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The Due Diligence Defense and the Refco IPO

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I. Introduction

The 1933 Securities Act imposes relatively stringent due diligence requirements upon any investment banking firm who acts as an underwriter of an Initial Public Offering ("IPO") of securities. While underwriters are required to perform a duly diligent investigation of a prospective issuer company in preparation for an IPO; underwriters must also maintain fiduciary duties owed to its client, that same prospective issuer it is required to investigate. The role of the IPO underwriter is typically transparent, and it is understood, accepted, and well-settled that underwriters serve two conflicting "masters"—the client, and the public equities market—conflicts of interest abound, yet are often tolerated.

While a prominent figure in the IPO process, underwriters are not the only significant participants, others include auditors, law firms, regulators, exchanges, the underwriting syndicate, and the issuer, to note a few. Despite weighty obligations imposed upon securities underwriters by Section 11 and 12 of the 1933 Securities Act, it seems inappropriate to saddle the underwriter with the entire burden to discover pre-offering fraud, especially in light of its dual roles, as well as its status as a dependent gatekeeper. This paper advocates a view that where fraudulent activity is so well concealed by the perpetrators that even sophisticated parties such as pre-IPO private equity investors, auditors, SROs, and even federal regulators, do not uncover material facts of the fraud, that the underwriting firms, absent active involvement in concealing fraud, cannot be reasonably construed as culpable, and perhaps not even liable, for losses connected to and caused by the well concealed schemes of an issuer and its executives.

The most likely path to avoidance of civil liability for Refco underwriters is a successful assertion of various due diligence defenses discussed here in detail. The outcome of Section 11 and 12 pending civil claims against the Refco underwriters, will depend upon the degree of due

diligence performed viewed under the light of a rule of reason. Although underwriters are required to perform a due diligence investigation of a prospective issuer, perhaps no amount of due diligence could have revealed Refco's scheme prior to the offering. The transactions at issue were highly complex, carefully timed, and well-concealed. According to one pundit, the off-balance sheet maneuvers designed to hide hundreds of millions in bad debts off-shore "isn't a needle in a haystack,... It's a needle in a pile of needles.'"[1]

IPO Underwriters should not be used as a "deep pockets" scapegoat to enable regulators, auditors, the company, and investors to avoid responsibility for their role in the Refco collapse. The very scope of the scandal begs the question: where were securities regulators and auditors before the offering? Refco's history was rife with regulatory misconduct, including the executives behind the scheme who had been subject to copious civil and regulatory actions,[2] and presumably offered enough "red flags" to alert all securities regulators and SROs, at a minimum, to the possibility that history tends to repeat itself. Moreover, Congressional leanings toward regulatory permissiveness, and the amended the Commodity Exchange Act,[3] and handed Refco the opportunity to use a totally unregulated Bermuda subsidiary, Refco Capital Markets, as the nearly perfect vehicle to commit fraud. Blame for one of the largest U.S. bankruptcies in history can certainly be shared on Wall and LaSalle Streets, but it also belongs on the D.C. beltway.

This paper considers the role of the Refco IPO underwriters and suggests that where a scheme to defraud is so secretive and effective that detection eludes regulatory agencies, SROs, auditors, and even highly sophisticated private equity investors who undertook their own due diligence investigations prior to the IPO, one cannot credibly point the finger of blame at the underwriting syndicate, at least not exclusively.[4] This paper further details the best defenses available to underwriters in this context, most notably the so-called "due diligence defenses,"

and posits that such defenses are viable and may altogether thwart the pending private claims against Refco's IPO underwriters.[5]

II. Humble Beginnings as a Backwater Brokerage

Refco's lineage can be traced back to 1969, when Thomas A. Dittmer formed a brokerage named Ray Friedman & Co, as a partnership with his stepfather, Ray E. Friedman.[6] Mr. Friedman[7] was a Sioux City, Iowa meat and grain dealer,[8] and Mr. Dittmer was considered among the largest cattleman in the U.S. [9] Dittmer is credited with the transformation of Refco from "an obscure cattle-trading firm into one of the biggest future brokers."[10] Refco began humbly, as a "middleman" between food buyers and farmers, which led to a commodities futures business.[11] Mr. Friedman sold the company to his stepson Dittmer in 1974.[12]

Refco quickly grew into a "financial powerhouse" during the late 1970s early 80s and used the early successes to expand its scope of market influence.[13] The firm began to actively manage investment portfolios, trade government securities, and even acquired businesses that raised hogs and refined metals. [14] By 1984, Refco's net capital exceeded $150 million, had more than 50 domestic and overseas offices/trading centers, and was on the short list of primary dealers trading Treasury securities with the blessing of the U.S. Federal Reserve.[15] When Refco traded, "tremors" rippled through the "highly volatile" commodity and futures markets, as big traders such as Refco could strongly affect prices, just by the mere fact of its presence on the trading floor.[16]

Phillip R. Bennett and Tone Grant both joined Refco in 1981,[17] and Bennett became its CFO in 1983.[18] When Dittmer retired in 1998, he named Bennett[19] as Refco CEO.[20] He also hired Dennis Klejna, a former CFTC Director of Enforcement (1983-1995), to serve as Refco's

general counsel,[21] a move made by Dittmer in an apparent attempt to "rapidly . . . burnish Refco's sullied image."[22]

III. A Sullied Image and a Record Rife with Wrist Slaps

Refco had perhaps the worst record in the history of the U.S. futures industry.[23] Dating back to when Bennett took the helm as CFO, Refco has been punished no less than 140 times by regulators for a variety of acts of misconduct, including a pattern of "sloppy record-keeping, filing false trading reports, inadequately supervising its traders and other violations.[24] According to the National Futures Association ("NFA"), Refco was a party in at least: 133 Exchange Regulatory Actions; a Respondent in 24 NFA Arbitration actions; and, involved in almost 150 CFTC Reparations Cases.[25] Perhaps Refco's cost-benefit risk analysis justified the serial misconduct? For example, after Refco was levied a fine in 1979 by the Chicago Mercantile Exchange ("Merc"), Leo Melamed, former Chairman of the Exchange, reportedly said that Dittmer scoffed at the sanction, "I made a few million, and you took a few thousand back so what?"[26]

Refco was fined in 1979 by the Merc, what was then "a record $250,000," and Refco Chairman Thomas H. Dittmer received a six-month trading suspension, and the firm was charged with "negligence in back-office record-keeping."[27] The CFTC levied a $525,000 fine against Refco and Dittmer[28] in 1983 for "exceeding speculative trading limits in cotton, soybeans, corn and wheat in 1979 and 1980."[29] In 1988 the CFTC charged Refco with "churning customer accounts, unauthorized trading and other violations."[30] Refco paid a $220,000 CFTC fine in 1990 as settlement for its alleged failure to maintain records, and for violating regulatory record keeping orders.[31] By 1992, "for the fifth time in the past decade," Refco was again the target of regulatory scrutiny.[32] These new charges included amendment of a settled 1990 action, which

added new charges. [33] CFTC regulators alleged that Refco and its founder (Dittmer's father-in-law) Ray E. Friedman, [34] "exceeded limits on speculative positions in pork-belly futures by trading in conjunction with customers on the Merc from October 1990 through January 1991."[35] This time regulators alleged that Refco had failed to properly supervise Mr. Friedman's activities, failed to maintain a written record of order for future contracts, and violated a prior cease and desist order.[36] The recidivist Refco simply settled the charges, paid a fine of $440.000, and agreed again to "'cease and desist'" from violating the Commodity Exchange Act.[37] The firm was already subject to three (3) prior cease and desist orders for alleged failures to supervise and a host of other alleged securities violations.[38] Mr. Friedman also settled charges against him personally for $150,000, surrendered his floor-broker registration, agreed to "sever all ties to [Refco], was barred for two months from trading futures and options, and then banned for six-months from trading pork belly futures and options."[39]

The CFTC continued its scrutiny of the rogue firm, and in 1994 following an 18 month investigation, filed a complaint against Refco and fined it $1.25 million charging that it "us[ed] customer assets to make loan payments on behalf of one of the firm's units, in violation of the Commodity Exchange Act ("CEA").[40] As part of the settlement, Refco was also required to "prepare a manual detailing how it will comply with regulatory requirements in the future, hire an independent consultant to review the manual, and make all the changes outlined in the manual."[41] Nonetheless, the severity of Refco's alleged misconduct continued to follow a pattern of escalation, and agreed to pay $3.5 million to settle a SEC administrative action in 1996, for "failing to supervise a former employee who had a role in a California securities-fraud scheme in the early 1990s."[42]

Bradley Reifler,[43] the grandson of Refco founder Ray E. Friedman,[44] and Dittmer's nephew, joined Refco in 1982 as head of institutional sales,[45] a post he held until 2000.[46] Mr. Reifler was also reportedly a central figure in a number of regulatory actions brought against the firm in the 1990s.[47] The CFTC brought an administrative action against Reifler Trading Corporation in 1997, that also named its president and sole shareholder, Bradley Reifler,[48] charging various violations of federal commodity laws and CFTC regulations.[49]

Hedge fund manager and former Refco client, Victor Niederhoffer, "wiped out" his entire equity position after a "ballooning loss in an option position prompted a margin call" during the Asian and Russian currency crisis of 1997.[50] To counteract "rumors" that Refco would be saddled with Niederhoffer's loses, Refco issued a statement representing that "it was financially fine."[51] However, Refco's President, Tone Grant, refused to comment on the conditions of Niederhoffer's portfolio and whether his Refco account was actually in arrears.[52] It was later confirmed Niederhoffer did in fact owe Refco "millions of dollars," which regulators believed "exceeded $40 million at its peak."[53] Niederhoffer's losses directly prompted the CFTC to draft a new rule designed to "monitor futures brokers more closely."[54] Niederhoffer wasn't the only casualty of the currency crises, and it was massive currency trading losses on both sides of the Atlantic that indirectly set into motion a series of events that years later would bring Refco to ruin.

Victor Niederhoffer

In 2002 the Securities and Futures Authority in London concluded disciplinary proceedings against the subsidiary Refco Overseas Limited, and fined the firm £300,000 (a Refco employee was also fined £15,000) for alleged involvement in a "fraudulent scheme [that] involved diverting profitable futures transactions by allocating them for the benefit of one

particular customer at the expense" of three other customers.[55] The CFTC announced a settlement with Refco Overseas Limited[56] on October 4, 2004, and ordered payment of $25,000 in civil penalties and to cease and desist from further violations of certain sections of the CEA and CFTC Regulations.[57]

Three months before the Refco IPO, Refco Group Ltd. announced on May 16, 2005, that its Refco Securities, LLC subsidiary received a "Wells Notice" from the Securities and Exchange Commission ("SEC"), arising from a previously announced SEC investigation of the subsidiary that had commenced in 2001 and related to alleged short sales of Sedona Corporation common stock, as well as other suspect transactions,[58] and involved an unregistered New York investment advisor known as Rhino Advisors, Inc., Rhino's president, an Austrian national named Thomas Badian, and AMRO International, S.A., a Panamanian hedge fund client of Rhino located in Switzerland. That SEC investigation later implicated the Vienna-based Austrian Bank für Arbeit und Wirtschaft ("Bank for Employment and Commerce"), und Österreichische Postsparkasse Aktiengesellschaft (BAWAG P.S.K. Group) ("BAWAG")[59] and its own staggering currency trading losses as part of a larger alleged overseas conspiracy.[60]

The SEC investigation related to Rhino Advisors and alleged market manipulation later extended to Badian's brother Andreas, also an Austrian national, and Pond Equities, a boutique Long Island brokerage firm with a history of disciplinary actions for alleged misconduct,[61] as well as a number of Pond Equities' NASD registered representatives who apparently acted on behalf various entities owned and/or controlled by BAWAG, and allegedly executed fraudulent and manipulative trades through Refco's brokerage system.[62] According to tape recorded conversations between Andreas Badian and Refco brokers, the younger Badian brother asked, *inter alia*, "want to short something illegally for twelve months? You got my number."[63]

The U.S. Attorney for the Southern District of New York had also commenced a parallel criminal investigation sometime just after the 2002 formation of the nascent Austrian Financial Markets Authority.[64] According to a November 2005 *Time Magazine* report, Rhino Advisors president, then 36 year-old Thomas Badian, fled the United States and returned to Europe after criminal conspiracy to commit securities fraud charges were filed against him by the U.S.

Helmut Elsner

Attorney in the Southern District of New York, and was reportedly a fugitive residing in, of all places, Vienna.[65] And while Austrian officials recently managed to extradite former BAWAG Chief Helmüt Elsner from his posh Côte d'Azur villa in the South-of-France hills outside Cannes, for whatever reason, U.S. officials have still not been able to retrieve Badian from Austrian soil, and federal charges are still pending against him in the Manhattan District Court.[66] Upon closer inspection, the links between BAWAG, Refco, Rhino and Pond Equities appear to be substantially more extensive than the *SEC v. Badian, et al*., case would first suggest.

A central figure in the scandal is a Geneva, Switzerland resident named Thomas Hackl, who was a BAWAG employee from 1991 through 2002, the time-frame during which the junior Flöttl's off-shore trading led to over a billion dollars in BAWAG losses, and later Hackl became a Refco executive.[67] Hackl's firm, Acies Asset Management, S.A., was reportedly "backed by Refco" and provided unspecified services for "a Liechtenstein bank [Bank Frick] that was part owned by BAWAG until May, 2006," court filings show.[68]

Mr. Hackl is a former head of BAWAG treasury and investment banking, and also acted as a BAWAG representative while he was concurrently Refco's international banking department chief, when he signed off on dozens of so-called "death spiral" convertible debenture

PIPE ("private investments in public equities") deals made by a handful of Liechtenstein-based hedge funds that BAWAG controlled, according to SEC filings.[69] Mr. Hackl was also apparently instrumental in at least one of the six alleged "round trip loans" made between Refco and BAWAG in furtherance of the concealment scheme, according to e-mails obtained by federal prosecutors.[70]

Mr. Hackl has not been formally charged in the BAWAG / Refco matter, and his lawyer contends he was merely a pawn in the scheme, and that "[e]verything [Mr. Hackl] did was at the direction of his superiors, either at BAWAG or at Refco."[71] Refco's record as an alleged recidivist securities law violator leaves it as no real surprise that a sweeping fraud against the investing public was committed, however, one can only wonder whether the SEC's various divisions coordinate regulatory efforts when an enforcement target seeks IPO approval. The SEC Enforcement Division was apparently aware of the alleged fraud, yet, after multiple amendments to the Refco registration statement, the Corporate Finance Division gave Refco a green light. Considering the depth of the alleged overseas conspiracy with BAWAG, and the monetary scope of the scheme, it is somewhat shocking that neither U.S. or European regulators brought the scandal to light until roughly a decade after the seeds of the scheme were first sown.

IV. Refco's Fast-Track from IPO to Chapter 11

Refco's pre-offering scheme apparently began in the late 1990s when Bennett (as Refco's CEO) and Tone ("Tony") N. Grant ("one of the former owners of Refco") hid "hundreds of millions of dollars of losses" which Refco had sustained as a result of prior trading losses.[72] In early 1997, Refco Group Holdings, Inc. (RGHI) owed Refco approximately $106 million, and Bennett and his confederates began to hide the losses through decades long manipulation and transfers of loans and funds under false pretenses.[73] RGHI was a Delaware corporation that was

owned "in whole or in part" by Messrs. Bennett and Grant, and reportedly held a substantial ownership interest in Refco.[74] From 1999 through 2005, Messrs. Bennett, Grant and Robert C. Trosten, Refco's former CFO, orchestrated a series of complicated transactions designed to conceal the RGHI receivables from Refco auditors and other "gatekeepers."[75]

A. The Rogue Brokerage and Project "Cleanup"

BAWAG had reportedly acquired a ten percent equity stake[76] in Refco in May 1999.[77] BAWAG later sold that Refco equity interest in 2004 to, of all people, Walter Flöttl, BAWAG's long-running former chief executive who was reportedly known as "Mr. BAWAG" during his tenure as the bank's CEO from 1972 to 1995.[78] The elder Flöttl had stepped down in the mid-nineties, presumably from internal pressure regarding non-disclosure of his son's Bermuda hedge-fund, Ross Capital Markets, Ltd., trading currency derivatives on BAWAG's dime.[79] Flöttl's Ross Capital Markets, Ltd. also used Refco as its broker during the financial crisis of the late 1990's and realized a fate similar to Mr. Neiderhoffer, although the scope of Flöttl's reported trading losses reportedly approached a billion dollars.[80]

Flöttl's heavily leveraged off-shore trading follies compounded quickly, and as the losses continued to mount, hundreds of millions in BAWAG depositor funds[81] were used to cover margin calls as bank executives threw caution to the wind and apparently ignored John Maynard Keynes' maxim,[82] with the apparent hope that the Asian and Russian currency crises would subside, and the staggering losses would quickly dissipate,[83] but the Japanese yen's prolonged slump continued for years.[84] Flöttl's bad derivative bets were reportedly concentrated in Asian currencies, including the yen, as well as various interest rate spread movements,[85] and were not entirely unlike the leveraged losses realized by other traders and hedge funds during the same

Asian and Russian currency crises, such as; Henryk de Kwiatkowski, Long-Term Capital Management, U.K. Barings Bank's Nick Leeson, and Refco client Neiderhoffer.[86]

Mr. Flöttl, has however, insisted that Refco was not left with any bad debts as a result of his risky and errant trading strategies.[87] BAWAG continued to secretively provide funds to Ross Capital in Bermuda, in order to allow Flöttl to continue trading, ultimately resulting in even deeper losses.[88] Moody's Investor's Service senior analyst Nicola Venedey once glibly characterized the BAWAG corporate culture in grossly understated tones as one where "[t]heir risk appetite was very high, and their transparency was very low."[89] After selling its Refco equity to the senior Flöttl, BAWAG's 2004 Annual Report stated: "successful cooperation with the REFCO Group will be continued without an equity stake, so that the BAWAG PSK Group will continue to benefit from this access route to international customers in the future."[90]

Wolfgang Flöttl

Refco apparently sought to expand its European clientele, and the BAWAG / Refco joint venture conveniently included certain securities clearing services for European exchanges futures and options trading, and BAWAG handled trades for Refco customers, including up to 20,000 financial institutions.[91] This cozy clearing relationship seems to have afforded both sides of the alleged conspiracy the possibility to prolong the concealment, and perhaps even to facilitate further violations of a host of foreign and domestic banking and securities laws.

According to the SPhinX Funds, a series of S&P Index mutual funds then-managed by former Refco executive vice-president, Christopher Sugrue, in a complaint filed in the Southern District of New York, SPhinX alleged that "Refco, in its pleadings, admitted that [Refco CEO Phillip R.] Bennett and BAWAG had a close business relationship that gave BAWAG

'substantial control and influence over Refco's affairs. . . .' [and that] BAWAG exercised control over Refco's affairs through the placement of high-ranking officers and employees in positions of influence at Refco."[92] Just like Refco, BAWAG was teetering on the brink of insolvency with roughly a billion dollars in near decade-old concealed currency trading losses that were being shuffled back and forth, on and off of Refco's balance sheet, every quarter in order to continue the complex conspiratorial ruse.[93]

BAWAG management feared admission of the scheme would trigger a depositor run and bank executives instead allegedly continued to conceal its growing uncollectible loan portfolio.[94] Bennett allegedly involved BAWAG executives in the scheme, code-named "cleanup," some time in early 2000.[95] The alleged conspiracy involved paying down the receivables from RGHI throughout Refco's fiscal year and replacing those receivables with other receivables from a handful of entities not related to Bennett. For example, one of the facets of the scheme involved Bennett "borrowing" money from BAWAG, and BAWAG would then "borrow" money from Refco Capital Markets (Refco's unregulated Bermuda subsidiary), and Bennett would then pay the money to Refco,[96] with the bad debts on Refco's books appearing as a collectible loan to BAWAG.[97] The hedge fund Liberty Corner Capital Strategies, LLC, was also allegedly a central figure in these ongoing "sham" transactions.[98] Like clockwork, at "every fiscal year-end and, later, at every fiscal quarter-end, Bennett directed transactions that turned the debt owed to Refco from RGHI into a debt owed to Refco by a Refco customer."[99] After each fiscal year end or quarter end, the transactions would then be unwound, and the debt returned to RGHI.[100]

As part of the alleged fraud, and related to this series of alleged "sham" transactions, at the beginning of every quarter, Refco Capital Markets would provide loans to several hedge funds, Liberty Corner Capital Strategies, among them. The hedge funds would then allegedly

pay interests on the "loans" and the interest was then recorded on Refco's financials. A few days into each quarter, the hedge funds would then make a loan to Refco Group Holdings, Inc. (Bennett's privately held company), which was effectively a "loan" from Refco to RGHI. Then Bennett's RGHI used the "loan" proceeds to repay the hedge funds with interest. Before the end of each quarter, the hedge funds would repay the loan obligation to Refco, and the cycle would continue.[101]

On August 11, 2005 Refco executives were the toast of Wall Street, and in celebration of its IPO, Phillip R. Bennett, Refco's then-Chairman, President and CEO, rang the New York Stock Exchange opening bell.[102] Refco filed a Current Report Form 8K on August 16, 2005 to announce the completion of its IPO.[103] However, Refco's reckoning would arrive less than sixty days after it had completed the NYSE offering.[104] Public revelation of the clandestine off-balance sheet chicanery between Refco and BAWAG all became public on the same day, October 10, 2005, when Refco revealed "that it had discovered through an internal review a receivable owed to the Company by an entity controlled by Phillip R. Bennett, Chief Executive Officer and Chairman of the Board of Directors, in the amount of approximately $430 million,"[105] marking the onset of the scandal that triggered the Refco implosion and threatened the Austrian bank's existence.[106]

Phillip Bennett

Peter James, who was hired as Refco's controller the month that Refco went public, reportedly discovered that Mr. Bennett and Refco Group Holdings (RGHI, one of Bennett's privately owned companies), were responsible for hundreds of millions in debt[107] and he noticed that there was a "larger-than-normal interest payment" made to Refco on an outstanding loan.[108] Bennett had reportedly pledged his personal Refco equity (34 percent of the firm) as collateral

for one of the many allegedly dubious BAWAG "loans," with common stock that had traded at roughly $28 to $29 the day the "loan" was granted, and in one day "plunged from $28.56 to $7.90, wiping out $2.6 billion of shareholder wealth,"[109] and as Refco's scandal unraveled, the shares became virtually worthless.[110]

It was also reported at the time that part of the alleged scheme involved Refco (through various Anguilla "shell" companies) holding purported "bonds" as custodian for the benefit of BAWAG, and that these "assets" were supposedly valued at roughly $525 million on BAWAG's balance sheet, although the stated identification numbers of those securities did not correspond with any registered bonds.[111] BAWAG and Refco's, through an ongoing pattern of off-balance sheet transactions designed to falsely create the appearance of solvency for both entities, and much like the Enron and Parmalat schemes, used various "shell" companies, in this instance, entities located on the British West Indies island of Anguilla as essential components of the continued concealment.[112]

Facing a mountain in uncollectible trading loss debts, and perhaps aware that U.S. law enforcement was closing in, Refco admitted its dirty secret discovered by the newly hired controller, and just a week after the lengthy cover-up conspiracy unraveled, Refco and its twenty-three affiliates and subsidiaries filed the fifteenth largest bankruptcy ($16.8B) in U.S. history, on October 17, 2005,[113] where further details were revealed that BAWAG had reportedly "loaned" €350 million ($410 million) to Refco CEO Phillip R. Bennett literally just hours before the rogue brokerage admitted the cover-up of its massive losses.[114] NYSE officials suspended trading of Refco shares and moved to de-list the stock on October 18, 2005.[115] *USA Today* called it "'one of the most spectacular financial failures in US history' - from IPO to bankruptcy in two months."[116] Two days after Refco admitted to details of the alleged cover-up, U.S.

authorities arrested Bennett, and charged him[117] with multiple counts of securities fraud, wire fraud, and filing false reports with the SEC, on October 12, 2005.[118] Bennett pleaded not guilty and has been under house arrest at his posh Park Avenue apartment since his arraignment.[119]

The U.S. Department of Justice and the SEC both brought enforcement actions against BAWAG in mid-2006, and the Vienna bank settled quickly, agreeing to pay Refco creditors a reported $683 million and to waive its nearly half-billion dollar claims against the Refco bankruptcy estate.[120] The alleged conspiracy between Refco and BAWAG designed to hide hundreds of millions in bad debts was perceived as especially egregious according to U.S. law enforcement officials "because the bank was planning to profit by unloading its own stake in Refco," SEC Enforcement attorney Scott Friestad told *Bloomberg*, "the bank's former executives understood that the deceptive year-end transactions would help Phillip Bennett and BAWAG cash out their ownership interests at the expense of innocent investors."[121] Claims were quickly brought by Refco clients such as hedge fund manager James Rogers,[122] and by U.S. law firms who filed a slew of now consolidated class-action securities fraud suits,[123] seeking to recover funds invested in Refco on behalf of its shareholders, creditors and customers, some of which alleged, *inter alia*, that BAWAG was "an active participant in the accounting fraud that led to the collapse of the once-dominant commodities brokerage."[124]

Meanwhile, Refco's $16.8 billion bankruptcy case continues to grind its way through Chapter 11 proceedings in the Manhattan Bankruptcy Court.[125] BAWAG was identified as Refco's largest unsecured creditor in its October 17, 2005 voluntary Chapter 11 bankruptcy petition Fed. R. Bankr. P. 1007(d) "fifty largest unsecured claims" list, with a stated debt of $451,158,506 as of "approximately October 13-18, 2005."[126] Despite reports that Refco CEO Bennett had pledged his nearly thirty-four percent Refco equity stake to secure BAWAG's

eleventh hour "loan" to him, the bankruptcy petition schedule noted that the list of unsecured creditors excludes: ". . . secured creditors _unless_ *the value of the collateral is such that the unsecured deficiency places the creditor among the holders of the 50 largest unsecured claims*."[127] Refco's Fed. R. Bankr. P. 1007(a) "corporate ownership statement," attached to the aforementioned Rule 1007(d) unsecured creditor schedule, disclosed in a footnote that former CEO Bennett was, at least as of the filing of the Chapter 11 petition, still the beneficial owner "directly and indirectly through each of Refco Group Holdings, Inc. and The Phillip R. Bennett Three Year Annuity Trust hold[ing] 43,052,000 [Refco] shares (33.8%)."[128] At recent prices, those same Refco shares, now trading on the "pink sheets," were worth less than $11 million.[129]

As part of Refco's pre-bankruptcy maneuvers, it sought to unload its brokerage unit, negotiated on the eve of filing its Chapter 11 petition, with private equity firm JC Flowers, but the eleventh hour deal fell through.[130] Refco ultimately liquidated the scandal-plagued brokerage unit, at a fraction of the price it had previously negotiated with JC Flowers, to the U.K.-based financial conglomerate, Man Group, PLC.[131] Incidentally, Man Group recently announced that the Refco brokerage unit it acquired just a year earlier will again become a publicly held concern in 2007, and it is widely expected to again be a NYSE listed issue, just as it was when the scandal first surfaced.[132] After sale of the brokerage, the former flagship, Refco LLC, held a reported $664.6 million in assets, and curiously, Refco Capital Markets, Ltd., the Bermuda-based subsidiary tied to many of Bennett's allegedly fraudulent dealings, including those with BAWAG, held the bulk of the dilapidated firm's remaining assets ($2.44 billion).[133] Refco's bankruptcy estate administrator announced on April 2, 2007 that there was "about $450 million left to distribute to the brokerage's customers and creditors."[134]

Stanley Fink

B. The Role of an Unregulated Off-Shore Derivative Subsidiary

Some of Refco's subsidiaries are regulated, and some are not. For example, Refco's broker dealer subsidiary (Refco Securities LLC) is regulated by the SEC and NASD, and Refco's futures brokerage (Refco LLC) is regulated mainly by the CFTC and the Chicago Mercantile Exchange. The parent company Refco Inc. is subject to oversight by the SEC and formerly the NYSE, however many Refco subsidiaries were not subject to any regulation.[135] Perhaps Refco's unregulated Bermuda subsidiary, Refco Capital Markets, Ltd., enabled Bennett and his alleged co-conspirators to conceal its "cleanup" scheme so effectively for so long.

