UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re REFCO, INC. SECURITIES LITIGATION	:	MASTER FILE NO. 05 Civ. 8626 (GEL)

MEMORANDUM OF LAW OF AMICUS CURIAE THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION IN OPPOSITION TO LEAD PLAINTIFFS' MOTION FOR PARTIAL SUMMARY JUDGMENT

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The Securities Industry and Financial Markets Association ("SIFMA") respectfully submits this memorandum as amicus curiae in opposition to the motion of Lead Plaintiffs ("Plaintiffs") for partial summary judgment against Defendants William Blair & Company, L.L.C., BMO Capital Markets Corp., CMG Institutional Trading LLC, Samuel A. Ramirez & Company, Inc., Muriel Siebert & Co., Inc., The Williams Capital Group, L.P., and Utendahl Capital Partners, L.P. (the "Junior Underwriters").

STATEMENT OF INTEREST

SIFMA brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets.[1]

PRELIMINARY STATEMENT

Plaintiffs have moved for partial summary judgment against the Junior Underwriters under Section 11 of the Securities Act of 1933 ("1933 Act") on a novel legal theory that has never been adopted by any court and that is inconsistent with over 75 years of industry practice. Specifically, Plaintiffs contend that Section 11 requires "each" underwriter in a syndicate to conduct its own, separate investigation before it can assert an affirmative due diligence defense,

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1 The views set forth in this brief are those of SIFMA. The undersigned outside counsel for SIFMA has performed legal services for certain of the Junior Underwriters in connection with the Refco matter, but has not been compensated by such underwriters for the preparation of this brief and appears herein solely as counsel on behalf of SIFMA.

even if the lead underwriters in the syndicate have conducted exhaustive due diligence on behalf of the syndicate as a whole. (Pl. Br. at 5-8).

SIFMA respectfully submits that Plaintiffs' reading of the statute is unsupported by the text of Section 11(b)(3), ignores the definition of reasonable investigation and belief in Section 11(c), is inconsistent with the understanding of Congress and commentators, and conflicts with prudent and longstanding industry practice recognized by the SEC. Congress did not intend to displace the common and reasonable commercial practice – which predates the Securities Act – by which the lead members of a syndicate and counsel for all underwriters perform due diligence as agents acting on behalf of the entire syndicate. This decades-old practice has very practical roots, and the legislative history confirms that Congress intended that underwriters should be able to delegate where it was reasonable to do so. Indeed, by expressly incorporating a "prudence" standard, Section 11(c) necessarily requires courts and juries to measure the conduct of underwriters by the reasonable commercial standards of their day.

Every court that has addressed the issue has assumed that junior underwriters stand or fall based on the due diligence done by the lead underwriters. Plaintiffs' cramped reading of Section 11 would offer no additional investor protection but would simply result in smaller and less diverse underwriting syndicates.

When read in full and in context, the depositions of the Junior Underwriters reflect a reasonable and customary response on their part to the lead managers' invitations to participate in the Refco initial public offering ("IPO"). Given all the facts and circumstances of the transaction as it was presented to the Junior Underwriters, it was sufficient for purposes of the Section 11 due diligence defense for them to rely on the reputations of the lead underwriters and underwriters' counsel and on their experience in dealing with the lead underwriters and counsel in prior transactions.

DISCUSSION

I. THE RELIANCE OF THE JUNIOR UNDERWRITERS IN THIS CASE ON DUE DILIGENCE PERFORMED ON THEIR BEHALF BY LEAD UNDERWRITERS AND COUNSEL FOR ALL UNDERWRITERS IS CONSISTENT WITH INDUSTRY STANDARD PRACTICES

A. The IPO Underwriting Syndicate System

Customarily, a prospective IPO issuer will determine which of several competing securities firms will act as lead managers for the IPO. The lead managers will often be firms that have been working for some time with the issuer, and have developed a working relationship.[2] Where there is more than one lead manager, one of them will act as the "book runner" for the IPO. The book runner or the lead managers will decide, often with input from the issuer, whether and when to invite other securities firms to join the syndicate as co-managers. They will also retain counsel to act for all the underwriters, including those not yet part of the transaction.

The book runner will take the lead on due diligence, but the other lead managers and the co-managers will often participate in meetings with the issuer, its management and counsel, underwriters' counsel, and the issuer's independent accountants. In these meetings, the registration statement will be drafted, discussed and revised. After the registration statement is filed with the SEC and comments are received from the SEC staff, the book runner will – and the lead managers and the co-managers may – participate in further meetings at which the staff

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2 This is a longstanding practice. See United States v. Morgan, 118 F. Supp. 621, 652 (S.D.N.Y. 1953) ("[T]he competition for business by investment bankers must start with an effort to establish or continue a relationship with the issuer. ... This is the initial step; and it is generally taken many months prior to the time when it is expected that the money will be needed."). Depending upon market conditions, that relationship may be more or less protracted.

comments are discussed and amendments to the registration statement are drafted, discussed and revised.

