

Laddering: What it is and what are the consequences

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Agenda

- Background
- Civil Actions
 - ▶ In Re Initial Public Offering Securities Litigation
 - ▶ Antitrust Litigation
- Regulatory Actions
- Coverage Litigation

Background

- Business climate
 - ▶ High market Capitalization
 - ▶ 700 plus IPOs in three years prior to these suits
 - ▶ Day traders/individuals began significant trading
- Typical IPO
 - ▶ Investment Banks (“IB”) and Issuer enter into Underwriting Agreement
 - ▶ Prospectus issued
 - ▶ Issuer files registration statement with SEC which incorporates the Prospectus
 - ▶ Pricing meeting
 - IB makes allocations to institutional clients of large blocks of shares

Various Components

- ▶ Laddering/tie-in agreements
 - ▶ Excess commissions
 - ▶ Analyst conflicts of interest
 - ▶ Spinning
- Governmental investigations as to each of these

Laddering/Tie-In Agreements

- Not a new phenomenon
 - ▶ 1984 SEC Report re “Hot Issue Market”
- IB require customers as condition of participation in hot stock offering, either:
 - ▶ To agree to purchase additional shares of the same company at a later time at an increased price, or
 - ▶ To participate in another IPO
- Undermines integrity of market as independent pricing mechanism; artificially stimulates demand
- Aftermarket purchasers unknowingly bought shares at artificially high rates

Excess Commissions

- As condition to IPO share allocation IB required client to pay higher commission either as to that issue or other issues
- After the fact commission payments tied to investor profits on IPO
- Prospectus did not disclose excess commissions and misrepresented actual commissions paid to IB

Analyst Claims

- Investment Banks' employee analysts issued knowingly false positive research reports and buy recommendations so as to benefit and/or obtain investment banking clients
- Investigations by SEC, NYSE and various state Attorneys General
- December 2002 announced Global Analyst Settlement of \$1.435b

Spinning

- IB provide shares of IPO to corporate executives to obtain Investment Banking business
- “Friends of Frank” Account at CSFB
 - ▶ 160 account holders
 - ▶ Brokers would sell 1/3 within few days, 1/3 30 days after and remaining thereafter resulting in high profits
 - ▶ Frank Quatrone terminated for e-mail instructing destruction of evidence

In the Beginning

- 25th August 2000 SEC Staff Legal Bulletin No. 10
 - ▶ “Reminded” investment banks that they are prohibited from requiring customers to make aftermarket purchases **until the distribution is completed**
 - ▶ Bulletin asserted the SEC’s position that such conduct violated Rules 101 and 102 of Regulation M
 - ▶ Regulation M prohibits underwriters and investors from engaging in manipulation that undermines the integrity of the market
 - ▶ The bulletin also noted that prior SEC bulletins and disciplinary decisions had determined that tie-in agreements violate federal securities laws and regulations

Wall Street Journal

- 6th December 2000 first in a series of articles regarding investigation into claims of misconduct
 - ▶ Formal investigations by SEC, NASD DOJ
 - ▶ Possible kickbacks to certain investment banks by investor clients seeking access to initial allotment of Hot IPO shares
 - ▶ Subsequent articles identified CSFB as the apparent primary target of the federal investigations
 - ▶ CSFB was said to have illegally required clients to increase their commission payments and/or to participate in “tie-in” agreements before CSFB gave them access to the IPO’s

Actions by IPO Underwriters

- CSFB
 - ▶ CEO Allen Wheat replaced
 - ▶ 3 SF brokers terminated for “encouraging institutional clients to pay oversized trading commissions in exchange for a generous share of hot technology IPO allocations.”
 - ▶ Frank Quattrone
 - ▶ SEC Criminal trail began 29th September 2003
 - ▶ NASD filed 2 complaints 6th March 2003
- Notable Research Analyst under Investigation
 - ▶ Jack Grubman of Solomon Smith Barney
 - ▶ Henry Blodget of Merrill Lynch
 - ▶ John Hoffman of Citigroup

CIVIL ACTIONS

In Re Initial Public Offering Securities Litigation

- Coordinated before Judge Shira Scheindlin
 - ▶ First suit filed against VA Linux 11th January 2001
 - ▶ 309 Issuers and 56 Investment Banks
 - ▶ Coordinated not consolidated

Resolution Potential

- No Investment Banks have settled
- Global settlement as to Issuers
- Unclear as to Investment Banks because of:
 - ▶ differing coverage defences
 - ▶ differing levels of involvement/culpability