Refco Capital Markets, Ltd. operated as an exempt company incorporated in Bermuda, meaning that it could do business anywhere it chose, except Bermuda.[136] One of Bennett's closest lieutenants, Santo Maggio, who is now a cooperating witness for federal prosecutors, acted as president of Refco Capital Markets, Ltd.[137] Neither U.S. nor Bermuda authorities regulated this subsidiary in any meaningful respect. [138] Refco also established Refco FX Associates, which later became part of Refco Capital Markets, and as a result, it too was also entirely unregulated. Refco Capital Markets did not have any employees at its Bermuda "headquarters," and all its business activities were conducted from the offices of Refco Securities LLC, a regulated Manhattan–based subsidiary.[139]

The unregulated Refco Capital Markets Ltd. traded over-the-counter derivates,[140] and its accounts were frozen in October 2005 as it was allegedly used as a vehicle to hide millions in bad debts off-shore.[141] The lack of any meaningful regulatory oversight over Refco's off-shore OTC derivative subsidiary may have enabled Refco Capital Markets to go undetected as it "loaned" $355 million to a customer, who in turn "loaned" a like amount to Bennett's firm (RGHI), who then used those funds to seemingly satisfy debts owed to Refco.[142] Bennett used

this Bermuda subsidiary time and again to "loan" hundreds of millions of dollars to a "customer" in furtherance of the "cleanup" scheme.[143]

Refco's unregulated Bermuda subsidiary was not required to segregate client and company funds into separate accounts – which was, in fact, all pooled in a single off-shore account.[144] According to relevant court documents, those commingled funds flowed freely back and forth between the New York, Bermuda, and other Refco units.[145] According to bankruptcy court documents and related testimony, Refco Capital Markets sent funds on an almost daily basis to other Refco entities, to make loans, finance acquisitions, pay bills, and other Refco units would send Refco Capital Markets money to invest –reportedly about $20 billion went from Bermuda to other Refco entities, and about $18 billion went to Bermuda since 2000.[146] Finances from the so-called PlusFunds, managed by former Refco executive Christopher Sugrue, were also reportedly commingled in the Bermuda account.[147] Refco referred to its Refco Capital Markets subsidiary as "the Company's non regulated subsidiary," which "represent[ed] a material portion of the business."[148] In fact, the vast majority of the funds that recently remained as part of the Refco bankruptcy estate were located in the Refco Capital Markets Bermuda account.[149]

V. The Regulatory Role?

CFTC officials were quick to pass the regulatory "hot potato," and stated that the Refco companies it regulated were "financially sound."[150] The New York Stock Exchange, which had listed the issue for exchange trading, should have conducted its own investigation of the company, and faced media criticism for failing to vet the firm's financials.[151] Refco's broker-dealer arm was regulated by the NASD, and Refco's futures brokerage firm was regulated by the Commodity Futures Trading Commission, neither of which uncovered the scheme.[152] Refco

Capital Markets brokered OTC derivative[153] and currency trades,[154] thanks to Congress, and its amendment to the Commodity Exchange Act,[155] was an entirely unregulated off-shore business.[156] This "modernization" amendment removed OTC derivative trading from virtually all regulatory scrutiny.[157] The SEC, CFTC, Department of Treasury, and Federal Reserve all asserted that "[m]ost OTC derivatives are not susceptible to manipulation," and "[t]he sophisticated counterparties that use OTC derivatives simply do not require the same protection under the CEA as those required by retail investors."[158] Former Federal Reserve Board Chairman Alan Greenspan was among those who adamantly opposed[159] any attempts by the CFTC "to impose new regulations on OTC derivatives."[160]

Reuben Jeffery III

The CFTC[161] had sought to develop derivative regulations in the late 1990s and contended that derivative market oversight could have prevented the Long Term Capital Management debacle.[162] However, the Federal Reserve and several financial industry players,[163] in addition to other market regulators, vigorously opposed any new OTC derivatives regulations.[164] Congress approved the Commodity Futures Modernization Act of 2000 (HR 4541) on December 15, 2000 and President Clinton signed it into law less than a week later.[165] The so-called "Commodity Futures Modernization Act of 2000" stripped the CFTC of much of the regulatory oversight it previously had over OTC derivatives trading.[166]

Academia and regulatory experts have asserted that Refco fell through a deliberately created regulatory crack that players in the derivatives industry had aggressively and successfully lobbied have promulgated.[167] However, there are those who believe that it is not the derivative unit that was the problem, and that statisticians are "spinning a desperate theory that Refco, a derivatives trader, fell through an intentional regulatory gap regarding derivatives. This is

absurd. Refco's accounting was fraudulent, not its derivatives trading."[168] Nonetheless, the complete lack of any oversight of Refco's Bermuda unit certainly increased the likelihood that Bennett's "cleanup" scheme would evade detection.

Although prior to the IPO, Refco had disclosed its auditors found "two significant deficiencies in [Refco's] internal controls over financial reporting,"[169] an SEC official stated that such a disclosure would not be enough of a reason to halt the offering.[170] Former SEC Chief Accountant Lynn Turner noted that the SEC's Corporate Finance division would not have spotted Refco's problems anyway, because of the type of review that the SEC typically performs during the pre-offering period.[171] Ms. Turner stated that "[i]t's unlikely that the type of a desktop review that the SEC performs would catch this type of alleged fraud," as the typical review entails the SEC staff reading through the prospectus, and if needed, asking the company for clarifications.[172]

It is more than slightly surprising that SEC pre-offering scrutiny was so cursory with respect to Refco's IPO, especially in light of the fact that the brokerage was the target of an ongoing enforcement investigation for years before the offering. The Commission has recognized the importance of the IPO process, and the necessity of promoting transparency and improving the flow of access to information regarding IPOs, yet somehow nobody at the SEC could smell the massive pre-offering book-cooking. The NYSE and NASD, at the request of the SEC, convened an IPO Advisory Committee in 2003 and produced a *Report and Recommendations*.[173] The Report observed that the SEC and SROs should promote "clearer channels of communication," among the general investment community, issuers, and underwriters,[174] and all investors should have the information which will allow them to make informed investment decisions in regards to the IPO.[175] The joint SRO Committee also

recommended improvement in the quality of underwriter performance and in public awareness regarding IPOs.[176] Under this recommendation, the Committee elaborated and emphasized that:

> [T]he basic and most essential ingredients to ensure the integrity of IPOs are an issuer's awareness and discharge of its obligations in the IPO context, an underwriter's ethical and fair performance of its duties and the participation of an informed investing public that understands the inherent volatility in the IPO market and the risks of IPO investing. To this end, we recommend measures to promote underwriter standards and to educate issuers and investors.[177]

The importance of a high level of diligence and awareness by underwriters was also emphasized, as was the need for a commitment to ethical conduct, professional responsibility and a high standard of integrity.[178] Again, the underwriter is being placed in the uncomfortable role of policing, and is expected to be vigilant, over the very same entity to which it owes a fiduciary duty as a client. Columbia Securities Law Professor, and author of *Gatekeepers*,[179] John Coffee, observed that Refco's underwriters will likely have more justification than the WorldCom underwriters to assert affirmative defenses because Bennett's concealed scheme began some time around 1998, whereas WorldCom's fraud took place only months prior to its offerings.[180]

VI. Refco Underwriters

Leveraged-buyout private equity titan, Thomas H. Lee Partners,[181] acquired a majority stake in Refco Group in 2004, with an eye toward an eventual Refco IPO, and with acquisition financing provided by financial heavyweights such as Credit Suisse First Boston, Deutsche Bank, and Bank of America.[182] At the time of the T.H. Lee private equity acquisition, Refco was among "the most active members on futures exchanges in Chicago, New York and around the world, operating in 14 countries,[183] and was also a "major broker of cash-market products."[184] Refco was one world's largest derivatives clearing firms,[185] and at the time was also the largest single source of customer-transaction volume on the Chicago Mercantile Exchange.[186] T.H.

Lee's "LBO" lenders, Credit Suisse and Bank of America, would later be among the lead underwriters of Refco's ill-fated IPO.

Thomas H. Lee Partners scrutinized the brokerage's financial data in 2004 prior to the leveraged buyout[187] and spent a reported $10 million hiring auditors KPMG, and others, who "conducted an exhaustive due diligence investigation, including speaking with numerous third parties who had done business with Refco and Bennett."[188] A spokesman reflected on the private equity firm's due diligence efforts regarding Refco, which took place over a seven-month period, and said that the firm stood by its investigation, and further stated that T.H. Lee had "conducted in-depth due diligence before making each of its over 90 investments since 1974,' the spokesman said, 'and Refco was no exception.'"[189] By 2005, Bennett had engaged Credit Suisse,[190] Bank of America, and Goldman Sachs Group Inc., to lead the effort to bring Refco public in a $583 million offering.[191] Credit Suisse led the offering, underwriting 6,855,550 shares and raising $150.8 million, Goldman Sachs underwrote 5,639,200 shares, raising $124 million, and Banc of America Securities underwrote 5,392,750 shares, raising $118.6 million.[192]

Thomas H. Lee

A. The Underwriter's Role

In the IPO context, an underwriter's primary market function is to distribute the offered securities on behalf of the issuer, provide the mechanism necessary to sell the offered securities (such as a sales force and support facilities), provide quasi-insurance to the issuer, and to also serve as an "information and reputational intermediary" between buyers and sellers.[193] Of course the federal securities laws impose additional burdens upon the underwriter, including that of diligent investigation into the issuer's business. The duties of the lead underwriter generally

include: "(1) advising the issuer; (2) providing investment-banking services, including management and financial support for company activities; (3) assistance in formulating the prospectus; (4) performing due diligence, (5) assessing the value of securities to be sold, (6) determining the IPO's structure and terms, and (7) creating and managing the securities' underwriting and distribution networks."[194]

To properly view the role of underwriters in the IPO process, one must recognize that it is not independent from the hiring issuer. Underwriters are generally considered to be dependent gatekeepers, whose first role is to further the interests of their clients. This function creates inherent conflicts in scenarios such as those within the Refco IPO, where underwriters should presumably not be held to higher (and possibly unattainable) standards than regulators, SROs, auditors, law firms and the like. Underwriters are less effective gatekeepers, as their primary duty is owed to the issuer client.

Although the Securities Act does impose certain stringent duties upon underwriters, a pragmatic dilemma invariably surfaces where the underwriter can act as an ineffective monitor, and risk civil liability (but preserve the client relationship); or it can vigorously monitor and shield itself from 1933 Act liabilities, but damage the client relationship and perhaps breach its fiduciary duty owed to the client. An economic conundrum exists created by regulation and case law on the one hand, and business economics on the other, potentially frustrating the very functions of underwriting. In such scenarios, the 1933 Act doctrines effectively fashion underwriters into deputized quasi-regulators charged with accomplishing objectives that the regulators themselves did not, or could not, achieve due to a concealed and complex pre-offering fraud that had been below the radar for nearly a decade.

B. Independent *v.* Dependent Gatekeepers

Gatekeepers can be distinguished as independent or dependent.[195] Examples of independent gatekeepers include auditors and securities analysts, for example, who are retained, by the principal, and act as agents performing a specific task or set of tasks.[196] An auditor is not considered to have a fiduciary duty to the client when performing auditing functions.[197] These independent gatekeepers are in a distinct position where they should be able to evaluate violations, or potential violations, generally without regard for client reprisals.[198]

Underwriters are typically considered to be *dependent* gatekeepers, who provide particularized advice and recommendations to a client, and who assist the client with meeting specific goals.[199] It might appear as though an underwriter is independent, considering the due diligence responsibilities the imposed by the Securities Act; but the contours of the underwriter's role are more complex, and despite those due diligence requirements, the underwriter is not meant to be completely independent of the issuer.[200] Often the dependent gatekeeper serves its client in a fiduciary capacity and owes a duty of care and loyalty to that client, and such is the case with securities underwriters and an issuer-client.[201]

Courts have recognized that underwriters owe a fiduciary relationship to its client.[202] The New York Court of Appeals held that although the underwriting agreement for an IPO did not by itself create a fiduciary duty, the advisory relationship between the underwriter and the issuer involved trust and confidence from which a fiduciary duty is created.[203] Underwriters typically act as advisors to the issuer client while performing the function of promoting, pricing, and distributing the issuer's securities.[204] Underwriters also frequently have a direct or indirect financial interest in outcome of an offering,[205] and can invest directly in the issuer's securities, unlike auditors who are prohibited from doing so.[206] Underwriters also occasionally provide

their services on a "best efforts" basis where no fee is earned unless the securities are sold in whole or in part depending upon the engagement agreement. The Second Circuit has stated:

> Underwriters have strong incentives to manipulate the IPO . . . process to facilitate the complete distribution and sale of an issue. Underwriting is a business; competitive forces dictate that underwriters associated with successful IPOs will attract future issuers. Moreover, because underwriters assume a large measure of risk in the event an IPO fails, they have a direct interest in the IPO's success.[207]

Underwriters perform a variety of valuable services for their clients, and have a strong interest in cultivating long-term relationships to obtain further consulting and other advisory work.[208] The inherent conflicts present in the underwriter's role in the IPO process do not logically enable it to act as the most effective due diligence monitor.[209] Nonetheless, underwriters are forced to walk a tightrope between developing a book of business, and scrutinizing a client's books and records.

VII. Securities Act Sections 11 and 12

Underwriters involved in public offerings may find themselves facing civil liability under Section 11 and 12(2) of the 1933 Securities Act[210] but can defend such claims with the interrelated affirmative defenses generally known as the "due diligence" defense. Under Section 11, underwriters must establish, at a minimum, that "after reasonable investigation, [had] reasonable ground to believe and did believe ... that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[211] To affirmatively defend a claim raised under Section 12(2), underwriters must establish that they "did not know, and in the exercise of reasonable care, could not have known, of [the] untruth or omission."[212]

The First Amended Complaint brought against the Refco underwriters, alleges that the "Refco Underwriter Defendants"[213] "sold and distributed Refco common stock to the investing

public pursuant to the registration statement and prospectus filed with the SEC in connection with the August 2005 IPO."[214] The Complaint further states that the underwriters had a duty to make a reasonable investigation of Refco to ensure that the IPO offering materials contained no misstatements or omissions of material facts,[215] and alleges that the underwriters specifically violated Sections 11 and 12(a)(2) of the Securities Act.[216]

A. Underwriter Liability Risk

Courts have emphasized the important role of underwriters in the IPO process, and hold them to a relatively high standard in the context of Section 11 and 12 shareholder claims. Courts have been "particularly scrupulous" in their examination of an underwriter's conduct[217] because they consider underwriters to be a "first line of defense" in preventing material omissions and misrepresentations from registration statements,[218] and because "[n]o greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter."[219]

According to the *Feit v. Leasco* Court, underwriters are diametrically opposed to issuer management (despite the conflict this creates with respect to the fiduciary duty owed by an underwriter to an issuer client). An "average investor probably assumes that some issuers will lie," but may have more confidence in the morality underwriters who have established good reputations for fair dealing.[220] According to the *WorldCom* Court, the purpose of an underwriter is different from that of the auditors, and they have unique access to information about a company at an important time in the company's existence – when it is seeks to raise capital.[221] The *Leasco* and *BarChris* Courts both cautioned underwriters to be alert to "exaggerations and rosy outlooks and chary of all assurances by the issuer,"[222] as statements by a prospective issuer

company to an underwriter may be "unduly enthusiastic" in order to induce an investment bank to underwrite the company's securities.[223]

An underwriter owes a duty under Section 11 to the investing public, "as well as to their own self-interest."[224] The underwriter's Section 11 duty of extends beyond merely listening to management's often self-serving explanations about the business affairs and taking those claims at face value. The underwriter must conduct an investigation that is reasonably calculated to expose all the facts that would be of interest to the "reasonably prudent investor."[225] If an underwriter conducts the investigation in this manner it will generally not be liable for material misrepresentations made in a registration statement that its investigation did not reveal, but if the underwriter does not conduct a reasonable investigation it can be held liable.[226]

The *WorldCom* Court found that there are "no signs of abandoning the early courts' demand that underwriters employ 'a high degree of care in investigation and independent verification of the company's representations.'"[227] The duty to investigate is placed upon the underwriters because, their role is critical to market integrity and the investing public's overall confidence.[228] However, in a scandal such as the Refco IPO, where regulators, SROs, and even highly sophisticated private investors such as Thomas H. Lee Partners did not uncover the scheme, it seems wholly unreasonable to expect Goldman-Sachs to have discovered what others could not. And with respect to Credit Suisse and Bank of America, each of these highly sophisticated firms had provided millions in debt financing a year earlier during the T.H. Lee leveraged buyout, and had their self-interest at stake in that financing, and substantial risk of loss if the loans were later non-performing, but still did not uncover Bennett's off-balance sheet voodoo when evaluating whether to finance the buyout of a majority of Refco equity.

B. Section 11 Liabilities

Section 11 of the Securities Act of 1933[229] imposes liability upon underwriters for untrue statements of material fact or material omissions contained within a securities registration statement.[230] The purpose of this provision is to "assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering."[231] Every person who signs a registration statement, every certifying or preparing accountant,[232] and every underwriter involved with the securities offering, is potentially exposed to Section 11 liability.[233] The U.S. Supreme Court has declared that the purpose of the imposition of Section 11 liability "reflects Congress' sense that underwriters, issuers, and accountants bear a 'moral responsibility to the public [that] is particularly heavy.'"[234] The boundaries of this legislatively imputed "moral responsibility" cannot be reasonably construed to extend beyond the expectations of the SEC and SROs, none of which brought the facts of the Refco scandal to light before the offering.

A plaintiff is not required to allege that defendants possessed any degree of scienter to assert a *prima facie* Section 11 claim,[235] only the demonstration of an existence of material misstatements or omissions within the registration statement is required.[236] The Third Circuit has characterized Section 11 as a "virtually absolute liability provision, . . ."[237] However, Section 11 does provide underwriters with two interrelated due diligence affirmative defenses.[238] The first defense is causation based, and is available to a defendant who can establish that the loss in the value of the security resulted from something other than the allegedly misleading statements contained within a registration statement.[239] The second is the defense of "due diligence," which can be asserted by all defendants except an issuer.[240] The due diligence

defense is actually composed of two separate affirmative defenses; the reliance defense, and the due diligence defense.[241]

C. Section 12 Liabilities

Section 12 is construed as a "broad anti-fraud measure,"[242] and a putative plaintiff need only to show some causal connection between the sale and the alleged communication, "even if not decisive."[243] Section 12(a)(2) claims can be asserted by the purchaser of a security against any seller who "offers or sells a security,"[244] by way of any prospectus or oral communication that contains an untrue statement of material fact or that omits a material fact which is necessary to make the statement not misleading.[245] Underwriters may be liable under Section 12(2),[246] and according to the U.S. Supreme Court, Section 12 liability "turns on *status*, not scienter: It imposes liability without requiring 'proof of either fraud or reliance.'"[247]

Section 12(a)(2) also provides two affirmative defenses that parallel the Section 11 affirmative defenses. The first affirmative defense[248] prohibits recovery where:

> [T]he person who offered or sold such security proves that any portion or all of the amount recoverable ... represents other than the depreciation in value of the subject security resulting from such resulting from such part of the prospectus or oral communications, with respect to which liability of that person is asserted . . . [249]

This defense is similar to the first Section 11 affirmative defense.[250] The second affirmative defense available under Section 12(a)(2) is the defense of reasonable care.[251] A defendant is required to demonstrate that it exercised reasonable care.[252] The *WorldCom* Court noted that an affirmative Section 12(a)(2) due diligence defense contemplates a less demanding reasonable care standard than that under the Section 11 duty of due diligence, and there is no substantive distinction between "expertised" and "non-expertised" statements under Section 12.[253]

D. The Due Diligence Defenses

The two Section 11 due diligence defenses[254] have been labeled by Courts as the "due diligence defense," and the "reliance defense."[255] The standard for determining whether an underwriter has satisfied the due diligence defense is the same for both the reliance and due diligence defense, the traditional tort-based "standard of reasonableness of a prudent man in the management of his own property."[256] The Supreme Court considers the analysis of a due diligence defense to be that of a "negligence standard."[257]

The due diligence defense has been employed in federal courts by underwriters since at least 1968.[258] This defense encourages the underwriter to acts reasonably, and is logically unavailable to a "negligent underwriter."[259] Whether due diligence has been sufficiently performed "is a question of degree, a matter of judgment in each case."[260] Courts utilize a variety of factors to analyze reasonableness, some examples include: 1) receipt of written representations from outside auditors and the company that the prospectus was accurate, surveying retailers to ensure that the company had not lowered its prices, and confirming certain facts regarding product returns with the company's customers;[261] and, 2) conducting a complete analysis of the company's finances, future plans, managements, and analyzing the state of the industry.[262] The SEC has observed that "only a court can make the determination of whether a defendant's conduct was reasonable under all the circumstances of a particular offering."[263] The law on due diligence is somewhat scant,[264] and there is no strict rule beyond that of a case-by-case determination guided by the traditional rule of reason.[265]

1. Due Diligence Defense

The due diligence defense is "afforded to underwriters for non-expertised portions of a registration statement."[266] The underwriter will be relieved of liability if upon performance of a

reasonable investigation, "it had reasonable grounds to believe and did believe that at the time of the registration statement became effective, that the registration's statements were true and not misleading."[267] Reasonable investigation under Section 11[268] requires more from an underwriter than merely reporting in the prospectus the data that the company presented.[269] An underwriter must also make reasonably diligent attempts to verify data submitted to it, in order to make the underwriter's involvement in the venture of any importance to investors.[270] Reasonable due diligence typically entails "a careful review of the issuer's financial statements and important contracts."[271] Refco's financials had apparently passed muster in reviews by auditors, SROs, sophisticated private investors and lenders, and even federal securities regulators before the IPO.

In order for the underwriter to successfully assert the due diligence defense, the *WorldCom* Court stated it "will have to show that they conducted a reasonable investigation of the non-expertised portions of the Registration Statements and thereafter had reasonable ground to believe that the interim financial statements were true,"[272] and its receipt of a so-called "comfort letter" alone is insufficient to establish the affirmative defense.[273]

> It is important to note that even if no reasonable investigation would have uncovered a fraud, an underwriter will prevail on its defense if can show it did conduct a reasonable investigation. Conversely, an underwriter must conduct a reasonable investigation to prevail on the due diligence defense, even if it appears that such an investigation would have proven futile in uncovering the fraud. Without a reasonable investigation, of course, it can never be known what would have been uncovered or what additional disclosures would have been demanded.[274]

Courts have granted summary judgment to underwriters where there has been a showing of extensive due diligence.[275] While courts continue to require underwriters to prove they have conducted a meaningful investigation before the grant of summary judgment, including reasonable scrutiny of unaudited financial information,[276] the underwriters must "'look deeper

and question more' where confronted with red flags."[277] Perhaps this nuance is the one on which the Refco Securities Act claims will turn, and whether the numerous potential "red flags" present in Refco's unsavory history of misconduct would trigger a higher degree of required scrutiny.