During this time, underwriters' counsel will provide to the issuer a draft underwriting agreement that will call for representations and warranties from the issuer as to business, legal and disclosure matters and will set forth the conditions to the closing of the IPO, including legal opinions and "negative assurance letters" from the issuer's counsel and underwriters' counsel.[3] The draft underwriting agreement will be the subject of negotiations among the issuer, its counsel and underwriters' counsel and, for purposes of the comfort letter, the issuer's independent accountants.

The final shape of the underwriting syndicate will often not take form until the preliminary prospectus included in the registration statement is deemed ready to be used for marketing purposes. At this time, additional underwriters will be invited to join the syndicate based upon the issuer's and lead underwriters' judgment as to which firms might be in a position to assist in the transaction because of their relationship with likely investors or their ability to provide research or after-market support subsequent to the completion of the IPO. Because the preliminary prospectus will already be in circulation prior to the time these late-invited underwriters are asked to join the syndicate, and because the lead underwriters and the issuer's management will at this time be fully involved in the marketing effort, the late-invited underwriters will as a practical matter have no opportunity to participate directly in due diligence or to suggest changes in the preliminary prospectus.

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3 The draft underwriting agreement provided to the issuer will be based on the book runner's standard form of underwriting agreement, which will be modified by underwriters' counsel to suit the circumstances of the particular IPO. Each of the larger securities firms that acts on a regular basis as a book-running underwriter of IPOs has such a standard form, and such forms become familiar to other underwriters.

In fact, because of the SEC's adoption in 2005 of Rule 159, changes to the preliminary prospectus at this point could require recirculation or other communications that might disrupt the schedule for the IPO. Also, negotiations regarding the underwriting agreement will have progressed to the point that a late-invited underwriter will not find it useful to suggest changes in the underwriting agreement.

It is quite clear to a late-invited underwriter that it will have no practical ability to participate in due diligence or have a direct effect on the preliminary prospectus or underwriting agreement for an IPO. Notwithstanding, many such underwriters believe that they are able to make a reasoned determination as to whether to accept or decline an invitation to participate in the IPO. The factors considered by such underwriters include (1) their prior familiarity with the issuer, its business, and the industry in which it participates; (2) the extent to which the issuer is an established business and any special risks presented by the nature of the issuer's business; (3) the competence and reputation of the book runner and the other lead managers; (4) the competence and reputation of underwriters' counsel and (5) the late-invited underwriter's own experience in prior transactions with the book runner, the lead managers and underwriters' counsel.[4]

On the other hand, whether an underwriter is the book runner or the last underwriter to be invited to join the IPO syndicate, it knows that it will be a party to the underwriting agreement with the issuer (or any selling shareholders) and a direct beneficiary of the relevant representations, warranties, and agreements contained therein. Whether an underwriter has the largest participation or the smallest, it knows that it will have an attorney-client relationship with

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4 Each underwriter is also aware that it will be paying a portion of the underwriting spread to the lead managers as a management fee that compensates the lead managers for their efforts in putting the deal together and also for conducting due diligence. Each underwriter will also pay a <u>pro rata</u> portion of underwriters' counsel's fees and expenses.

a specified law firm that will act as counsel for all of the underwriters. It knows that the certificates, legal opinions, negative assurance letters and comfort letters specified in the underwriting agreement as conditions to closing will also be addressed to and delivered to each underwriter and that any changes in the form of such documents or deviations from or waivers of closing conditions will be approved by underwriters' counsel. Based on industry practice and prior experience with underwriters' counsel and with the book runner's form of underwriting agreement, each underwriter can be highly confident that this will be the case.

B. The Refco IPO and the Invitations to the Junior Underwriters

In this case, certain of the lead managers had occasion to perform due diligence in connection with Refco as far back as June 2003. For purposes of the IPO, a registration statement on Form S-1 was filed with the SEC on April 8, 2005 and amended on four separate occasions in response to comments from the SEC staff and to update the information contained therein. The fourth such amendment was filed on July 25, 2005 and contained a preliminary prospectus intended to be used to market the IPO. The preliminary prospectus disclosed that Cravath Swaine & Moore was acting as underwriters' counsel and that Weil Gotshal & Manges LLP and Mayer, Brown, Rowe & Mawe LLP were acting as issuer's counsel.

The invitations to the junior underwriters were issued on or about July 29, 2005. In addition to describing the proposed economic terms of the junior underwriters' participation, the invitations described Refco's business ("a leading independent provider of execution and clearing services for exchange-traded derivatives and a major provider of prime brokerage services in the fixed income and foreign exchange markets") and provided the SEC file number for the registration statement. The invitations also stated that the junior underwriters' participation would be subject to the provisions of the Credit Suisse First Boston LLC ("Credit Suisse") master agreement among underwriters ("MAAU") dated January 17, 2003. The MAAU contained a broad authorization to Credit Suisse to act as manager of the IPO, including authority to incur expenses for legal counsel for the underwriters and to communicate with the SEC.

