UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re REFCO, INC. SECURITIES LITIGATION	:	05 Civ. 8626 (GEL)

LEAD PLAINTIFFS' MEMORANDUM OF LAW IN SUPPORT OF MOTION FOR PARTIAL SUMMARY JUDGMENT

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Lead Plaintiffs respectfully submit this memorandum of law in support of their motion for partial summary judgment on liability for Count V (Section 11) as against Defendants William Blair & Company, LLC ("William Blair"), Harris Nesbitt Corp. (n/k/a BMO Capital Markets, Inc.) ("BMO"), Samuel A. Ramirez & Company, Inc. ("Ramirez"), CMG Institutional Trading LLC ("CMG"), Muriel Siebert & Co. Inc. ("Siebert"), The Williams Capital Group, L.P. ("Williams Capital") and Utendahl Capital Partners, L.P. ("Utendahl") (collectively, the "Junior Underwriters").

PRELIMINARY STATEMENT

This motion presents a straightforward question of law: is an underwriter of publicly-issued securities entitled to assert the affirmative defense of "reasonable investigation" provided in Section 11 of the Securities Act of 1933 ("Securities Act") when the underwriter has admitted that it conducted no investigation whatsoever, and did nothing to ascertain whether any other underwriter had performed a reasonable investigation, of statements in a registration statement later revealed to be materially untrue and misleading? Because the answer to this question is "no," Lead Plaintiffs respectfully submit that they are entitled to summary judgment as to liability against the Junior Underwriters.

The fundamental issue here is whether an underwriter that chooses not to conduct any investigation into the accuracy of a registration statement can carry its burden of establishing an affirmative defense under Section 11, when that affirmative defense requires the underwriter to prove that "he had, after reasonable investigation, reasonable ground to believe and did believe," that the registration statement was accurate. 15 U.S.C. § 77k.[1] The language of Section 11 makes clear that an underwriter seeking to establish this affirmative defense — commonly

[1] All emphasis is added unless otherwise noted.

referred to as the "due diligence" defense — must show that it actually conducted a "reasonable investigation" into the accuracy of the registration statement.

The record reveals that the Junior Underwriters here chose not to make any investigation into the accuracy of the registration statement pursuant to which Refco Inc. ("Refco" or the "Company") conducted its initial public offering ("IPO") in August 2005.[2] Instead, these banks consented to the inclusion of their names in Refco's IPO Registration Statement as underwriters, underwrote and sold more than $39 million of now-worthless Refco stock to the public, and pocketed their underwriting fees, but did nothing whatsoever to ensure that investors received accurate information. Doing nothing is not sufficient for an underwriter to avail itself of the affirmative due diligence defense under Section 11, since the predicate for even entertaining that defense is that the underwriter — "he" — had done something. *See, e.g., In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 678 (S.D.N.Y. 2004) ("Section 11(b) plainly commands that underwriters conduct an investigation" into the accuracy of the registration statement) (emphasis in original)).

Confronted with their truancy at their Rule 30(b)(6) depositions, the Junior Underwriters claimed to have relied on other underwriters to conduct the investigation regarding Refco's IPO Registration Statement. But this provides them with no cover, because none of the Junior Underwriters did anything to verify whether the supposed diligence being conducted by the other underwriters was adequate — or even if it was being conducted at all. *See, e.g.*, ¶ 69 ("Q: What, if anything, did William Blair do to verify that the due diligence being performed by other

[2] The Refco IPO was conducted pursuant to a series of documents filed with the SEC, including a Form S-1A registration statement dated August 10, 2005, and a Form 425B1 prospectus dated August 10, 2005 (the "Prospectus") (collectively, the "IPO Registration Statement"). ¶ 1. (All references to "¶ _" are to the Rule 56.1 statement filed contemporaneously with this motion.)

members of the syndicate and relied upon by William Blair was adequate? A: Nothing. Q: Does William Blair even know whether the other underwriters performed due diligence? A: Not specifically."); ¶ 62 ("Q: Did Utendahl take any steps to independently verify the due diligence conducted by [the lead underwriters] or any other underwriter involved in the Refco IPO? A: No."); ¶ 66 ("Q: Did - did anyone at Siebert do anything to confirm or verify that the other underwriters involved were conducting adequate due diligence in respect of the Refco IPO? A: We did not.").[3]

