U.S. Regulation of the International Securities and Derivatives Markets, § 11.01, INTRODUCTION

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 11.01 (11th and 12th Editions 2014-2017)
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As the earlier chapters of this book indicate, the United States has a complex system of securities regulation. This chapter discusses a further important aspect of this system: how the rules and regulations are enforced. The financial crisis and collapse of several financial institutions, coming on the heels of several high-profile corporate scandals and the enactment of the Sarbanes-Oxley Act, along with public outrage and resulting Congressional pressure, including the enactment of the Dodd-Frank Act, created an environment for heightened enforcement in the United States. Particularly in the wake of the financial crisis, criminal prosecutors, the SEC and civil litigants brought and are continuing to bring actions with unprecedented speed against financial institutions, corporations, executives and, in some cases, their outside accountants and advisors. At the same time, state regulators have instigated a series of investigations and enforcement actions against financial institutions and other market participants.

Similar to the basic regulatory framework, the enforcement structure is multifaceted. In many instances, the same allegedly improper conduct can give rise to liability based on more than one statutory provision, and this liability can be enforced in legal actions brought by both governmental entities and private parties. Remedies and sanctions for improper securities activities can be sought in three basic ways: through civil litigation, administrative proceedings and criminal prosecutions. None of these mechanisms is exclusive. Thus, a party accused of violative conduct may be forced to defend itself in more than one type of proceeding.

In *civil litigation*, private parties seek to recover losses allegedly suffered as a result of the defendant's conduct, or request injunctive relief to compel or enjoin action by the defendant. These private rights of action either arise from express statutory provisions or are implied, *i.e.*, created by judges to provide remedies for violations of statutes or rules that are silent as to possible remedies for noncompliance. Government agencies, such as the SEC, may also bring civil actions to seek forfeiture of illegally obtained profits, civil monetary penalties (which may be greater or less than damages awarded in a private civil suit) and/or injunctive relief.

The SEC has an active enforcement program with substantial available resources.

Administrative proceedings are brought by government agencies such as the SEC and are conducted pursuant to rules promulgated by the relevant agency before administrative law judges it employs. An agency's determination in an administrative proceeding is subject to review by an appellate court, but the scope of review is limited. For certain violations of the federal securities laws, the SEC may bring administrative proceedings to impose civil penalties or to

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obtain cease and desist orders mandating an immediate halt to the allegedly improper conduct.

Unlike civil litigation, *criminal proceedings* based on the federal securities laws may be brought only by the Department of Justice (the "DOJ"), either on its own initiative or as a result of a referral by the SEC. Defendants convicted in criminal proceedings face substantial fines and, in the case of individuals, terms of imprisonment. Increasingly, state authorities are seeking to use state criminal laws to prosecute perceived misconduct in the securities markets.

These enforcement mechanisms and remedies are, as a basic matter, applicable to conduct in the United States and to entities registered and regulated under the U.S. securities laws, such as broker-dealers and investment advisers. In addition, these enforcement mechanisms and remedies may reach certain conduct occurring or entities located outside the United States in connection with securities transactions on U.S. exchanges or in the United States.

This chapter deals with the most significant consequences of violating the U.S. securities laws. [1] Its focus is on enforcement of the securities laws as they

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relate specifically to *securities transactions*; the principal enforcement mechanisms available for other regulatory schemes, such as the broker-dealer sections of the Exchange Act and the Advisers Act, are summarized in the chapters dealing with the subject matter to which they relate. [2]

Section 11.02 examines liability for failing to register securities. Section 11.03 discusses liability for disclosure improprieties connected with registered public offerings. Section 11.04 discusses disclosure liabilities connected with private offerings, including a separate discussion of offerings under Rule 144A. Section 11.05 reviews liabilities connected with secondary market transactions, including disclosure violations, insider trading, market manipulation and other fraudulent conduct. Section 11.06 considers liabilities connected with tender and exchange offers, including fraudulent or manipulative conduct and insider trading. Section 11.07 discusses the enforcement provisions of the Sarbanes-Oxley Act. Section 11.08 examines the Foreign Corrupt Practices Act, an important piece of legislation mandating certain accounting controls and prohibiting certain payments to foreign officials. Section 11.09 discusses various enforcement scenarios for violation of these laws, including the possibility of class action lawsuits, SEC enforcement actions, civil or criminal actions under the Racketeer Influenced and Corrupt Organizations Act ("RICO"), [3] or other criminal proceedings. Section 11.10 reviews the circumstances in which U.S. law will be applied, and the reach of the U.S. judicial system, to activities and entities outside the United States. Finally, § 11.11 discusses special litigation issues relating to derivatives.

Although the U.S. securities law enforcement process must be respected by those engaged in securities activities with U.S. aspects, it should be kept in perspective. Most important, the vast majority of carefully conducted transactions do not give rise to litigation of any sort, and it is sometimes possible, where securities litigation without merit has been started, for a defendant to secure a favorable judicial ruling dismissing the case at an early stage of its otherwise generally lengthy life. In addition, even in most cases where a case proceeds beyond its preliminary stages, there is a rational sense of proportionality regarding the eventual outcome. Governmental proceedings and civil litigation by private parties relating to relatively less serious alleged violations are often settled by negotiations and do not result in major adverse consequences.

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More serious accusations of improper conduct (in terms of size, intent, the systematic nature of the violation or other factors) can result, whether settled or not, in more significant consequences. Further, SEC enforcement activity has increased in the wake of criticism the Enforcement Division of the SEC faced after its failure to prevent or detect various high-profile corporate scandals. In addition, the SEC has focused on gatekeepers, such as lawyers (both general counsel and outside counsel) and auditors.

The financial crisis of 2008—along with significant frauds and corporate misconduct—spurred a large volume of litigation that has and continues to generate notable decisions that reach into many of the subject matters of this chapter. In one example, plaintiffs attempted to sue all of the parties arguably involved in the sale of mortgage-backed securities—from the issuers, to underwriters, to rating agencies—under a number of theories that, in many ways, test the limits of the securities laws. These cases provide particularly important guidance to market participants, and they are a recurring theme of this chapter.