The lead managers and underwriters' counsel were well-known to the Junior Underwriters, both in terms of reputation and prior experience on similar transactions. Refco was not a high-risk startup or a troubled company in a troubled industry but rather a profitable company that was well-known among securities firms, such as the Junior Underwriters.

The IPO was priced on August 10, 2005 and closed on August 16, 2005. The Junior Underwriters' aggregate participation in the IPO was less than 6% of the total size of the transaction. Because the largest number of shares was sold by the lead managers and the co-managers, the Junior Underwriters earned only the underwriting portion of the "spread" and a selling concession on such shares as were allocated to them. Accordingly, two of the Junior Underwriters earned approximately $150,000 and $130,000, respectively, while five of the Junior Underwriters earned approximately $45,000 (in all cases before expenses payable by the underwriters).

II. SECTION 11 PERMITS THE PRACTICE OF REASONABLE DELEGATION OF DUE DILIGENCE TO LEAD UNDERWRITERS AND COUNSEL FOR ALL UNDERWRITERS

Plaintiffs ask this Court to adopt a novel reading of Section 11 by which a junior underwriter must perform independent due diligence, thus creating a new source of liability for junior members of an underwriting syndicate. Unsurprisingly, Plaintiffs' theory has never been adopted by any court. Rather, courts have consistently assumed that if a lead underwriter satisfies its due diligence obligation, "no inquiry will be made into the due diligence" of the other participating underwriters. Endo v. Albertine, 147 F.R.D. 164, 171 (N.D. Ill. 1993). Accord In re Gap Stores Secs. Litig., 79 F.R.D. 283, 302 (N.D. Cal. 1978) ("proof of the due diligence of the managing underwriter will most likely exonerate the participants as well");

Competitive Assoc., Inc. v. Int'l Health Sci., Inc., No. 72 Civ. 1848, 1975 WL 349, at **19-20 (S.D.N.Y. Jan. 22, 1975) (holding that lead underwriters' due diligence "inured to the benefit of all of the underwriters" and each was "entitled to prevail upon the affirmative defense of due diligence" save for one underwriter separately accused of conspiring to manipulate the market price of the securities); In re Activision Secs. Litig., 621 F. Supp. 415, 434 (N.D. Cal 1985) (same); In re Computer Memories Secs. Litig., 111 F.R.D. 675, 687-688 (N.D. Cal. 1986) (same); Hammond v. Hendrickson, No. 85 C 9829, 1986 WL 8437, at *9 (N.D. Ill. Jul. 30, 1986) (same); In re Itel Secs. Litig., 89 F.R.D. 104, 112 (N.D. Cal. 1981) (same). Thus, summary judgment has been granted on the basis of the lead underwriter's due diligence where the investigation was "conducted primarily by the managing underwriters [who were] experienced people . . . who were assisted by attorneys and accountants." Weinberger v. Jackson, No. 89-2301, 1990 WL 260676, at *3 (N.D. Cal. Oct. 11, 1990).

The courts have been right all along. Plaintiffs' reading of the statute is unsupported by the text of Section 11(b)(3), ignores the definition of reasonable investigation and belief in Section 11(c), is inconsistent with the understanding of Congress and commentators, and conflicts with prudent and longstanding industry practice recognized by the SEC.

A. The Plain Language of Section 11 Does Not Support Plaintiffs' Reading.

Plaintiffs' argument that each underwriter must do independent due diligence is based upon a strained and implausible reading of the language of Section 11 that no court has ever before adopted. Section 11 allows an underwriter to assert a due diligence defense when

> 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) (2006) (emphasis added). Plaintiffs argue that because the statute says that "he" had such a belief after reasonable investigation, each underwriter must have personally conducted such an investigation. (Pl. Br. at 1, 14, 15).

But the single pronoun "he" does not bear the weight Plaintiffs seek to place upon it. As a matter of simple grammar, the statute merely says that "he" (i.e., each underwriter) must have a "reasonable ground" for belief (as well as actual belief) in the truth of the registration statement. The statute does not say that each underwriter must have personally conducted the investigation that helps gives rise to that reasonable ground for belief. Indeed, the statute does not speak expressly to who conducts the "reasonable investigation" at all. Nothing in the statute in any way prohibits the underwriter from delegating the due diligence investigation or relying on the investigation of others – as underwriters have done for many decades. And given that underwriters are business entities, as they were in 1933, it would be absurd to read the singular "he" to preclude such entities from acting – as they customarily do – through multiple employees and agents. Certainly, there is no indication that Congress intended to require an underwriter to conduct all its due diligence through a particular individual, to follow a particular division of responsibility in connection with its participation in an offering or to forbid an underwriter from retaining attorneys or other agents to perform their customary functions in the due diligence process. Statutes are not to be read to "lead[] to absurd or futile results." E.E.O.C. v. Commercial Office Prods. Co., 486 U.S. 107, 120 (1988); see also United States v. Dauray, 215 F.3d 257, 264 (2d Cir. 2000) (stating that "[a] statute should be interpreted in a way that avoids absurd results").

