJ on possible violations of the FCPA. Shareholders are also bringing class actions, alleging inadequate disclosure to shareholders of the corporation’s FCPA exposure. They are also filing derivative actions alleging that management improperly caused or failed to prevent FCPA violations.

“Say on Pay”

Another aspect of Dodd-Frank is the requirement of advisory shareholder votes to approve senior executives’ compensation. In 2011, the first year of such votes, more than a third of the corporations that had negative votes on raises became subject to shareholder derivative actions. While courts are so far split in their treatment of these cases, corporations should take note as the 2012 proxy season progresses.

In summary, the ever-changing landscape of securities regulation and enforcement presents a highly complex thicket of thorny rules and pitfalls that can easily trip up even the most vigilant CEOs, CFOs and their general counsel. The best guides through these difficult areas will be highly experienced counsel who can call on expertise across the spectrum of transactional issues, SEC enforcement, white collar defense and civil litigation.