Footnotes

1 Although this chapter focuses on the consequences of violating the federal securities laws (most particularly, the Securities Act and the Exchange Act), actions that violate the securities laws may also violate other federal or state laws. *See* § 16 of the Securities Act ("[T]he rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist in law or in equity.") and § 28 of the Exchange Act ("[T]he rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity…."). Determining whether claims under the securities laws may coexist with claims under other statutory regimes sometimes presents a complicated statutory question. For example, the U.S. Supreme Court decided in *Credit Suisse Securities (USA) LLC v. Billing*, 551 U.S.264 (2007), that the securities laws preclude the application of the antitrust laws in the context of certain IPO underwriting practices. The Court reached this conclusion by applying a four-pronged test (derived from *Gordon v. New York Stock Exchange*, 422 U.S. 659 (1975)) to determine whether, "given context and likely consequences, there is a 'clear repugnancy' between the securities laws and the antitrust complaint [at issue in *Credit Suisse*]." After applying this analysis, the Court concluded that the securities laws are "clearly incompatible" with antitrust laws, at least in the context of the underwriting practices raised in the *Credit Suisse* action (the plaintiffs alleged that the nation's leading underwriting firms had participated in schemes to inflate the aftermarket prices of the stocks offered in certain IPOs through practices such as "tie-in" agreements, "laddering" arrangements and pre-committing analysts to issue positive reports about the relevant companies). Whereas the *Credit Suisse* plaintiffs framed these facts as violations of the antitrust laws (in particular § 1 of the Sherman Antitrust Act, § 2(c) of the Robinson-Patman Act, and state antitrust laws), the plaintiffs in *In re Initial Public Offering Securities Litigation*, 241 F. Supp. 2d 281, 293–94 (S.D.N.Y. 2003) (consolidated actions), had framed the facts as violations of the securities laws through the use of misleading statements and market manipulation.

In addition, as noted above, state laws may provide bases for state criminal authorities or civil plaintiffs to challenge alleged misconduct in securities transactions. *See, e.g.*, CAL. CORP. CODE §§ 25400 (outlining prohibited activities) (West 2010), 25500 (creating a private right of action), 25540 (establishing criminal liability) (West 2006 & Supp. 2011); DEL. CODE ANN tit. 6, §§ 7303 (Supp. 2010) (securities fraud), 7322 (criminal penalties), 7323 (civil liability) (2005); N.Y. GEN. BUS. LAW §§ 352–359-g (McKinney's 1996 & Supp. 2011) (granting broad investigative powers over suspected securities frauds to New York Attorney General and creating misdemeanor and felony offenses for securities fraud). Although this chapter considers certain jurisdictional aspects of the intersection of state and federal laws, *see* § 11.09[1][a] (discussing the jurisdictional issues raised by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Pub. L. No. 105-353, 112 Stat. 3227 (1998)), it does not address the substantive provisions of state law that these transactions may implicate.

2 Chapters 14 and 16 respectively.

3 RICO, Pub. L. No. 91-452, 84 Stat. 922 (1970) (codified at 18 U.S.C. §§ 1961–1968).

U.S. Regulation of the International Securities and Derivatives Markets, § 11.02, LIABILITIES CONNECTED WITH SECURITIES ACT REGISTRATION REQUIREMENTS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 11.02 (11th and 12th Editions 2014-2017)
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[1] When Is Registration Required?

Section 5 of the Securities Act requires that every offer and sale of a security be registered with the SEC unless a specific exemption from registration applies. [4] The terms "offer" and "sale" have been broadly construed to include various preliminary activities that, while not normally thought of as offers, might be viewed as impermissibly affecting the market for the securities to be offered. Thus, unusual publicity about an intended offer, including circulation of press releases or publication of research reports, may be held to be a prohibited offer under § 5 of the Securities Act. [5]

If a security is being offered or sold without registration, the seller bears the burden of establishing an exemption from the registration requirement. As discussed in earlier chapters, several broad exemptions may apply to a proposed offer or sale. First, private offerings are generally exempt under § 4(a)(2) of the Securities Act and exempt in certain cases under Rule 144A under the Securities Act. [6] Secondary market transactions are generally exempt under a combination

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of four sections: § 4(a)(1) (exempting transactions by any person other than an issuer, underwriter or dealer), § 4(a)(3) (exempting dealers in most instances), [7] § 4(a)(4) (exempting unsolicited brokerage transactions) and § 4(a)(7) (a new, non-exclusive safe harbor exemption for resales of restricted or control securities other than by an issuer or one of its subsidiaries). Offers and sales of securities outside the United States may be exempt from the registration requirement under Regulation S.

The most important consequence of this structure is that offers and sales to the public in the United States by issuers and underwriters are always subject to registration absent an exemption. In addition, the term "underwriter" is defined more broadly in the Securities Act than its business sense. [8] For example, any kind of public offer or sale (including sales on an exchange, a block trade or a market-maker transaction) for an issuer, or by a person or entity that has acquired from or is selling for an issuer, is subject to registration. The registration requirement is not limited to what the business world refers to as "public offerings" or "underwritten offerings." Finally, because for certain purposes the Securities Act includes within the term "issuer" any person that controls, is controlled by, or is under common control with an issuer, offers and sales to the public by or for such persons (commonly referred to as "affiliates") also require registration. [9] There is no bright-line test to determine whether a person is an affiliate, and the determination depends on the facts of a particular case; common examples of affiliates of an issuer include large shareholders, subsidiaries and certain officers and directors. [10]

[2] Liabilities for Failure to Register

[a] Securities Act § 5

Issuers, underwriters or dealers that violate the registration requirements of § 5 of the Securities Act are subject to a variety of remedies in enforcement actions brought by the SEC. In the case of parties guilty of premature offering

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activity (known as "gun-jumping"), the SEC can, as a practical matter, delay the offering for a substantial period of time by refusing to declare the registration statement effective. [11] In addition, the SEC may bring suit in federal district court to enjoin the acts or practices found to violate § 5, for disgorgement of any profits gained as a result of those acts, and for penalties ranging from $89,078 to $890,780 for corporate entities, depending on the egregiousness of the offending conduct and the harm that may have been caused to other parties. [12] In rare instances involving willful conduct, the SEC may also ask the DOJ to consider instituting criminal proceedings. [13]

[b] Securities Act § 12(a)(1)

Parties who improperly offer or sell securities to the public without complying with the registration requirements of § 5 of the Securities Act are also subject to civil suits by any purchaser of the securities. Under § 12(a)(1) of the Securities Act, the seller is strictly liable to the purchaser irrespective of whether the purchaser's loss was in any way related to the failure to register the securities or whether any material misstatement or omission was made in connection with the sale. The purchaser need only show that the securities were subject to registration but unregistered, that he or she bought the securities and that the defendant was the "seller" within the meaning of § 12(a)(1). [14]