In any event, one pronoun in one sentence of a statute is not meant to be read in isolation; the court's job "is to construe statutes, not isolated provisions." Gustafson v. Alloyd Co., 513

U.S. 561, 569 (1995). Section 11(b)(3)(A)'s due diligence defense must be understood in the context of § 11(c), which provides:

> In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

15 U.S.C. § 77k(c) (2006) (emphasis added). It would be difficult for Congress to emphasize more clearly that the touchstone of the due diligence defense is prudence, including the prudence of delegating tasks to others, such as other underwriters and underwriters' counsel.

B. Section 11 Was Originally Understood to Permit Underwriters' Use of Agents to Perform Due Diligence.

Congress recognized, when it enacted Section 11, that the due diligence defense could be satisfied by an underwriter's delegated agents. When originally enacted in 1933, Section 11(c) stated that for purposes of determining what constitutes a reasonable investigation "the standard of reasonableness shall be that required of a person occupying a fiduciary relationship." 48 Stat. 74, 73 Cong. Ch. 38 (1933). In explaining this standard, the conference report recognized that "[d]elegation to others of the performance of acts which it is unreasonable to require that the fiduciary shall individually perform is permissible." H.R. Rep. No. 73-152 at 26, 1933 WL 984 (May 20, 1933) (Conf. Rep.) (emphasis added). Of course, some of the defendants who can assert a due diligence defense – like corporate directors – owe pre-existing fiduciary duties, which they commonly discharge through their delegated agents, but a leading commentator has noted that the same principle applies to the underwriters' statutorily-created defense:

> Since this language is not confined to directors, it can and should be read to allow participating underwriters to delegate investigatory functions to a lead underwriter who coordinates all dealings with the issuer.

Ernst L. Folk III, Civil Liabilities Under the Federal Securities Act: The BarChris Case, 55 Va. L. Rev. 1, 57-58 (1969) (emphasis added). Another leading commentator noted, contemporaneously, the flexibility of the standard:

> Reasonability . . . will differ widely according to the person involved. Under some circumstances such a standard would require personal knowledge of the facts assumed to be true. Delegation to others of the duty to verify the facts would under other circumstances suffice to meet the requirement . . . [T]ake the situation of the underwriters. The type of investigation which can reasonably be demanded of the sponsoring or principal underwriters is one thing; that which the Act requires of the small participating underwriter in order that he shall satisfy its requirements is another thing . . .
>
> These conceptions permitting a reasonable delegation of duties by the various parties connected with the flotation of an issue, are not interfered with by that provision of Section 11 which likens the standard of reasonableness to be applied, to that which the law commonly requires of a person occupying a fiduciary relationship.

James Landis, Liability Sections of Securities Act Authoritatively Discussed, 18 The American Accountant, 330, 332 (1933) (emphasis added).

Nonetheless, the term "fiduciary" to describe an underwriter's statutory due diligence was "terrifyingly portrayed" as likely to create excessive liabilities, see Folk, 55 Va. L. Rev. at 18, so the following year, Congress amended Section 11(c) to substitute the current formulation: "[t]he Securities Exchange Act of 1934 relaxes the standard for determining what constitutes reasonable investigation and reasonable ground for belief in connection with an issue from that imposed on a fiduciary to that required of a prudent man in the management of his own property." Stock Exchange Practices, Senate Report No. 73-1455, 1934 WL 1292, at *154 (June 6, 1934) (emphasis added). Thus, Congress clarified that while underwriters are not fiduciaries, their due diligence defense is established by reference to the standard of care applied under "the accepted common law definition of the duty of a fiduciary." H.R. Rep. 73-1838, 1934 WL 1291

(May 31, 1934) (Conf. Rep.). As discussed infra, the use of a familiar common law standard ensured that courts would take account of the practical considerations that any prudent person would consider in determining what sort of inquiry to conduct and whether it should sensibly be delegated to someone better situated to carry out such an investigation.

C. The Section 11 Prudence Standard Requires Examination of Reasonable Commercial Practice in Use at the Time of the Underwriting.

1. *Congress' Choice of a Prudence Standard Requires Examination of Reasonable Commercial Practices in Use at the Time of the Underwriting.*

Contrary to Plaintiffs' argument, this Court is not being asked to rule that industry practice trumps the rules of law. (Pl. Br. at 19). Rather, SIFMA's position is simply that Section 11(c) – which Plaintiffs fail to even cite – necessarily incorporates industry standards into the assessment of how the proverbial "prudent man" would act under the circumstances of a particular IPO.

Like any flexible standard of prudent conduct, the Section 11 due diligence defense has no content in the abstract. It only has meaning in a specific factual context, i.e., the conduct of underwriters of a particular registered public offering of securities. Congress did not enact a detailed code of specific obligations for underwriters, as it did with the extensive disclosure requirements imposed on issuers by a web of SEC rules and forms. Instead, it commanded judges and juries to determine what was "reasonable" or "prudent," using those commonly-accepted common law terms as their only guide.