2. Reliance Defense

The remaining Section 11 defense is the so-called reliance defense, available to an underwriter who has relied on any portion of a registration statement professed to be made under the authority of an expert opinion.[278] The underwriter will generally be relieved of liability if, at the time the registration statement became effective, it had "no reasonable grounds to believe and did not believe, that the statements in the registration statement were untrue or that there was an omission of material fact necessary to make the statements not misleading."[279] An underwriter may also rely on "expertised parts of a prospectus" such as an accountant's certified financial statement, unless there are reasonable grounds to believe that the certified financial statements are somehow materially false.[280]

An underwriter may rely upon an accountant's expert opinion under the reliance defense if three prerequisites are met: 1) the accountant's opinion must be "reported" in the registration statement; 2) the accountant's opinion must be an audit opinion; and 3) the accountant must have given consent to its audited opinion being incorporated into the registration statement.[281] While underwriter defendants can rely on audited financial statements, this reliance "may not be blind."[282] Additionally, reliance upon accountant comfort letters for interim financial statements will not suffice for reliance defense purposes.[283] And where "red flags" emerge concerning the reliability of audited financial statements, reliance upon audited financial statement will not shield the underwriter from Section 11 liability.[284]

The *WorldCom* Court articulated a succinct definition of what constitutes a "red flag" in the Section 11 context: "[a]ny information that strips a defendant of his confidence in the accuracy of those portions of a registration statement premised on audited financial statements is a red flag, whether or not it relates to accounting fraud or an audit failure."[285] Again, a critical factual question in the Refco matter that will almost assuredly be subject to a vigorous contest, is whether Refco's deplorable record as a serial securities law violator constitutes a sufficient "red flag" to raise the level of required diligence of the underwriter defendants, and whether the audited statements by Grant Thornton included anything material that might also be construed as a "red flag," consistent with the *WorldCom* definition.

3. Investigation Reasonably Calculated to Reveal Facts of Interest

There is no strict rule as to what constitutes an investigation that is reasonably calculated to reveal the facts that would be of interest to a reasonable prudent investor—each case is different.[286] A review of common law can offer some guidance to an underwriter defendant, however, it is surely not the most efficient or effective mechanism to require an underwriter to have to stay current with all various common law requirements of what is considered adequate due diligence. Although courts vary on what is considered adequate due diligence, and each case is different, there is some measure of consensus on the general requirements.

While underwriters are generally not expected to possess detailed knowledge of an issuer's corporate affairs, "they are expected to exercise a high degree of care in investigation and independent verification of the company's representations. . . [t]acit reliance on management assertions is unacceptable; the underwriters must play devil's advocate."[287] At a minimum, an underwriter should review important contracts and minutes,[288] and investigate any inconsistencies in the representations made by management.[289] A few of the leading cases in this

area shed some light on the standards that various courts have expected of underwriters in the due diligence context.

a. *Feit v. Leasco*

The *Leasco* Court found that the underwriter defendants "barely established that they reasonably investigated," despite the fact that it was established that a thorough review was conducted of all available financial data, independently examined audits and actuary reports, detailed inquiries of the company's major banks were conducted, a study of the corporate records, major agreements and minutes was undertaken, and due diligence meetings where the registration statements were reviewed line by line were conducted.[290] Underwriters must exercise a high degree of care and independently verify and investigate the company's representations.[291] The *Leasco* Court also determined that liability could still be attached because the underwriter defendants failed to recognize a problematic agreement in which management was involved, however "on balance" the Court concluded that the underwriters had effectively established the due diligence defenses with respect to the registration statement.[292]

b. *Escott v. BarChris*

The *BarChris* Court found that the underwriters did not make a reasonable investigation as to whether or not the portions of the prospectus, which were not made on the authority of the auditor, were in fact true.[293] Although the underwriters believed that those portions of the prospectus were true, this belief was deemed to be unreasonable, and the due diligence defense was only partially established as to audited portions of the prospectus.[294] The underwriters reviewed the annual reports and prospectuses of other companies within the industry, examined the issuer's prior prospectuses, most recent unaudited interim financial statement and annual

reports, and corporate minutes from the previous five years, as well as major contracts, and attended several in-person meetings with the issuer where pertinent questions were asked and satisfactory answers were apparently provided.[295] Nevertheless the *BarChris* Court held that the underwriters had not conducted a reasonable investigation with respect to the truth of the non-expert portions of the prospectus, because they made "almost no attempt to *verify* management's representations."[296]

BarChris further emphasized that the purpose of Section 11 is the protection of investors, and that underwriters are accordingly responsible for the truth and accuracy of the representations made in a prospectus.[297] The Court noted that underwriters should not be able to escape liability by merely "taking at face value representations made to them by the company's management," because if this was permitted, Section 11 underwriter liability would offer "investors no additional protection."[298] The underwriter defendant must establish it made a reasonable attempt to verify data submitted to them by the issuer's management, and cannot rely solely on the company, as "[a] prudent man in the management of his own property would not rely on them."[299] In other words, the underwriter must verify management's representations by referring to materials available to them such as loan agreements, books, corporate minutes and other corporate agreements.[300] Reliance on management's oral statements is not reasonable.[301]

c. *Software Toolworks*

The *Software Toolworks Inc. Securities Litigation* plaintiffs argued that the underwriter defendants should have discovered the false and misleading statements in the prospectus.[302] The Ninth Circuit granted summary judgment on some aspects of asserted due diligence defenses and denied summary judgment in other areas, finding that the underwriters had sufficiently investigated the issuer's business with Nintendo.[303] The underwriter investigation included

obtaining written auditor representations and statements from the issuer as to the accuracy of the prospectus, confirming the issuer's return policy with its customers, and surveying various retailers regarding pricing and other relevant product-related details.[304] Summary judgment was denied on other aspects of the underwriters' involvement, and the Court pointedly stated that "'[r]ather than play 'devil's advocate,' as *Feit* requires an underwriter to do, the *Software Toolworks* underwriters 'did little more than rely on Toolworks' assurances that the transactions were legitimate,'" thus making summary judgment in their favor inappropriate.[305]

d. *WorldCom*

WorldCom plaintiffs alleged the underwriter defendants violated Section 11[306] and 12(a)(2)[307] of the Securities Act of 1933. WorldCom "conducted a public offering of debt securities by issuing approximately $5 billion worth of bonds" in 2000.[308] A registration statement and prospectus were filed, and incorporated into the 10K and 10Q.[309] The underwriter defendants[310] sought summary judgment including "a declaration that they have no liability for any false statements in the WorldCom financials that accompanied the registration statements or for the alleged omissions from those registration statement."[311]

The *WorldCom* Court determined that CEO Bernie Ebbers and other WorldCom executives had manipulated public filings concerning the company's true financial condition, and because the false public filings were incorporated into the bond offering registration statements, the underwriter defendants would be liable for those materially false statements if they were unable to show sufficient due diligence in their investigation of the company in connection with the contested bond offerings.[312] The underwriters did perform due diligence, which involved two telephone calls with WorldCom management, one teleconference with Andersen and WorldCom executives, submission of due diligence questions to WorldCom, a review of board

minutes, SEC filings, press releases, and the revolving credit agreement.[313] As is often the case in Section 11 and 12 litigation, the factual question of whether this investigation was reasonable under the circumstances would determine the outcome of underwriter liability.

The *WorldCom* plaintiffs contended that "red flags" existed that should have alerted the underwriter defendants to question the audited financials, and that almost no investigation of WorldCom in connection with the underwriting of the bond offerings was undertaken, and as a result, the underwriter due diligence defense should fail.[314] The underwriter defendants contended that WorldCom management effectively concealed the financial fraud from outside auditors, and from almost everyone within the company, and that the underwriters were similarly duped. The underwriter defendants further asserted they were entitled to rely upon the audited financial statements as an accurate depiction of the company's financial condition, and were entitled to rely upon "comfort letters" from the outside auditor that were provided for the WorldCom financial statements.[315] The underwriters also argued that they did not have a duty to investigate the reliability of the audited financial statements unless they had reasonable grounds to believe that the financial statements were not accurate.[316] The underwriters also contended that none of the alleged material omissions were actionable because the information was either not material, or it had already been publicly disclosed.[317]

The Court partially granted the underwriter defendants' motion for summary judgment, finding that the plaintiffs successfully raised certain questions of material facts as to whether the underwriters conducted a reasonable investigation.[318] Specifically, the plaintiffs' challenges to the limited number of conversations between the underwriters, auditor, and issuer; the perfunctory nature of the related inquiries; and the underwriters' failure to inquire into issues of particular importance within its own internal evaluations of the financial condition of the

company were all persuasive to the Court.[319] The underwriters attempted to argue that difference in the contested figures in the WorldCom 10K as compared to two of its closest competitors were publicly available. However the Court found that the mere fact that the differences were publicly available information did not release the underwriters of their duty, and the difference in the financial figures between the 10K and its competitors was a "red flag"[320] that triggered a duty to investigate "even the audited financial statements."[321] As a result, the *WorldCom* Court denied the underwriters' motion for summary judgment as to the reliance defense.[322] In the context of the reliance defense, "red flags" do not have to be well known, they only have to exist in order to create a duty to inquire because the "red flags" created a reasonable ground for the underwriters to believe that the reporting of assets may have been inaccurate.[323]

The *WorldCom* Court granted summary judgment for the underwriters as to the question of whether Ebbers' personal financial situation, and specifically the manner and extent that his wealth was connected to WorldCom's stock price, required the underwriters to inquire.[324] The Court stated that the plaintiffs did not show that the underwriters "had any reason to believe that Ebbers would use his access and power to commit fraud."[325] One could reasonably expect that the record of *WorldCom*, and the weight of its detailed opinion will likely bear on the outcome of the Refco litigation. However, the Refco case will almost certainly turn on the specific operative facts, perhaps most notably whether the reviewing court will consider various facts related to Refco sufficient to be considered "red flags" that trigger a heightened underwriter scrutiny, and if so, whether the underwriters discharged their respective duties.

VIII. Conclusion

The Refco scheme led to a series of ignominious firsts, culminating with the largest ever bankruptcy of a U.S. brokerage firm, less than a quarter after CEO Phillip Bennett rang the NYSE's opening bell. The masterminds of the scheme, code-named "cleanup," created a complicated web of "sham" transactions that included numerous co-conspirators and concealed hundreds of millions in trading losses on both sides of the Atlantic that could be traced back to the Asian and Russian currency crises of the late nineties. The degree of sophistication used to further the scheme, the permissive regulatory climate for OTC derivatives, and a desperate Austrian bank willing to facilitate the conspiracy while hiding its own massive losses, all combined to create a "perfect storm" that allowed the Refco ruse to remain undetected for almost a decade. And despite the rogue broker being a serial violator of various securities laws and regulations for decades, not one regulator stepped in until *after* the scandal was headline financial news.

And for whatever reason, the SEC and DOJ had parallel investigations underway for years prior to the offering, yet the IPO was permitted to proceed after cursory regulatory reviews of the registration statement and its numerous amendments. Similarly, none of the various SROs with oversight authority of aspects of Refco's business found the enormous off-shore financial irregularities. By the same token, Thomas H. Lee Partners, who reportedly spent $10 million in fees to KPMG and others to perform extensive due diligence prior to completing a leveraged buyout of a majority stake in the brokerage, did not even catch a whiff of Bennett's massively cooked books. Nor did Refco's outside auditor, Grant-Thorton.

All of these sophisticated entities, with all of their combined acumen and resources, failed to unearth the scam, which necessarily begs the question of just how far the Refco

underwriters could be expected to go to satisfy the reasonableness test required to assert affirmative defenses in Securities Act litigation? The reasonableness of an ordinarily prudent person in the management of their own property is the essence of the affirmative defense standard. The underwriting defendants can convincingly point to the Thomas H. Lee acquisition, as well as the due diligence performed by LBO lenders Credit Suisse and Bank of America when evaluating whether to finance that 2004 private equity transaction. When these two underwriting defendants were acting in the role of prospective lenders, *with their own property at risk*, Refco's financials apparently passed muster, and each loaned millions to facilitate the leveraged buyout.

Securities Act claims against underwriters usually involve fact-intensive litigation with a case-by-case analysis governed by a general rule of reason. There is perhaps no single fact more persuasive than two of the underwriting defendants, who had their own property at risk and funded T.H. Lee's acquisition of a majority of Refco just one year before the IPO. Imposing liability on these underwriting defendants might instinctively seem "just," at least in the sense that brokerage clients, creditors, and IPO investors were apparently defrauded of billions, and the underwriters are assuredly "deep pockets" with sufficient funds to pay the aggrieved.

However, holding these underwriters accountable where so many others were unable to detect the scheme is fundamentally unjust, and effectively deputizes these investment banks as quasi-regulators, charged with a responsibility that the actual regulators were incapable of achieving. Moreover, holding these investment banks liable for something that no other entity could accomplish is an abject frustration of the principle of reason, despite the tragedy that other co-defendants are unlikely financially capable of making the plaintiffs whole. The Refco underwriting defendants, much like JP Morgan in the recent Enron matter, have every reason to be cautiously optimistic that summary judgment will eventually be granted in their favor.

Endnotes

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[1] Riva D. Atlas and Jonathan D. Glater, *Mystery at Refco: How Could Such a Huge Debt Stay Hidden?*, N.Y. Times, Oct. 24, 2005.

[2] See Section III *infra* setting forth actions against Refco and related parties.

A few additional actions, not set forth in Section III, include actions against Dittmer: 1) a 1984 an Arkansas federal court established that Dittmer and Refco "violated federal commodities laws in an effort to defraud customers on cattle-future prices." Richard Gibson and Jeffrey Zaslow, *Brash Trader: Thomas Dittmer Roils Commodities Markets With Clout, Timing --- But He and Refco, His Firm, Are Set Back in Lawsuit Involving Cattle Futures --- A Mistake in Eggs Pays Off,* WALL ST. J., Aug. 13, 1984; 2) in 1979 Mr. Dittmer was fined and barred for 120 days from trading cotton futures and paid a $150,000 fine. See Richard Gibson and Jeffrey Zaslow, *Brash Trader: Thomas Dittmer Roils Commodities Markets With Clout, Timing --- But He and Refco, His Firm, Are Set Back in Lawsuit Involving Cattle Futures --- A Mistake in Eggs Pays Off,* WALL ST. J., Aug. 13, 1984.

Actions against Ray E. Friedman: The founder of Refco's predecessor, was convicted in 1952 by a federal court in Iowa of conspiracy to defraud the government. Bennett's Refco Scheme Exposed by Hunch: 'It Hit Me' (Correct), BLOOMBERG.COM, October 27, 2005, http://quote.BLOOMBERG.COM/apps/news?pid=nifea&&sid=aNbiVOYM8VMA (last visited April 20, 2007).

Other actions against Refco: 1) In 1979 and 1980, the president of United Arab Emirates the traded some of his $200 million commodities investment through Refco. When almost half of the money was lost the Sheik sued Refco in Chicago federal court alleging that Refco "deliberately ignored trading instructions from them." Refco settled the suit for an undisclosed amount and one of the Sheik's advisers "languished [sic] for months in an Abu Dhabi jail." Richard Gibson and Jeffrey Zaslow, *Brash Trader: Thomas Dittmer Roils Commodities Markets With Clout, Timing --- But He and Refco, His Firm, Are Set Back in Lawsuit Involving Cattle Futures --- A Mistake in Eggs Pays Off,* WALL ST. J., Aug. 13, 1984; 2)

Actions against other Refco individuals: 1) In 1994 Robert L. "Red" Bone, a Reco Inc. broker at the firm's Springdale, Arkansas office, "was disciplined by regulators for a variety of wrongdoing both before and after [Hilary Rodham] Clinton's successful foray into cattle-futures trading in the late 1970s." Jeffrey Taylor and Bruce Ingersoll, *Hillary Clinton's Commodities Broker Was Disciplined for Variety of Violations*, WALL. ST. J., March 29, 1994; 2) In 1980 the Merc conducted an investigation which did not target Clinton, but rather focused on Bone and Refco and the block trades. Bone was suspended for a year for "'"serious and repeated violations of record-keeping functions, order-entry procedures, margin requirements, and hedge procedures.'" and Refco was fined $250,000 and Dittmer's trading privileges were suspended for six months. Block trading was not specified in the Merc's announcement of the action. Jeffrey Taylor, *Chicago Merc Has Trade Data On First Lady --- Activity May Have Been Part of Controversial `Block' Futures Trading*, WALL ST. J., April 28, 1994.

[3] The Commodity Exchange Act is codified at 7 U.S.C. § 1, et seq.

[4] Other pre-offering participants should have more of a responsibility in discovering the fraud perpetrated – such as the accountants and the regulators. For example regulators are scrutinizing the activities of the law firm, Mayer Brown Row & Maw, and its role in drafting the Refco CEO Phillip Bennett's related loan documents that are at the crux of the Refco scandal. *See* Matthew Goldstein, *Going After the Lawyers in Refco's Stunning Fall*, THESTREET.COM, Nov. 21, 2005, http://www.thestreet.com/pf/markets/matthewgoldstein/10253733.html (last visited April 24, 2007) (Refco relied upon Mayer Brown to handle most of its litigation and perform all of its corporate legal work.). *Id.* (Joseph Collins, a Mayer attorney who worked directly with Refco, also performed legal work for Bennett's privately owned Refco Group Holdings Inc.). *Id.*

[5] *In re Refco, Inc. Securities Litigation*, 05 Civ. 8626, SDNY, First Amended Consolidated Class Action Complaint, May 5, 2006, para. 55-69, *available at* 2006 WL 1627495.

[6] Elliot Blair Smith, *Refco's Flameout Ends History of Ups, Downs*, USATODAY.COM, Nov. 8, 2005, *available at* http://www.usatoday.com/money/industries/brokerage/2005-11-08-refco-usat_x.htm (last visited April 19, 2007).

[7] Ray E. Friedman, the founder of Refco's predecessor, was convicted in 1952 by a federal court in Iowa of conspiracy to defraud the government. Bennett's Refco Scheme Exposed by Hunch: 'It Hit Me' (Correct), October 27, 2005, BLOOMBERG.COM, *available at* http://quote.BLOOMBERG.COM/apps/news?pid=nifea&&sid=aNbiVOYM8VMA (last visited April 19, 2007).

Friedman spent 23 months years in prison "for selling substandard chickens to the Army during the Korean War," Carrick Mollenkamp, *Behind Wall Street failure: Unregulated Bermuda unit*, The Assoc. Press, July 3, 2006.

President Lyndon Johnson granted him a ``full and unconditional'' pardon in June 1966. Bennett's Refco Scheme Exposed by Hunch: 'It Hit Me' (Correct), October 27, 2005, BLOOMBERG.COM, http://quote.BLOOMBERG.COM/apps/news?pid=nifea&&sid=aNbiVOYM8VMA (last visited April 19, 2007).

In 1966 Friedman left the Army and "moved to Chicago to learn the commodities trade." Elliot Blair Smith, Refco's Flameout Ends History of Ups, Downs, Nov. 8, 2005, USATODAY.COM, *available at* http://www.usatoday.com/money/industries/brokerage/2005-11-08-refco-usat_x.htm (last visited April 26, 2007).

In 1967 while working as a clerk on the Mercantile Exchange floor, he bough more egg futures than he intended. However, he handled this purchase "because only about 10% or less of a contract's face value must be posted," and he waited out the market until "eggs mounted a surprising rally," and "he made more than $165,000" on the "mistake." Richard Gibson and Jeffrey Zaslow, *Brash Trader: Thomas Dittmer Roils Commodities Markets With Clout, Timing --- But He and Refco, His Firm, Are Set Back in Lawsuit Involving Cattle Futures --- A Mistake in Eggs Pays Off,* WALL ST. J., Aug. 13, 1984.

With the profits from this "mistake" he bought a seat on the Merc and financed the startup of Ray E. Friedman. later named Refco. In the matter of Stuart N. Gimbel, Philip Getson, David Mondi and Roman Sasin, Respondents, CFTC Docket No. 84-20, July 28, 1986, Respondent Getson's Motion for Final Order and Withdrawal of Appeal, CFTC No. 84-20, 1986 WL 65845, at *4, para. 5; *see also* Richard Gibson and Jeffrey Zaslow, *Brash Trader: Thomas Dittmer Roils Commodities Markets With Clout, Timing --- But He and Refco, His Firm, Are Set Back in Lawsuit Involving Cattle Futures --- A Mistake in Eggs Pays Off,* WALL ST. J., Aug. 13, 1984.[7] Ray E. Friedman died in November 2004 at the age of 91. Elliot Blair Smith, Refco's flameout ends history of ups, downs, USA Today, Nov. 8, 2005, *available at* http://www.usatoday.com/money/industries/brokerage/2005-11-08-refco-usat_x.htm.

[8] *Bennett's Refco Scheme Exposed by Hunch: 'It Hit Me'* (Correct), BLOOMBERG.COM, October 27, 2005, http://quote.BLOOMBERG.COM/apps/news?pid=nifea&&sid=aNbiVOYM8VMA (last visited April 13, 2007).

[9] Richard Gibson and Jeffrey Zaslow, *Brash Trader: Thomas Dittmer Roils Commodities Markets With Clout, Timing --- But He and Refco, His Firm, Are Set Back in Lawsuit Involving Cattle Futures --- A Mistake in Eggs Pays Off*, WALL ST. J., Aug. 13, 1984.

[10] *Id.*

[11] Carrick Mollenkamp, *Behind Wall Street failure: Unregulated Bermuda unit*, ASSOC. PRESS, July 3, 2006. Futures contract are "agreements to buy or sell a specified amount of goods at a set price on a specific date, which allow buyers and sellers to hedge against price swings and speculators to bet on price moves." *Id.*

[12] *Bennett's Refco Scheme Exposed by Hunch*, *supra* note 9. Under Dittmer's tutelage, in the 70's Refco "scored one of the best-known coups in commodity trading history," when Dittmer bought "cattle futures at 53.5 cents a pound in 1978 and rode the market up to 79.75 cents." Refco profited millions of dollars from this historic "coup," which a competition said "'we'll probably be reading about 50 years from now.'" In 70s and the 80's Dittmer owned more than an 80% interest in Refco. Gibson & Zaslow, *supra* note 10.

[13] Gibson & Zaslow, *supra* note 9.

> According to one Refco broker, Jack R. Musteen, he made $100,000 in commissions a month, another Refco broker, Steven Johns said that he bought "'at least' a dozen corvettes." Another Refco employee said that "'money was coming in so damn fast, everyone was buying up 1,000-acre farms, trying to keep it away from Uncle Sam.'"

Id.

[14] Gibson & Zaslow, *supra* note 9.

[15] *Id.*

[16] *Id.* Although there was no illegality in moving the market in commodity futures, there was illegality in exceeding the size limits of individual traders' positions. Refco's influence on the market was undeniable. In 1982, a shortage of coffee occurred after Refco bought large amounts of coffee futures for a coffee-exporting interests. *Id.*

[17] Jeffrey Zaslow, *Refco Finishes Reorganization Of Its Affiliates --- Futures Brokerage Intends To Spruce Up Image, Make More Acquisitions*, WALL ST. J., Aug. 14, 1985. Tone Grant came from the Commerce Union Corp, a Nashville Tennessee bank holding company, where he was senior vice president and general counsel.

[18] *Bennett's Refco Scheme Exposed by Hunch*, *supra* note 8.

[19] Reifler, Friedman's grandson, says "he walked into Bennett's office one day to find Bennett crawling around on the floor, as if he were looking for a contact lens. 'What are you doing?' Reifler says he asked Bennett. ``'I'm looking for your customers, Brad,' Bennett replied, according to Reifler. " *Refco's Collapse Reveals Decades of Quarrels With Regulators*, Jan. 5, 2006, BLOOMBERG.COM, *available at* http://www.BLOOMBERG.COM/apps/news?pid=nifea&&sid=a50aqPG7x7qo.

[20] Bennett's Refco Scheme Exposed by Hunch: 'It Hit Me' (Correct), October 27, 2005, BLOOMBERG.COM, *available at* http://quote.BLOOMBERG.COM/apps/news?pid=nifea&&sid=aNbiVOYM8VMA (last visited April 19, 2007); *see also* Edward Robinson, *Refco's Collapse Reveals Decades of Quarrels with Regulators,* BLOOMBERG.COM, Jan. 5, 2006, http://quote.BLOOMBERG.COM/apps/news?pid=nifea&sid=a50aqPG7x7qo (last visited Apr. 19, 2007).

[21] Edward Robinson, *Refco's Collapse Reveals Decades of Quarrels with Regulators*, BLOOMBERG.COM, Jan. 5, 2006, *available at* http://quote.BLOOMBERG.COM/apps/news?pid=nifea&sid=a50aqPG7x7qo (last visited Apr. 19, 2007).

[22] *Id.*

[23] Edward Robinson, *The rise and fall of Refco and its maverick chief,* INT'L HERALD TRIBUNE, Jan. 6, 3006, *available at* http://www.iht.com/articles/2006/01/05/news/bxrefco.php. The National Futures Association indicates that Refco LLC has had 147 CFTC cases, 24 NFA Arbitration Actions, and 133 Exchange Regulatory Actions, s*ee* NFA, Refco LLC, *available at* http://www.nfa.futures.org/basicnet/Details.aspx?entityid=0001975&rn=N.

[24] *Id.*

[25] *See* NFA, Refco LLC *available at* http://www.nfa.futures.org/basicnet/Details.aspx?entityid=0001975&rn=Y; and Refco Inc. *available at* http://www.nfa.futures.org/basicnet/Details.aspx?entityid=0001975&rn=N.

[26] Mollenkamp, *supra* note 11.

[27] Gibson & Zaslow, *supra* note 9. Around the same time, the FBI, in order to "familiarize themselves with commodities-trading figures," "obtained a videotape of a lavish party that Mr. Dittmer threw for Mr. Friedman's 65th birthday." *Id.* Apparently during this time Dittmer was "baffled by the scrutiny attracted by his freewheeling ways."

> . . . says Michael Weiner, an exchange vice president at the time, 'There was an honest frustration on his part. He couldn't understand what all the fuss was about." Like many commodity traders, Mr. Dittmer seems to see the market as the ultimate regulator; he told this newspaper in an interview several years ago, "You can take all the regulators, all the exchanges, everybody, and there's still only one thing that will regulate anything, and that's the market. Over time, it will make small men big and big men small.'

Id.

[28] Dittmer, who apparently was also the President of Refco at this time, was barred for 120 days from trading cotton futures and paid a $150,000 fine. Gibson & Zaslow, *supra* note 9.