Even if some delegation of responsibility to other underwriters were appropriate notwithstanding the language of Section 11, the Junior Underwriters' failure to verify any aspect of the "due diligence" supposedly being conducted by other underwriters renders the due diligence defense unavailable. The Securities Exchange Commission ("SEC") has interpreted Section 11 as requiring an underwriter that chooses to rely on another bank's efforts to investigate the issuer to nonetheless conduct some investigation of its own into whether that other bank's investigation is adequate:

> Section 11 does not by its terms distinguish between managing underwriters (managers) and underwriters who participate as members of the underwriting group (participants). It speaks only of 'every underwriter, of whatever type. . . . Even though the participant may appoint the manager as his agent to do the investigation . . . he must satisfy himself that the managing underwriter makes the kind of investigation the participant would have performed if he were the manager. He should assure himself that the manager's program of investigation

[3] The Junior Underwriters are the subjects of this motion because they are unique in taking no steps of their own to investigate the accuracy of the IPO Registration Statement, nor any steps to verify the adequacy of the due diligence conducted by other underwriters, whereas other Defendant banks that acted as underwriters on the Refco IPO appear to have at least taken some steps to attempt an investigation – albeit an inadequate one – prior to selling Refco shares to the public. One underwriter, Sandler O'Neill & Partners, L.P., settled with the Class in August 2008, and is no longer a defendant in this action. Junior Underwriter CMG, despite being noticed on June 3, 2008, has not yet sat for a deposition. However, Lead Plaintiffs are not aware of evidence indicating that CMG conducted its own investigation into the accuracy of the IPO Registration Statement, or that CMG took any steps to verify the adequacy of the due diligence investigation conducted by any other underwriter involved in the IPO. ¶¶ 58, 71.

> and actual investigative performance are adequate. The participant's checks on the manager are vital since they may provide additional assurance of verification of the statements in the registration statement. Section 11 accords a due diligence defense to each person engaged in the distribution (except the company) in the expectation that each such person will make a reasonable investigation in light of the circumstances so that he can avoid the heavy civil liabilities imposed by that section . . .Thus, although the participant may delegate the performance of the investigation, he must take some steps to assure the accuracy of the statements in the registration statement. To do this, he at least should assure himself that the manager made a reasonable investigation.

SEC Release No. 9671, 1972 WL 125474, at *6 (July 27, 1972).

The SEC Release emphasizes a critical fact — the due diligence defense under Section 11 is unique to each underwriter ("each such person" and "every underwriter"), and therefore each underwriter must separately establish that it conducted a reasonable investigation. To do so where, as here, a bank opts to do no diligence of its own, each Junior Underwriter must come forward with evidence that, at a minimum, (1) it assured itself that the "program of investigation and actual investigation" being conducted by the lead underwriters on the Refco IPO was adequate, and (2) it took "some steps" to ensure that Refco's IPO Registration Statement was accurate, which "at least" included assuring itself that the lead underwriters did in fact make a reasonable investigation. *Id*. This they cannot do.

The facts underlying this motion are undisputed. On August 10, 2005, Refco sold more than $670 million worth of shares in an initial public offering. Refco enlisted the services of fifteen Wall Street banks (the "Underwriters") to help the Company sell itself to the public. Each of the Underwriters — including the Junior Underwriters subject to this motion — consented to the inclusion of its name in the IPO Registration Statement, and each sold shares of Refco to investors. But just forty-two trading days after Refco's IPO, in one of the most abrupt corporate meltdowns in history, Refco announced that it had concealed hundreds of millions of dollars of uncollectible debt owed by a related-party entity owned by its CEO. This disclosure

set into motion a fatal chain of events that ended with Refco filing for bankruptcy a week later, with all of the shares sold in the IPO — including the over $39 million worth of shares sold by the Junior Underwriters — rendered virtually worthless.

The failure to disclose Refco's material related-party debt rendered numerous statements in the IPO Registration Statement materially untrue and incomplete. As a result, each of Refco's Underwriters is strictly liable on Lead Plaintiffs' Section 11 claim unless it can prove that it conducted a "reasonable investigation" into the accuracy of the IPO Registration Statement. *See WorldCom*, 346 F. Supp. 2d at 662. As the undisputed facts here show, none of the Junior Underwriters did any investigation whatsoever and, further, took no steps to verify whether those on whom they purportedly relied did so in their stead. Accordingly, the Lead Plaintiffs are entitled to summary judgment on their Section 11 claim (Count V) against the Junior Underwriters.