When a federal statute borrows such commonly understood language, "Congress intends to incorporate the well-settled meaning of the common-law terms it uses" and a court should look to the common law standards. Neder v. United States, 527 U.S. 1, 23 (1999); see also Safeco Ins. Co. of Amer. v. Burr, 127 S. Ct. 2201, 2209 (2007) ("a common law term in a statute comes with a common law meaning, absent anything pointing another way"); United States v. Delis, 558 F.3d 177, 180, 183 (2d Cir. 2009) ("where…a statute incorporates language with an accepted common-law definition, [the court's] construction of the statute is guided by that accepted meaning absent a clear contrary indication"); United States v. Terrazas, 570 F. Supp. 2d 550, 553 (S.D.N.Y. 2008) ("Congress incorporates the common-law meaning of the terms it uses if those terms…have accumulated settled meaning under…the common law and the statute does not otherwise dictate"). Tort law has long measured the reasonableness of actions by current industry customs and standards. Berretta v. Tug Vivian Roehrig, LLC, 259 F.App'x. 343, 345 (2d Cir. 2007) (evidence of "industry standards, customs, or practices" in determining what constituted "reasonable prudence and due care" properly considered); Gunther v. Airtran Holdings, No. 05 Civ. 2134, 2007 WL 193592, at *10 (S.D.N.Y. Jan. 24, 2007) ("[E]vidence of [the defendant's] customary procedures and the broader industry's practices in boarding passengers with disabilities is relevant because it may reflect on the reasonableness of defendant's behavior.").[5] It would be contrary to this longstanding presumption to attempt to apply a statutory "prudent man" standard without reference to widespread industry practices.[6]

A reasonableness standard requires "exercising [at least] … such attention, in perception of the circumstances, memory, knowledge of other pertinent matters, intelligence, and judgment

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5 See also Cruz v. New York City Transit Auth., 136 A.D.2d 196, 199-200 (App. Div. 1st Dep't 1988) (holding trial court erred in precluding expert testimony regarding design and construction industry practices because "[p]roof of a generally accepted practice, custom or usage within a particular trade or industry is admissible as tending to establish a standard of care, and proof of a departure from that general custom or usage may constitute evidence of negligence").

6 Similarly, when Congress defines standards of commercial conduct with such open-ended terms as "reasonableness," it delegates to the courts the task of adapting the governing standards over time to changing business practices. See, e.g., Leegin Creative Leather Products v. PSKS, Inc., 127 S. Ct. 2705, 2720 (2007) (holding that the Sherman Act's prohibition on unreasonable restraints of trade "evolve[s] to meet the dynamics of present economic conditions", as evidenced by the "case-by-case adjudication . . . [of] the rule of reason.").

as a reasonable man would have." Restatement (Second) Torts § 289(a) (1965).[7] This necessarily includes "the usual and customary conduct of others under similar circumstances ... as an indication of what the community regards as proper" and as "a composite judgment as to the risks of the situation and the precautions required to meet them." See Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws, 48 Bus. Law, 1185, 1233 (1993) (citing W. Page Keeton et al., Prosser and Keeton on Torts, 193 (5th ed. 1984)). Discussing the 1934 revision of the definition of reasonable inquiry, Professor Folk observed that the common law is "indispensable" in interpreting a "prudent man" standard, as it "resembles one of the classic common law tests of a director's duty of care" which requires "the same degree of care which a business man of ordinary prudence generally exercises in the management of his own affairs." Folk, 55 Va. L. Rev. at 42-43. These are, by their nature, standards that depend upon commercial reality, not inflexible application of rote rules.

In the context of underwriting syndicates, it is beyond question that the industry has long regarded it as proper for participating underwriters to delegate the due diligence investigation to the lead underwriters:

> The lead underwriter is usually the only underwriting syndicate member to investigate the issuer to verify the contents of the offering materials. . . . [T]he syndicate members usually delegate to the lead underwriter their responsibility to insure the accuracy of the offering materials . . . . The underwriting syndicate members therefore sink or swim with the lead underwriter in the usual case.

Consumers Power Co. Sec. Litig., 105 F.R.D. 583, 612 (E.D. Mich. 1985) (emphasis added). This practice is so firmly rooted that it has been said that "the cornerstone of due diligence lies in

[7] The Restatement is commonly accepted as an authority on the "judicial consensus" on common law concepts incorporated in the federal securities laws. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 344 (2005); see also In re Global Crossing, Ltd. Secs. Litig., 471 F.Supp.2d 338, 343 (S.D.N.Y. 2006) (Lynch, J.) (adopting rule articulated by the Restatement).

the activities of lead underwriter[s]; therefore, participating underwriters should be allowed to delegate to the lead underwriter their investigatory responsibility." In re Gap Stores, 79 F.R.D. at 300 (citing Folk, 55 Va. L. Rev. at 54-56).[8] This has been the prevailing industry standard since before the passage of the 1933 Act[9] and has been noted in many versions of the leading treatise Securities Regulation, which states in its most recent edition that:

> [t]he members of the underwriting syndicate other than the managing or so-called 'lead' underwriter typically do not undertake an investigation of the issuer at all, but rely entirely upon the managing underwriter to do an investigation for them. The syndicate members are entitled to rely upon this investigation if it in fact complies with the statutory requirements.