Recovery under § 12(a)(1) is limited to rescission or, if the plaintiff no longer owns the security, damages based upon the difference between the purchase price and the plaintiff's resale price. [15] If the plaintiff obtains rescission, he or she recovers the purchase price plus interest. A § 12(a)(1) claim must be

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brought within one year of the alleged violation. The period is not suspended ("tolled") pending the purchaser's discovery of the alleged violation. [16]

Besides rebutting the elements of the plaintiff's *prima facie* case, a defendant has only two defenses to § 12(a)(1) liability. [17] First, he or she may show that the transaction or the security was exempt from the registration requirements of § 5. [18] If no exemption applies, the defendant must show *both* (i) that the plaintiff was at least equally at fault for the violation, in the sense that he or she actively promoted the unregistered sale, [19] and (ii) that barring the plaintiff's suit does not frustrate the effective enforcement of the securities laws. [20] The Supreme Court has stated that, because the Securities Act is "specifically designed to protect investors, even where a plaintiff actively participates in the distribution of unregistered securities, his or her suit should not be barred where the promotional efforts are incidental to his or her role as an investor." [21]

[3] Preemption of State Securities Law Registration Requirements

Until 1996, issuers involved in most large interstate offerings subject to the registration requirements of U.S. federal law were also required to observe the

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separate registration requirements of state securities (or "blue sky") laws. Most states have adopted the Uniform Securities Act, which among other things declares it unlawful for any person to offer or sell any security without registration unless specified exemptions, such as those for offers or sales of securities listed on one of the major U.S. securities exchanges, apply. [22] As in the federal Securities Act, the Uniform Securities Act provides for multiple remedies for violation of its registration provisions, including private civil suits, stop orders and injunctive proceedings by state regulatory authorities, and even criminal proceedings. [23]

This system of dual federal and state registration requirements was dismantled by the National Securities

Markets Improvement Act of 1996 (the "NSMIA"), [24] which among other things amended § 18 of the Securities Act to provide for federal preemption of state registration requirements. Section 18 now provides that, with respect to all "covered securities" (including securities listed on a national securities exchange and securities issued by registered investment companies), state rules requiring or regulating registration shall not apply, and such rules may not "directly or indirectly prohibit, limit or impose conditions" upon the use of offering documents, proxy statements or similar disclosure documents. [25]

Notably, the amendment to § 18 made clear that the federal preemption with respect to registration requirements did not extend to other areas of state securities regulation, including specifically state power "to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer." [26] Like the federal framework examined in §§ 11.03[2] and

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11.04[2] below, the Uniform Securities Act prohibits sales of securities through fraud or misrepresentation and creates criminal and civil liability for violations of its provisions. These provisions of state law remain intact, except in the context of class actions, [27] and provide additional deterrence against malfeasance in connection with securities transactions.

Footnotes

4 *See* § 5 of the Securities Act. *See also* §§ 1.02 and 3.02 for a discussion of the statutory requirements for registered public offerings in the United States. Issuers should be aware that the registration requirement applies to both their sales of newly issued securities and their resales of securities that they have previously issued and later repurchased ("treasury securities").

5 *See* § 3.02[2] and § 7.02[4] for a discussion of the publicity permitted in connection with an intended offering.

6 *See* § 7.02 and § 7.04[1].

7 Registration is required for underwriter or dealer transactions in securities constituting the whole or part of an unsold allotment, and also is required for dealer transactions in securities within the first 40 days after those securities were first publicly offered. § 4(a)(3)(A) and (C) of the Securities Act. Transactions by a dealer include transactions as agent (or broker), as well as transactions as principal. *See* the definition of "dealer" in § 2(a)(12) of the Securities Act.

8 *See* § 2(a)(11) of the Securities Act.

9 *See* § 2(a)(11) of the Securities Act.

10 *See SEC v. Cavanagh*, 155 F.3d 129, 143 (2d Cir. 1998) ("A control person, such as an officer, director, or controlling shareholder, is an affiliate of an issuer and is treated as an issuer when there is a distribution of securities. Thus, an affiliate ordinarily may not rely upon the § 4(1) exemption—he must either re-register his shares or qualify for a different exemption before undertaking to sell them.").

11 *See* § 2(a)(11) of the Securities Act; *Investment Company Filing Guidance—1993* (avail. Feb. 2, 1993) (Premature offering activity "is commonly referred to as 'gun jumping.' In such a case, acceleration of the effectiveness of the registration statement may be delayed and a 'cooling off' period with a re-circulation of any preliminary prospectus may be required.").

12 *See* §§ 20(b) and 20(d) of the Securities Act; SEC Release No. 33-10104 (June 27, 2016). These provisions apply to all other violations of the Securities Act and its associated rules and regulations; they are not particular to § 5 of the Securities Act.

13 *See* §§ 20(b) and 24 of the Securities Act. Again, this remedy is available for all violations of the Securities Act and its associated rules and regulations.

14 A person is a seller under the statute if he or she (i) passes title to the security or (ii) solicits the purchase and has a financial interest in the sale. A person who solicits a sale must be "motivated at least in part by a desire to benefit his own financial interests or those of the securities owner" to be a statutory seller under § 12(a)(1) of the Securities Act. *Pinter v. Dahl*, 486 U.S.622, 647 (1988).

15 *See Myers v. Da Silva*, Fed. Sec. L. Rep. (CCH) ¶99,166 (E.D. Cal. Mar. 14, 1983) at 95,628 (noting that the proper remedy is determined by plaintiff's circumstances, not plaintiff's election: "if plaintiff still owns the tainted securities he may only sue for rescission").

16 In the circumstances where it is applicable, the principle of "tolling" delays or suspends the counting of time (a "limitations period") within which a securities action must be commenced. For example, if a one-year statute of limitations for a fraud claim is tolled until discovery of the fraud, the plaintiff has one year to bring a claim after such discovery even if the fraud occurred more than one year before. The principle of tolling does not apply under § 12(a)(1) of the Securities Act. *See Lampf, Pleva, Lipkin, Prupis & Petigrow v. Gilbertson*, 501 U.S.350, 363 (1991); *Gardner v. Investors Diversified Capital, Inc.*, 805 F. Supp. 874 (D. Colo. 1992); *Barton v. Peterson*, 733 F. Supp. 1482, 1490 (N.D. Ga. 1990).

17 These defenses are products of case law; they are not set forth in the statute.

18 The burden is on the defendant to establish that the sale of the security was exempt from registration. *See SEC v. Cavanagh*, 445 F.3d 105, 111 n.13 (2d Cir. 2006); *SEC v. North American Research & Development Corp.*, 424 F.2d 63, 71 (2d Cir. 1970).