STATEMENT OF UNDISPUTED FACTS

I. THE IPO REGISTRATION STATEMENT CONTAINED MATERIALLY UNTRUE AND MISLEADING STATEMENTS

A. The IPO

In an IPO conducted on or about August 10, 2005, Refco sold approximately $670 million worth of shares to the Underwriters, who in turn sold all of those shares to public investors. ¶ 2. The IPO Registration Statement included the Company's unaudited financial statements for the quarters ended May 31, 2004 and May 31, 2005. ¶ 4.

The Junior Underwriters were seven of the fifteen Wall Street banks that acted as underwriters on the Refco IPO. ¶ 6. Each of the Junior Underwriters consented to having its name listed as an underwriter in the Prospectus given to investors, and each of them sold shares of Refco to the investing public. ¶¶ 7-13. Collectively, the Junior Underwriters sold over $39

million worth of Refco shares to investors. *Id*. (listing amounts sold by each Junior Underwriter).

B. Refco Discloses The RGHI Receivable

On October 10, 2005, Refco announced that it had discovered an approximately $430 million dollar receivable owed to the Company by a related-party entity (Refco Group Holdings Inc. or "RGHI") owned and controlled by Refco CEO Phillip Bennett. ¶ 14. As a result of the failure to disclose this related party receivable in Refco's prior financial statements, the Company determined that its financial statements for the fiscal years ended February 28, 2002, February 28, 2003, February 29, 2004, and February 28, 2005, and for the quarter ended May 31, 2005, "should no longer be relied upon." *Id*.

On October 11, 2005, Refco supplemented its previous disclosure by announcing that it believed the multi-hundred million dollar receivable "consisted in major part of uncollectible historical obligations…that arose as far back as 1998." ¶ 13. Refco further stated that "[t]hese obligations were transferred periodically to the entity controlled by Mr. Bennett [*i.e.*, RGHI] and the Company's books and records then reflected a receivable from that entity…. The fact that the receivable was from a company controlled by Mr. Bennett was hidden at the end of quarterly and annual reporting periods by reason of transfers to a third party…." *Id.*

On October 17, 2005, Refco filed for bankruptcy in the United States Bankruptcy Court in this District. ¶ 16.

C. Untrue And Misleading Statements And Omissions Regarding Refco's Unaudited Financial Results

Lead Plaintiffs will demonstrate at trial that the IPO Registration Statement contained a host of untrue statements and omitted numerous material facts. For purposes of this motion, however, Lead Plaintiffs focus on a sub-set of those financial and other statements that were

indisputably untrue and incomplete in material respects. Each of these statements was contained in the "non-expertised" portions of the IPO Registration Statement (*i.e.*, was not purported to have been made on the authority of an expert).[4]

It is well-established that unaudited financial information included in a registration statement is considered "non-expertised" information for purposes of Section 11. *See, e.g.*, *WorldCom*, 346 F. Supp. 2d at 665-66. Refco's IPO Registration Statement contained numerous untrue statements of material fact relating to Refco's unaudited financial results for the periods ended May 31, 2004 and May 31, 2005. ¶¶ 17-42. For instance, the IPO Registration Statement included Refco's unaudited financial statements for the three-month periods ending May 31, 2005 and May 31, 2004, which falsely stated that Refco had:

- total assets of $74,317,191,000 for the three months ended May 31, 2005;
- receivables from customers of $1,807,446,000 (net of reserves) for the three months ended May 31, 2005; and
- net income of $42,587,000 and $59,270,000 for the three months ended May 31, 2005 and May 31, 2004, respectively.

¶¶ 17-30.

The IPO Registration Statement also included a significant amount of financial information set forth in the textual (non-expertised) portions of the IPO Prospectus, including that "for the three months ended May 31, 2005, we generated . . .$42.6 million of net income,"

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[4] Section 11 provides that a defendant is not liable for untrue statements made in the registration statement if those statements have been made on the authority of an "expert" (*i.e.*, "expertised" statements) if the defendant "had no reasonable ground to believe and did not believe" that the statements were untrue. *See WorldCom*, 346 F. Supp. 2d at 662; 15 U.S.C. § 77kb(3)(C). To satisfy this requirement, an underwriter must conduct a detailed investigation whenever there are "red flags" that suggest that the expertised statements might be inaccurate. This portion of the due diligence defense is not at issue on this motion, which focuses exclusively on untrue and misleading non-expertised statements. Lead Plaintiffs leave for another day their discussion of the numerous "red flags" that raised significant questions about the accuracy of the "expertised" statements in Refco's IPO Registration Statement.