Coffee, Seligman & Sale, Securities Regulation: Cases and Materials 888 (10th ed. 2007) (emphasis added). The managing underwriter has long been "thought of as a 'gatekeeper' or 'reputational intermediary' on whom investors relied to reduce their information costs," and so too have "[m]embers of the underwriting syndicate, who could not as a practical matter conduct their own due diligence, [ ] relied on the managing underwriter for a similar purpose." Charles J. Johnson, Jr. and Joseph McLaughlin, Corporate Finance and the Securities Laws, Ch. 5, at 5-3 (4th ed. 2006, supplemented 2008).

A junior underwriter also relies upon underwriters' counsel as an independent check on the lead underwriters' due diligence. "It is beyond dispute that 'an attorney is his client's agent and representative,'" United States v. Int'l Bhd. of Teamsters, 133 F.R.D. 99, 102 (S.D.N.Y. 1990), and any investigation conducted by underwriters' joint counsel can be treated as part of each underwriter's due diligence. See, e.g., Feit v. Leasco Data Processing Equip. Corp., 332 F.

8 The SEC also recognizes the book runner's key role in performing the due diligence function. Rule 461 of the 1933 Act requires the issuer and the managing underwriter to confirm to the SEC that they are aware of their responsibilities under the Act as a condition to acceleration of the effective date of the registration statement. 17 C.F.R. § 230.461 (2008).

9 A detailed history can be found in Morgan, 118 F. Supp. at 635-55.

Supp. 544, 582-583 (E.D.N.Y. 1971); In re Int'l Rectifier Sec. Litig., No. 91 Civ. 3357, 1997 WL 529600, at **4, 8 (C.D.Cal. Mar. 31, 1997) (accord); Phillips v. Kidder, Peabody & Co., 933 F. Supp. 303, 318 (S.D.N.Y. 1996) (accord). This reliance is not merely theoretical, as in the sense of being the addressee of opinions and negative assurance letters as discussed above, but also intensely practical in the sense that underwriters' counsel represents the entire syndicate and not just the lead underwriters. Lead underwriters therefore do not have unfettered discretion to proceed with a transaction in the face of "red flags" or other indications that the disclosure is deficient.

Just so, the prudence of a junior underwriter's decision to participate in an IPO and to rely on the lead managers' due diligence depends as much on the reputation of underwriters' counsel for competence and independence as on the reputation and competence of the lead managers and co-managers; the junior underwriters' prior experience in dealing with them; and any prior business dealings between the junior underwriters and the issuer. Equally relevant is the fact that industry practice in similar IPOs is for junior underwriters to weigh the same considerations in determining whether to accept or reject an invitation to participate in the transaction in the first place.[10]

2. *The SEC Has Recognized That The Reasonableness Standard is Flexible and Must Reflect Commercial Realities.*

SEC Rule 176, adopted under the 1933 Act in 1982, sets forth "relevant circumstances" regarding the reasonableness of an investigation or grounds for belief under Section 11. 17 C.F.R. § 230.176 (2008). The SEC adopted Rule 176 as part of its promulgation of the

[10] This is not to say that junior underwriters might not, in a given offering, conduct sufficient independent due diligence to be able to assert a due diligence defense even if the investigation by the lead underwriters is found wanting.

integrated disclosure system,[11] primarily in response to concerns about how such a disclosure regime might adversely affect the ability of potential Section 11 and 12 defendants to perform due diligence. The SEC recognized the flexible, fact-specific nature of due diligence: in the adopting release, the SEC said that while the rule described "some circumstances" that may affect the reasonableness of an inquiry, the SEC also recognized that there might be other circumstances beyond those enumerated in the rule that might bear upon the reasonableness of the conduct of persons subject to Section 11. Adoption of Integrated Disclosure System, Securities Act Release No. 6383, 1982 WL 90370 (Mar. 3, 1982). The SEC referred to "[j]udicial interpretations of section 11 [that] have confirmed the principle that what constitutes reasonable investigation and reasonable ground for belief depends upon the circumstances of each registration" and stated that the prospect of "continued flexible application of that standard by the courts should provide assurance to subject persons that they will not incur unreasonable investigative burdens." Id. And Rule 176(f) expressly refers to the relevance of "reasonable reliance" on persons "whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the issuer and the filing)."[12] 17 C.F.R. § 230.176(f) (2008). As we have seen, the junior underwriters of the

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11 The integrated disclosure system permitted issuers to incorporate by reference into their 1933 Act registration statements their periodic reports filed with the SEC under the Securities Exchange Act of 1934. Underwriters expressed concern that incorporation by reference would diminish their ability to influence an issuer's disclosure for purposes of registered public offerings.