19 It is not sufficient to show that the plaintiff knew the securities were not registered and that no registration exemption was available. The defendant must prove that the plaintiff's role in the offering was more as a promoter than an investor—for example, that he or she induced the issuer not to register the securities, or was equally involved with the defendant in developing and carrying out a plan to distribute unregistered securities.

20 This is the *in pari delicto* defense, and it is available as a defense against private actions under any of the securities laws. *Pinter v. Dahl*, 486 U.S.622, 635 (1988). The Court first held that the *in pari delicto* defense, as formulated above, was applicable to § 10(b) actions in *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S.299, 310–11 (1985). In *Pinter v. Dahl*, 486 U.S. 662 (1988), the Court held that this defense applies to all private actions under the federal securities laws, including actions for rescission under § 12(a)(1).

21 *Pinter v. Dahl*, 486 U.S.622, 638–39 (1988).

22 *See* §§ 301 and 403(a)(8) of the Uniform Securities Act. At least 40 states have adopted the Act in whole or in part. Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879, 905 (2006). One notable exception is New York, which has never adopted the Uniform Securities Act, and whose current statute, the Martin Act, dates from 1921. N.Y. GEN. BUS. LAW § 352–359-g (McKinney's 1996 & Supp. 2011). *See infra* Note 584.

23 *See* §§ 306 and 408–410 of the Uniform Securities Act. As a practical matter, most state regulatory authorities have lacked the resources to enforce their "blue sky" laws effectively by injunctive or criminal proceedings, so such statutes have been principally enforced through private civil suits. The civil liability provisions of the Uniform Securities Act are patterned after § 12 of the Securities Act, with damage remedies available to the purchaser for offers and sales of securities made in violation of the registration provisions, as well as for other violations of the Act. *See* § 410 of the Uniform Securities Act.

24 *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

25 *See* §§ 18(a) and 18(b) of the Securities Act. *See* § 2.04[8] for a further discussion of state securities laws.

26 § 18(c)(1) of the Securities Act.

27 In 1998, Congress passed the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998) which requires most private securities class action lawsuits alleging fraud to be pursued exclusively in federal court under federal law. *See* § 11.09[1][a].

U.S. Regulation of the International Securities and Derivatives Markets, § 11.03, LIABILITIES CONNECTED WITH DISCLOSURE IN REGISTERED PUBLIC OFFERINGS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 11.03 (11th and 12th Editions 2014-2017)
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For both U.S. and non-U.S. companies, one of the most important aspects of the U.S. securities enforcement process is related to remedies for allegedly improper disclosures (such as false statements) in connection with securities activities. Although improper disclosures can arise in a variety of other significant contexts, the most comprehensive framework of remedies for deficient disclosure applies in the case of registered public offerings of securities, including offerings of ADRs representing shares of non-U.S. issuers. [28] We first discuss, therefore, the various remedies and sanctions that exist to deal with asserted disclosure deficiencies in connection with U.S. public offerings, as well as steps that can be taken by issuers and others involved in the offering process to reduce the related risks. [29]

As in many other areas of the U.S. securities laws, remedies for disclosure deficiencies in public offerings are predicated on a variety of statutory provisions. The most important of these are §§ 11 and 12(a)(2) of the Securities Act, which are discussed below in § 11.03[1] and [2], respectively. The SEC's power under § 8 of the Securities Act to issue "stop orders" in response to disclosure violations is examined in § 11.03[3]. Two other liability provisions applicable to disclosure violations in registered public offerings, § 17 of the Securities Act and Rule 10b-5 under the Exchange Act, are addressed briefly in § 11.03[4] below, with further treatment in § 11.04 (disclosure liabilities in private offerings). Section 11.03[5] discusses safe harbors from liability under U.S. securities laws for certain projections and other forward-looking statements. Finally, § 11.03[6] notes the existence of similar enforcement provisions in the state securities laws.

[1] Securities Act § 11

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[a] Elements of Claim

Section 11 of the Securities Act imposes liability for certain types of deficient disclosure in a registration statement, including the prospectus. [30] Specifically, a § 11 claim arises when any part of the registration statement at the time it becomes effective either (i) contains an untrue statement of a material fact or (ii) omits mention of a material fact required to be included in the registration statement or otherwise necessary to make the included statements not misleading. A fact is material if there is a substantial likelihood that a reasonable purchaser would consider it important in making his purchase, or otherwise stated, if the reasonable investor would view it as "significantly alter[ing] the 'total mix' of information made available." [31]

If either of these deficiencies exists, any purchaser of the securities covered by the registration statement may bring a civil suit, whether he or she purchased the securities in the initial distribution or, as some courts have held, in the aftermarket where the securities are traceable to the initial offering. [32] The traceability requirement, however, effectively limits claims in follow-on offerings (*i.e.*, offerings that follow the issuer's initial public offering) to those who purchased in the offering. [33]

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The plaintiff generally need not prove that he or she relied on the misstatement or omission in the registration statement in purchasing the securities. [34] The plaintiff also is not required to prove a causal relationship between the material misstatement or omission and the decline in the value of the security. [35] Finally, the plaintiff is not required to prove fraudulent intent ("*scienter*") on the part of the defendant.

[b] Who May Be Liable

Five basic categories of offering participants are subject to primary liability under § 11 of the Securities Act. [36] They are:

- the issuer;
- every person who signed the registration statement; [37]
- every director or partner of the issuer at the time of the filing, and every person who, with his consent, was named in the registration statement as about to become a director or partner; [38]
- every underwriter for the securities being registered; [39] and

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- every "expert" named with its consent as having prepared a portion of the registration statement. [40]

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In addition, under § 15 of the Securities Act, liability may be extended to any person who "controls" one of these primarily liable parties, in the sense that he or she has the power to direct or cause the direction of its management and policies, whether through the ownership of voting securities, by contract or otherwise. [41] Therefore, a large shareholder (or an officer not otherwise liable) may be liable for claims against the corporation he or she controls. [42] A controlling person may escape liability if that person can show that he or she had neither knowledge nor "reasonable ground to believe" in the existence of the facts giving rise to liability on the part of the person he or she controls. [43]

Because § 11 specifies the persons who are potentially liable thereunder for a disclosure violation, the courts have found that there is no additional liability for "aiding and abetting" a § 11 violation. [44]

[c] Defenses

All defendants, including the issuer, can escape liability by proving that the plaintiff knew of the material misstatements or omissions at the time he or she purchased the security. [45] If this difficult defense [46] cannot be sustained, the issuer is strictly liable for the disclosure violation.