that "Prime Brokerage/Capital Markets operating profit for the three months ended May 31, 2005 increased $18.5 million, or 58.5%, to $50.1 million from $31.6 million for the three months ended May 31, 2004," and that the Company's Consolidated EBITDA for the twelve months ended May 31, 2005 was $296,747,000 while its actual leverage ratio was 3.03x. ¶¶ 31-36. In addition, the IPO Registration Statement falsely stated that "the unaudited consolidated financial statements as of May 31, 2005 and for the three months ended May 31, 2004 and 2005 include all adjustments (consisting of normal, recurring adjustments) that are, in the opinion of management, necessary for a fair presentation of our financial position and result of operations for the period presented." ¶¶ 37-8.[5]

D. Untrue And Misleading Statements And Omissions Regarding Refco's Related Party Transactions

The failure to disclose the multi-hundred million dollar related-party debt owed to Refco by RGHI also rendered numerous statements in the IPO Registration Statement regarding Refco's "related party" transactions materially untrue and misleading. For instance, in the portion of the IPO Prospectus entitled "Certain Relationships and Related Transactions," Refco did not disclose the existence of the related-party debt owed to it by RGHI, the entity owned by Bennett. ¶ 39-40. This information was required to be set forth therein, and its absence rendered that entire portion of the IPO Prospectus materially misleading. Indeed, the IPO Registration Statement contains numerous references to RGHI, without once disclosing its huge debt to Refco

[5] Among other evidence of the material falsity of the statements set forth above are that the persons who controlled Refco at the time of the IPO – Defendants Thomas H. Lee Partners, Thomas H. Lee Equity Fund V, L.P., Thomas H. Lee Parallel Fund V, L.P., Thomas H. Lee Equity (Cayman) Fund V, L.P., Thomas H. Lee Investors Limited Partnership, the 1997 Thomas H. Lee Nominee Trust, and senior THL executives Thomas H. Lee, David V. Harkins, Scott L. Jaeckel and Scott A. Schoen (the "THL Defendants") – admitted in their Answer filed in this action that the IPO Registration Statement was materially false and misleading, including the financial information set forth above. ¶¶ 43-4.

— thus rendering each of the statements relating to RGHI materially untrue and misleading. ¶¶ 41-2.

II. THE JUNIOR UNDERWRITERS CONDUCTED NO INVESTIGATION INTO THE ACCURACY OF REFCO'S IPO REGISTRATION STATEMENT

Lead Plaintiffs have conducted Rule 30(b)(6) depositions of six of the Junior Underwriters on the topic of what diligence, if any, they performed regarding the IPO Registration Statement. In these depositions, each of the Junior Underwriters testified that it conducted no due diligence investigation whatsoever in connection with Refco's IPO. ¶¶ 46, 48, 50, 52, 54 and 56.

For instance, William Blair's corporate representative testified as follows:

> Q: And when you say [William Blair] did not perform any independent due diligence, what due diligence did you perform, if any?
>
> A: None.
>
> * * *
>
> Q: Prior to the Refco IPO becoming effective, which was on or about August 10th, 2005, did William Blair do any investigation whatsoever into the accuracy of the statements made in the IPO Prospectus?
>
> A: No.

¶¶ 46. Likewise, Ramirez's corporate representative testified as follows:

> Q: [D]id Ramirez conduct any due diligence whatsoever in connection with the Refco IPO?
>
> A: No, Ramirez & Company did not.

¶ 50. As set forth in more detail in Lead Plaintiffs' Rule 56.1 statement, every one of the Junior Underwriters that has sat for a deposition has testified substantially the same as William Blair and Ramirez — they performed no due diligence to confirm the accuracy of Refco's IPO Registation Statement. *See, e.g.*, ¶ 52 ("Q: Did Siebert conduct any due diligence independent of the book-running managers and co-managers in respect of the Refco IPO? A: Apart from

reading this document [the IPO Registration Statement], we did not conduct any due diligence in the Refco IPO"); ¶ 48 ("Q: So it's true that no one from Utendahl participated in or conducted due diligence in connection with the Refco IPO? A: Due diligence, no.").

Indeed, the record establishes that, in connection with underwriting tens of millions of dollars in Refco securities, these Junior Underwriters did not bother to (1) participate in any due diligence calls (¶¶ 46, 48, 50, 52, 54 and 56); (2) speak to Refco's management (¶¶ 46, 48, 50, 52, 54 and 56); (3) communicate with Refco's auditor (¶¶ 46 and 56); (4) visit Refco's offices (¶¶ 46, 48, 50, 52, 54 and 56); (5) visit any of Refco's customers (¶¶ 46 and 56); (6) communicate with Refco's attorneys (¶¶ 46, 52 and 56); or (7) make any other effort to verify the accuracy of the IPO Registration Statement (¶¶ 46, 48, 50, 52, 54 and 56).