12 While the proposing release for Rule 176 cites the legislative history of the 1933 Act and states that the references to reasonable reliance "appear[]" to have been included to avoid placing excessive burdens on the issuer's directors, Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act, Securities Act Release No. 6335, 1981 WL 31062 (Aug. 6, 1981), as discussed above, they are equally applicable to underwriters, and the SEC has subsequently recognized that the circumstances listed in Rule 176 itself were written "in a general way to apply to virtually any kind of offering and to apply to any person that could claim a due diligence defense". The Regulation of Securities Offerings, Securities Act Release No. 7606A, 1998 WL 792508 (Nov.

Refco IPO, as is commonly the case, relied on the experience and reputation of the managing underwriters and underwriters' counsel, all of whose duties, functions and responsibilities in connection with the IPO should have given them knowledge of the material facts relating to Refco. Expecting the junior underwriters to duplicate any part of this effort would be unreasonable, and expecting them to "check" the efforts of managing underwriters and underwriters' counsel would elevate form over substance.

Plaintiffs rely on the SEC's 1972 Securities Exchange Act Release No. 9671 as supporting the position that a junior underwriter must undertake independent due diligence as a matter of law (Pl. Br. at 15-16); however, they substitute the trees for the forest, for the primary message of this Release is that a junior underwriter may delegate its due diligence obligations to a lead underwriter, thereby "reliev[ing] himself of the task of actually verifying the representations in the registration statements," if the delegation is "reasonable in light of all the circumstances." Obligations of Underwriters, Brokers and Dealers, Securities Exchange Act Release No. 9671, 1972 WL 125474, at *6 (July 27, 1972) (quoting the 1933 conference report). The SEC's observation in this Release that a participating underwriter should take "some steps" to assure the accuracy of the disclosure in the registration statement must be taken in the context of the SEC's express statement that it was not "adopt[ing] standards as to due diligence" and was instead relying on "self-regulatory organizations to establish standards of conduct for their members" (id. at *3), a position that would be nonsensical if the requirement of independent due diligence by each underwriter was already imposed by the statute. The release principally focuses on the responsibilities of underwriters and others in connection with "new high risk ventures" and was occasioned by the SEC's then-recent publication of a report on the "hot

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17, 1998) (emphasis added). Indeed, Rule 176(g) refers, when the person is an underwriter, to "the role of the particular underwriter" as another such factor. 17 C.F.R. § 230.176(g) (2008).

issues" market. The release states explicitly that "in making a reasonable investigation, the participating underwriter need not duplicate the investigation made by the manager. The participant may delegate the performance of the investigation to the manager … [if] 'reasonable in light of all the circumstances.'" Id. at *6 (emphasis added).[13]

III. PRECLUDING LATE-ARRIVING JUNIOR UNDERWRITERS FROM DELEGATING DUE DILIGENCE TO LEAD UNDERWRITERS AND COUNSEL FOR ALL UNDERWRITERS WOULD NOT INCREASE INVESTOR PROTECTION BUT WOULD ONLY LEAD TO SMALLER AND LESS DIVERSE SYNDICATES.

As set forth above, a reasonableness standard ultimately turns on what it is reasonable to require of the defendant. Plaintiffs' reading of Section 11(b)(3) would create undesirable, unjust and ultimately unreasonable consequences, and under Section 11(c), this Court should consider those consequences and reject Plaintiffs' position.

A. Junior Underwriter Due Diligence Would Be Duplicative and Unlikely to Uncover Additional Facts, But Would Instead Add Costs and Pointless Formalities.

There is a reason why junior underwriters, however prudent or reasonable, do not do independent due diligence; it would be a waste of time and money. As Professor Folk explains:

> In accordance with industry practice, participating underwriters count on the lead underwriter to immunize them from section 11 liability by satisfying the requirements of the 1933 Act. This is not unreasonable since chaos would prevail if each underwriter participated in the investigation and tried to verify the accuracy of the registration statement . . . The congressional purpose of protecting investors is largely accomplished if the lead underwriter makes a satisfactory investigation. Although supplementary, independent inquiries by the participating underwriters might occasionally dredge up an additional misstatement, the margin of

[13] Given the focus and context of the release, the circumstances potentially requiring greater due diligence in some cases would surely include the situation where an IPO issuer was a "new high risk venture" of the type that the release discussed. By contrast, however, Refco had a substantial operating history in a business familiar to all of the underwriters; its average net income for the four full years preceding the IPO was $31 million, and its net income for the first quarter of 2005 was $43 million.

> improvement probably would not warrant the expense and confusion of proliferating inquiries. Such a quest for the perfect prospectus would not be worth the effort.

Folk, 55 Va. L. Rev. at 56-57. In comparing Professor Folk's reasoned analysis to SEC Release No. 9671, the court in In re Gap Stores properly concluded that requiring a participating underwriter to "double check the diligent manager's methods" would produce an "absurd result" – the participant would be liable for failure to check methods that, if checked, would have proved that the manager had acted with due diligence. 79 F.R.D. at 301. Indeed, it strains credulity to suggest that if an offering were underwritten by only one underwriter and that underwriter was required to perform, and did perform, over the course of many months or even years, due diligence consisting of a "reasonable" investigation, that an additional investigation of a few days would be anything but superfluous, inefficient, and unreasonably excessive.