[29] Zaslow, *supra* note 18. ("Refco accepted the fines in a consent decree but didn't admit or deny the allegations."). Tone Grant, a former Marine Corps prosecutor, Refco's Executive Vice President and General Counsel, and Dittmer's Lawyer, stated that Dittmer, "'didn't want to be in an adversarial relationship' with the commission." This fine was the largest ever assessed by the CFTC. Gibson & Zaslow, *supra* note 9.

[30] Bruce Ingersoll, *Refco and Paragon charged by CFTC With Violation*, WALL ST. J., June 8, 1988.

> In an administrative complaint, the agency held Refco liable for the alleged violations of Paragon, its owner and eight salesmen who funneled futures business to Refco.
>
> Under a 1982 amendment to the Commodity Exchange Act, independent retail sales firms can serve as "introducing brokers" for large commodity firms. In this instance, Refco guaranteed the performance of Paragon, which acted as a Refco branch office, according to CFTC officials.
>
> The alleged violations occurred between April 1985 and July 1985, when Refco revoked its guarantee agreement with Paragon and the sales firm went out of business. Refco is only the second commodity firm to be held liable for an introducing broker's conduct, CFTC officials said.
>
> The churning of customers accounts, according to a CFTC official, 'wasn't confined to Paragon. Two Refco brokers were charged with churning customers accounts between February 1985 and June 1985 before they joined the Paragon sales force.'
>
> The Refco spokesman said Paragon had been one of the Refco Group Ltd. unit's 120 introducing brokers. The alleged churning occurred in 12 customer accounts with assets totaling $66,000, he said.
>
> 'Only three customers complained about the handling of their accounts at Paragon, and Refco quickly satisfied all three claims,' the spokesman said. 'Refco terminated Paragon within one month of the first complaint about it, whereas the CFTC has taken three years to take any action against Paragon.'

Id.

[31] *Refco to Pay Fine Of $220,000 to Settle Charges by CFTC*, WALL. ST. J., Aug. 30, 1990.

> Refco was charged with failing to maintain the records, failing to retain customer risk-disclosure statements, failing to supervise, and violating two cease-and-desist orders entered by the CFTC in 1983 and 1988 relating to record keeping and supervision charges. The CFTC charges involved Dittmer's stepfather, Refco founder Ray Friedman, who the CFTC alleged traded, beginning in June 1988 and continuing for about a year, for an unnamed customer and "violated speculative position limits for pork belly futures on the Chicago Mercantile Exchange." Friedman, who also settled the charges, himself was charged with "aiding and abetting Refco in not keeping written records of the orders."
>
> In a prepared statement, Refco said: 'The alleged record-keeping violations did not affect the profitability of customer accounts. It is Refco's intent to comply with all applicable laws, rules and regulations. Refco has settled this matter in order to maintain its positive working relationship with the CFTC and to avoid the costs and distraction of protracted litigation.'

Id.

[32] *In the Matter of Refco, Inc, Respondent*, CFTC Docket No. 92-15, Mar. 12, 1992, CFTC No. 92-15, 1992 WL 52595; *see also* News Release, *Commission Settles Charges Against Ray Friedman and Refco Inc.*, Mar. 12, 1992, CFTC 3471-92, 1992 WL 99740; *see also* Refco, Inc. and Ray E. Friedman, CFTC Docket No. 90-21, Mar. 12, 1992, CFTC No. 90-21, 1992 WL 52585, Order of Dismissal, George H. Painter, Administrative Law Judge.

[33] News Release, *Commission Settles Charges Against Ray Friedman and Refco Inc.*, Mar. 12, 1992, CFTC 3471-92, 1992 WL 99740.

[34] Some articles state that Ray E. Friedman is the father-in law of Mr. Dittmer, other articles state that Friedman is Dittmer's step father.

[35] *See In the Matter of Refco, Inc, Respondent*, CFTC Docket No. 92-15, Mar. 121, 1992, CFTC No. 92-15, 1992 WL 52595, para # 3-4, *1; *see also see also* News Release, *Commission Settles Charges Against Ray Friedman and Refco Inc*., Mar. 12, 1992, CFTC 3471-92, 1992 WL 99740.

> The charges stemmed from alleged speculative position limit violations by Friedman who was trading pork belly futures in conjunction with certain of his customers on the Chicago Mercantile Exchange through accounts maintained at REFCO. The sanctions imposed by the Commission include civil penalties totaling $590,000 for REFCO and Friedman.

Id.

[36] *In the Matter of Refco, Inc, Respondent*, CFTC Docket No. 92-15, Mar. 12, 1992, CFTC No. 92-15, 1992 WL 52595.

[37] Kevin G. Salwen, *Refco Runs Afoul Of U.S. Regulators For the Fifth Time*, WALL ST. J., Mar. 13, 1992; *see also* Refco, Inc. and Ray E. Friedman, CFTC Docket No. 90-21, Mar. 12, 1992, CFTC No. 90-21, 1992 WL 52585, Order of Dismissal ("Notwithstanding the fact that the amended complaint names Refco as a respondent and that the order accepting the offer of respondent Friedman refers to the complaint and not the amended complaint, counsel for the Division of Enforcement informs the court that the opinion and order filed by the Commission on March 4, 1992, terminates the proceedings in Docket Number 90-21."); *see also* In the matter of Refco, Inc. and Ray E. Friedman, Opinion and Order Accepting Offer of Settlement of Ray E. Friedman, CFTC Docket No. 90-21, Mar. 4, 1992, 1992 WL 48913.

[38] *Id.*

[39] Salwen, *supra* note 37.

> CFTC Enforcement Director Dennis Klejna said the repeated problems at the firm were a major reason for the stiff penalty over apparently minor violations in a thinly traded contract. "The important thing from the enforcement standpoint is that they violated three different cease-and-desist orders," he sa*id.* "That provided us with a lot of concern." In addition to the three other settled cases with the CFTC, another Refco administrative case is on appeal to the full commission.

Id.

[40] Jeffrey Taylor, *CFTC Fines Refco $1.25 Million Over Complaint*, WALL ST. J., Dec. 21, 1994. According to the CFTC, Refco would:

> The complaint says that during this period, Refco routinely wire-transferred sums ranging from $2 million to $123 million from its segregated customer account to Refco Capital for the unit's use. Refco Capital would issue checks to cover these sums and deposit them into Refco's segregated account, but often there wasn't enough money in Refco Capital's account to cover the checks, the complaint asserts. Because of the transfers, Refco had insufficient money segregated for its customers' accounts in amounts ranging from $219,000 to $102 million at various times, the complaint says.

Id.

[41] *Id.*

> 'The complaint alleges that Refco Capital Corp. used Refco Inc. customer funds to pay down its overnight loans,' said Dennis Klejna, the CFTC's enforcement director. 'The Commodity Exchange Act requires that customer funds be segregated from company assets. That's a core, key, sacrosanct provision of the act.'
>
> In addition to yesterday's filing, the CFTC has disciplined Refco five times in the past 11 years, imposing fines of $375,000 in 1983, $21,000 in 1988, $220,000 in 1990 and $440,000 in 1992, Mr. Klejna sa*id.* 'This new fine is so high because of this enforcement history, and because they violated cease-and-desist orders entered in three of the previous cases,' Mr. Klejna said.

Id.

[42] *Refco Agrees to Pay Total of $3.5 Million To Settle SEC Action*, WALL ST. J., Aug. 7, 1996. Four separate SEC legal proceedings were settled by Refco and three of its former employees yesterday in Los Angeles and Washington, bringing an end to the SEC's five-year investigation of Mr. Wymer, who defrauded dozens of municipalities in California, Iowa and Colorado of about $174 million. Ms. Cacheris said 17 of Mr. Wymer's clients held brokerage accounts with Refco. "This should be the final chapter," she added. *Id.*

[43] Mr. Reifler is now CEO of Pali Capital Inc, a securities brokerage based in NY. *Refco's Collapse Reveals Decades of Quarrels With Regulators*, BLOOMBERG.COM, Jan. 5, 2006, http://www.BLOOMBERG.COM/apps/news?pid=nifea&&sid=a50aqPG7x7qo (last visited Apr. 18, 2007).

[44] Philip Boroff, *Refco Plans to Auction Collection of Photos by Warhol, Gursky*, BLOOMBERG.COM, Jan. 19, 2006, http://www.BLOOMBERG.COM/apps/news?pid=10000088&sid=a.i9lgCespDU&refer=culture (last visited Apr. 18, 2007).

[45] *Refco's Collapse Reveals Decades of Quarrels With Regulators*, BLOOMBERG.COM, Jan. 5, 2006, http://www.BLOOMBERG.COM/apps/news?pid=nifea&&sid=a50aqPG7x7qo (last visited Apr. 18, 2007).

[46] Elliot Blair Smith, *Refco's flameout ends history of ups, downs*, USA TODAY, Nov. 8, 2005, *available at* http://www.usatoday.com/money/industries/brokerage/2005-11-08-refco-usat_x.htm.

[47] *Harish and Indra Pal v. Reifler Trading Corp, and Refco, Inc, and Bradley C. Reifler*, CFTC Docket 95-R 151, February 2, 1998, *available at* http://www.cftc.gov/ogc/oporders98/ogcpal.htm.

[48] See National Future Association for actions against or involving Reifler Trading Corporation, *available at* http://www.nfa.futures.org/BasicNet/Details.aspx?entityid=0089767.

[49] *CFTC Files Administrative Complaint Against Reifler Trading Corp., Liberty Futures, Inc., and Three Individuals Alleging Unregistered "Correspondent" Relationships, Among Other violations of Federal Commodity Law and CFTC Regulations*, CFTC Release No. #4088-97, CFTC Docket #98-2, December 18, 1997, *available at* http://www.cftc.gov/opa/enf97/opareifler.htm.

[50] Laura Jereski and Aaron Lucchetti,, *The Market Calms Down: Niederhoffer Is Sunk By Market Maelstrom*, WALL ST. J., Oct. 30, 1997. Niederhoffer is a money manager and author of "The Education of a Speculator." *Id; see also* Aaron Lucchetti, *CFTC Plans Monitor of Brokers After Losses by Fund Manager*, WALL ST. J., Jan. 6, 1998 ("After taking a leveraged options position that would have gained in value if the S&P index rose or stayed relatively stable, Mr. Niederhoffer received a margin call for about $50 million from his clearing broker, Refco Inc., when the Dow Jones Industrial Average fell 554.26 points, or 7.18%, on Oct. 27.").

[51] Jereski & Lucchetti, *supra* note 50.

[52] *Id.*

[53] Aaron Lucchetti, *CFTC Plans Monitor of Brokers After Losses by Fund Manager*, WALL ST. J., Jan. 6, 1998.

[54] *Id.*

> The proposed rule change would effectively tighten the reporting requirements for futures brokers, who execute transactions and advise clients about trades in the volatile futures markets. Currently, such futures merchants keep records of their customers' trading positions and funds, but are not required to report daily fluctuations in those funds to the CFTC or other self-regulatory bodies. Under the proposed rule, however, futures brokers would have to notify regulatory authorities immediately if the segregated account of customer funds slipped too low. 'There were some problems' with the reporting of futures brokers' positions in listed stock-index derivative products during October 1997's stock-market volatility, said one person knowledgeable about the circulating rule proposal. 'There were some concerns that the reporting wasn't prompt enough.' While the 'segregated fund' requirement is generally regarded as a rarely used safeguard, concern about enforcing the guideline emerged in October, when stock indexes plummeted, then recovered, in volatility tied to Asian financial problems. CFTC had no ability to quickly discover whether or not there were "potential problems with Refco's segregated fund level," until Tuesday, a day after Niederhoffer's losses.`
>
> The rule, which comes in response to market volatility in October 1997, would require that brokers notify the CFTC or designated self-regulators in instances of insufficient funding. Currently, futures merchants keep records of their customers' trading positions and funds, but are not required to report daily fluctuations in those funds or cases of insufficient funding.
>
> 'The earliest possible notice of such an event should facilitate a resolution,' to underfunding problems, the CFTC said in a statement, adding that enhanced reporting decreases the chance that one firm's funding problems could touch off a "domino effect on other firms.' In October, no futures merchants experienced a financial failure, but 'certain futures commission merchants had difficulty' meeting fund requirements, the CFTC sa*id.* Much of the agency's concern was prompted by the losses of Victor Niederhoffer, a hedge-fund manager who sold volatile S&P 500 futures-options at the Chicago Mercantile Exchange in October. On Oct. 27, concern about Mr. Niederhoffer's losses sharpened to the point that his futures broker, Refco Inc., issued a statement assuring its own financial health.
>
> Brokerage firms "are not required to produce information about customer fund levels until noon the next business day. And while firms are obligated to keep 100% of customer funds set aside, they are not required to report instances in which those funds slip below the required level."
>
> The concern about segregated funds stemmed from the possibility that losses could have damaged the brokerage firm's ability to keep its obligation to its customers. While a regulator close to the situation said no problems emerged with Refco's segregated funds, the time lapse and lack of reporting requirements could allow precious hours to slip away before action is taken to stem losses.
>
> The CFTC has "to know about those problems as soon as they develop," said one industry official with knowledge of the talks. The agency simply "wasn't getting information fast enough on the 27th," of October. While many firms have knowledge about customer fund problems well before they are required to compile the information, some industry observers say the rule change would raise questions about futures brokers' responsibility to report short, temporary situations of inadequate funding because of transfers.

Id.

[55] Board Notice 612 Disciplinary Action, The Securities and Futures Authority, London, Jan. 11, 2002, Refco Overseas Limited and David Campbell, *available at* http://www.fsa.gov.uk/pubs/additional/612.pdf.

> ROL's main business activity is acting as a clearing and execution broker in financial and commodity derivatives products. Mr Campbell joined ROL in August 1998 and was formally registered as Senior Executive Officer in November 1998. At the material time ROL maintained a branch office in Rome. Business from the Rome branch was handled by ROL's financial futures desk. The Rome branch also reported to London on all business, administrative and operational matters and ROL was responsible for Rome's compliance function.
>
> The case relates to the circumstances in which a broker at the Rome branch ("the Rome Broker") was involved in a fraudulent scheme with the employees of 3 ROL customers in Rome.

Between March and September 1999, the Rome Broker perpetrated the fraud by either withholding customer account details on placing orders with the financial futures desk in London or by amending customer account details after orders had been executed. The effect of the scheme was to divert substantial sums of money away from the other 3 customers causing them considerable losses, although some of those losses may have resulted from bona fide dealings.

Id.

[56] CFTC Release 5002-04, Oct. 4, 2004, *CFTC Settles Charges Against Three UK-Based Trading Firms For Participating In Illegal Wash Trades On U.S. Markets: Fimat International Banque SA, Refco Overseas Ltd. and Credit Lyonnais Rouse Limited Ordered to Pay Total of $75,000 in Civil Penalties*, *available at* http://www.cftc.gov/opa/enf04/opa5002-04.htm.

[57] Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions, CFTC Docket No. 04-27, *In the Matter of Refco Overseas Limited, Respondent*. Sept. 29, 2004, *available at* http://www.cftc.gov/files/enf/04orders/enf-refco_overseas-order.pdf. Refco "knowingly participated in illegal wash trading on the Coffee, Sugar & Cocoa Exchange (CSCE), which, at the time, was a subsidiary of the New York Board of Trade. The CFTC issued orders imposing a civil penalty and other sanctions on each respondent." *See* CFTC Release, *supra* note 56.

[58] Refco Group Ltd., LLC and Refco Finance Inc, 8K filed May 16, 2005, *available at* http://sec.gov/Archives/edgar/data/1305464/000110465905023812/a05-9509_18k.htm.

[59] *See* BAWAG Web page, *available at* http://www.bawag.com/bawag/home/nav__en.html. BAWAG was first named "Arbeiterbank" and renamed "Bank für Arbeit und Wirtschaft" in 1963." BAWAG web page, "Bawag History," http://www.bawagpsk.com/bawagpsk/UeberUns/UeberUns__en/Firmengeschichte__en,templateId =render,setId=bawagpsk,path=_2A125984_2A_2F126866_2F125984_2F122828_2FCR122828_2FCD121012.html (last visited April 4, 2007); *see also* DËR STANDARD (Oliver Schopf) political cartoon (cover page), *available at* http://www.oliverschopf.com/ir/pol_kar/oester/o603x486/bawag.jpg (last visited April 5, 2007) (Caption reads: "Die Vogelgrippe!!" Translated: "The Bird Flu!!").

[60] *See SEC Files Settled Action Against Major Austrian Bank for Aiding And Abetting Refco Fraud*, SEC Litigation Release No. 19716, June 5, 2006, *available at* http://www.sec.gov/litigation/litreleases/2006/lr19716.htm (last visited March 17, 2007); *and* SEC civil enforcement complaint in the matter captioned *SEC v. BAWAG P.S.K. Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse Aktiengesellschaft,* Case No. 06 CV 04222 (DC) (J. Chin, S.D.N.Y.), filed June 5, 2006, *available at* http://www.sec.gov/litigation/complaints/2006/comp19716.pdf (last visited March 17, 2007).

[61] *See*, *e.g.*, NASD BrokerCheck re Pond Equities (CRD# 30934), http://www.brokercheck.nasd.com (at least 13 different state and/or federal regulatory events cited) *see also* http://www.nasd.com/web/groups/enforcement/documents/monthly_disciplinary_actions/nasdw_015733.pdf (last visited April 5, 2007).

[62] *See* SEC Litigation Release in the matter of SEC v. Badian, *et al*., Case No. 06-CV-2621 (SDNY), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19639.htm (last visited April 8, 2007); *see also* SEC Complaint filed April 3, 2006, *see*, *e.g.*, Complaint at ¶¶ 35-38, p. 10, *available at* http://www.sec.gov/litigation/complaints/2006/comp19639.pdf (last visited April 8, 2007).

[63] *See SEC v. Badian*, *et al*., Case No. 06-CV-2621 (SDNY), Complaint filed April 3, 2006, *available at* http://www.sec.gov/litigation/complaints/2006/comp19639.pdf (last visited April 8, 2007).

[64] *See Austrian Bank "Bawag" to Pay $337.5 million for Restitution to Victims of Refco Fraud*, U.S. DOJ PRESS RELEASE, June 5, 2006, *available at* http://www.usdoj.gov/usao/nys/pressreleases/June06/bagwagnon-prosecutionagreementpr.pdf (last visited April 5, 2007) ("against BAWAG arising from its involvement with the

fraud at Refco. In total, BAWAG and the ÖGB will pay at least $675 million in connection with the non-prosecution agreement and to settle the bankruptcy estate claims against them. The Government will distribute half of the $337.5 million in forfeited funds to the Refco bankruptcy estate, and half to other victims of the Refco fraud."). *Id.* Refco first disclosed these U.S. investigations in an October 12, 2004 Form S4 Registration Statement related to the public issuance and sale of $600 million in senior subordinated notes related to the financing of a partial leveraged buyout of a portion of Refco's equity by private equity firm Thomas H. Lee Partners, *available at* http://www.sec.gov/Archives/edgar/data/1305464/000104746904030948/a2144492zs-4.htm (last visited April 4, 2007). Refco specifically disclosed:

> SEC Investigation
>
> In 2001, the Division of Enforcement of the SEC commenced an informal investigation into short sales of the stock of Sedona Corporation. The SEC requested that we produce documents relating to any of our accounts that traded in the stock of Sedona. In June 2001, the SEC issued a formal order of investigation into short sales of Sedona stock and other transactions. In 2002 and 2003, we received subpoenas from the SEC and a request for a written statement. Generally, the subpoenas and the request required the production of documents, tapes and information regarding two of our former brokers who handled the account of Amro International, S.A., one of our former customers that engaged through its account with us in short sales of Sedona stock and whose financial advisor settled SEC charges with respect to such short sales in February 2003; our relationship with Amro and its two principals; other securities traded by Amro; and our record keeping, supervisory and short sale policies and restrictions. Although there were issues previously raised by the SEC with respect to document production and retention by us, we believe that we have now substantially complied with those subpoenas and requests. In October 2003, we received a subpoena from the U.S. Attorney's Office for the Southern District of New York, which called for the production of documents we had produced to the SEC. In addition to producing documents in response to the foregoing subpoenas, we have made our employees available to testify before the SEC and to be interviewed by the U.S. Attorneys' office. Refco Securities, LLC has been advised that it is not currently the subject of the U.S. Attorneys' investigation. At the present time, it is not possible to predict the outcome of the foregoing investigations with certainty.

Id. [italics in original]; *see also SEC v. Rhino Advisors, Inc. and Thomas Badian*, Feb. 27, 2003 settled SEC Enforcement complaint, *available at* http://www.sec.gov/litigation/complaints/comp18003.htm (last visited Jan. 27, 2007) (The SEC had brought (and settled) an enforcement action against the unidentified "financial advisor settled SEC charges with respect to such short sales in February 2003."). *Id.*

[65] Thomas Badian fled the United States after the U.S. Attorney brought criminal charges in the Southern District of New York alleging a criminal conspiracy to commit securities fraud in violation of *18 U.S.C. § 371* against him in this District on or about December 3, 2003 see *USA v. Badian et al.*, Case No. 1:03-mj-02355-UA (SDNY). Mr. Badian's last reported whereabouts were, of all places, Vienna, Austria, according to *Time Magazine*. *See* Daniel Kadlec, *Watch Out, They Bite!*, TIME, Nov. 09, 2005, *available at* http://www.time.com/time/printout/0,8816,1126706,00.html (last visited April 7, 2007).

> Thomas Badian was expecting a package, just not this one. Standing in his doorway, smiling, he opened the envelope a courier handed to him. Then he froze, and the color drained from his face. It was over: after two years overseas, the former New York City hedge-fund operator had been located. Badian slammed the door of his posh Vienna, Austria, apartment in the heart of the city's embassy quarter--but not before being officially served with a civil lawsuit linking him to the beleaguered U.S. commodities firm Refco and tying him and Refco to a type of fraud that some argue has destroyed thousands of companies and bilked investors out of billions of dollars.

Id.

[66] *Ex-Bawag CEO is extradited*, INT'L HERALD TRIBUNE, Feb. 14, 2007.

> Elsner helped to cover up the losses over many years in offshore accounts at Refco, the now collapsed U.S. broker, and by using the assets of OeGB, the Austrian trade union federation, as collateral, according to the central bank's investigation. Bawag, formally known as Bank fur

> Arbeit und Wirtschaft, has also been under investigation for lending Phillip Bennett, Refco's former chief executive, several hundred million dollars just before the brokerage firm filed for bankruptcy in 2005.

Id.

[67] Vernon Silver, Otis Bilodeau, Matthias Wabl, Julia Werdigier, and Allan Dodds Frank, *Refco's Bad Bank*, BLOOMBERG MARKETS, August 2006 *available at* http://www.bloomberg.com/news/marketsmag/bawag.pdf. Particularly "Thomas Hackl: Man in the Middle," at 6.

[68] *Id.*

[69] *Id.*; *see also* SEC filings where Mr. Hackl acted as signatory for various Liechtenstein-based hedge funds controlled by BAWAG, *available at* http://www.secinfo.com/$/SEC/Name.asp?X=thomas+hackl&List=S#Signatory (last visited April 8, 2007).

[70] Silver, *supra* note 67.

> Thomas Hackl was running the treasury and investment banking units at Austria's Bawag PSK Bank on Feb. 21, 2002, when an e-mail from Santo Maggio, a top executive at U.S. futures broker Refco Inc., appeared on his computer. 'Good Morning Thomas,' Maggio began, according to the e-mail, which was obtained by U.S. investigators. He then outlined a transaction prosecutors say was central to the multibillion-dollar fraud that caused New York–based brokerage Refco to collapse in bankruptcy last year.
>
> Maggio wanted to confirm the wire instructions for two cash transfers. Bawag was to cable $300 million to Refco. The same day, Refco would send $210 million back to Bawag, Austria's fourth-largest bank. 'If you have any questions, please contact me,' Maggio wrote in the e-mail, a copy of which was used as evidence in a lawsuit filed against Bawag by Refco's creditors on April 21. He signed off, 'Regards, Sandy.'
>
> The transaction was one of six so-called round-trip loans that Maggio's boss, Refco Chief Executive Officer Phillip Bennett, used to mask the company's true financial condition, U.S. prosecutors said as part of a June 2 settlement that allowed Bawag to avoid criminal charges. Bennett, 57, borrowed $1.6 billion from Vienna-based Bawag over six years to conceal debts he kept off Refco's balance sheet, the U.S. said in the non-prosecution agreement. Maggio's lawyer, Paul Shechtman, declined to comment.

Id.

[71] *Id.*

> Hackl hasn't been accused of wrongdoing. In an e-mail response to questions, Hackl said he left Bawag as an employee in 2002 and remained affiliated with Bawag until the end of 2004. He declined to elaborate. Avraham Moskowitz, a New York–based lawyer who represents him, says Hackl took orders from others. 'He acted at all times as a functionary,' Moskowitz says. 'Everything he did was at the direction of his superiors, either at Bawag or at Refco.'
>
> Wittingly or not, Hackl played a key role in the web of dealings between Refco and Bawag, including the bank's efforts to hide a loss of almost ¤350 million from hedge fund investments in 2000, according to four people with direct knowledge of investigations in Austria and the U.S.
>
> One former top executive at Bawag told investigators that Hackl proposed shifting the loss to an offshore fund called Liquid Opportunities. On Dec. 28, 2000, Bawag wired €364 million to a Liquid Opportunities account at Refco, according to the U.S. non-prosecution agreement. The fund sent Bawag €364 million on the same day, wiping the loss off its books, the agreement says. Five years later, Hackl bought Bawag's stake in Liquid Opportunities and seven Anguilla-based companies the bank also used to hide losses.

Id.

[72] *U.S. Indicts Former Owner of Refco and Expands Charges in Refco Fraud,* DOJ Release, United States Attorney, Southern District of New York, Jan. 16, 2007, *available at* www.usdoj.gov/usao/nys/pressreleases/January07/bennetttrostengrantrefcoS3indictmentpr.pdf; *see also* Mollenkamp, *supra* note 11 ("Refco Capital Markets also made big loans to customers to finance high-risk investments. When these clients were unable to cover trading losses, the unit helped hide the bad loans, the civil and criminal actions allege.").