Rather than conduct its own due diligence investigation, each Junior Underwriter purportedly "relied" on the investigation supposedly being conducted by the "lead" members of the group of underwriters involved in the Refco IPO. ¶¶ 46, 52, 56, 62, 64, and 68.[6] Notwithstanding their claimed reliance on the lead underwriters, however, the Junior Underwriters did nothing to verify whether the investigation supposedly being conducted by other underwriters was properly planned or adequately executed. Indeed, the Junior Underwriters did nothing to verify whether the lead underwriters actually performed any diligence. For instance, William Blair testified as follows:

> Q: What, if anything, did William Blair do to verify that the due diligence being performed by other members of the syndicate and relied upon by William Blair was adequate?

[6] Discovery to date regarding the lead underwriters' diligence has produced compelling evidence that the lead underwriters will be unable to carry their burden of establishing a due diligence defense, but even if the lead underwriters were able to raise a fact question about their due diligence, it would be irrelevant for purposes of this motion—which addresses the investigations (or lack thereof) performed by the Junior Underwriters.

A: Nothing.

* * *

Q: Did William Blair review any aspect of the due diligence that any other underwriter performed on Refco?

A: No.

* * *

Q: Did William Blair make any effort to discuss with any other member of the underwriting syndicate any aspect of the due diligence that they may have performed on Refco?

A: No.

Q: Does William Blair even know whether the other underwriters performed due diligence?

A: Not specifically.

¶¶ 60. Similarly, Utendahl's corporate representative testified as follows:

Q: Did Utendahl take any steps to independently verify the due diligence conducted by Credit Suisse First Boston or any other underwriter involved in the Refco IPO?

A: No.

¶ 62. Siebert's corporate representative testified as follows:

Q: Did anyone at Siebert do anything to confirm or verify that the other underwriters involved were conducting adequate due diligence in respect of the Refco IPO?

A: We did not.

¶ 66.

As detailed in Lead Plaintiffs' Rule 56.1 Statement, each of the Junior Underwriters testified substantially the same as William Blair, Utendahl and Siebert — even though they claim to have "relied" on the due diligence investigation of the lead underwriters, they did nothing to verify that any such investigation was adequate, or even that it was being conducted at all. *See, e.g.*, ¶ 64 ("Q: And did Ramirez take any steps whatsoever to test and verify that the due

diligence conducted by the other underwriters was adequate in connection with the Refco IPO? […] A: No."); ¶ 68 ("Q: And did Williams Capital review any of the work that those entities [*i.e.*, the other underwriters and underwriters' counsel] did in preparing the IPO prospectus? A: No. We relied on them.").

ARGUMENT

Summary judgment is appropriate where "the pleadings, the discovery and disclosure materials on file, and any affidavits show that there is no genuine issue as to any material fact and that the movant is entitled to judgment as a matter of law." *Alfano v. Cigna Life Ins. Co. of New York*, No. 07 Civ. 9661 (GEL), 2009 WL 222351, at *12 (S.D.N.Y. Jan. 30, 2009) (citing Fed. R. Civ. P. 56(c)). A genuine issue of material fact exists only when a factual dispute "might affect the outcome of the suit under the governing law." *Roe v. City of Waterbury*, 542 F.3d 31, 35 (2d Cir. 2008). When a movant seeks summary judgment against a party who bears the ultimate burden of proof on an issue, "the movant's burden will be satisfied if he can point to an absence of evidence to support an essential element of the nonmoving party's claim." *Goenaga v. March of Dimes Birth Defects Found.*, 51 F.3d 14, 18 (2d Cir. 1995). "A party claiming relief may move … for summary judgment on all or part of the claim," Fed. R. Civ. P. 56(a), and summary judgment "may be rendered on liability alone, even if there is a genuine issue as to the amount of damages," Fed. R. Civ. P. 56(d)(2).

I. THE LEGAL STANDARDS GOVERNING THE SECTION 11 CLAIM AGAINST THE JUNIOR UNDERWRITERS

In Count V, Lead Plaintiffs assert a claim under Section 11 of the Securities Act against the Junior Underwriters for liability based on untrue statements and omissions in the IPO Registration Statement. As discussed below, the legal standards governing Section 11 claims are well-developed.

A. Liability Under Section 11 Of The Securities Act

As the Supreme Court has stated, the Securities Act "was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976). 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." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82 (1983).