Needless formality would also be occasioned by a requirement that junior underwriters conduct independent investigations or send redundant levels of observers to participate in due diligence. The evolution of industry practice underscores this. For example, SEC Release 9671 refers to the convention of the "due diligence meeting," an event that at the time of the Release consisted of a meeting before the effective date of the registration statement that was attended by representatives of the issuer and the underwriters and that was "ostensibly for the purpose of allowing the participants to exercise 'due diligence.'" Obligations of Underwriters, Brokers and Dealers, Securities Act Release No. 9671, 1972 WL 125474, at *7. But participation in such meetings accomplished little or nothing. The SEC observed that the most junior members of the participants' underwriting departments were often assigned to attend, and dismissed them as not helpful in informing the participants. Others have referred to the practice of the formal all-hands due diligence meeting as a "ritual" and "largely a formality" that "is unlikely to save the other underwriters if the managing underwriter has failed in his duty of investigation. On the other hand, if it has performed that duty, the meeting seems to be unnecessary." Coffee, Seligman & Sale, at 888. As a result, industry practice evolved: due diligence meetings became less frequent in the 1970s and 1980s, being gradually replaced by investor meetings. Given time and resource restrictions, any requirement that a participating underwriter perform "some" due diligence would likely result in empty pro forma exercises similar to the former due diligence meeting.

B. Plaintiffs' Proposed Rule Would Exclude Some Junior Underwriters from Syndicates.

It has long been the case, both before and after 1933, that some securities firms specialize in originating and executing IPOs and other securities offerings and that other firms specialize in helping to achieve a mix of institutional and retail distribution, after-market support and research. Some of these may be smaller, minority or women-owned firms that lack the resources of the larger investment houses upon whose due diligence they frequently rely, and with whom they have developed longstanding business relationships giving rise to well-founded trust. The particular genius of the underwriting process in the United States has been to build syndicates for the purpose not only of spreading the risk of a transaction but also to combine the specialties of a diverse group of firms for the purpose of effecting a distribution that serves the interests of issuer and investors alike.

If participating underwriters were not able to rely on the due diligence efforts of the lead underwriters and on the assistance for this purpose of underwriters' counsel, they could not rationally participate in IPOs: First, the need to provide due diligence opportunities to participating underwriters would lead to the "chaos" predicted by Professor Folk, as discussed <u>supra</u>, and to needless expense for the issuer and syndicate as the managing underwriters' efforts were duplicated (or "checked") by each participating underwriter. Issuers would object not only to the likely resulting delay but also to their own increased costs as well as the likely higher underwriting spread to the extent that the syndicate had to bear increased due diligence expenses. Second, some participating underwriters – whether large or small – do not have corporate finance departments that could assume a due diligence burden, and others could simply not justify bearing the expense of such an effort.[14] The result would be the exclusion of smaller and specialized firms from syndicates.

Investors are exposed to no additional risk because of the addition of the junior underwriters, and as explained above, junior underwriters are invited to join the syndicate so late in the process that they will have little or no practical opportunity to participate directly in due diligence or to suggest changes in the preliminary prospectus. Notwithstanding, Plaintiffs seek to require that a junior underwriter undertake additional diligence with no practical purpose but to drive up the costs of the offering and potentially to result in a de facto exclusion of junior underwriters from transactions like the Refco IPO. Plaintiffs fail to explain how such a result would be wise or just from a policy perspective or would afford investors any more protection than the lead underwriters' thorough investigation.

Plaintiffs ask this Court to attach unprecedented liability to industry practices that predate the 1933 Act and for which Congress has neither imposed express liability nor dictated changes to prevailing practices in the intervening 76 years. In so doing, the Plaintiffs request a judicial enlargement of liability that would adversely effect the securities markets, unsettle longstanding practices, and restrict access to capital. This is a task that is properly left to Congress. See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 772 (2008) (citing, as a reason to decline to extend the reach of § 10(b) of the Securities Act of 1934, that the likely consequence would be to raise the cost of doing business as contracting parties might want to

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14 As noted earlier, five of the Junior Underwriters earned a total of $45,000 each (before expenses) as a result of their participation in the Refco IPO.

protect against the risks of liability and the potential that expansion would deter overseas firms from doing business in the United States); Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 188-189 (1994) (citing disservice to "the goals of fair dealing and efficiency in the securities markets" and the inability of newer and smaller companies to obtain advice from professionals because of the latter's potential securities liability as reasons for holding that a private plaintiff may not maintain an aiding and abetting suit under § 10(b)).

CONCLUSION

Plaintiffs' position that junior underwriters may not depend on the due diligence performed by lead underwriters is not supported by the text of Section 11, court decisions, the understanding of Congress and commentators or more than 75 years of industry practice recognized by the SEC. Plaintiffs' position should be rejected.

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