[73] See US Indictment, Phillip R. Bennett, Robert C. Trosten and Tone N. Grant, Jan. 16, 2007, No. 05CR01192, S.D.N.Y., *available at* 2007 WL 185717, para. 6; *see also U.S. Indicts Former Owner of Refco*, *supra* note 73.

[74] *U.S. Indicts Former Owner of Refco*, *supra* note 72.

[75] *Id.*

[76] Mollenkamp, *supra* note 12.

[77] See Refco website archive, May 20, 1999 Refco press release headline, *available at* http://web.archive.org/web/19991117040513/www.refco.com/news/news.asp (last visited April 4, 2007).

[78] Richard Beales, Doug Cameron, Jeremy Grant, Andrew Parker, James Politi, Haig Simonian, Peter Thal Larsen, and David Wighton, *A crisis of confidence: how Refco veered from a Wall Street debut into bankruptcy* FIN. TIMES, Nov. 11, 2005. *See also Refco Collapse May Force Austria's Bawag to Tighten Loan Rules,* BLOOMBERG, Nov. 16, 2005, *available at* http://www.BLOOMBERG.COM/apps/news?pid=10000085&sid=aoEKr.KLPMi4&refer=europe (last visited April 7, 2007); *see also* Lars Toomre, *Austria Issues Arrest Warrants for Wolfgang Floettl and Phillip Bennett*, March 28, 2006, *available at* http://www.toomre.com/node/332/ (last visited April 5, 2007).

> With recent news that Wolfgang Floettl also incurred unreported losses at Bawag during the period of 1996-2000, one has to seriously question just how 'arm's length' all transactions between Refco and Bawag ever were subsequent to mid-year 1997. For instance, since Wolfgang Floettl was the son of the head of Bawag bank (widely known as "Mr. Bawag") and he is rumored to have incurred serious losses that were concealed by both institutions, one might reasonably question why and at what price Bawag agreed to purchase 10% of Refco in 1999.

Id.

[79] *See* Beales, *supra* note 78.

[80] Laura Jereski and Aaron Lucchetti, *The Market Calms Down: Niederhoffer Is Sunk By Market Maelstrom*, WALL ST. J., Oct. 30, 1997.

> In 1997 Victor Niederhoffer, money manager and author of "The Education of a Speculator," "wiped out" his entire equity positions of $130,000, after a "ballooning losses in an option position prompted a margin call. Niederhoffer Investments Inc., marketing manager Albert Hallac, said that "Refco Inc. -- through which Mr. Niederhoffer executed his trades -- has taken effective control of what remains of the portfolio." To counteract :"rumours" that Refco would be on the hook for millions as a result of Niederhoffer's loses, Refco issued a statement that "it was financially fine," however Refco President Tone Grant refused to comment on the conditions of Niederhoffer's portfolio and whether he still owed Refco money.) *Id*

Id., *see also* Lucchetti, *supra* note 53.

> Niederhoffer was a "hedgefund manager who made a bet on S&P 500 futures-options at the Chicago Mercantile Exchange." "After taking a leveraged options position that would have gained in value if the S&P index rose or stayed relatively stable, Mr. Niederhoffer received a margin call for about $50 million from his clearing broker, Refco Inc., when the Dow Jones Industrial Average fell 554.26 points, or 7.18%, on Oct. 27." It was confirmed later that Niederhoffer did owe Refco "millions of dollars," and regulators believed the amount "exceeded $40 million at its peak." Refco denied any financial trouble.

Id.

[81] Jereski & Lucchetti, *supra* note 80.

> Refco and Bawag had strong ties. In 1999, the bank had bought a 10 per cent stake in Refco, which it sold in 2004. Bawag's long-time chief executive had been Walter Flöttl, who stepped down in 1994 after it emerged that the bank had lent Dollars 2bn to Ross Capital, his son Wolfgang's Bermuda-based hedge fund. Ross Capital used Refco as its broker and ran up some losses during the financial crises of the late 1990s. But Wolfgang Flöttl, a prominent figure in the New York social scene, insists it did not leave Refco with any bad debts.

Id.

[82] John Maynard Keynes wrote in 1931, "markets can remain irrational far longer than you or I can remain solvent," *available at* http://www.maynardkeynes.org/ (last visited April 7, 2007).

[83] Haig Simonian, *Bawag concealed Euros 1.3bn losses for five years*, FIN. TIMES, Mar. 25, 2006 (The bank's "Caribbean losses arose from business with Ross Capital, a derivatives specialist run by Walter Flottl, son of a former Bawag chief executive. The biggest loss stemmed from a massive misplaced bet on Japanese rate swaps during the Asian financial crisis."). *Id.* Niederhoffer's losses were also incurred during the Asian financial crisis, in 1997. *See* Beales, *supra* note 78.

[84] *See, e.g.*, *Bawag Used Refco to Help Mask Almost EU1 Billion Loss (Update7)*, BLOOMBERG, March 24, 2006, http://www.BLOOMBERG.COM/apps/news?pid=10000085&refer=europe&sid=aDqt_Mdn6iwU (last visited April 8, 2007) ("The Japanese yen fell for eight straight weeks in 2000, <u>the longest continuous decline in half a decade</u>. It fell 11 percent against the euro and 5.6 percent against the dollar during the last quarter of the year."). *Id.* [emphasis added].

[85] *Flottl Charged with Improper Use of Bank's Funds*, AUSTRIA TODAY, Oct. 27, 2006.

[86] *See* Laura Jereski and Aaron Lucchetti, *The Market Calms Down: Niederhoffer Is Sunk By Market Maelstrom*, WALL ST. J., Oct. 30, 1997. In 1997 Victor Niederhoffer, money manager and author of "The Education of a Speculator," "wiped out" his entire equity positions of $130,000, after a "ballooning losses in an option position prompted a margin call. Niederhoffer Investments Inc., marketing manager Albert Hallac, said that "Refco Inc. -- through which Mr. Niederhoffer executed his trades -- has taken effective control of what remains of the portfolio." To counteract :"rumours" that Refco would be on the hook for millions as a result of Niederhoffer's loses, Refco issued a statement that "it was financially fine," however Refco President Tone Grant refused to comment on the conditions of Niederhoffer's portfolio and whether he still owed Refco money. *Id.*, *see also* Lucchetti, *supra* note 53 (Niederhoffer was a "hedgefund manager who made a bet on S&P 500 futures-options at the Chicago Mercantile Exchange." "After taking a leveraged options position that would have gained in value if the S&P index rose or stayed relatively stable, Mr. Niederhoffer received a margin call for about $50 million from his clearing broker, Refco Inc., when the Dow Jones Industrial Average fell 554.26 points, or 7.18%, on Oct. 27." It was confirmed later that Niederhoffer did owe Refco "millions of dollars," and regulators believed the amount "exceeded $40 million at its peak." Refco denied any financial trouble.) *Id.*.

[87] Beales, *supra* note 78.

[88] *See also See* David Crawford and Carrick Mollenkamp, *Bad Bet: How a Hedge-Fund Mogul Disrupted an Austrian Bank --- Mr. Flottl's Big Losses Triggered a Coverup; Selling the Van Gogh*, WALL ST. J., Jan. 25, 2007, available at http://online.wsj.com/article/SB116186493590604582.html?mod=hps_us_pageone (last visited Apr. 10, 2007) (Bawag also "lent Mr. Flöttl an additional $18 million to keep his Gulfstream jet aloft, according to the central bank audit last year.").

[89] *Refco, Bank Hid USD 1 Billion Loss from Hedge Funds, Arafat Casino*, June 22, 2006, AUSTRIA TODAY; *see also* Silver, *supra* note 67 ("Venedey says Bawag management's inability to provide checks and balances led

Moody's to downgrade the bank's financial strength rating on May 31 to E+, meaning 'very modest' strength, two notches above the lowest grade, from C+, defined as 'adequate.'"). *Id.*

[90] *See* BAWAG 2004 Annual Report, *available at* http://www.bawagpsk.com/bawag/Service/Downloads__Antraege/PDF/Ueber__uns/Geschaeftsberichte/Geschaeftsberichte__en/GSKonzern2004__en,property=Data.pdf (last visited April 4, 2007).

[91] Silver, *supra* note 67.

[92] *See*, *e.g.*, SPhinX, Ltd., *et al.* v. Phillip R. Bennett and BAWAG, Case No. 1:06-CV-05013, filed June 26, 2006 (SDNY), ¶ 49 at (numerated) page 12 of Complaint (later dismissed voluntarily on Jan. 23, 2007 pursuant to FRCP 41(a)). *See also* Silver, *supra* note 67.

[93] *U.S. Indicts Former Owner of Refco*, *supra* note 73.

> According to the superseding Indictment, from as early as the mid-1990s, Refco --which was then privately-held and controlled in part by Bennett and Grant -- sustained hundreds of millions of dollars of losses through its own and its customers' trading. In order to hide the existence of the losses, Bennett and Grant transferred many of them to appear as a debt owed to Refco by Refco Group Holdings, Inc. ('RGHI') -- the holding company that controlled Refco and was, in turn, controlled by Bennett and [Refco president Tone] Grant.

Id.

[94] *See Bawag Used Refco to Help Mask Almost EU1 Billion Loss (Update7)*, BLOOMBERG, March 24, 2006, http://www.BLOOMBERG.COM/apps/news?pid=10000085&refer=europe&sid=aDqt_Mdn6iwU (last visited April 7, 2007).

> 'A public debate would have impeded our efforts to minimize the damage,' [Guenter] Weninger, [65, the chairman of Bawag's supervisory board] said at the press conference, explaining why the losses weren't revealed sooner. 'I saw a danger that customers would leave, that jobs might be lost and that the bank would be harmed.'

Id.; *see also* Crawford, *supra* note 88.

> Bawag agreed to lend Mr. Floettl money to invest through his hedge fund, according to a prosecutor. The loans would be unsecured: If his investments went bad and he couldn't repay the loans, Bawag had no right to go after his other assets, the prosecutor says. What made the arrangement attractive to Bawag is that he would pay higher interest rates than customers in Austria, Mr. Elsner later told police and prosecutors.
>
> Beginning in late 1995, Bawag lent hundreds of millions of dollars to entities Mr. Floettl controlled, according to Bawag records. In the summer of 1998, with markets volatile, Mr. Floettl placed a big bet that the yen would fall against the dollar. 'But that didn't happen,' Mr. Floettl told Austrian prosecutors early last year, according to a transcript. 'The dollar weakened because of a crisis in the American financial market.'
>
> As his trading positions deteriorated, Wall Street firms issued margin calls, demanding cash to cover his positions, Mr. Floettl later told police. Selling off the positions to meet the calls would have left him broke, Mr. Floettl said. He met the margin calls primarily with money he had borrowed from Bawag, according to an Austrian National Bank audit conducted during the investigation last year.
>
> 'The margin calls over a period of six business days reduced our investment to almost nothing,' Mr. Floettl said in his statement to prosecutors and police. He lost about $759 million over a short period in 1998, including about $640 million borrowed from Bawag, according to an Arthur Andersen audit of Mr. Floettl's trading records ordered by the bank's board.
>
> Mr. Elsner later told police investigators that he began to worry that Bawag's losses would be revealed. That October, Bawag lent Mr. Floettl another $90 million, according to a written statement by Mr. Elsner to other bank executives.

Id.; see also Daily Briefing, ATLANTA J.-CONST., Nov. 23, 2006. Ironically a depositor run occurred in May 2006. ("In May, the Austrian government and other banks and insurance companies teamed up on a plan to rescue BAWAG, Austria's fourth-largest bank, after it lost more than 1 billion euros ($1.28 billion) in currency speculation deals in the Caribbean. The bank came close to liquidation in the spring as depositors withdrew large amounts after news broke of the bank's losses.") *Id.*

[95] Mollenkamp, *supra* note 11. Emails between Bawag and Bennett in 2000 revealed the use of this name for the scheme.

[96] *Id.*

[97] *Id.*

[98] *Id.*

[99] *U.S. Indicts Former Owner of Refco*, *supra* note 72.

[100] *Id.*

[101] Atlas & Glater, *supra* note 1 ("The effect of the transaction was to convert, for bookkeeping purposes, an obligation by RGHI to Refco into an obligation by the hedge funds to Refco every time an auditor might look. But during the quarter, RGHI held the obligation to Refco.").

[102] NYSE Events, Refco Inc. Visits the NYSE [on August 11, 2005], Sept. 9, 2005, *available at* http://www.nyse.com/events/1126175661959.html. On August 11, 2005 the "NYSE welcome[d] REFCO Inc. (NYSE – listed RFX) to the roster of NYSE – listed companies." NYSE Events, Initial Public Offering of REFCO Inc., Aug. 11, 2005, *available at* http://www.nyse.com/events/1123670418159.html .

[103] Ex. 99.1 to 8K filed Aug. 16, 2005, *available at* http://sec.gov/Archives/edgar/data/1321746/000110465905039844/a05-14370_4ex99d1.htm. ["Refco 8K"].

[104] *U.S. Indicts Former Owner of Refco*, *supra* note 72. ("In August 2005, Refco conducted an initial public offering ('IPO') . . . On October 10, 2005, Refco issued a press release announcing, in substance, that it had discovered that it was owed a debt of approximately $430 million by an entity controlled by Bennett."). *See also Bawag Used Refco to Help Mask Almost EU1 Billion Loss (Update7)*, BLOOMBERG, March 24, 2006, http://www.BLOOMBERG.COM/apps/news?pid=10000085&refer=europe&sid=aDqt_Mdn6iwU (last visited April 8, 2007) ("Refco and 23 affiliates filed the 15th-biggest bankruptcy in U.S. history on Oct. 17, after saying CEO Phillip Bennett concealed about $430 million in loans the company couldn't collect from customers. Creditors are trying to recoup $16.8 billion.").

[105] Refco 8K, *supra* note 103. The press release also stated the following:

> Mr. Bennett today repaid the receivable in cash, including all accrued interest. Based on the results of the review to date, the Company believes that the receivable was the result of the assumption by an entity controlled by Mr. Bennett of certain historical obligations owed by unrelated third parties to the Company, which may have been uncollectible. The Company believes that all customer funds on deposit are unaffected by these activities. Independent counsel and forensic auditors have been retained to assist the Audit Committee in an investigation of these matters.
>
> This receivable from the entity controlled by Mr. Bennett was reflected on the Company's prior period financials, as well as on the Company's May 31, 2005 balance sheet. The receivable was not shown as a related party transaction in any such financials. For that reason, and after consultation by the Audit Committee with the Company's independent accountants, the Company determined, on October 9, 2005, that its financial statements, as of, and for the periods ended, February 28, 2002, February 28, 2003,

February 28, 2004, February 28, 2005, and May 31, 2005, taken as a whole, for each of Refco Inc., Refco Group Ltd., LLC and Refco Finance, Inc. should no longer be relied upon.

Id. ("Also at the request of the Board, Santo C. Maggio, President and Chief Executive Officer of Refco Securities, LLC and Refco Capital Markets, Ltd., has taken a leave of absence. Peter McCarthy has been appointed President of Refco Securities, LLC. ").

[106] *See* Silver, *supra* note 67.

[107] Robinson, *supra* note 21.

[108] Atlas & Glater, *supra* note 1.

[109] Daniel Kadlec, *Squandered Futures*, TIME, Oct. 16, 2005, *available at* http://www.time.com/time/printout/0,8816,1118342,00.html (last visited April 25, 2007). Refco's common stock (formerly NYSE: RFX, now OTC Pink Sheets: RFXCQ) recent trading of Refco common shares is at prices roughly 99.9 percent lower, or, approximately twenty-six cents ($0.26) per share. RFXCQ Quote *available at* http://finance.yahoo.com/q?s=RFXCQ.PK&d=t (last visited April 9, 2007).

[110] *See Refco Collapse May Force Austria's Bawag to Tighten Loan Rules,* BLOOMBERG, Nov. 16, 2005, *available at* http://www.BLOOMBERG.COM/apps/news?pid=10000085&sid=aoEKr.KLPMi4&refer=europe (last visited April 7, 2007); *see also* Chris McMahon, Daniel Collins, and Steve Zwick, *It's a mess! Refco implodes,* FUTURES (FUTURES MAGAZINE GROUP), Dec. 1, 2005.

> Bawag got whacked twice: once by selling a 10% stake in Refco just prior to the company's IPO, missing out on the surge in share prices after going public; and then by loaning $424 million to Phillip Bennett, who used Refco stock as collateral, as well as loaning $100 million to Refco itself.

Id; see also Ex-Bawag CEO is extradited, INT'L HERALD TRIB., Feb. 14, 2007.

> Elsner helped to cover up the losses over many years in offshore accounts at Refco, the now collapsed U.S. broker, and by using the assets of OeGB, the Austrian trade union federation, as collateral, according to the central bank's investigation. Bawag, formally known as Bank fur Arbeit und Wirtschaft, has also been under investigation for lending Phillip Bennett, Refco's former chief executive, several hundred million dollars just before the brokerage firm filed for bankruptcy in 2005.

Id.

[111] *Bawag PSK linked to collapse at Refco*, INT'L HERALD TRIB., March 25, 2006 ("The U.S. investigation of Refco's collapse found as much as $525 million in securities linked to Bawag with identification numbers that did not correspond with registered bonds, four people with direct knowledge of evidence gathered in the investigation said this month."); *see also Selling heavy on Refco debt*, CREDIT INV. NEWS, March 20, 2006.

> Trading volume was heavy on Refco's bank loan last week after a news report that the company held offshore accounts with $525 million in fake bonds. The bond accounts were reportedly at Refco's Bermuda-based unit, according to a Bloomberg report. Refco's term loan 'B' was down a point to 98 1/2. The loan had been trading slightly north of par at the end of last month. Its bonds fell five-and-a-half points to 51.

Id.; And interestingly enough, $525 million was also the precise amount that BAWAG had to pay (after one year, or if Bawag is taken over), "split equally between the [DOJ] and the Refco creditors." *Id. See* Greg Burns*, Refco collapse casts shadow on 'point' man*, CHI. TRIB., Feb. 18, 2007, *available at* http://www.chicagotribune.com/business/chi-0702180337feb18,1,1378231.story?coll=chi-news-hed (last visited Feb. 18, 2007). *See also* Silver, *supra* note 67.

> The day was Oct. 10 [2005], when Refco went public with the news it had a hidden deficit. Bawag sold its stake that day in offshore Liquid Opportunities [operated by former Refco executive Christopher Sugrue] and the related Anguilla companies Bawag used to hide losses, according to evidence gathered by Austrian

> investigators. **The buyer was Thomas Hackl, Bawag's former head of treasury and investment banking, three people close to the investigation say. Hackl, 41, left Bawag to work at Refco** as head of global asset management from 2002 to '04. [emphasis added].

Id.

[112] *Refco Bank Hid USD 1 Billion Loss from Hedge Funds, Arafat Casino*, June 22, 2006, AUSTRIA TODAY.

> Bawag dumped uncollectible loans into the Refco brokerage account of a British Virgin Islands fund called Liquid Opportunities and then into companies based on the Caribbean island of Anguilla.
>
> The day was October 10, when Refco went public with the news it had a hidden deficit. Bawag sold its stake that day in offshore Liquid Opportunities and the related Anguilla companies Bawag used to hide losses, according to evidence gathered by Austrian investigators. The buyer was Thomas Hackl, Bawag´s former head of treasury and investment banking, three people close to the investigation say.

Id.; *See also Arrest warrant is denied*, INT'L HERALD TRIB., May 4, 2006 ("Bawag disclosed March 24 [2006] that it used offshore companies in the Caribbean island of Anguilla and accounts at the collapsed futures broker Refco to mask the losses."); *see also* Roddy Boyd, *Jerry's Bad Tie – Trade for Refco Figure Gave NYSE Prez Black Eye*, N.Y. POST, April 27, 2006 ("Flottl's hedge fund trading activities from the 1990s have come under scrutiny given the disclosure last month that Bawag - the bank that loaned him nearly $2 billion - hid more than $1 billion in losses sustained by his fund, Ross Capital. Some of the losses were stashed in accounts at Refco, according to Bawag, while others were funneled into shell companies in Anguilla."). *See also* Otis Bilodeau and Allan Dodds Frank, *Refco Probes Lead to $525 Million in Phantom Bonds (Update2)*, BLOOMBERG, March 15, 2006, http://www.BLOOMBERG.COM/apps/news?pid=10000103&sid=aCvbrIeoyRVE (last visited April 9, 2007).

> New York-based Refco held the securities for Bawag P.S.K. Bank, Austria's fourth-largest bank, and Liquid Opportunity, an offshore hedge fund, under identification numbers that don't correspond to registered bonds, said the people, who declined to be identified because the investigations are ongoing. One person said Bawag and Liquid Opportunity had shares in six Anguilla companies, which in turn held the bonds.
>
> The U.S. Attorney in Manhattan and the Securities and Exchange Commission are trying to find out where the bonds originated and how they were valued, the people sa*id*. . . .
>
> Bawag plans to filed a claim for the money 'shortly' in Refco's bankruptcy case, Heimhofer sa*id.* He declined to comment further.
>
> Refco's creditors are hunting for information about six companies based in the British West Indies that may be linked to the bonds that prosecutors are scrutinizing.
>
> Liquid Opportunity and Bawag held shares in the six companies, which in turn held the bonds, according to a person with knowledge of the Refco accounts who didn't want to be identified because of the ongoing investigations by the Justice Department and the SEC.
>
> The companies, named for islands in the South Pacific and regions of Argentina, were incorporated on July 26, 2004, by a local agent, according to government records in Anguilla.
>
> They were initially listed as Refco creditors with a combined claim of $543 million, according to court filings prepared by Refco's lawyers. Unlike other creditors identified by Refco, none of the companies filed any legal papers in the bankruptcy case. Refco has since dropped four of the six from its creditors list and now says that it doesn't owe any money to the remaining two.
>
> Vanished
>
> In December, a judge overseeing Refco's bankruptcy authorized the creditors to subpoena former Refco executives, including Bennett, and Bawag for details about the six companies, court filings show.
>
> 'All of a sudden, half a billion dollars of liabilities just vanished,' said Howard Seife, a lawyer at Chadbourne & Parke in New York who represents Refco creditors. 'No one appeared on their behalf in court. It was as if they didn't exist.'

A woman who answered the phone at the office of the agent for the six companies, Anguilla Offshore Management Ltd., declined to give her name and said she couldn't provide any information about them. 'You'll have to contact the customers directly for that,' she sa*id*. . . .

PlusFunds Connections

Through a Liechtenstein-based partnership, Bawag and Liquid Opportunity's Jonathan Knight are co-investors in at least two dozen companies, according to SEC filings. They also share a connection to Refco through PlusFunds Group Inc., a New York- based money manager that sells investments based on hedge fund indexes. U.S. officials haven't accused PlusFunds or any related individuals of wrongdoing in connection with the bond accounts.

PlusFunds Chairman Christopher Sugrue worked at Refco as a senior vice president from 1993 to 1998. A biographical note formerly posted on PlusFunds' Web site said he was 'involved' in Bawag's purchase of the stake in Refco in 1999.

Last year, Sugrue, 35, pledged his controlling interest in PlusFunds to Refco as collateral for a loan of more than $200 million, according to a Dec. 16 lawsuit by Refco creditors against a client of PlusFunds and a person with direct knowledge of the loan, who asked not to be identified while the suit is pending. Neither Sugrue nor PlusFunds is a party to that lawsuit. . . .

PlusFunds helped draw investors to Liquid Opportunity, and Liquid Opportunity in turn was a participant in the PlusFunds ``platform,'' International Portfolio Analytics said in its 2001 statement. PlusFunds made money by investing client assets in all or some of the 41 hedge funds in the Standard & Poor's Hedge Fund Index. The company filed for bankruptcy protection on March 6.

Offshore companies played central roles in the accounting frauds at Enron Corp. and Parmalat Finanziaria SpA, according to prosecutors in those cases.

MIT Doctorate

Houston-based Enron allegedly used subsidiaries in the Cayman Islands to cut the company's U.S. taxes and hide losses, before collapsing in the U.S.'s second-largest bankruptcy in 2001. Parmalat, the Italian food company that in 2003 filed the country's biggest-ever bankruptcy case, inflated sales, fabricated assets and funneled debt through units in the Netherlands Antilles and the Cayman Islands, according to Italian court documents.

Refco lawyers told Esseks, one of Garcia's prosecutors handling the Refco probe, about Liquid Opportunity as early as Oct. 21, according to court filings in Refco's bankruptcy case.

Liquid Opportunity's Knight, who holds a doctorate from the Massachusetts Institute of Technology in Cambridge, Massachusetts, made investments for other clients through offshore entities including Gamma Capital Opportunity Partners, Siam Capital Management and Regenmacher Holdings Ltd., SEC filings show. Regenmacher is the German word for 'rainmaker.'

Alpha Capital AG, a Liechtenstein-based investment firm part-owned by Bawag, participated in many of the same investments, according to the filings.

Id.

[113] *See* Refco 8K, *supra* note 103.

[114] *See also* Tom Bawden, *Bawag gets start to start sale as US settlement draws near*, THE TIMES (LONDON), May 23, 2006.

Bawag, a largely domestic retail bank, shot to international prominence when it approved a $410 million loan to Phil Bennett, Refco's chief executive, just hours before the brokerage announced that it had hidden $430 million of bad debt, triggering its demise.

Id.

[115] *New York Stock Exchange Suspends Trading and Moves to Delist Refco Inc.*, NYSE News Release, Oct. 18, 2005, *available at* http://www.nyse.com/press/1129631944151.html. Trading was halted on Oct. 13, 2005; *see also New York Stock Exchange to Continue Trading Halt of Refco Inc.*, NYSE News Release, Oct 13, 2005, *available at* http://www.nyse.com/press/1129199884331.html.