Defendants other than the issuer bear the burden of proving that they have met a prescribed standard of care. [47] For purposes of this defense (commonly known as the "due diligence" defense), the registration statement is deemed to have two sets of sections: those prepared by experts ("expertized") and the others.

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With respect to the nonexpertized portions of the registration statement, a potentially liable defendant [48] must prove that he or she had, after "reasonable" investigation, "reasonable" ground to believe that the included information was true and that no material facts were omitted. [49] The standard of reasonableness is "that required of a prudent man in the management of his own property." [50] Because of the investigation requirement, issuers and underwriters participating in an offering engage, together with their respective advisers, in a detailed examination of the issuer's business and finances. [51] Such an examination can last for weeks in the case of a first-time issuer with a complex business, or can involve a single meeting or conference call for an offering by a seasoned issuer off a "shelf" registration statement involving underwriters and counsel that regularly follow and are familiar with the issuer's affairs. Underwriters generally request that the issuer's accountants deliver "comfort letters" regarding financial information included in the registration statement and that their counsel and issuer's counsel deliver to them "negative assurance" letters indicating that counsel has made certain investigations in connection with preparation of the registration statement and confirming that counsel is not aware of any material misstatement or omission in the registration statement.

With respect to expertized portions of the registration statement, defendants other than the relevant expert must prove that, at the time that the registration statement was effective, they had no reasonable ground to believe, and did not believe, that there was a material misstatement or omission. [52] No reasonable investigation is required to establish the defense. This reduced standard of diligence applies most frequently to the audited financial statements in a registration statement, because such financial statements are included in reliance on the auditors' report thereon and upon the authority of the auditors as experts, as well as the auditors' consent to being named as experts. Although no reasonable

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investigation is required to establish a reliance defense, courts have held that the existence of "red flags" can create a duty to investigate expertized information, including audited financial statements. [53] As a result, the examination of an issuer by underwriters and their advisers includes a thorough review of financial statements and other financial information with an issuer and its accountants.

The due diligence investigation necessary to establish a defense may depend upon the defendant's role in the transaction and his or her relationship to the issuer. In the first of the relatively few reported cases to analyze § 11 liability, [54] the court discussed factors relevant to whether a defendant had established a due diligence defense. The court stated that an underwriter must "make some reasonable attempt to verify the data submitted" to it and may not rely solely on statements or assurances of the issuer's officers and counsel. [55] The court distinguished the greater level of investigation required of a director who is a lawyer preparing the registration statement than of an outside director, *e.g.*, with respect

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to legal and corporate documents. [56] The court also found that a corporate officer could not reasonably rely on expertized information when, based on the officer's own knowledge of the company's financial data, he or she had reason to know it was not correct. [57]

Rule 176 under the Securities Act provides some additional guidance on the factors that should be taken into account in determining the reasonableness of the due diligence investigation. [58] Under this rule, relevant factors include:

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- the type of issuer;
- the type of security;
- the type of person (*e.g.*, whether a director, officer or underwriter);
- for officers, the type of office held;
- for directors, whether they have any other relationship with the issuer;
- for underwriters, the type of underwriting arrangement;
- reasonable reliance on officers, employees and others whose duties should give them knowledge of the facts in question; and
- whether, with respect to information incorporated by reference to another document, the person had any responsibility for preparation and filing of the incorporated document. [59]

An issuer faced with suit under § 11 may also be able to rebut allegations of material misstatements or omissions with respect to statements of opinion, including statements of belief, statements expressing uncertainty about a current matter, and predictions about the future, under certain circumstances. [60] In *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, the Supreme Court identified three bases of liability for statements of opinion under § 11. [61]

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First, because "every such statement explicitly affirms one fact: that the speaker actually holds the stated belief," a statement of opinion can be actionable as a misstatement of material fact if it was subjectively disbelieved by the defendant at the time it was expressed. [62] Second, a statement of opinion can be actionable as a misstatement if it is accompanied by "embedded statements of fact" that are untrue. [63] For example, if a speaker supports its opinion with a specific fact that is untrue, there can be liability for that misstatement. To avoid liability on this ground, an issuer can show that its challenged opinion did not contain embedded statements of facts or that any such facts were true. Third, "because a reasonable investor may, depending on the circumstances, understand an opinion statement to convey facts about how the speaker has formed the opinion," a statement of opinion can be actionable under § 11's omissions provision if it "omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion" and "those facts conflict with what a reasonable investor would take from the statement itself." [64] Thus, a statement of opinion about legal compliance (*i.e.*, "we believe our conduct is lawful") may be an actionable omission if the issuer made the statement without having consulted a lawyer because "an investor, though recognizing that legal opinions can prove wrong in the end, still likely expects such an assertion to rest on some meaningful legal inquiry—rather than, say, on mere intuition." [65] The Supreme Court has cautioned, however, that an opinion statement "is not necessarily misleading when an issuer knows, but fails to disclose, some fact cutting the other way." [66] Further, "whether an omission makes an expression of opinion misleading always depends on context," and requires consideration of the text surrounding the opinion, "including hedges, disclaimers, and apparently conflicting information," as well as "the customs and practices of the relevant industry." [67] An issuer may therefore be able to avoid omission liability for statements of opinion by disclosing the basis for its opinion or by establishing that an investor would not have been misled about that basis when the statements are viewed in context.

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In *Tongue v. Sanofi*, the Second Circuit applied this standard in affirming the dismissal of claims regarding an issuer's optimistic statements of opinion concerning the expected timing of a drug's approval and launch, despite the issuer's alleged failure to disclose the FDA's negative feedback about the methodology used in the drug's trials. [68] In reaching that result, the Second Circuit concluded that the omitted facts did not "conflict with what a reasonable investor would take from the statement itself" because investors in a pharmaceutical company are aware of ongoing dialogue between the company and the FDA, as well as the FDA's previously disclosed concerns with the applicable methodology. [69] The Second Circuit also concluded that the issuer was not under an obligation to disclose the specific negative feedback it received from the FDA "merely because it tended to cut against their projections." [70]

Issuers can also defeat liability with respect to forward-looking opinions and other forms of "soft information," such as predictions and discussions of risk, by including appropriate cautionary language about the reliability of this information within the prospectus. Under the so-called "bespeaks caution" doctrine, which has been developed by the courts and incorporated into federal statutory law outside the initial public offering context, [71] cautionary language such as disclaimers may render certain alleged misrepresentations or omissions immaterial as a matter of law. [72] The idea is that a suitably warned purchaser cannot reasonably have relied on this information in making his or her investment decision.