Section 11 provides that an enumerated set of actors who bring securities to the public, including underwriters, are liable to purchasers of registered securities if "any part of the registration statement [pursuant to which the securities are offered], 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 …." 15 U.S.C. § 77k(a). Reliance is not an element of a claim under Section 11. *See, e.g., Weiss v. Blech*, No. 95 Civ. 6422, 1997 WL 458678, at *3 (S.D.N.Y. Aug. 11, 1997). Thus, to establish their *prima facie* claim under Section 11, Lead Plaintiffs need only show the existence of an untrue statement or omission of material fact in the IPO Registration Statement. *See DeMaria v. Andersen*, 318 F.3d 170, 178 (2d Cir. 2003); *In re Twinlab Corp. Sec. Litig.*, 103 F. Supp. 2d 193, 201 (E.D.N.Y. 2000) ("Section 11 places a relatively minimal burden on a plaintiff.").

B. In Order To Avail Itself Of Section 11's Affirmative Defense To Liability, Each Underwriter Must Demonstrate That It Conducted A Reasonable Investigation Into The Accuracy Of The Registration Statement

Section 11 provides that each entity acting as an underwriter on a registered offering shall be liable for untrue statements and omissions in the registration statement, unless the underwriter

can affirmatively prove that it conducted a "reasonable investigation" into the accuracy of the registration statement. As regards any part of the registration statement not purporting to be made on the authority of an expert, Section 11(b)(3)(A) states that an underwriter may evade liability only by carrying its burden of showing 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)(A). Section 11 thus makes clear that an underwriter hoping to avail itself of a due diligence defense for non-expertised statements must show both that (i) it conducted a "reasonable investigation" into the accuracy of each such statement, and (ii) based on that investigation, it had reasonable ground to believe that the registration statement was accurate in all respects.[7]

In a comprehensive opinion regarding underwriters' Section 11 liability in the *WorldCom* litigation, Judge Cote relied on principles of statutory construction "to interpret the language of the statute enacted by Congress." 346 F. Supp. 2d at 677 (citation omitted). Judge Cote stated that "such statutory interpretation must 'begin with the language employed by Congress and the assumption that the ordinary meaning of that language accurately expresses the legislative purpose.'" *Id.* (citing *Engine Mfrs. Ass'n v. S. Coast Air Quality Mgmt. Dist.*, 541 U.S. 246 (2004)). Her review of the statutory language led Judge Cote to hold that "Section 11(b) plainly commands that underwriters conduct an investigation as to portions of a registration statement

[7] As noted above, it is well-established that unaudited financial information is "non-expertised" information within the meaning of Section 11. *WorldCom*, 346 F. Supp. 2d. at 666. With respect to the untrue statements in the non-expertised portions of Refco's IPO Registration Statement, the due diligence defense is the only affirmative defense to liability available to the Junior Underwriters.

not made on the authority of an expert." 346 F. Supp. 2d at 678 (emphasis in original). *See also Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 581-82 (E.D.N.Y. 1971) (an underwriter "must make an investigation reasonably calculated to reveal all of those facts which would be of interest to a reasonably prudent investor").

This result is supported by comparing the language in Section 11 setting forth the requirements for investigating "expertised" statements as opposed to "non-expertised" statements. For statements made on the authority of an expert, an underwriter can establish its due diligence defense by showing "he had no reasonable ground to believe and did not believe" that the registration statement was inaccurate. 15 U.S.C. §77k(b)(3)(C). By contrast, for "non-expertised" statements, Section 11 introduces an additional requirement such that an underwriter must show that "he had, after reasonable investigation, reasonable ground to believe and did believe . . . ." that the registration statement was accurate. 15 U.S.C. §77k(b)(3)(A). Congress plainly intended for the words "after reasonable investigation" to have meaning — to require that an underwriter undertake an actual investigation for non-expertised statements. While reasonable minds could debate how much investigation is "reasonable" under the Securities Act, that debate of course rests on the unremarkable premise that the defendant must have conducted some investigation. That is not the case here with respect to the Junior Underwriters.