Issuer Settlement

- Issuers involved in elaborate courting ritual with their D&O insurers/Plaintiffs and IB.
 - ▶ Both cloaked in secrecy with confidentiality agreements in place
- Began with Issuers indemnity demand to IB pursuant to Underwriting Agreement which was refused
- Thereafter Issuers, their D&O insurers and Plaintiffs entered into settlement discussions
- When settlement appeared possible IB stepped forward to discuss indemnity issues

Issuer Settlement

- 26th June 2003 announcement by Plaintiffs of settlement with the Issuers and their directors and officers
- Insurer guarantee of \$1 billion paid at conclusion of litigation
- For every dollar received from IB, \$1 billion payment is reduced proportionately
- Insurers recoup defense costs at \$5 billion
- Cooperation and assignment provisions

Motions to Dismiss

- Motions brought by:
 - ▶ 55 IB
 - ▶ 309 Issuers
 - ▶ 243 Individual Defendants who were directors and officers of certain of the Issuers
 - ▶ thousands of other Individual Defendants had earlier been voluntarily dismissed by plaintiffs
- Rulings offered little relief as to IB
- Rulings were marginally better as to the Issuers
- None of the rulings came as a major surprise and were anticipated by Insurers for the IB and the Issuers

19th February 2003 Decision on Motions to Dismiss

- Judge Scheindlin described the complaints as:
 - ▶ alleging a “vast scheme” to defraud the investing public
 - ▶ summarized the allegations as “an *industry-wide scam* ... whereby people were put into IPOs, the stock was hyped, the insiders got out, and the little people who bought [the stock] on their broker’s recommendations were left holding the bag. That’s the guts of what these cases are coming down to.”

Section 11/15 Claims

- Section 11 of the Securities Act of 1933 imposes liability for material misrepresentations or omitted facts in a Registration Statement. Against all defendants
- Section 15 of the Securities Act of 1933 imposes liability on controlling persons. Against the Issuers' directors and officers
- Section 11 claims generally do not require evidence of active misconduct for liability to attach
- Liability exists even though the representation or omission was caused by a third party and the issuer was free from fault or negligence

Section 11 Claims

- Plaintiff does not need to prove causation, reliance or intentional wrongdoing
- Not liable if the misrepresentation or omission in the Prospectus not “material.”
- Regulation S-K, Item 508(I) requires the Prospectus disclose stabilizing transactions or any other transaction that affects the price
- SEC considers “tie-in” agreements to be “stabilizing” transactions thus must be disclosed in the Prospectus and Registration Statements

Ruling on Section 11/15 Claims

- Section 11 claims, even if based on general allegations of fraud, are not subject to heightened pleading standards imposed by Rule 9 of the Federal Rules
- Under the relaxed pleading standard, Plaintiffs' generalized claims of misrepresented and omitted facts in the Registration Statements were legally sufficient
- Section 11 claims were dismissed only as to those 10 Issuers whose sales price never dropped below their offering price
- Generalized allegations of control person liability were also deemed legally sufficient, except as to those Individual Defendants who did not sign the Registration Statement

Section 10(b)/20 Claims

- Section 10(b) of the Securities Exchange Act of 1934 imposes liability for market manipulation and offering misconduct
 - Against the IB, Issuers and their directors and officers
- Plaintiffs also asserted Section 20(a) against the Issuers' directors and officers for control person liability

Pleading Standard Applied for 10(b) Claims

- As to claims arising from alleged misrepresentations or omissions in connection with purchase or sale of a security, Judge Scheindlin applied the PSLRA pleading standards, requiring factual allegations establishing:
 - ▶ the specific misleading or omitted statement,
 - ▶ the reason why the statement was misleading,
 - ▶ the factual circumstances supporting allegations, and
 - ▶ scienter, meaning “motive and opportunity to commit fraud” or “strong circumstantial evidence of conscious misbehavior or recklessness.”