[116] Tom Hudson, National Introducing Brokers Association (NIBA), News, *'Reputation , Risk and Reward'* NIBA 14th Annual Conference Keynote Transcript, Nov. 2005, NIBA Luncheon Comments, Nov. 12, 2005, (Thomas Hudson is of First Business Morning News), *available at* http://209.85.165.104/search?q=cache:vWXMBoaaPBMJ:www.theniba.com/news/newsItem.aspx%3Fnews%3D43+regulator%27s+role+in+refco%27s+ipo&hl=en&ct=clnk&cd=4&gl=us

[117] *U.S. Indicts Former Owner of Refco*, *supra* note 72.

[118] Greg Burns*, Refco collapse casts shadow on 'point' man*, CHICAGO TRIB., Feb. 18, 2007; *see also U.S. Indicts Former Owner of Refco*, *supra* note 73.; *See also* United States of America v. Phillip R. Bennett, Oct. 12, 2005, *available at* http://www.refcoclassaction.com/Criminal_Complaint.pdf.

[119] Terry Brennan, *Judge Approves Refco Settlement*, DAILY DEAL, June 9, 2006.

[120] *See Austrian Bank "Bawag" to Pay $337.5 million for Restitution to Victims of Refco Fraud,* U.S. DOJ PRESS RELEASE, June 5, 2006, *available at* http://www.usdoj.gov/usao/nys/pressreleases/June06/bagwagnon-prosecutionagreementpr.pdf (last visited April 5, 2007) ("against BAWAG arising from its involvement with the fraud at Refco. In total, BAWAG and the ÖGB will pay at least $675 million in connection with the non-prosecution agreement and to settle the bankruptcy estate claims against them. The Government will distribute half of the $337.5 million in forfeited funds to the Refco bankruptcy estate, and half to other victims of the Refco fraud."). *Id.*; *see also SEC Files Settled Action Against Major Austrian Bank for Aiding And Abetting Refco Fraud*, SEC Litigation Release No. 19716, June 5, 2006, *available at* http://www.sec.gov/litigation/litreleases/2006/lr19716.htm (last visited March 17, 2007); *and* SEC civil enforcement complaint in the matter captioned *SEC v. BAWAG P.S.K. Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse Aktiengesellschaft,* Case No. 06 CV 04222 (DC) (J. Chin, S.D.N.Y.), filed June 5, 2006, *available at* http://www.sec.gov/litigation/complaints/2006/comp19716.pdf (last visited March 17, 2007). *See also Summary of Proposed Settlement Among Refco, Official Committee of Unsecured Creditors, And BAWAG, P.S.K., Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse Aktiengesellschaft*, June 7, 2006 U.S. Bankruptcy Court (SDNY) statement, *available at* http://www.refcocommittee.com/Refco/RefcoCC.nsf/AllWebEditSelect/DA8E2BB0C208FFCF8525718700066984/$File/BAWAG%20Notice.pdf?OpenElement. Numerous other relevant documents *available at* http://www.refcodocket.com.

[121] *See* Silver, *supra* note 67, at 3.

[122] Matthew Goldstein, *Jim Rogers' Funds Sue Refco*, THESTREET.COM, Oct. 25, 2005, http://www.thestreet.com/markets/hedgefunds/10249291.html (last visited Apr. 22, 2007).

[123] *See In Re Refco, Inc. Securities Litigation* (First Amended Consolidated Class Action Complaint), Case No. 05 Civ. 8626, filed May 5, 2006, *available at* http://refcosecuritieslitigation.com/courtdox/RefcoAmCplt5.5.06.pdf; *see also* Refco Securities Litigation, *available at* http://refcosecuritieslitigation.com/.

[124] *See* Matthew Goldstein, *Refco Suit Targets Austrian Patron Bawag*, THESTREET.COM, Apr. 25, 2006, http://www.thestreet.com/_tscs/stocks/brokerages/10281417.html (last visited April 8, 2007).

[125] *In re Refco, Inc.,* et al, LLC, Chapter 11, U.S. Bankruptcy Court Southern District of New York, Case No. 05-60134, docket *available at* http://www.pacer.org, *see also* Refco Bankruptcy Petition, *available at* http://www.refcoclassaction.com/CH11.pdf (last visited April 8, 2007).

[126] *Id.*

[127] *See Id.* ("The list of unsecured creditors excludes: "(1) persons who come within the definition of "insider" set forth in 11 U.S.C. 101 or (2) secured creditors unless the value of the collateral is such that the unsecured deficiency places the creditor among the holders of the 50 largest unsecured claims.").

[128] *Id.* at 19 *n*.1.

[129] Shares of Refco common stock closed at $0.25 on April 13, 2007 (43,052,000 x $0.25 = $10,763,000.00). http://finance.yahoo.com/q?s=RFXCQ.PK&d=t (last visited April 9, 2007).

[130] James Politi and David Wighton, *JC Flowers team quits auction of Refco brokerage unit*, FIN. TIMES, Oct. 25, 2006 ("A consortium led by private equity group JC Flowers last night pulled out of the bidding for the futures brokerage unit of bankrupt Refco, the firm's lawyer told a bankruptcy hearing."). *See also* Oct.17, 2005 Memorandum of Understanding between Refco, Inc. and JC Flowers, *available at* http://www.sec.gov/Archives/edgar/data/1321746/000095017205003277/ex99_2.txt (last visited April 3, 2007).

[131] Alistair Barr, *Man Group Wins Refco LLC; price set at $323M*, MARKETWATCH, Nov. 10, 2005.

> Refco LLC's decision to transfer accounts to Man Group under a Chapter 7 bankruptcy filing may help the hedge-fund firm shield itself from litigation, according to one legal expert.
>
> 'In a Chapter 7 filing, you get a court order that pretty much protects the buyer from liabilities of the seller, with a few exceptions,' Fred Lipman, a partner at law firm Blank Rome LLP, sa*id.* 'It's not perfect, but it's the most protective way of selling assets in a situation like this.'

Id. See also Civil RICO Complaint in the matter captioned *Eagletech Communications, Inc. v. Citigroup, Inc.*, Case No. 07007880 Florida Circuit Court (17th Judicial Circuit, Broward County), Complaint filed April 10, 2007 (Naming Man Group, PLC as a defendant and alleging it has indirect connections to the Luchese organized crime family as the clearing broker in a series of trades related to an alleged "PIPE" stock manipulation scheme), *see* p. 26, (numerated ¶ 2), Complaint *available at* http://www.internationalshareholdersgroup.com/pdf/Eagletech_v_Citigroup_Complaint_Filestamped.pdf.

[132] *See*, *e.g.*, Julia Werdigier, *Man Group, the Large British Hedge Fund, Plans to Spin Off Its Brokerage Unit*, N.Y. TIMES, Mar. 31, 2007, *available at* http//www.nytimes.com/2007/03/31/business/worldbusiness/31hedge.html (last visited April 3, 2007); *see also Man Financial NYSE IPO*, BANKING NEWSLINK, GLOBAL NEWS WIRE, Apr. 3, 2007.

> Man Group confirmed that it would float Man Financial on the New York Stock Exchange subject to shareholder and regulatory approvals. Man Financial is the US derivatives brokerage business. The business will be renamed MF Global at the time of the separation. Man Group do not say what holding they will maintain, only that a majority shareholding will be offered in the IPO. They expect the IPO to happen during the third quarter [of 2007].

Id.

[133] *Judge says he will OK Refco's plan for leaving bankruptcy*, CHICAGOTRIBUNE, Dec. 16, 2006, *available at* http://www.chicagotribune.com/business/chi-0612160043dec16,0,2949965.story?coll=chi-business-hed (last visited April 9, 2007).

> A federal judge Friday signed off on Refco Inc.'s Chapter 11 plan, clearing the way for the commodities brokerage to exit bankruptcy by paying creditors a fraction of the $16.8 billion they were owed.
>
> Judge Robert Drain of the U.S. Bankruptcy Court in Manhattan said at a hearing that he would confirm the plan. 'The settlements embodied in the plan are in the best interests of the various debtors . . . and are also fair and equitable,' Drain sa*id.*

> Refco, once one of the country's biggest commodity brokerages, entered bankruptcy protection in October 2005 amid allegations that its chief executive hid $430 million in bad debt. The executive, Phillip Bennett, has pleaded not guilty to fraud charges. Refco has since sold its flagship business and is winding down its remaining operations.
>
> In the bankruptcy plan Refco settled objections from all parties save for Sphinx Funds, a group of class-action plaintiffs and an individual creditor. Drain overruled those remaining objections. The company has said it expects to exit bankruptcy proceedings by the end of the month if the plan is approved. However, after a conference in his chambers with attorneys, Drain agreed to delay a decision on converting the case to a liquidation until a later date. . . .
>
> The company has $3.65 billion in cash that could be available for distribution to creditors if the company wins court authorization for its bankruptcy reorganization plan, according to court documents.
>
> Refco LLC, which once housed Refco's flagship brokerage business, has $664.6 million in assets, according to company documents. Refco Capital Markets Ltd., a Bermuda-based unit that was tied to many of the allegedly fraudulent transactions attributed to Bennett, has $2.44 billion in assets. At the time it filed for Chapter 11 protection, Refco estimated its debt at $16.8 billion. . . .
>
> On Thursday [Dec. 14, 2006] the Austrian bank that nearly collapsed as a result of its links to Refco, Bawag PSK, said it was sold to a consortium led by Cerberus Capital Management for more than $3 billion, of which $200 million will go to Refco's creditors.

Id.

[134] *Refco Trustee Looks to Distribute $450M*, FORBES, April 2, 2007, *available at* http://www.forbes.com/feeds/ap/2007/04/02/ap3575819.html; *see also Judge says he will OK Refco's plan for leaving bankruptcy*, CHICAGOTRIBUNE, Dec. 16, 2006, *available at* http://www.chicagotribune.com/business/chi-0612160043dec16,0,2949965.story?coll=chi-business-hed; *See also Goldin Forgoes a $2.4M Fee on Refco Work*, FORBES, April 10, 2007, *available at* http://www.forbes.com/feeds/ap/2007/04/10/ap3599979.html. ("In January, Refco said it paid at least $145.3 million to the army of lawyers and restructuring professionals working on its bankruptcy case.").

[135] Deborah Solomon and Michael Schroeder, *How Refco Fell Through Regulatory Cracks --- Scandal Highlights a System That Didn't Require Much Oversight of the Firm's Units*, WALL ST. J., Oct. 18, 2005

[136] Mollenkamp, *supra* note 12.

[137] Andrew Parker, et al., *Refco insider co-operating with prosecutors*, FT.COM, Oct. 26, 2005, *available at* http://www.ft.com/cms/s/9b0fbd50-466b-11da-8880-00000e2511c8,Authorised=false.html?_i_location=http%3A%2F%2Fnews.ft.com%2Fcms%2Fs%2F9b0fbd50-466b-11da-8880-00000e2511c8.html&_i_referer=http%3A%2F%2Fnakedshorts.typepad.com%2Fnakedshorts%2F2005%2F10%2Frefcos_maggio_f.html.

[138] Mollenkamp, *supra* note 12.

> A spokeswoman for the Bermuda Monetary Authority, the nation's financial regulator, says its main role is to protect "retail and unsophisticated" investors. Firms such as Refco Capital Markets, which cater to sophisticated investors, are entitled to exemptions from Bermuda regulation, she says.

Id.

[139] *Id.*

[140] Refco News, *Refco Hires Advisors, Reaffirms Regulatory Capital At Refco LLC And Refco Securities LLC, Announces A 15 Day Moratorium On Customer Withdrawals At Refco Capital Markets, Ltd*, Oct. 13, 2005, *available at* http://www.refco.com/nr/nr.news.asp?id=1383 ("Refco is one of the largest global clearing firms for derivatives.").

[141] *Id.*

[142] Solomon, *supra* note 136.

[143] See *Arch Insurance Co. v. Bennett, et al.*, Amended Complaint for Declaratory Judgment, June 22, 2006, No 06/600805, 2006 WL 4045485.

> According to the Bennett Indictment, Bennett caused Refco to enter into certain transactions at the close of Refco's fiscal year ending February 2004 that had the effect of temporarily hiding RGHI's debt to Refco (the "February 2004 Transactions"). On or about February 20, 2004, Bennett allegedly caused Refco Capital Markets, Ltd. to loan approximately $720 million to a Refco customer. On the same day, the customer loaned $720 million to RGHI. RGHI then used the $720 million to pay down its debt to Refco. These loans were unwound on or about March 4, 2004, after Refco's fiscal year-end.
>
> According to the Bennett Indictment, Bennett caused Refco to enter into certain transactions at the close of Refco's fiscal year ending February 2005 that had the effect of temporarily hiding RGHI's debt to Refco (the "February 2005 Transactions"). On or about February 23, 2005, Bennett allegedly caused Refco Capital Markets, Ltd. to loan approximately $345 million to a Refco customer. On the same day, the customer loaned $345 million to RGHI. RGHI then used the $345 million to pay down its debt to Refco. These loans were unwound on or about March 8, 2005, after Refco's fiscal year-end.
>
> According to the Bennett Indictment, Bennett caused Refco to enter into certain transactions at the close of Refco's fiscal first quarter end for 2005 that had the effect of temporarily hiding RGHI's debt to Refco (the "May 2005 Transactions"). On or about May 25, 2005, Bennett allegedly caused Refco Capital Markets, Ltd. to loan approximately $450 million to a Refco customer. On the same day, the customer loaned $450 million to RGHI. RGHI then used the $450 million to pay down its debt to Refco. These loans were unwound on or about June 6, 2005, after Refco's fiscal first quarter-end.

Id.; see also Solomon, *supra* note 136.

[144] Mollenkamp, *supra* note 12.

[145] *Id.*

[146] *Id.*

[147] *Id.*

> Among those demanding money was Christopher Sugrue, a former Refco executive who ran a money-management firm called PlusFunds Group Inc. On Oct. 11, he burst into the office of Mr. Hreben, Refco's treasurer, in the company's lower Manhattan headquarters, according to sworn testimony from Mr. Hreben. Mr. Sugrue demanded that $300 million of PlusFunds money be transferred from unregulated Bermuda accounts to regulated U.S. ones in order to protect the funds, according to the sworn statement. "He appeared to be very upset and was shouting," Mr. Hreben said in his statement. Mr. Hreben ordered him out.
>
> The next day, Mr. Sugrue returned to see Ms. Kraker, who helped run the Refco Capital Markets financing desk. "He stood behind me at my station on the trading floor asking repeatedly if the money had been transferred as he had demanded," she said in a sworn statement.
>
> Refco transferred the money, and Mr. Sugrue withdrew it. Others also withdrew their funds, depleting the coffers of Refco Capital Markets. Refco froze the unit's customer accounts and declared bankruptcy. A bankruptcy court later froze the money withdrawn by PlusFunds because under bankruptcy law, all Refco Capital Markets clients have to be treated equally. In an interview earlier this year, Mr. Sugrue said he had every right to recover the money.

Id.

[148] Refco News, *supra* note 141.

[149] *See Refco Trustee Looks to Distribute $450M*, FORBES, April 2, 2007, *available at* http://www.forbes.com/feeds/ap/2007/04/02/ap3575819.html; *see also Judge says he will OK Refco's plan for leaving bankruptcy*, CHICAGOTRIBUNE, Dec. 16, 2006, *available at* http://www.chicagotribune.com/business/chi-0612160043dec16,0,2949965.story?coll=chi-business-hed.

[150] Solomon, *supra* note 136.

[151] Charles Gasparino, *Refco Reverb Is the Financial Implosion of the futures broker another sign that investors cannot trust Wall Street to fully vet the companies that they underwrite?* NEWSWEEK, Oct. 20, 2005, *available at* http://www.msnbc.msn.com/id/9753706/site/newsweek/. The NYSE's Listed Company Compliance division is comprised of the Financial Compliance section and a Corporate Compliance section and its Financial Compliance is responsible for reviewing a company's financial results at the time it joins the NYSE, NYSE Regulation, Financial Compliance, *available at* http://www.nyse.com/regulation/listed/1091545087925.html.

[152] J. Henderson, *Sarbanes-Oxley Fails to Prevent Refco Accounting Scandal,* Ludwig von Mises Institute, Oct. 18, 2005, *available at* http://blog.mises.org/archives/004229.asp.

[153] "Derivatives are financial contracts whose value is derived, hence the name, from movements in stocks, bonds, currencies, commodities or some other benchmark. Some are traded on exchanges, such the Chicago Mercantile Exchange. Some are traded 'over the counter' by dealers, investors or others, and aren't subject to much regulation." Solomon, *supra* note 136.

[154] Robinson, *supra* note 24.

[155] Solomon, *supra* note 136.

[156] *Id.*

[157] *Id.*

[158] Report of The President's Working Group on Financial Markets, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act*, Department of Treasury, Board of Governors of the Federal Reserve System, Securities & Exchange Act, & the Commodity Futures Trading Commission, Nov. 1999, *available at* www.ustreas.gov/press/releases/reports/**otc**act.pdf.

[159] The Federal Reserve Board, Testimony of Chairman Alan Greenspan, The regulation of OTC derivatives, Before the Committee on Banking and Financial Services, U.S. House of Representatives, July 24, 1998, *available at* https://www.federalreserve.gov/BoardDocs/Testimony/1998/19980724.htm.

> I do not mean to suggest that counterparties will not in the future suffer significant losses on their OTC derivatives transactions. Since 1994 the effectiveness of their risk management skills has not been tested by widespread major declines in underlying asset prices. I have no doubt derivatives losses will mushroom at the next significant downturn as will losses on holdings of other risk assets, both on and off exchange. Nonetheless, I see no reason to question the underlying stability of the OTC markets, or the overall effectiveness of private market discipline, or the prudential supervision of the derivatives activities of banks and other regulated participants. The huge increase in the volume of OTC transactions reflects the judgments of counterparties that these instruments provide extensive protection against undue asset concentration risk. They are clearly perceived to add significant value to our financial structure, both here in the United States and internationally.

Id.

160. *Id.*

> Accordingly the Federal Reserve Board sees no reason why these markets should be encumbered with a regulatory structure devised for a wholly different type of market process, where supplies of underlying assets are driven by the vagaries of weather and seasons. Inappropriate regulation distorts the efficiency of our market system and as a consequence impedes growth and improvement in standards of living.
>
> Instead, the Federal Reserve believes that the fact that OTC markets function so effectively without the benefits of the CEA provides a strong argument for development of a less burdensome regulatory regime for financial derivatives traded on futures exchanges. To reiterate, the existing regulatory framework for futures trading was designed in the 1920s and 1930s for the trading of grain futures by the general public. Like OTC derivatives, exchange-traded financial derivatives generally are not as susceptible to manipulation and are traded predominantly by professional counterparties.

Id.

[161] The CFTC changed its tune and opposed regulation when a new Chairperson took the helm. *See* Jerry Hagstrom, *Commodity Clash*, GOVEXEC.COM, Oct. 1, 1997, *available at* http://www.govexec.com/features/1097s6.htm

[162] Solomon, *supra* note 136. Brooksley Born, Chairperson of the CFTC in 1997, testified at a Feb 11, 1997 Senate Agriculture Committee hearing on deregulation of the nation's commodity exchanges, and stated:

> [T]he bill's industry-supported provisions creating unregulated professional markets--those made up of trading professionals with more than $10 million in assets—'would result in pervasive deregulation of the U.S. futures and options markets' and mean that recent trading scandals like the one in Singapore that brought down Britain's Barings bank could be replicated in the United States. Since Congress created the CFTC in 1975 to regulate both the agricultural and nonagricultural futures markets, Born noted, the United States has never had a commodity exchange scandal as big as the Barings failure.

Id.; *see also* Jerry Hagstrom, *Commodity Clash*, GOVEXEC.COM, Oct. 1, 1997, http://www.govexec.com/features/1097s6.htm (last visited April 24, 2007); *see also* Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management – How One Small Bank Created a Trillion-Dollar Hole*, (Fourth Estate Publishing 2001) ISBN-10: 1841155047.

[163] American Bankers Association, ABA Securities Association, the Bond Market Association, the Emerging Markets Traders Association, the Financial Services Roundtable, the Foreign Exchange Committee, the Futures Industry Association, the International Swaps and Derivatives Association and the Securities Industry Association. *See Regulators Urge CFTC Officials to Forbid Control of Derivatives*, Nov. 9, 1999, INTERACTIVE J., http://cyber.law.harvard.edu/rfi/press/cftclimit.htm (last visited April 25, 2007).

[164] Solomon, *supra* note 136; *see also* The Federal Reserve Board, Testimony of Chairman Alan Greenspan, *supra* note 160.

[165] Dean Kloner, Stroock & Stroock & Lavan, *The Commodity Futures Modernization Act of 2000*, COMMODITY FUTURES, Vol. 29, July 17, 2001, *available at* www.stroock.com/SiteFiles/Pub134.pdf.

[166] See Refco Group Ltd., LLC and Refco Finance Inc, Form S-4, Amendment No. 6, filed on April 6, 2005, *available at* http://sec.gov/Archives/edgar/data/1305464/000104746905009372/a2146748zs-4a.htm, p. 173.

[167] Solomon, *supra* note 136 ("'It's an intentional regulatory gap, and the derivatives world worked very hard to create that gap,' says Donald Langevoort, a Georgetown University law professor and former special counsel at the Securities and Exchange Commission.").

[168] Henderson, *supra* note 153.

[169] Refco Inc., Form S-1, filed with SEC on July 25, 2005, p. 23, *available at* http://www.sec.gov/Archives/edgar/data/1321746/000104746905019982/a2156229zs-1a.htm#page_da10213_1_22.

In connection with their audit of our most recently audited financial statements, our independent auditors reported to us that we had two significant deficiencies in our internal controls over financial reporting. Under standards established by the Public Company Accounting Oversight Board, a "significant deficiency" is defined as a deficiency that results in more than a remote likelihood that a misstatement of the financial statements that is more than inconsequential will not be prevented or detected. One significant deficiency was determined to exist based on the need to increase our existing finance department resources to be able to prepare financial statements that are fully compliant with all SEC reporting guidelines on a timely basis. The second significant deficiency was determined to exist based on our lack of formalized procedures for closing our books. Currently we utilize the services of an outside service provider to assist in our financial reporting process. As we prepare for the completion of the offering, we are in the process of enhancing our financial reporting capability by hiring additional internal audit and finance personnel and developing formalized closing procedures, including through the implementation of software upgrades throughout our operations. Although these measures are designed to address the issues raised by our independent auditors, these and any future measures may not enable us to remedy these significant deficiencies or avoid other significant deficiencies in the future. In addition, these and any other significant deficiencies will need to be addressed as part of the evaluation of our internal controls over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 and may impair our ability to comply with Section 404. See '—We will be exposed to risks relating to the evaluation of our internal controls over financial reporting as required by Section 404 of the Sarbanes-Oxley Act of 2002.'

Id.

[170] Solomon, *supra* note 136.

[171] *Id.*

[172] *Id.*

[173] NYSE/NASD IPO Advisory Committee, *Report and Recommendations of a Committee Convened by the New York Stock Exchange, Inc. and NASD at the request of the U.S. Securities and Exchange Commission*, May 2003, *available at* www.nyse.com/pdfs/iporeport.pdf. This Committee was "was convened . . . at the request of Harvey L. Pitt, then-Chairman of the U.S. Securities and Exchange Commission (the ''SEC''), to ''review the IPO underwriting process, particularly price setting and allocation practices, in light of recent experience, and to recommend to the securities industry community such changes as may be necessary to address the problems that have been observed.'" *Id.* at 2. The Committee made twenty recommendations which followed four basic themes:

(1) The IPO process must promote transparency in pricing and avoid aftermarket distortions;

(2) Abusive allocation practices must be eliminated.

(3) Regulators must improve the flow of, and access to, information regarding IPOs.

(4) Regulators must encourage underwriters to maintain the highest possible standards, establish issuer education programs regarding the IPO process and promote investor education about the advantages and risks of IPO investing.

Id. at *3.

[174] *Id.* at 14.

[175] *Id.*

[176] *Id.* at 18.

[177] *Id.*

[178] *Id.* at 19.

[179] JOHN C. COFFEE, GATEKEEPERS, THE ROLE OF THE PROFESSIONS IN CORPORATE GOVERNANCE (Oxford University Press) (2006).

[180] Alistair Barr, *Refco Investor Suit Target IPO Banks*, MARKETWATCH, Nov. 21, 2005, *available at* http://www.marketwatch.com/News/Story/Story.aspx?guid={334E7A2C-13F0-4B41-90A7-975F708E665E}&siteid=google.

[181] Peter A. McKay and Michael McHugh, *Buyout Firm Is in Talks to Acquire Futures Brokerage House Refco*, WALL ST. J., May 25, 2004.

[182] *Id.* Financial details of yesterday's deal weren't disclosed, but Phillip R. Bennett, Refco's president and chief executive officer, said it involved the buying out of the stakes in Refco held by the Austrian bank Bawag and former Refco CEO Tone Grant. *Id.*

> Moody's assigned a single-B3 rating to a $600 million issue of eight-year senior subordinated notes by Refco Group Ltd. to fund a leveraged buyout by Thomas Lee Partners. The deal is expected Thursday or Friday. A conjunctive $875 million offering of bank debt was rated single-B1.

Michael Mackenzie, *Patchy Recovery Prods Carry Trade Back to Life --- As Threat of Rate Increase Recedes, Investors Return To High-Yielding Strategy*, WALL ST. J., July 20,2004.

[183] Thomas H. Lee, in 2004, brought in KPMG to examine Refco's financial data. Atlas & Glater, *supra* note 1.

[184] Peter A. McKay and Michael McHugh, Buyout Company Acquires Stake In Refco Group, WALL ST. J., June 9, 2005.

[185] "Refco is one of the largest global clearing firms for derivatives." Refco News, R*efco Hires Advisors, Reaffirms Regulatory Capital At Refco LLC And Refco Securities LLC, Announces A 15 Day Moratorium On Customer Withdrawals At Refco Capital Markets, Ltd*, Oct. 13, 2005, *available at* http://www.refco.com/nr/nr.news.asp?id=1383

[186] Lynn Cowan, *Refco Stock Gains 25% in Debut*, WALL ST. J., Aug. 12, 2005.