Consistent with the statutory language of Section 11, the SEC has taken the position that junior underwriters must conduct some investigation — rather than rely passively on the lead underwriters — in order to get the benefit of the due diligence defense. The SEC has stated that "Section 11 does not by its terms distinguish between managing underwriters (managers) and underwriters who participate as members of the underwriting group (participants). It speaks only of 'every underwriter,' of whatever type" and that "although the participant may delegate the

performance of the investigation, he must take some steps to assure the accuracy of the statements in the registration statement. To do this, he at least should assure himself that the manager made a reasonable investigation." SEC Release No. 9671, 1972 WL 125474, at *6.[8]

In *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968), as here, the non-lead underwriters conducted no due diligence themselves and relied solely on the lead underwriter. The court held that the lead underwriter's due diligence was inadequate but specifically left open the possibility that the junior underwriters could be liable for failing to conduct a "reasonable investigation" even if the lead underwriter had satisfied its obligations:

> In view of this conclusion [that the lead underwriters failed to conduct a reasonable investigation], it becomes unnecessary to decide whether the underwriters other than Drexel [the lead] would have been protected if Drexel had established that as lead underwriter, it made a reasonable investigation.

Id. at 697. Thus, although the court did not decide the precise issue, it implied that junior underwriters could be liable for failing to conduct their own adequate investigation, even if the lead underwriter proved its due diligence defense.

II. SUMMARY JUDGMENT IS APPROPRIATE BECAUSE REFCO'S IPO REGISTRATION STATEMENT WAS MATERIALLY UNTRUE AND INCOMPLETE, AND BECAUSE UNDERWRITERS WHO DID NOT INVESTIGATE ITS ACCURACY ARE NOT ENTITLED TO INVOKE THE "REASONABLE INVESTIGATION" DEFENSE OF SECTION 11

Applying the legal standards set forth above to the undisputed facts, Lead Plaintiffs are entitled to summary judgment as to liability against each of the Junior Underwriters.

First, as detailed above, the IPO Registration Statement contained a number of indisputably untrue and/or incomplete statements that were not made on the authority of an

[8] "'The Commission's interpretations [in a release] of [the federal securities laws] and of its own regulations thereunder are entitled to deference.'" *SEC v. Stanard*, No. 06 Civ. 7736 (GEL), 2009 WL 196023, at *29 (S.D.N.Y. Jan. 27, 2009) (quoting *SEC v. McNulty*, 137 F.3d 732, 741 (2d Cir. 1998)).

expert. *See, e.g,* ¶¶ 17-42. Nor can there be any question that these untrue and misleading "non-expertised" statements were material to investors, as they relate to, among other things, the falsification of the Company's most recent quarterly financial results before the IPO. The Company and the THL Defendants who controlled Refco have admitted the obvious — that this fraud rendered Refco's financial statements and the IPO Registration Statement materially false. ¶¶ 14-15 and 44. There is no genuine issue of material fact on this point.

Second, the undisputed facts demonstrate that, as a matter of law, none of the Junior Underwriters is entitled to assert a due diligence defense. Each Junior Underwriter made a deliberate choice not to conduct any due diligence investigation in connection with the Refco IPO. *See, e.g.*, ¶¶ 46, 48, 50, 52, 54, 56. Nonetheless, they consented to the inclusion of their names in the IPO Registration Statement, sold over $39 million of Refco stock to the public, and collected their underwriting fees. By doing so, they also agreed to assume Section 11 liability to investors if the IPO Registration Statement contained materially untrue statements — liability exposure that could only be avoided if they could prove they did a reasonable investigation.

While the Junior Underwriters attempt to defend themselves by claiming they relied on the lead underwriters to conduct due diligence, the undisputed record shows that they did nothing to ensure that the investigation supposedly being conducted by the leads was adequate – or even taking place. ¶¶ 60, 62, 64, 66, 68 and 70. The SEC has stated that, to the extent that a junior underwriter may be permitted in certain circumstances to rely in part on an investigation being conducted by the leads, the junior underwriter "must satisfy himself that the managing underwriter makes the kind of investigation [the Junior Underwriter] would have performed" and "must take some steps to assure the accuracy of the statements in the registration statement. To

do this, he at least should assure himself that the manager made a reasonable investigation." SEC Release No. 9671, 1972 WL 125474, at *6. The Junior Underwriters made no such effort.

The choice made by the Junior Underwriters here to do nothing renders them ineligible to assert the affirmative due diligence defense under Section 11. As Judge Cote observed in *WorldCom*, "[n]o greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter." 346 F. Supp. 2d at 662. The Supreme Court has held that underwriters and other parties that are potentially liable under Section 11 bear a "moral responsibility to the public [that] is particularly heavy." *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 581 (1995). Courts have long-recognized that "the purpose of Section 11 is to protect investors. Indeed, it is well-established that underwriters must "exercise a high degree of care in investigation and independent verification of the Company's representations." *Feit*, 332 F. Supp. at 582. Because underwriters are the "first line of defense" in ensuring the accuracy of registration statements, courts must be "particularly scrupulous in examining their conduct." *WorldCom*, 346 F. Supp. 2d at 662 ("Congress believed that subjecting underwriters to the liability provisions [of Section 11] would provide the necessary incentive to ensure their careful investigation of the offering.").