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Disclaimers, however, are not a failsafe; if the seller did not have at least a reasonable basis for making the predictive statements, the disclaimers will not be sufficient to defeat liability. [73]

The "bespeaks caution" doctrine only protects statements that are considered forward-looking. [74] Courts have at times struggled to define what makes a statement "forward-looking." The Second Circuit tackled the question in *Iowa Public Employees' Retirement System v. MF Global, Ltd.* [75] In *MF Global*, the plaintiffs complained that the defendant had failed to disclose that its risk management protocols, which limited trading in brokerage accounts in certain ways, were not always enforced upon the company's employees trading for their own accounts. The district court dismissed the allegations under the "bespeaks caution" doctrine, interpreting plaintiffs' complaint as an allegation that MF Global had failed to disclose that "the risk management system might be unable to prevent future negative outcomes" and was thus alleging that MF Global "had failed to disclose the risk of a future negative event." [76] The Second Circuit held that the district court had applied the "bespeaks caution" doctrine too broadly for failing to recognize that the "allegation specifies an omission of present fact" that was "ascertainable when the challenged statements were made." [77] Recognizing that the line between forward-looking statements and statements of present fact may be hard to draw, and that some statements may contain elements of both, the court explained that "[a] forward-looking statement expresses the issuer's inherently contingent prediction of risk or future cash flow" whereas "a non-forward looking statement provides an ascertainable or verifiable basis for the investor to make his own prediction." [78]

More recently, in litigation arising out of Facebook's initial public offering, a judge in the Southern District of New York concluded that the defendants were not sheltered from liability under the bespeaks caution doctrine, even

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though the company made "significant disclosures" warning that it could lose revenue in the future as the use of its mobile products increased, because the plaintiffs adequately alleged that the defendants were aware that those trends were already occurring. [79] The court therefore concluded that Facebook had a duty to disclose that known trend under Item 303 of Regulation S-K under the Securities Act, and that the bespeaks caution doctrine did not apply to the alleged omission of that existing information. [80]

Cautionary language can also help an issuer rebut allegations of material misstatements or omissions in contexts other than those involving soft information. In *WorldCom Securities Litigation*, [81] the court held that an issuer unaffiliated with WorldCom did not violate § 11 when it made a registered offering of notes linked to WorldCom's equity. The historical prices for WorldCom's common stock listed in the prospectus supplement relating to the notes were artificially inflated as a result of WorldCom's wrongdoing and were therefore materially false and misleading. The court pointed to language in the issuer's prospectus supplement that clearly cautioned that the issuer did not know whether WorldCom had disclosed all events occurring before the date of the prospectus supplement, that the issuer had not participated in the preparation of any of WorldCom's public filings and that the issuer had not made any due diligence investigation or inquiry of WorldCom in connection with the equity-linked note offering. [82]

Finally, courts generally hold that expressions of "puffery" and corporate optimism do not give rise to securities violations, either because they are too general to cause a reasonable investor to rely upon them or because no investor would consider such statements to be material. [83] For example, the Second

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Circuit recently dismissed claims alleging that an issuer made misstatements about its "culture of high ethical standards, integrity, operational excellence, and customer satisfaction" and "its reputation for upholding the highest standards of personal integrity and business conduct," notwithstanding the plaintiffs' allegation that the statements were "knowingly and verifiably false when made," because the statements' "generality … prevents them from rising to the level of materiality required to form the basis for assessing a potential investment" and "an investor would not depend on the statements as a guarantee that the company would never take a step that might adversely affect its reputation." [84]

[d] Remedies

A plaintiff who prevails on a § 11 claim may recover monetary damages, which are measured in one of three ways. [85] If the plaintiff still holds the security at the time of judgment, the plaintiff may recover the difference between the purchase price and its value at the time the suit was filed. [86] If the plaintiff sold the security before filing suit, he or she may recover the difference between the purchase and resale prices. Finally, if the plaintiff sold the security during the course of the litigation, the plaintiff may recover the difference between the purchase price and either the resale price or the price at the time the suit was filed, whichever is greater. In any of these contexts, the defendant may reduce the plaintiff's damages by proving that the decline in the value of the security is attributable to factors other than the material misstatement or omission. [87]

Defendants are jointly and severally liable to the plaintiff, meaning that any of them may be held responsible for the plaintiff's damages in full. [88] There is an exception for underwriters, whose liability generally is limited to the value

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of their own underwriting commitment. [89] Outside directors are also exempt from joint and several liability, except in cases of "knowing" securities fraud. [90] Under certain circumstances, discussed below, defendants have a right to recover contribution from one another. [91]

[e] Indemnification, Contribution and Insurance

Indemnification, contribution and insurance are methods by which defendants seek to shift liability in whole or in part to fellow wrongdoers, or to insurance carriers who agree to cover their litigation costs and damages in exchange for regular premiums. While contribution and insurance payments are generally permissible under the securities laws, the SEC and the courts have strictly limited the availability of indemnification. These issues, which apply equally to the Securities Act and the Exchange Act, are addressed below.

[i] *Indemnification*

There are no express rights of indemnification under the Securities Act or the Exchange Act, and a majority of courts have held that such rights may not be implied. [92] The SEC takes the position that an issuer's agreement to indemnify its directors, officers and controlling persons for securities law violations is against public policy and unenforceable. [93] Courts have generally agreed, on the grounds

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that indemnification agreements defeat the deterrent policies of the securities laws. [94]

The SEC policy by its terms does not apply to (i) the issuer's indemnification of underwriters for liabilities arising out of information in the registration statement not provided by the underwriters, [95] or (ii) a selling securityholder's indemnification of the issuer (or *vice versa*) in a secondary offering by such securityholder. [96] However, the courts may not enforce such agreements, particularly where the securities law violation involved intentional or reckless conduct. [97] The courts are divided as to whether indemnification is available when the underwriter has been merely negligent. [98] Because of this uncertainty, U.S. underwriting agreements generally provide for a contractual right of contribution if the indemnification provisions are not enforceable.