[187] Atlas & Glater, *supra* note 1.

[188] *Id.*

[189] *Id.*

[190] Dennis K. Berman and Randall Smith, *Do Goldman's Many Hats Fit? From Refco Deals to the NYSE, The Wall Street Firm Is All Over; It Insists It Avoids Bad Conflicts*, WALL ST. J., Oct. 20, 2005.

> Credit Suisse Group's Credit Suisse First Boston, which had represented Refco in its mid-2004 sale to Thomas H. Lee Partners, the leveraged-buyout firm. CSFB also played a leading role in distributing $1.4 billion in bank loans and junk bonds to finance the buyout for Lee.

Id.

[191] Financial Policy Forum, Derivatives Study Center, In the News, 2006 (Edward Robinson, Bloomberg, *Refco's Collapse Reveals Decades of Quarrels with Regulators*), *available at* http://www.financialpolicy.org/dscquotes2006.htm; The Underwriter in Refco were:

> Banc of America Securities LLC, CMG Institutional Trading LLC, Credit Suisse Securities (USA) LLC, Deutsche Bank Securities, Inc., Goldman, Sachs & Co., Harris Nesbitt Corp., HSBC Securities (USA) Inc., J.P. Morgan Securities, Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, Muriel Siebert & Co. Inc., Samuel A. Ramirez & Company, Inc., Sandler O'Neill & Partners, L.P., The Williams Capital Group, L.P., Utendahl Capital Partners, L.P., and William Blair & Company, L.L.C.

In re Refco, Inc. Securities Litigation, No. 05 Civ. 8626, 2007 WL 57872, *1 n. 3 (S.D.N.Y. Jan. 9, 2007).

[192] Barr, *supra* note 180.

[193] Ronald J. Gilson and Reinier H. Kraakman, *Article: The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 618 (1984).

> Recall the problem facing an innovative issuer. Buyers find it too expensive to determine for themselves whether the issuer's new form of security warrants a higher price; and even if the issuer could educate them individually, the verification problem remains. Buyers still must be convinced of the accuracy of the information the issuer provides. A reputable investment banker may be able to solve both problems. Processing costs are obviously lower for a single investment banker than for a disparate group of individual buyers. This fact reflects the savings that accrue both from collectivization and from the potential for scale and scope economies in information processing.
>
> From our perspective, however, the investment banker's role in reducing verification costs is even more critical. The difficulty confronting the issuer and prospective buyers is that determining the quality of the issuer's information is expensive ex ante, but not ex post. Before the sale, prospective buyers must incur verification costs to assess the issuer's good faith; after the sale, the issuer's behavior will reveal the quality of the information at virtually no cost. In this setting, a common technique for economizing on information costs is for sellers to make capital investments in brand name or reputation as a means of signaling the quality of the information. By making the investment in reputation, the seller signals its belief that when the purchaser learns the truth ex post, the quality of the information provided by the seller ex ante will be proved high. If the original information proves to be of low quality, the value of the seller's investment in reputation will diminish. Thus, the seller's investment in reputation demonstrates that it is not in his interest to misrepresent the accuracy of its information; and the buyer can rely upon that signal in lieu of engaging in costly verification itself.

Id. at 619.

[194] Noam Sher, *Negligence Versus Strict Liability: The Case of Underwriter Liability in IPO's*, 4 DEPAUL BUS. & COMM. L.J. 451, 455 (2006).

[195] Arthur B. Laby, *Differentiating Gatekeepers*, 1 BROOK. J. CORP. FIN. & COM. L. 120, 122, 2006, available at . www.brooklaw.edu/students/journals/bjcfcl/(119-163)LABYv2.pdf. The recognition of dependent and independent gatekeepers in the financial market is not new. The Securities Act places responsibilities on underwriters, auditors, directors, and early securities laws recognized the difference between dependent and independent gatekeepers. *Id.*, *citing* 15 U.S.C. § 80a-10(a).

[196] *Id.* at 124.

[197] *Id.* at 127.

[198] *Id.* at 124.

[199] *Id.* at 127.

[200] *Id.* at 132.

[201] *Id.* at 127. Attorneys are also considered dependent gatekeepers.

[202] *Id.* at 133.

[203] *Id.* at 133.

EBC I, Inc. v. Goldman, Sachs & Co., 832 N.E.2d 26, 31–33 (N.Y. 2005) ("eToys hired Goldman Sachs to give it advice for the benefit of the company, and Goldman Sachs thereby had a fiduciary obligation to disclose any conflict of interest concerning the pricing of the IPO."); *see also* Breakaway Solutions, Inc. v. Morgan Stanley & Co. Inc., No. Civ. A. 19522, 2004 WL 1949300, at *13 (Del. Ch., Aug. 27, 2004) (holding that issuer sufficiently alleged fiduciary relationship with its description of relationship with defendant underwriters).

Id.

[204] *Id.* at 133.

> Even where the issuer does not engage an underwriter, but one simply acts for the benefit of an issuer in furtherance of a distribution, that person is considered an underwriter. In the case of *SEC v. Chinese Consolidated Benevolent Association*, an association, which helped the Chinese government during a bond offering in soliciting and receiving funds from Chinese communities in the United States, was considered an underwriter although it had no contractual relationship with the issuer. SEC v. Chinese Consol. Benevolent Ass'n, 120 F.2d 738, 740 (2d Cir. 1941). Similarly, promoters, officers, and control persons who promote an offering are generally considered underwriters as well. JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION CASES AND MATERIAL, 351–52 (5th ed. 2006).

Id. at 133, *n*.88.

[205] *Id.* at 133, *citing* Royce de Barondes, *NASD Regulation of IPO Conflicts of Interest—Does Gatekeeping Work?*, 79 TUL. L. REV. 859, 862 (2005) ("[Investment banks] may, and occasionally do, have financial interests in an issuer or a securities offering in addition to receipt of underwriting fees.").

[206] *Id.*; *see also* 17 C.F.R. § 210.2-01(c)(1)(i)(A) (2006) (stating that an accounting firm is not independent if firm or immediate family member has "any direct investment in an audit client").

[207] *Billings v. Credit Suisse First Boston Ltd.*, 426 F.3d 130, 139 (2d Cir. 2005).

[208] Laby, *supra* note 195, *citing* JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION CASES AND MATERIAL, 125.

[209] Practitioners and academia assert that Section 11 and 12 against underwriters is not justifiable or feasible. *In re WorldCom, Inc. Securities Litig.*, 346 F Supp 2d 628, 671-72 (S.D.N.Y. 2004).

> Professor Coffee, for one, has observed that "it is not clear that the underwriter today still performs the classic gatekeeping function.... Many argue that serious due diligence efforts are simply not feasible within the time constraints of shelf registration. Given these constraints, they claim that the solution lies in downsizing *671 the threat under section 11." John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation,* 52 Bus. Law. 1195, 1211 (1997).
>
> Another professor has remarked that "there is a strong practical case to be made for absolving underwriters of all inquiry obligations short of recklessness.... As underwriter involvement diminishes in significance relative to the deal as a whole, it becomes that much more problematic to apply a negligence-based standard in the first place." Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment,* 63 Law & Contemp. Probs. 45, 67 (2000)
>
> A third asserts that in today's capital markets, "it is reasonable to question whether the underwriter's 'due diligence' role is justified at all.... [F]or shelf registrations, disinterested advance due diligence is the exception not the rule." Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime,* 79 Wash. U.L.Q. 491, 522 (2001) (citation omitted)

Id.

[210] *See* Section 11 (15 U.S.C. §§ 77k(a)(5)) and Section 12(2) (15 U.S.C. § 77l (2)) of the 1933 Securities Act. *See also In re Software Toolworks Inc. Sec. Litig.,* 50 F.3d 615, 621 (9th Cir.1994), *quoting 15 U.S.C.* §§ 77k(a)(5) and 77 l (2); *see also In re WorldCom, Inc. Securities Litig.*, 346 F Supp 2d 628, 656 (S.D.N.Y. 2004), *quoting Gustafson v Alloyd Co*., 513 U.S. 561, 571 (1995) "The 'primary innovation' of the Securities Act was the creation of duties in connection with public offerings, principally 'registration and disclosure obligations.'"

[211] *In re Software Toolworks Inc. Sec. Litig.,* 50 F.3d 615, 621 (9th Cir.1994), *quoting 15 U.S.C.* § 77k(b)(3).

[212] *Id. quoting* § 77 *l* (2) and *citing Sanders v. John Nuveen & Co.,* 619 F.2d 1222, 1228 (7th Cir.1980), *cert. denied,* 450 U.S. 1005, 101 S.Ct. 1719, 68 L.Ed.2d 210 (1981), (". . . section 11's "reasonable investigation" standard is similar, if not identical, to section 12(2)'s "reasonable care" standard . . . ").

[213] *In re Refco, Inc. Securities Litigation*, 05 Civ. 8626, SDNY, First Amended Consolidated Class Action Complaint, May 5, 2006, para. 55-69, *available at* 2006 WL 1627495.

> 1) Credit Suisse Securities (USA) LLC (known at the time of the IPO as Credit Suisse First Boston LLC); 2) Banc of America Securities LLC ("BAS"), a subsidiary of Bank of America Corporation; 3) Deutsche Bank Securities, Inc. ("Deutsche Bank"), a subsidiary of Deutsche Bank AG; 4) Goldman, Sachs & Co. ("Goldman Sachs"), a subsidiary of The Goldman Sachs Group; 5) Merrill Lynch, Pierce, Fenner & Smith Incorporated; 6) J.P. Morgan Securities, Inc. ("J.P. Morgan"), a subsidiary of J.P. Morgan Chase & Co.; 7) Sandler O'Neill & Partners, L.P.; 8) HSBC Securities (USA) Inc. ("HSBC"), a subsidiary of The HSBC Group; 9) William Blair & Company, L.L.C.; 10) Harris Nesbitt Corp. ("Harris Nesbitt"), a subsidiary of the Bank of Montreal; 11) CMG Institutional Trading LLC; 12) Samuel A. Ramirez & Company, Inc.; 13) Muriel Siebert & Co. Inc.; 14) The Williams Capital Group, L.P.; 15) Utendahl Capital Partners, L.P.

Id.

[214] *Id.*

[215] *Id.*

[216] *Id.* para. 254-256 (Counts Five and Seven).

> The Stock Underwriter Defendants did not conduct a reasonable investigation of the statements contained in the IPO Registration Statement, and did not possess reasonable grounds for believing that the statements in the IPO Registration Statement were true and not misleading. In particular, the Stock Underwriter Defendants did not conduct a reasonable investigation into the accuracy of the textual descriptions in the IPO Registration Statement relating to, among other things, the Company's past performance, operations, business condition, and future prospects. Nor did the Stock Underwriter Defendants conduct a reasonable investigation into the accuracy of the financial information included in the IPO Registration Statement, including the financial information contained in the textual portions of the IPO Registration Statement, as well as that contained in the attached audited and unaudited financial statements.
>
> The Stock Underwriter Defendants' failure to conduct a reasonable investigation into the unaudited financial statements in the IPO Registration Statement was particularly negligent given the recent seminal opinion in this District, *In re WorldCom, Inc. Sec. Litig.,* 346 F. Supp. 2d 628 (DLC) (S.D.N.Y. 2004), which reiterated and confirmed that underwriters cannot simply rely on an auditors' work when investigating the accuracy of unaudited financial statements. Rather, because "the public relies on the underwriter to obtain and verify relevant information and then make sure that essential facts are disclosed" (*Id.* at 685), underwriters must conduct their own, independent (and reasonable) investigation into the accuracy of unaudited financial statements.
>
> In addition, the IPO Registration Statement contained risk factors relating to, among other things, the Company's substantial indebtedness; its compliance with regulatory requirements; its internal controls over financial reporting; and risks relating to employee misconduct. Having identified these factors as risks for potential investors, the Stock Underwriter Defendants were obligated to, but did not, conduct an especially

diligent investigation into these issues in order to obtain reasonable assurance that the statements contained in the IPO Registration Statement were true and not misleading.

Id.

[217] *In re WorldCom, Inc.* Securities Litig., 346 F Supp 2d 628, 662 (S.D.N.Y. 2004)*, quoting Feit v. Leasco Data Processing Equip. Corp.,* 332 F.Supp. 544, 581 (E.D.N.Y.1971); *see also In re Enron Corp. Sec., Derivative & ERISA Litig.,* 235 F.Supp.2d 549, 612-13 (S.D.Tex.2002), *citing Chris-Craft Industries, Inc. v. Piper Aircraft Corp.,* 480 F.2d 341, 370 (2d Cir.1973), *cert. denied,* 414 U.S. 910, 94 S.Ct. 231, 232, 38 L.Ed.2d 148 (1973).

> Self-regulation is the mainspring of the federal securities laws. No greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter. He is most heavily relied upon to verify published materials because of his expertise in appraising the securities issue and the issuer, and because of his incentive to do so. He is familiar with the process of investigating the business condition of a company and possesses extensive resources for doing so. Since he often has a financial stake in the issue, he has a special motive thoroughly to investigate the issuer's *613 strengths and weaknesses. Prospective investors look to the underwriter, a fact well known to all concerned and especially to the underwriter, to pass on the soundness of the security and the correctness of the registration statement and prospectus.

Id.

[218] *WorldCom*, *supra* note 217, at 662, *quoting*, 2 Gary M. Lawrence, *Due Diligence in Business Transactions* § 2.03A (2004).

[219] *WorldCom*, *supra* note 217, at 662, *quoting Chris-Craft Indus., Inc. v. Piper Aircraft Corp.,* 480 F.2d 341, 370 (2d Cir.1973).

> What constitutes "reasonable investigation" and a "reasonable ground to believe" will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data. What is reasonable*578 for one director may not be reasonable for another by virtue of their differing positions.
>
> "It was clear from the outset, however, that the duty of each potentially liable group was not the same. The House report on the bill that became the original Securities Act stated that the duty of care to discover varied in its demands upon the participants with the importance of their place in the scheme of distribution and the degree of protection that the public had a right to expect from them. It has been suggested that although inside directors might be better able to show that they undertook some investigation, the outside director could more easily demonstrate that the investigation he actually undertook was sufficient to sustain his defense."

Feit v. Leasco Data Processing Equip., 332 F.Supp. 544, 577-78, *quoting* Comment, BarChris: Due Diligence Refined, 68 COLUM. L. REV. 1411, 1416 (1968).

[220] *Feit v. Leasco Data Processing Equip.*, 332 F.Supp. 544, 581 (E.D.N.Y. 1971).

> In a sense, the positions of the underwriter and the company's officers are adverse. It is not unlikely that statements made by company officers to an underwriter to induce him to underwrite may be self-serving. They may be unduly enthusiastic.

Id. at 581, *quoting Escott v. BarChris Construction Corp.*, 283 F.Supp. 643, 696 (S.D.N.Y.1968).

[221] *WorldCom*, *supra* note 217, at 684, and *n.*53.

> The public relies on the underwriter to obtain and verify relevant information and then make sure that essential facts are disclosed. Acting with the degree of diligence that applies to a prudent man when managing his own property, underwriters should ask those questions and seek those answers that are appropriate in the circumstances. They are not being asked to duplicate the work of auditors, but to conduct a reasonable investigation. If their initial investigation leads them to question the accuracy of financial reporting, then the existence of an audit or a comfort letter will not excuse the failure to follow

> through with a subsequent investigation of the matter. If red flags arise from a reasonable investigation, underwriters will have to make sufficient inquiry to satisfy themselves as to the accuracy of the financial statements, and if unsatisfied, they must demand disclosure, withdraw from the underwriting process, or bear the risk of liability.

Id.

[222] *Leasco*, *supra* note 220, at 581.

[223] *Id.*, *quoting Escott v. BarChris Construction Corp.*, 283 F.Supp. 643, 696 (S.D.N.Y.1968).

[224] *Leasco*, *supra* note 220, at 581.

> "Such adversity is required since the underwriter is the only participant in the registration process who, as to matters not certified by the accountant, is able to make the kind of investigation which will protect the purchasing public. Management may be so hard pressed for cash and so incorrigibly optimistic that they will accept or undervalue the risk of civil liability. The directors, as noted above, are not free to assume an adverse role, and in any event they are not entirely free from the pressures on and optimism of management. The SEC simply does not have the staff to verify independently even the more dubious registration statements. Only the underwriter and the accountant are free to assume an adverse role, have little incentive to accept the risk of liability, and possess the facilities and competence to undertake an independent investigation. They may therefore reasonably be required to share the burden of verification.

Id. at 582, *quoting* Comment, BarChris: Due Diligence Refined, 68 COLUM. L. REV. 1411, 1421 (1968).

[225] *Leasco*, *supra* note 220, at 581-82.

[226] *Leasco*, *supra* note 220, at 582.

[227] *WorldCom*, *supra* note 217, at 675-76, *quoting Leasco*, 332 F.Supp. at 582.

[228] *In re Enron Corp. Sec., Derivative & ERISA Litig.,* 235 F.Supp.2d 549, 612 (S.D.Tex.2002), *citing Sanders v. John Nuveen & Co.,* 554 F.2d 790, 1070 (7th Cir.1977).

[229] 15 U.S.C.A. § 77k.

[230] 15 U.S.C.A. § 77k; *see also WorldCom*, *supra* note 218, 646 (S.D.N.Y. 2004), *citing* 15 U.S.C. § 77k(a) ("Section 11 of the Securities Act provides that any signer, director of the issuer, preparing or certifying accountant, or underwriter may be liable if 'any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.'"). A registration statement is "'a filing that included the prospectus and other information required by Section 7 of the Securities Act.'" *WorldCom*, *supra* note 218, at 657, *quoting* 12 C.F.R. §16.2(m). And, a prospectus is "'an offering document that includes the information required by Section 10(a) of the Securities Act.'" *WorldCom*, *supra* note 217, at 657 *quoting* 12 C.F.R. § 16.2(l).

[231] *WorldCom*, *supra* note 217, at 657, *quoting Herman & MacLean v. Huddleston,* 459 U.S. 375, 381-82, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983).

[232] *See Enron*, *supra* note 228, at 611-612.

> Under § 11, an accountant may be civilly liable for certifying or preparing any financial report that is included in a registration*612 statement or prospectus which contains a material misrepresentation or omission. 15 U.S.C. § 77k. *See Herman & MacLean v. Huddleston,* 459 U.S. at 382 n. 11, 103 S.Ct. 683 ("Accountants are liable under § 11 only for those matters which purport to have been prepared or certified by them."). An accountant may establish a defense of due diligence to a § 11 claim if he demonstrates that "he had, after reasonable investigation, reasonable grounds to believe and did believe, at the time such part

> of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(b)(3)(B)(i).

Id.

[233] *WorldCom*, *supra* note 217, 656-7, *citing* 15 U.S.C. § 77k(a).

> Section 7(a) of the Securities Act provides that registration statements must be accompanied by the information and documents specified in Schedule A of the Act, which sets forth thirty-two items that must be included in a registration statement. 15 U.S.C. § § 77g(a), 77aa. Section 7(a) also authorizes the SEC to enact "rules or regulations" so that "disclosure fully adequate for the protection of investors is otherwise required to be included within the registration statement." 15 U.S.C. § 77g(a). Pursuant to Section 7(a), the SEC issued Regulations S-X, 17 C.F.R. § 210 *et seq.,* and S-K, 17 C.F.R. § 229 *et seq.* Regulation S-X governs the form and content of financial statements required to be included in a registration statement. Regulation S-K dictates the non-financial information that must be included in a registration statement. In a catch-all provision, the SBC regulations also provide that "[i]n addition to the information expressly required to be included in a registration statement, *there shall be added such further material information, if any, as may be necessary to make the required statements,* in the light of the circumstances under which they are made, *not misleading."* 17 C.F.R. § 230.408 (emphasis supplied). *See DeMaria v. Andersen,* 318 F.3d 170, 180 (2d Cir.2003).

Id. at 657 [emphasis in original].

[234] *WorldCom*, *supra* note 217, at 657, *quoting Gustafson v. Alloyd Co.,* 513 U.S. 561, 581, 115 S.Ct. 1061, 131 L.Ed.2d 1 (1995), *quoting* H.R. Rep. No. 85, 73d Cong., 1st Sess., at 5 (1933). Gustafson also stated ("The 'primary innovation' of the Securities Act was the creation of duties in connection with public offerings, principally "registration and disclosure obligations.'") *Id.* at 656, *quoting Gustafson* at 571; *see also Leasco*, *supra* note 220, at 577 (E.D.N.Y., 1971)

> 'The purpose of the civil liability imposed by section 11 is to protect the investor through full disclosure, and the standards of reasonable investigation must be framed in light of this goal. They should also reflect the two criteria set forth in the legislative history: (1) the importance of the role played by each participant in the scheme of distribution and (2) the reliance that the investor is justified in placing upon each participant. These criteria seem to be satisfied by a requirement that some of the parties to the registration process play a more adverse role vis-a-vis management than they may have in the past. The less a participant relies on management, the more the investor may rely on the involvement of the participant in the registration process.'

Leasco, *supra* note 220, at 577, *quoting Comment, BarChris: Due Diligence Refined*, 68 COLUM. L. REV. 1411, 1419 (1968).

[235] *In re Suprema Specialties, Inc. Securities Litigation*, 438 F.3d 256, 269 (3d Cir. 2006), *quoting In re Adams Golf, Inc. Sec. Litig.*, 381 F.3d 267, 274, *n*.13 (3d Cir. 2004); *see also In re Turkcell Iletisim Hizmetler, A.S. Securities Litigation*, 202 F. Supp.2d 8, 12 (S.D.N.Y. 2001), *citing Herman & MacLean v. Huddleston,* 459 U.S. 375, 382, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983). ("Section 11 does provide a due diligence defense for underwriters, but the burden of proof for the defense is on the defendants. The plaintiffs need not allege that defendants breached their duty of due diligence. Moreover, plaintiffs need not plead defendants' knowledge as there is no scienter requirement in section 11.")

[236] *In re Suprema Specialties, Inc. Securities Litigation*, 438 F.3d 256, 269 (3d Cir. 2006), *citing Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 *n*.13 (1983)

[237] *In re Suprema Specialties*, 438 F.3d at 269, *quoting In re Adams Golf, Inc. Sec. Litig.*, 381 F.3d 267, 274 *n*.13 (3d Cir. 2004).

[238] *WorldCom*, *supra* note 217, 659, *quoting* and *citing Huddleston,* 459 U.S. at 382, 103 S.Ct. 683; *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.,* 480 F.2d 341, 370-71 (2d Cir.1973); *see also* 15 U.S.C. § 77k(e).

[239] 15 U.S.C. § 77k(e). *WorldCom* states that "defendant's burden in establishing this defense is heavy since 'the risk or uncertainty' is allocated to defendants." *WorldCom* at 659, *quoting Akerman v. Oryx Comm., Inc.,* 810 F.2d 336, 341 (2d Cir.1987); *see also McMahan & Co. v. Warehouse Ent.*, *Inc.*, 65 F.3d 1044, 1048-49 (2d Cir.1995).

[240] *WorldCom*, *supra* note 217, at 659, *citing Herman & MacLean v. Huddleston,* 459 U.S. 375, 82, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983) and *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.,* 480 F.2d 341, 370-71 (2d Cir.1973) Huddleston stated "Section 11 of the Securities Act "was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering.'" *WorldCom* at 657, *quoting Huddleston* at 381-82.

[241] *WorldCom*, *supra* note 217, at 662-63.

[242] *Id.* at 659, *citing Metromedia Co. v. Fugazy,* 983 F.2d 350, 361 (2d Cir.1992).

[243] *Id.*

[244] The seller must be the immediate seller. *See WorldCom*, *supra* note 217, at 659.

> Section 12 creates a cause of action against sellers who 'passed title, or other interest in the security, to the buyer for value.' *Pinter v. Dahl,* 486 U.S. 622, 642, 108 S.Ct. 2063, 100 L.Ed.2d 658 (1988); *see also Wilson v. Saintine Exploration & Drilling Corp.,* 872 F.2d 1124, 1126 (2d Cir.1989) (applying *Pinter'* s § 12(1) analysis to what is now § 12(a)(2)); *Capri v. Murphy,* 856 F.2d 473, 478 (2d Cir.1988) (same). To be liable as a seller, the defendant must be the 'buyer's immediate seller; remote purchasers are precluded from bringing actions against remote sellers. Thus, a buyer cannot recover against his seller's seller.' *Pinter,* 486 U.S. at 644 *n*.21, 108 S.Ct. 2063. As underwriters in a firm commitment underwriting become the owners of any unsold shares, they may be liable as sellers for direct sales to the public.

Id. at 283.

[245] *See* 15 U.S.C. § 77l(a)(2).

[246] *WorldCom*, *supra* note 217, at 659.

> Defendants may be liable under Section 12(a)(2) either for selling a security or for soliciting its purchase. First, Section 12 creates a cause of action against sellers who "passed title, or other interest in the security, to the buyer for value." *Pinter v. Dahl,* 486 U.S. 622, 642, 108 S.Ct. 2063, 100 L.Ed.2d 658 (1988); *see also Wilson v. Saintine Exploration & Drilling Corp.,* 872 F.2d 1124, 1126 (2d Cir.1989) (applying *Pinter'* s § 12(1) analysis to what is now § 12(a)(2)); *Capri v. Murphy,* 856 F.2d 473, 478 (2d Cir.1988) (same). To be liable as a seller, the defendant must be the 'buyer's immediate seller; remote purchasers are precluded from bringing actions against remote sellers. Thus, a buyer cannot recover against his seller's seller.' *Pinter,* 486 U.S. at 644 n. 21, 108 S.Ct. 2063. As underwriters in a firm commitment underwriting become the owners of any unsold shares, they may be liable as sellers for direct sales to the public. *In re WorldCom, Inc. Sec. Litig.,* 219 F.R.D. at 283.
>
> Second, persons who are not in privity with the plaintiff may be liable if they "successfully solicit[ed] the purchase, motivated at least in part by a desire to serve [their] own financial interests or those of the securities owner." *Pinter,* 486 U.S. at 647, 108 S.Ct. 2063; *see also Commercial Union Assurance Co.,* 17 F.3d at 616. In finding that Section 12 included liability for solicitation, the Supreme Court observed that "[t]he solicitation of a buyer is perhaps the most critical stage of the selling transaction .... [and] the stage at which an investor is most likely to be injured." *Pinter,* 486 U.S. at 646, 108 S.Ct. 2063.