In this case, the conduct of the Junior Underwriters utterly fails to comport with the role that Congress, the courts, and the SEC have envisioned for underwriters. By making a deliberate choice not to investigate the accuracy of Refco's IPO Registration Statement, and not take steps to ensure that the lead underwriters were making such an investigation, each of the Junior Underwriters assumed the risk that the IPO Registration Statement would contain untrue statements or omit material facts. Now that Refco's IPO Registration Statement has been revealed to have been materially untrue and incomplete when issued, it would be contrary to the

purpose and intent of the Securities Act to allow any of the Junior Underwriters — each of whom was paid fees in connection with the IPO — to avoid liability for the losses suffered by public investors by asserting an affirmative defense that Congress intended only for underwriters that conducted a "reasonable investigation" prior to selling securities to public investors.

Lead Plaintiffs anticipate the Junior Underwriters may argue that it is "industry practice" in the financial industry for junior underwriters to rely on diligence performed by lead underwriters. But if the "industry practice" is for junior underwriters to do nothing other than distribute their allotment of shares and collect their underwriting fee, then the Court must remind all underwriters of the obligations of the law. It is well-established that "any defense of industry custom or good faith does not trump the rule of law." *Travelers Cas. & Sur. Co. v. Ace Amer. Reins. Co.*, 392 F. Supp. 2d. 659, 666 (S.D.N.Y. 2005). In *SEC v. U.S. Funding Corp.* – a securities fraud case – the court granted the SEC's motions for summary judgment and to strike the defendant's affirmative defenses, including a defense alleging that the defendant had acted consistent with customary industry practice. The court held that "[t]he Court is not aware … of any industry 'standards and customs' that trump our nation's federal securities laws. The purpose of the securities laws, in fact, was to accomplish the exact opposite." *SEC v. U.S. Funding Corp.*, No. Civ. 02-2089 (WJM), 2006 WL 995499, at *9 (D.N.J. Apr. 11, 2006) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)).[9]

[9] Along similar lines, in *Worldcom*, the underwriter defendants had argued that the regulatory regime relating to shelf registration, in particular SEC Rule 176, had diluted underwriters' due diligence obligation in the context of a shelf offering. In rejecting this argument, Judge Cote noted that the SEC's "own commentary on the rule makes clear that Rule 176 did not alter the fundamental nature of underwriters' due diligence obligations." 346 F. Supp. 2d. at 669. Judge Cote further noted that "current law continues to place a burden upon an underwriter to conduct a reasonable investigation of non-expertised statements in a registration statement, including an issuer's interim financial statements." *Id.* This decision both reaffirms the importance of underwriters' due diligence in the context of public securities offerings, and serves to demonstrate that when such an important obligation has not been

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Finally, important policy considerations counsel against allowing an underwriter to assert an affirmative defense grounded in the requirement that it conduct a "reasonable investigation" in a case where it actually did nothing. When Congress passed the Securities Act in 1933, it permitted underwriters to participate in offering securities to the public (and be compensated for doing so) but at the same time expected each underwriter to act as an important "gatekeeper" protecting investors from over-exuberant or dishonest issuers. This gatekeeping role is critical to the operation of our capital markets, because it would be impractical to afford individual investors in a public offering the means or opportunity to review inside information or conduct the type of investigation that underwriters are charged to conduct. Recent events in our financial markets demonstrate the wisdom and necessity of adhering to the careful system of checks and balances put in place by Congress. By eschewing their gatekeeping role and choosing to bring Refco's securities to market without making any attempt to confirm that Refco's IPO Registration Statement was truthful and complete, the Junior Underwriters have subverted the protections Congress intended for the Securities Act to provide to investors. Choices should have consequences, in the financial markets as much as anywhere else. By choosing to do nothing when selling Refco stock to the public, each of the Junior Underwriters has forfeited the right to assert the due diligence defense.

CONCLUSION

Because there is no genuine dispute that the IPO Registration Statement included material untrue statements, and because the Junior Underwriters cannot possibly sustain their burden with

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altered even by regulations designed to streamline public offerings, "industry custom" will certainly not suffice to diminish its rigor.

respect to any potential affirmative defense, the Junior Underwriter Defendants should be found liable to the Lead Plaintiffs as alleged in Count V of the Complaint.

Dated: April 1, 2009

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