Ruling on 10(b) Claims

- For IB, Scheindlin concluded the existence of tie-in and kickback agreements in order to increase profits, provided basis to find that plaintiffs pled a market manipulation claim
- As to the Issuers and their directors and officers, Scheindlin held that insider sales at inflated profits, coupled with the “opportunity” to discover Investment Bank misconduct, were sufficient against 185 (approximately two-thirds) of the Issuers
- Certain directors and officers, who engaged in no sales, were dismissed

Renewed Attacks on Pleadings

- After ruling on motion to dismiss, 2nd Circuit imposed more stringent pleading requirements
- In light of ruling, IB filed motion for Judgment on the pleadings
- IB asserted that complaints failed to allege sufficient facts to establish loss causation
- 31st December 2003, Judge Scheindlin held that complaints met the more stringent standard
- Court held it was permissible to infer that the artificial inflation would ultimately dissipate causing financial harm to investors.
- Accordingly, plaintiffs sufficiently pled a claim for financial losses caused by IB purported wrongful conduct

Motion for Class Certification

- Parties jointly selected 7 test cases
 - Aspect medical
 - Corvis
 - Engage Technologies
 - FirePond
 - IXL
 - Sycamore Networks
 - VA Linux
- ▶ Plaintiffs may add additional cases
- ▶ Thereafter will file briefing as to certification
- ▶ Defense will argue that class certification should not occur, or should occur only in a limited manner

Discovery

- Ruling on motion to dismiss lifted the discovery stay under the PSLRA
 - ▶ Phase one: IB produce documents that were turned over to regulators
 - ▶ Phase Two: IB disclose documents relating to disputed Public Offering
 - IB have deposed several lead plaintiffs to gain information for class certification motion
 - Informal understanding that more extensive discovery will occur with respect to 7 test cases
- Beginning in January 2004, plaintiffs will select an additional five Issuers, and the defense may select up to five additional Issuers, whose offerings will be joined with the test cases selected for briefing regarding the class certification motions
- Those lawsuits will be the “test cases” allowed to proceed through discovery, dispositive motion process, and all pre-trial and trial proceedings

Antitrust Litigation

- Only against limited number of Investment Banks before Judge William Pauley
- IB conspired to fix share allocations and commissions through underwriting syndicate
- Motion to dismiss
 - ▶ IB argue that federal securities law preempt Plaintiffs' ability to assert antitrust claims
 - ▶ Court requested SEC and DOJ intervene
 - ▶ Subsequent Second Circuit opinion adopting preemption

Ruling on Motion to Dismiss

- 3rd November 2003 Judge Pauley granted motion
- IB misconduct was deemed actionable only under federal securities laws, and not state or federal antitrust and unfair competitions laws
- 18th November motion for reconsideration filed which remains under submission
- 2nd December 2003 notice of appeal filed

REGULATORY ACTIONS

Analyst Regulatory Settlement

- On 29th April 2003, regulators announced that ten investment banks had finalized their settlement
 - ▶ \$80 million for investor education
 - ▶ \$487.5 million in penalties
 - ▶ \$387.5 million for restitution of profits
 - ▶ \$432.5 million is for independent research
- Structural changes in how IB handle research, forcing them to separate their research analyst and banking operations

Analyst Regulatory Settlement Payment Chart

| Firm | Penalty (\$ Millions) | Disgorgement (\$ Millions) | Independent Research (\$ Millions) | Investors Education (\$ Millions) | Total (\$ Millions) |
|--------------------------------|--------------------------|-------------------------------|---------------------------------------|--------------------------------------|------------------------|
| Bear Stearns | 25 | 25 | 25 | 5 | 80 |
| CSFB | 75 | 75 | 50 | 0 | 200 |
| Goldman | 25 | 25 | 50 | 10 | 110 |
| J.P. Morgan | 25 | 25 | 25 | 5 | 80 |
| Lehman | 25 | 25 | 25 | 5 | 80 |
| Merrill Lynch | 100* | 0 | 75 | 25 | 200 |
| Morgan Stanley | 25 | 25 | 75 | 0 | 125 |
| Piper Jaffray | 12.5 | 12.5 | 7.5 | 0 | 32.5 |
| SSB | 150 | 150 | 75 | 25 | 400 |
| UBS | 25 | 25 | 25 | 5 | 80 |
| Total (\$ millions) | 487.5 | 387.5 | 432.5 | 80 | \$1,387.5 |

*Payment made in prior settlement of research analyst conflicts of interest with the states securities regulators.