Id.

[247] *WorldCom*, *supra* note 217, at 659, *quoting Gustafson,* 513 U.S. at 582 (emphasis added).

[248] *WorldCom*, *supra* note 217 at 660, *citing Royal Am. Managers, Inc. v. IRC Holding Corp.,* 885 F.2d 1011, 1019 (2d Cir.1989).

[249] *WorldCom*, *supra* note 217 at 660, *quoting* 15 U.S.C. § 77l(b).

[250] See 15 U.S.C. § 77k(e).

[251] *WorldCom*, *supra* note 217 at 666, *citing Royal Am. Managers, Inc. v. IRC Holding Corp.,* 885 F.2d 1011, 1019 (2d Cir.1989).

[252] *WorldCom*, *supra* note 217 at 664.

> This difference is attributable to the emphasis placed on the importance of registration statements and the underwriter's vital role in assuring their accuracy.

Id., *citing John Nuveen & Co. v. Sanders,* 450 U.S. 1005, 1009 (1981).

[253] *WorldCom*, *supra* note 217 at 663.

> Section 12(a)(2) provides that a defendant shall not be liable if he "sustain[s] the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission" which is "necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading." 15 U.S.C. § 77l(a)(2).
>
> Thus, while Section 11 imposes a duty to conduct a reasonable investigation as to any portion of a registration statement not made on the authority of an expert, Section 12(a)(2) does not make any distinction based upon 'expertised' statements and only requires the defendant to show that it used reasonable care. This difference is attributable to the emphasis placed on the importance of registration statements and the underwriter's vital role in assuring their accuracy. *See John Nuveen & Co. v. Sanders,* 450 U.S. 1005, 1009 (1981) (Powell, J., dissenting from denial of *cert.*).

Id. at 663.

[254] Both Sections 11 and 12 provide an affirmative due diligence defense. *See* 15 U.S.C. § 77k(b)(3) and 15 U.S.C. 77l(d)(2); *see also Picard Chemical Inc. Profit Sharing Plan v. Perrigo Co*., No. 195-CV-141, 1:95-CV-290, 1998 WL 513091, *14 (W.D. Mich. 1998), *citing* 15 U.S.C. § 77k(b)(3).

> A defendant who relies on the due diligence defense to a claim under § 11 must show that 'after reasonable investigation, [he had] reasonable ground to believe and did believe ... that the statements [ ] were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements [ ] not misleading.'

Id.; see also Picard Chemical Inc. Profit Sharing Plan v. Perrigo Co., No. 195-CV-141, 1:95-CV-290, 1998 WL 513091, *14 (W.D. Mich. 1998), *citing* 15 U.S.C. § 771(a)(2) ("The standard of due diligence under § 12(2) requires a defendant to show 'he did not know, and in the exercise of reasonable care could not have known, of [the] truth or omission.'"); *see also Toolworks, supra* note 211, at 50 F.3d 615, 621 (9th Cir.1994) (Both standards of the Section 11 and 12 defenses are essentially identical.).

[255] *WorldCom*, *supra* note 217, at 663; *see also In re Enron Corp. Securities, Derivative & ERISA Litigation*, No. MDL-1446, Civ.A. H-01-3624, Civ.A. H-04-0088, 2005 WL 3704688, *17 (S.D. Tex., Dec. 5, 2005).

[256] *In re Enron Corp. Securities, Derivative & ERISA Litigation*, No. MDL-1446, Civ.A. H-01-3624, Civ.A. H-04-0088, 2005 WL 3704688, *17 (S.D. Tex., Dec. 5, 2005), *citing* 15 U.S.C. § 77k(c) and *WorldCom*, 346 F.Supp.2d at 663; *see also* 15 U.S.C. § 77k(c); *see also In re Enron Corp*., 235 F.Supp.2d at 613, *quoting* 15 U.S.C. § 77(k)(c); and *Toolworks*, *supra* note 212, at 621.

[257] *Enron*, *supra* note 228, at 613, *quoting Toolworks* at 621, *quoting Ernst & Ernst v. Hochfelder*, 425 US 185, 208 (1976).

[258] *Escott v. BarChris Const. Corp*, 283 F. Supp. 643 (D.C.N.Y. 1968); *see also Competitive Associates, Inc. v. International Health Sciences, Inc.*, 72 Civ. 1848-CLB, 1975 WL 349 (Jan 22, 1975); *see also Ernst & Ernst v. Hockfelder*, 425 US 185, 208 *n*.26 (1976).

> Other individuals who sign the registration statement, directors of the issuer, and the underwriter of the securities similarly are accorded a complete defense against civil liability based on the exercise of reasonable investigation and a reasonable belief that the registration statement was not misleading. ss 11(b)(3)(A), (C), (D), (c). *See, e. g.*, *Leasco*, *supra* note 220, at 575-583 (E.D.N.Y.1971) (underwriters, but not officer-directors, established their due-diligence defense). See generally R. Jennings & H. Marsh, Securities Regulation 1018-1027 (3d ed. 1972), and sources cited therein; Folk, Civil Liabilities Under the Federal Securities Acts: The Barchris Case, 55 VA. L. REV. 199 (1969).

Id.

[259] *Eichenholtz v. Brennan*, 52 F.3d 478, 485 (3d Cir. 1995). Refused to allow the underwriters to be indemnified per the indemnification agreement because indemnification "run[s] counter to the policies underlying the securities acts." *Id.* at 485.

[260] *BarChris, supra* note 258, at 697.

[261] *Toolworks*, supra note 211, at 622.

[262] *Competitive Associates, Inc. v. International Health Sciences, Inc .,* 1975 WL 349 at *18, Fed.Sec.L.Rep. ¶ 94,966 (S.D.N.Y. Jan. 22, 1975)

[263] *WorldCom*, *supra* note 217, at 670, *quoting* SEC Rel. 6335, 1981 WL 31062, at *13.

[264] *WorldCom*, *supra* note 217, at 674.

> Just as there is little judicial elaboration of the reliance defense, so too there is 'little judicial gloss' on the due diligence defense afforded to underwriters for non-expertised portions of a registration statement. *Leasco,* 332 F.Supp. at 576. *See also Glassman v. Computervision Corp.,* 90 F.3d 617, 628 (1st Cir.1996) ('The law on due diligence is sparse....'); John C. Coffee, Jr., *A Statutory and Case Law Primer on Due Diligence Under the Securities Law,* 886 P.L.I./Corp 11, 17 (1995) ("Few decisions have wrestled with the concepts in § § 11(b) and 11(c)."); Joseph McLaughlin, *Some Challenges to Underwriters and Their Counsel in the Modern Capital Markets Environment,* 28 Wake Forest L.Rev. 61, 67 (1993) (noting 'relative paucity of judicial interpretations of the underwriters' 'due diligence' defense"); Partnoy, *Barbarians at the Gatekeepers,* 79 Wash. U.L.Q. at 514 (2001) (Section 11 due diligence defense has generated "little case law."). While there is a paucity of caselaw, 'two early cases,' *Escott v. BarChris Construction Corp.,* 283 F.Supp. at 643, and *Leasco*, *supra* note 220, at 544, 'remain the major polestars" in defining what constitutes a reasonable investigation. Coffee, 886 P.L.I./Corp. at 17 (citation omitted).

Id.

[265] *See, e.g.*, *BarChris, supra* note 258, at 697.

[266] *WorldCom*, *supra* note 217, at 674, *citing Leasco*, 332 F.Supp. at 576.

[267] *Enron, supra* note 256, at *17, *citing* 15 U.S.C. § 77k(b)(3)(A).

[268] *Leasco*, *supra* note 220, *quoting Comment, BarChris: Due Diligence* Refined, 68 COLUM. L REV. 1411, 1416 (1968).

> What constitutes 'reasonable investigation' and a 'reasonable ground to believe' will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data. What is reasonable for one director may not be reasonable for another by virtue of their differing positions.

‘It was clear from the outset, however, that the duty of each potentially liable group was not the same. The House report on the bill that became the original Securities Act stated that the duty of care to discover varied in its demands upon the participants with the importance of their place in the scheme of distribution and the degree of protection that the public had a right to expect from them. It has been suggested that although inside directors might be better able to show that they undertook some investigation, the outside director could more easily demonstrate that the investigation he actually undertook was sufficient to sustain his defense.’

Id.

[269] *Enron*, *supra* note 228, at 613, *citing BarChris*, 283 F.Supp. at 697 (S.D.N.Y.1968),

[270] *Enron*, *supra* note 228, at 613 (“They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them.”).

[271] *WorldCom*, *supra* note 217, at 676, *quoting* Honorable Robert W. Sweet, *Ades v. Deloitte & Touche,* Nos. 90 Civ. 4959(RWS), 90 Civ. 5056(RWS), 1993 WL 362364, at *19 (S.D.N.Y. Sep. 17, 1993).

[272] *WorldCom*, *supra* note 217, at 683.

[273] *Id.*

[274] *Id.* at 683-84.

[275] *Weinberger v. Jackson,* No. C-89-2301-CAL, 1990 WL 260676, at *3 (N.D.Cal. Oct.11, 1990).

After reviewing the record, this court concludes that there is no genuine issue of material fact that the underwriters did meet the standards required of them by section 11 and section 12(2). Their investigation of Altos was conducted primarily by the managing underwriters. It was conducted by experienced people, who were assisted by attorneys and accountants. The underwriters reviewed the industry, the company, the company's management, and the company's past and projected manufacturing, sales and financial performance. The underwriters had over twenty meetings with various management personnel, covering all aspects of the company's business. Company personnel were specifically questioned about the development and scheduled availability of products, related operating systems and applications software. The underwriters also contacted many of Altos' suppliers, customers, and distributors, who were asked extensive questions about the company's operations. The underwriters reviewed company documents including operating plans, product literature, corporate records, financial statements, contracts, and lists of distributors and customers. They examined trade journals and other industry-related publications to ascertain industry trends, market trends and competitive information. They also made physical inspections of the company's facilities. When any negative or questionable information was developed as a result of their investigation, the underwriters discussed it with the appropriate persons and arrived at informed decisions and opinions. The underwriters also obtained written representations from the selling stockholders and the company that as of the closing date of the public offering, there were no misstatements or omissions.

Id.; *see also In re Int'l Rectifier Sec. Litig.,* No. CV91-3357-RMT(BQRX), 1997 WL 529600, at *3 (C.D.Cal.1997).

As required by the SEC, the Underwriters commenced formal due diligence into IR's operations. The Underwriters first held an organizational meeting which was attended by Kidder, Montgomery, Latham & Watkins (the law firm representing the Underwriters), O'Melveny & Meyers (IR's attorneys), and Coopers & Lybrand (IR's outside accountants)-collectively “the Working Group.” Building upon the Underwriters' already-existing base of knowledge about IR and the semiconductor industry, the diligence conducted in preparation for the stock offering was unquestionably extensive.

At the outset, the Underwriters interviewed eleven senior and middle management employees on a variety of subjects including IR's management, operations, customer-base, technology, expenditures, and growth potential. The Underwriters interviewed IR's major customers, IR's outside quality consultants (Andersen

Consulting), IR's outside accountants (Coopers & Lybrand), IR's patent attorney, and IR's outside environmental counsel. The Underwriters inspected IR's major factories and reviewed IR's internal financial forecasts and other important documents. Latham & Watkins examined IR's key contracts and its compliance with applicable laws.

> The entire Working Group reviewed IR's preliminary prospectus line-by-line, maintaining contact with IR's management as revisions were made. The Underwriters conducted their own independent analysis of IR's business plan and created their own model of IR's expected earnings, which demonstrated that IR's internal forecasts were actually conservative. The Underwriters continued their diligence throughout the pre-offering period, receiving an oral confirmation from IR's management that they believed the prospectus to be correct, a written confirmation from IR's management stating the same and a "cold comfort" letter from Coopers & Lybrand representing that it knew of no material changes in IR's financial position since its last audit.

Id. at *3-4; *see also Phillips v. Kidder, Peabody & Co.,* 933 F.Supp. 303 (S.D.N.Y.1996), *aff'd,* 108 F.3d 1370, 1997 WL 138814 (2d Cir.1997).

> The defendant claims that it conducted extensive due diligence which rendered a physical count of inventory unnecessary. In support of this claim it submitted an affidavit of Robert J. Stefan, an investment banker in the Corporate Finance Department of Kidder between 1981 and 1988. According to Mr. Stefan, Kidder engaged in the following forms of due diligence:

> (1) analyzing and investigating CDI's business, including its marketing strategy, sources of supply and competitive position in computer retailing, including discussions and/or meetings with management, outside directors, suppliers, department stores, lending banks, accountants and lawyers;

> (2) reviewing the Company's financial statements, forecasts, budgets, and accounting controls, including discussions and/or meetings with management, outside directors, accountants, suppliers, and lending banks;

> (3) discussing with CDI's principal suppliers, IBM and Apple, the Company and its marketing strategy, competence of company management, prospects for expansion, and suppliers' intentions to increase production and allotments;

> (4) reviewing CDI corporate documents, including its articles of incorporation, by-laws, board minutes, and 1983 private placement memorandum;

> (5) analyzing the personal computer business, including the composition of its manufacturing, retail, and computer sectors, CDI's competition, and projections of the market's future size and profitability;

> (6) researching the background and experience of CDI's management, outside directors, counsel, and outside auditors;

> (7) reviewing and investigating CDI's lists of projected store openings, leases and letters of intent with host department stores;

> (8) analyzing costs and expenses associated with opening and operating new computer*319 stores, including costs related to construction, financing of accounts receivable, and working capital requirements, and including meetings and/or discussions with management and accountants;

> (9) discussing with management and outside authorities historic and projected performance of new stores, including working capital requirements, construction costs, and financing of accounts receivable;

> (10) reviewing CDI's banking relationship, and verifying, among other things, banks' confidence in CDI and willingness to increase credit lines;

> (11) reviewing and discussing with management and accountants the Company's projected performance for the second quarter of fiscal 1985;

> (12) drafting, reviewing and commenting on drafts of the Registration Statement and Prospectus and correspondence with the SEC;

(13) reviewing IPO prospectuses of other personal computer retailers, comparing price/earnings multiples, monitoring those company's stock prices and obtaining clearance of IPO with various Blue Sky authorities;

(14) reviewing employment contracts, employee salaries, employee benefit plans, and employee training programs.

Id. at 318-319.

[276] *WorldCom*, *supra* note 217, at 677, *citing Glassman,* 90 F.3d at 629 ("[A] failure by the underwriters either to verify a company's statements as to its financial state or to consider new information up to the effective date of an offering would almost certainly constitute a lack of due diligence.").

[277] *WorldCom*, *supra* note 217, at 677, *quoting Enron,* 235 F.Supp.2d at 707; *see also Univ. Hill Found. v. Goldman, Sachs & Co.,* 422 F.Supp. 879, 900 (S.D.N.Y.1976) (whether or not underwriter conducted "reasonable investigation" depends on "the presence or absence of 'warning signals' to [underwriter] that something more might be in order.") (citation omitted).

[278] *Enron*, *supra* note 257, at *17, *citing* 15 U.S.C. § 77k(b)(3)(B), and *WorldCom*, *supra* note 218, at 662-63. *See also* 15 U.S.C. 77k(b)(3)(C).

[279] *Id.*

There is a different standard that applies when a Section 11 defendant is entitled to rely upon the opinion of an expert. '[A]s regards any part of the registration statement purporting to be made on the authority of an expert,' a defendant other than that expert will not be liable if he demonstrates that *he had no reasonable ground to believe and did not believe,* at the time such part of the registration statement became effective, *that the statements therein were untrue* or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading. 15 U.S.C. § 77k(b)(3)(C) (emphasis supplied).

Section 11 also provides a defense to an expert as concerns 'any part of the registration statement purporting to be made upon his authority as an expert.' The expert must prove that *he had, after reasonable investigation, reasonable ground to believe and did believe,* at the time such part of the registration statement became effective, *that the statements therein were true* and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading. 15 U.S.C. § 77k(b)(3)(B) (emphasis supplied).

WorldCom, *supra* note 217, at 663.

[280] *Enron*, *supra* note 228, at 613, *citing* 15 U.S.C § 77k(b)(3)(C), and *Toolworks*, *supra* note 211, at 623. *Compare to* 15 U.S.C. § 77k(b)(3)(A)*:* If unaudited financials are included in a registration statement, the underwriter must "*demonstrate affirmatively* under Section 11 (Section 11(b)(3)(A) *that, after conducting a reasonable investigation, they had reasonable ground to believe, and did believe, that the interim financial data was true."* *WorldCom*, *supra* note 217, at 666. [emphasis in original].

[281] *Enron*, *supra* note 256, at *17, *citing WorldCom*, 346 F.Supp.2d at 664-65. ("reviews of unaudited interim financial statements, even where the auditor provides the underwriter with a "comfort letter" containing representations about the auditor's review of the interim financial statement, do not constitute such opinions and are not considered to be expertised statements for purposes of a reliance defense."). *Id.*

[282] *WorldCom*, *supra* note 217, at 671. According to Justice Powell, Section 11:

[E]xplicitly absolve[s] [an underwriter] of the duty to investigate with respect to "any part of the registration statement purporting to be made on the authority of an expert" such as a certified accountant if "he had no reasonable ground to believe and did not believe" that the information therein was misleading. This provision is in the Act because, *almost by definition, it is reasonable to rely on financial statements certified by public accountants.*

> Justice Powell further explained that underwriters' reliance on certified financial statements is not only reasonable but also, in his view, "essential to the proper functioning of securities marketing, to the trading in securities, to the lending of money by banks and financial institutions, and to the reliance by stockholders on the reports of their corporations."
>
> He observed that "where breaches by accountants occur, it is the accountants themselves--not those who rely in good faith on their professional expertise--who are at fault and who should be held responsible.

WorldCom, *supra* note 217, at 671-72, *quoting* and *citing John Nuveen & Co. v. Sanders,* 450 U.S. 1005, 1010 *n*.4 (1981) (Powell, J., dissenting from denial of cert.).

[283] *WorldCom*, *supra* note 217, at 666. ("Comfort letters do not "expertise any portion of the registration statement that is otherwise non-expertised.") *Id.* quoting William F. Alderman, *Potential Liabilities in Initial Public Offerings, in How To Prepare an Initial Public Offering 2004* 405-06 (2004); *see also* Committee on Federal Regulation of Securities, *Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws,* 48 Bus. Law. 1185, 1210 (1993) (*"Task Force Report"*) (underwriters "remain responsible" for unaudited interim financial information as in the case of other non-expertised information).

[284] *WorldCom*, *supra* note 217, at 672.

[285] *WorldCom*, *supra* note 217, at 673 ("It is equally important to note that what constitutes a red flag depends on the facts and context of a particular case."). *Id.*

[286] *BarChris, supra* note 258, at 697.

[287] *Leasco*, *supra* note 220, at 582, *citing* Comment, BarChris: Due Diligence Refined, 68 COLUM. L. REV. 1411, 1417 (1968).

[288] *Leasco*, *supra* note 220, at 582.

[289] *Id.*

[290] *Id.* at 561 and 583.

[291] *Id.* at 582.

[292] *Id.* at 583.

[293] *BarChris, supra* note 258, at 697.

[294] *Id.* The due diligence defense was established as to the audited figures. *Id.*

[295] *WorldCom*, *supra* note 217, at 674, *citing BarChris*, 283 F.Supp. at 693-95.

[296] *WorldCom*, *supra* note 217, at 674, *citing BarChris*, 283 F.Supp. at 697.

[297] *Escott v. BarChris Const. Corp*, 283 F.Supp. 643, 697 (D.C.N.Y. 1968).

[298] *BarChris, supra* note 258, at 697.

[299] *Id.*

[300] *Leasco*, *supra* note 220, at 576-77, *citing Escott v. BarChris Const. Corp.,* 283 F.Supp. 643, 683 (S.D.N.Y. 1968).

[301] *Id.*

> It is claimed that a lawyer is entitled to rely on the statements of his client and that to require him to verify their accuracy would set an unreasonably high standard. This is too broad a generalization. It is all a matter of degree. To require an audit would obviously be unreasonable. On the other hand, to require a check of matters easily verifiable is not unreasonable. Even honest clients can make mistakes. The statute imposes liability for untrue statements regardless of whether they are intentionally untrue. The way to prevent mistakes is to test oral information by examining the original written record.

Id. at 577 *quoting BarChris* at 690.

[302] *Toolworks*, *supra* note 211, at 622.

[303] *Id.*

[304] *Toolworks*, *supra* note 211, at 622-23. However the Court reversed the district court's grant of summary judgment on other aspects of the underwriters' due diligence efforts where "there were questions of fact as to whether underwriters performed adequate due diligence on the issuer's post-prospectus entry of $7 million in large consignment sales, which were later reversed in the final financial statements for the quarter." *Id.* at 626.

[305] *WorldCom*, *supra* note 217, at 676, *citing Toolworks*.

[306] *WorldCom*, *supra* note 217, at 637. Section 11 is 15 U.S.C. § 77k.

[307] *Id.*

[308] *WorldCom*, *supra* note 217, 645.

[309] *Id.*

[310] *Id.* at 636.

> The underwriters consist of Salomon Smith Barney, Inc., now d/b/a/ Citigroup Global Markets Inc. and Salomon Brothers International Limited (collectively "SSB"); J.P. Morgan Chase & Co., J.P. Morgan Securities, Ltd., & J.P. Morgan Securities, Inc. (collectively "J.P. Morgan"); Banc of America Securities LLC; Chase Securities Inc.; Lehman Brothers Inc., Blaylock & Partners, L.P.; Credit Suisse First Boston Corp.; Deutsche Bank Alex. Brown, Inc., now known as Deutsche Bank Securities, Inc.; Goldman, Sachs & Co.; UBS Warburg LLC; ABN/AMNRO Inc.; Utendahl Capital; Tokyo-Mitsubishi International plc; Westdeutsche Landesbank Girozentrale; BNP Paribas Securities Corp.; Caboto Holding SIM S.p.A.; Fleet Securities Inc.; and Mizuho International plc.

Id. at 637 *n*.4.

[311] *WorldCom*, *supra* note 217, at 634.

> The Underwriter Defendants move for summary judgment with respect to the financial statements that were incorporated into the Registration Statements. They assert that there is no dispute that they acted reasonably in relying on Andersen's audits and comfort letters. The Underwriter Defendants contend that they were entitled to rely on WorldCom's audited financial statements and had no duty to investigate their reliability so long as they had 'no reasonable ground to believe' that such financial statements contained a false statement. They also assert that they were entitled to rely in the same way on Andersen's comfort letters for the unaudited quarterly financial statements incorporated into the Registration Statements.

Id. at 661.

[312] *Id.* at 634.

[313] *Id.* at 653.

[314] *Id.* at 634.

[315] *Id.* at 634-35.

[316] *Id.* at 637.

[317] *Id.*

[318] *Id.* at 682.

[319] *Id.* at 683.

[320] *Id.* at 679-80.

> The Underwriter Defendants argue that the standard that should apply is whether they had 'clear and direct notice" of an 'accounting' problem. They argue that case law establishes that "ordinary business events' do not constitute red flags. They are wrong. There is no basis in law to find a requirement that a red flag arises only when there is 'clear and direct' notice of an accounting issue. The standard under Section 11 is whether a defendant has proven that it had 'no reasonable ground to believe and did not believe' that a registration statement contained material misstatements, a standard given meaning by what a 'prudent man' would do in the management of his own property. Nor is the bar lowered because there is an expert's opinion on which an underwriter is entitled to rely. The 'prudent man' standard applies to Section 11(b)(3)(C). Finally, what constitutes an ordinary business event and what constitutes a red flag is an issue of fact. These are exquisitely fact intensive inquiries that depend on the circumstances surrounding a particular issuer and the alleged misstatement. There is no category of information which can always be ignored by an underwriter on the ground that it constitutes an ordinary business event. What is ordinary in one context may be sufficiently unusual in another to create a duty of investigation by a 'prudent man.'

Id.

[321] *WorldCom*, *supra* note 217, at 679.

> The fact that the difference was publicly available information does not absolve the Underwriter Defendants of their duty to bring their expertise to bear on the issue. The Underwriter Defendants do not dispute that they were required to be familiar with the Exchange Act filings that were incorporated by reference into the Registration Statement. If a 'prudent man in the management of his own property,' 15 U.S.C. § 77k(c), upon reading the 1999 Form 10-K and being familiar with the other relevant information about the issuer's competitors would have questioned the accuracy of the figures, then those figures constituted a red flag and imposed a duty of investigation on the Underwriter Defendants. A jury would be entitled to find that this difference was of sufficient importance to have triggered a duty to investigate the reliability of the figures on which the ratio was based even though the figures had been audited.

Id.

[322] *WorldCom*, *supra* note 217, 678.

[323] *WorldCom*, *supra* note 217, at 680.

[324] *WorldCom*, *supra* note 217, at 681.

[325] *Id.*

> The issue here is whether the Underwriter Defendants' knowledge of Ebbers, including his financial circumstances, gave them reason to believe the WorldCom audited financial statements were inaccurate. Without some evidence that the Underwriter Defendants had reason to believe that Ebbers was

> untrustworthy, his dependence on WorldCom's financial health, even though extraordinary, is insufficient to constitute a red flag that he may have caused a manipulation of WorldCom's financial statements.

Id.