[ii] *Contribution*

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Contribution is an equitable doctrine developed in response to the traditional regime of "joint and several liability," in which any single defendant could be held liable for the full extent of plaintiff's damages, even if multiple persons were in fact responsible for those damages. The right of the person who discharges the common liability to recover contribution from others who share fault is thought to promote both fairness and the deterrent policies of the securities laws, because all persons potentially liable to the plaintiff will have to bear a share of the loss rather than only those named as defendants. Section 11(f) of the Securities Act expressly provides for contribution among defendants who are jointly liable, although a person found liable for fraudulent misrepresentation cannot recover in contribution from a defendant who is not. [99] Under a 1995 amendment to the Securities Act, outside directors now are exempted from joint and several liability, except in cases of "knowing" securities fraud, and instead are liable only for a portion of the total damages based on the percentage of responsibility that the jury attributes to them. [100]

[iii] *Insurance*

Companies routinely purchase, and the SEC does not object to, liability insurance for directors and officers, although the SEC does require disclosure of the premium paid by the registrant or selling shareholder for any policy, obtained in connection with a registered public offering, that insures or indemnifies directors or officers against liabilities connected with the registration. [101]

[f] Statutes of Limitations and Repose

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The statutes of limitations and repose (the periods in which a plaintiff must commence litigation) for claims brought pursuant to § 11 are "one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence," but in no event more than three years after the security was first *bona fide* offered to the public. [102]

Many courts have held that the plaintiff bears the burden to plead and prove facts demonstrating compliance with the limitations periods. [103] Specifically, a complaint should set forth the (i) time and circumstances of plaintiff's discovery of the fraudulent statement, (ii) reasons why it was not discovered earlier if more than one year has elapsed since the statement was made, and (iii) diligent efforts that plaintiff undertook in seeking such discovery. [104] While ordinarily the plaintiff also bears the burden of pleading and establishing that it is entitled to tolling, [105] the Supreme Court has held that equitable tolling— *i.e.*, tolling in circumstances not contemplated by the statute—is not available. [106]

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As noted above, § 13 provides a three-year repose period for claims under § 11. This period begins when the security is "*bona fide* offered to the public," but the statute is ambiguous as to the meaning of that phrase. In *P. Stolz Family Partnership L.P. v. Daum*, the Second Circuit held that in determining whether a *bona fide* offer was made, "the relevant question … is when was the stock really and truly (genuinely) offered to the public, as opposed to, say, a simulated offering." [107]

The court in *P. Stolz* further interpreted § 13 to mean that the statute of repose begins to run from the *first bona fide* offering of the security to the public, rather than from the *last* such offering. The court reasoned that this interpretation was appropriate because the entire purpose of a statute of repose is to

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provide an easily ascertainable and certain date for the quieting of litigation, and using the last offered date would add uncertainty and fluidity to that calculation and prevent finality. It held as much notwithstanding its acknowledgement that the rule leaves open the remote possibility that a plaintiff's claim may in some instances become barred before it even accrues. [108]

[2] Securities Act § 12(a)(2)

[a] Elements of Claim

Section 12(a)(2) of the Securities Act provides a second basis for liability for deficient disclosure in connection with public offerings. [109] Unlike § 11, which is limited to disclosure in a registration statement, § 12(a)(2)'s remedy applies to both written and oral communications in connection with the offer or sale of a security. [110] The statute provides that any person who offers or sells a

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security by means of a "prospectus or oral communication" [111] that contains a material misstatement, or fails to state a material fact that is "necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading," is liable to the purchaser for damages. [112] An oral communication must relate to the prospectus for it to be actionable under § 12(a)(2). [113]

As in § 11, the plaintiff is not required to establish that the defendant acted with fraudulent intent (*scienter*), or that the plaintiff relied upon the misstatements or omissions in making his or her purchase—although the plaintiff must prove that he or she was not actually aware of these disclosure violations at the time. [114] The plaintiff also must demonstrate that the misstatement or omission somehow affected (though not necessarily prompted) the purchase, but this

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showing has been presumed where the misleading information was in a written prospectus, since the dissemination of such information is deemed to affect the market price of the security. [115]

Unlike § 11, which establishes liability for a range of offering participants, § 12(a)(2) liability is expressly limited to those who offer or sell the securities. However, this provision has been construed to include not only the immediate seller, but also others who had a financial interest in the sale and actively participated in its solicitation. [116] Thus, directors, officers and principal shareholders of an issuer may be liable as "sellers" under § 12(a)(2) where they authorize the promotional efforts of the underwriters, help prepare the offering documents and work closely with the underwriters in conducting sophisticated "information" or "due diligence" meetings with retail and institutional sales personnel. [117]

Moreover, as in § 11, liability may be extended to "controlling persons," unless these persons can prove that they neither knew nor had a reasonable basis to know the facts giving rise to the liability of those they control. [118] The courts have held that there is no aiding and abetting liability under § 12(a)(2) of the Securities Act. [119]

[b] Defenses

A seller has an affirmative defense to § 12(a)(2) liability if he or she can prove that he or she "did not know, and in the exercise of reasonable care could not have known," of the untrue statement or omission. One court has interpreted

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this standard as requiring the exercise of "ordinary care," with the determination of what this involves dependent on the circumstances of the transaction. [120]

Unlike the due diligence defense under § 11, § 12(a)(2) does not expressly impose a duty to investigate. However, some courts have implied such a duty under certain circumstances. [121] Accordingly, it has become customary for underwriting banks in public offerings exempt from SEC registration, such as offerings of commercial paper exempt under § 3(a)(3) of the Securities Act, to proceed as if the duties necessary to establish a defense under § 12(a)(2) are the same as those under § 11, and as if the same measures they use to protect themselves under § 11 also will protect them under § 12(a)(2).

The indemnification and contribution provisions in underwriting agreements for registered public offerings apply to liability arising from misleading misstatements or omissions in the preliminary and final prospectuses as well as the registration statement. As previously discussed, the courts may not always enforce these indemnification provisions, but generally will honor contractual provisions providing for contribution rights among offering participants. [122]

[c] Remedies

Section 12(a)(2) of the Securities Act provides an express measure of damages for disclosure violations. If the plaintiff still owns the security, he or she is entitled to rescind the sale and recover the purchase price, plus interest, less income earned. If the plaintiff no longer owns the security, he or she can recover

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damages. Pursuant to the Litigation Reform Act, [123] damages for violations of § 12(a)(2) are limited to the depreciation in the value of the plaintiff's securities actually caused by the false statements or omission. [124]

[d] Statute of Limitations

Like § 11 suits, claims under § 12(a)(2) of the Securities Act are governed by the limitations and repose periods imposed by § 13 of the Securities Act. Such periods are one year after the plaintiff discovered or reasonably should have discovered the misstatement or omission, but in no event more than three years after the sale. [125] Because § 12(a)(2) is governed by the same statute of limitations as § 11 claims, the issues discussed in § 11.03[1][f] are also germane to limitations issues under § 12(a)(2). [126]

[3] Stop Orders

In addition to the civil damage remedies provided by §§ 11 and 12(a)(2), the Securities Act provides for various remedies by the SEC in response to improper disclosure in a registration statement. Chief among these remedies is the so-called "stop order" under § 8 of the Securities Act, by which the SEC may (i) deny effectiveness to a registration statement that will otherwise automatically become effective if it appears inaccurate or incomplete in any material respect, [127] or (ii) suspend the effectiveness of a previously filed registration statement if it contains a material misstatement or omission. [128] In both cases, the issuer is entitled to notice and a hearing before the SEC issues the stop order, and the stop order remains in effect until the registration statement has been amended in accordance with the SEC's instructions.