April 28, 2003

Analyst Regulatory Settlement

- IB agreed not to seek indemnification from Insurers or take a tax deduction for the \$487.5 Penalty Payments
- \$387.5 million will be paid into a restitution fund to benefit investors
- The Investor Education Payments will be paid to the states, which will use the money for various purposes

Analyst Regulatory Settlement

- On July 3rd 2003, Judge Pauley, who is overseeing the approval of the Global Analyst Settlement in SDNY, directed the banks to provide additional information as to the settlement
- Judge Pauley asked whether the IB “sought indemnification or reimbursement from an insurer or other entity for any portion of the Federal Payment.”
- 31st October 2003 Court approved the Global Analyst Settlement

Evidence from Analyst Investigation

- A Lehman Brothers analyst responded in an e-mail to research complaints by stating:
 - ▶ “It’s hard enough to be right about stocks, it’s even harder to build customer relationships when all of your companies blow up, you knew they were going to, and you couldn’t say anything.”

COVERAGE LITIGATION

Vigilant v. CSFB Litigation

- 22nd January 2002 SEC Complaint alleged:
 - ▶ In exchange for shares in hot IPO's CSFB wrongfully extracted from certain customers a large portion of the profits those customers made by flipping their IPO stock
 - ▶ The profits were channelled to CSFB in the form of excessive brokerage commissions generated by the customers in unrelated securities trades that the customers generally effected solely to satisfy CSFB's demands for a share of the IPO profits

Vigilant v. CSFB Litigation

- 29th January 2002 CSFB consented to Court's entry of Injunctive decree and Court entered final judgment.
 - ▶ It is further ordered, adjudged and decreed that CSFB shall pay \$70 million, representing disgorgement of monies obtained improperly by CSFB as a result of conduct alleged in the complaint
 - ▶ Final Judgment also stated that CSFB would pay a civil penalty of \$30 million
 - ▶ Statement that CSFB neither admitting nor denying liability

CSFB Demand for Reimbursement

- Demanded reimbursement for \$70 million and attorneys fees in responding to SEC and NASD investigations
- Vigilant denied and filed action for declaratory relief in New York State Court
- CSFB filed third-party complaint against
 - ▶ London Underwriters at interest
 - ▶ Travelers
 - ▶ Swiss Re

Decision Regarding Cross-Motions for Summary Judgment

- In ruling that CSFB is not entitled to coverage for the \$70 million disgorgement payment, Judge Moskowitz found that:
 - ▶ The Final Judgment specifically links the disgorgement payment to the improper activity that the SEC complaint alleged. Therefore, this is not merely a case in which a party settled an action without admitting liability.
 - ▶ CSFB correctly states that the Final Judgment is not the same as a final adjudication of the facts after a trial. However, the effect of the Final Judgment, under the particular facts of this case, is essentially the same because the Final Judgment states that CSFB is disgorging money that it obtained improperly.

CSFB Cross-Motion for Defense fees

- Judge Moskowitz ruled that CSFB is entitled to coverage for Defense Costs.
- The court reasoned that the policy's Loss definition includes Defense Costs, and that the term Loss would encompass the costs incurred defending the SEC action.
- Judge Moskowitz stated that "Moreover, none of the insurers have opposed this portion of the cross-motion".
- Judge Moskowitz referred the parties to a Special Referee to hear and provide recommendations regarding CSFB's claim for Defense Costs.

Appeal

- On 8th August 2003, CSFB filed its notice of appeal of Judge Moskowitz's decision
- CSFB has until 8th May 2004 to perfect its appeal
- The London insurers on the first excess policy filed a cross-appeal with regard to Judge Moskowitz's award of Defense Costs to CSFB

Vigilant v. Bear Stearns

- On 9th July 2003, Vigilant, Federal and Gulf, filed a declaratory judgment action in the New York State Supreme Court for the County of New York
- These Insurers issued the first \$50 million in professional liability coverage for Bear Stearns
- The lawsuit seeks a declaration that coverage is not available for Bear Stearns' \$80 million payment in the Global Analyst Settlement under the Policies

No coverage for the Global Analyst Settlement

- Bear Stearns failed to comply with the policies' consent and cooperation provisions
- Coverage is excluded by the investment banking exclusion
- The fines, penalties and disgorgement payments do not constitute Loss
- The independent research and investor education payments do not constitute Loss
- Intentional harmful conduct is not insurable

Status of Action

- Vigilant has agreed to extend Bear Stearns' time to respond to the complaint until 20 days after the Court approves the Global Analyst Settlement

The Road Ahead

- Approval of Issuer settlement
- Class Certification process
- Test Case determination
- Potential further coverage litigation
- Potential settlement by Investment banks with limited exposure
- Ongoing governmental investigations