[4] Other Liability Provisions

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Disclosure violations in registration statements may also implicate § 17 of the Securities Act and Rule 10b-5 under the Exchange Act, broad antifraud provisions that provide a variety of remedies, including civil or administrative proceedings by the SEC, criminal liability and, in the case of Rule 10b-5, civil damage suits by private parties. [129] These provisions, which also apply to fraudulent acts in connection with private placements and secondary market transactions, are discussed further in § 11.04[2] and [3].

[5] Special Liability Rules for Forward-Looking Statements

Projections and forecasts about an issuer and other forward-looking statements are by their nature uncertain and may prove to be incorrect, thus raising special liability concerns for an issuer, including a potential duty to correct or update them when they are no longer true. [130] With the adoption of Regulation FD, [131] these statements are required to be disclosed to a much wider audience when material, which will often (and for earnings, revenue or similar line item forecasts, always) be the case, with an attendant increase in the issuer's exposure to liability for such statements.

Special liability rules apply with respect to both written and oral forward-looking statements. Forward-looking statements may be protected as statements of opinion under certain circumstances. [132] Outside the initial public offering context, corporate issuers also generally now enjoy a qualified safe harbor for forward-looking statements, so long as these statements are accompanied by "meaningful cautionary statements" or were not made with actual knowledge of their falsity.

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The Litigation Reform Act, enacted in 1995, provides issuers that are subject to the reporting requirements of the Exchange Act, their officers, directors and employees and their underwriters (with respect to information provided by such issuers or derived therefrom) the principal source of protection for projections and other forward-looking statements, whether written or oral, that turn out to be inaccurate or materially misleading. The Litigation Reform Act creates a two-pronged safe harbor from liability under the Securities Act and the Exchange Act where (i) a forward-looking statement [133] is identified as

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such [134] and is accompanied by [135] meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement or is "immaterial" [136] *or* (ii) a plaintiff is unable to prove that the forward-looking statement was made with actual knowledge that it was materially false or misleading. [137] At least two issues have caused courts to differ in their applications of the first prong. Most courts have noted that the first prong, unlike the second prong, contains no reference to the defendant's state of mind. Thus, these courts have found that the first prong is satisfied irrespective of defendants' knowledge of the truth or falsity of their forward-looking statements. [138] This position, however, has not been uniformly adopted. [139]

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Second, courts have struggled to define what makes a cautionary statement "meaningful" in order to benefit from the safe harbor. Courts have generally agreed that mere "boilerplate" cautionary language will not suffice, and the risk disclosures must be tailored to the defendant's actual business. [140] These principles, like much of the analysis of the safe harbor provision, have been borrowed from the "bespeaks caution" doctrine; [141] the House Conference Committee that adopted the Litigation Reform Act stated that the statutory safe harbor was based on—but not intended to replace—the common law doctrine. [142]

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Disagreement among the courts has focused on how to apply the safe harbor at the pleadings stage in cases where the plaintiff alleges that an undisclosed contingency caused worse-than-predicted results. The Seventh Circuit's decision in *Asher v. Baxter* [143] suggests that it could be difficult for a defendant to prevail on a motion to dismiss in such a circumstance. In *Asher*, the court ruled that before a motion to dismiss can be granted, at least some discovery may be required to determine whether the defendant had actually disclosed the important risks that it "objectively faced when it made its forecasts." [144] At the pleadings stage, the court found no basis to conclude that the defendant had disclosed the "principal or important risks." [145] Courts following *Asher* may conclude that discovery is nearly always necessary where the contingency that causes worse-than-predicted results is not identical to the risks described in the forward-looking statement. [146]

In contrast, the Eleventh Circuit Court of Appeals in *Harris v. IVAX Corp.* [147] affirmed a ruling on motion to dismiss in the defendant's favor. The plaintiff had alleged that the safe harbor would not protect a press release that disclosed an anticipated quarterly loss of $43 million when the defendant's actual loss turned out to be $179 million, of which $104 million was a "goodwill write-down" that the company had never disclosed. The court concluded that the "failure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor. [W]hen an investor has been warned of risks of a significance similar to that actually realized, she is sufficiently on notice of the investment to make an intelligent decision about it." [148] While the *Harris* analysis permits a broader application of the safe harbor at the pleading stage, companies can increase their chances of qualifying for the safe harbor by updating their risk disclosures to follow corporate developments. [149]

The Litigation Reform Act sets forth specific procedures for complying with the safe harbor with respect to oral forward-looking statements. Pursuant to these procedures, it is sufficient for an issuer (or its director, officer or employee) making an oral forward-looking statement to (i) state that the discussion or presentation will contain forward-looking statements, (ii) state that actual results could differ materially from those projected in such forward-looking statements and (iii) refer the audience to a "readily available" written document where the "meaningful cautionary statements" can be found. [150] Documents filed with the SEC or publicly disseminated are considered "readily available." [151]

While the Litigation Reform Act safe harbor has generally been an effective safe harbor from liability for forward-looking statements in certain contexts, it has a number of qualifications. First, it applies only in private civil suits [152] alleging liability under the Securities Act or the Exchange Act. [153] Second, as previously mentioned, it is available only for issuers that are subject to the reporting

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requirements of the Exchange Act. [154] Third, it does not apply to statements made in the context of an initial public offering, a tender offer or a going private transaction, in financial statements or in beneficial ownership reports under § 13(d) of the Exchange Act. [155]

Finally, the language of the safe harbor does not affect the scope of any duty to update specific forward-looking statements that fall within it. [156] The Litigation Reform Act explicitly declined to resolve the question whether an issuer making projections must update them when they appear no longer to be accurate, providing only that nothing in the Act shall impose such a duty. [157] In the absence of clarity on the extent and scope of a duty to update that may be imposed by the courts, issuers have continued to be cautious about making public projections, despite the safe harbor, in light of the significant possibility that they will be compelled to update them in circumstances in which they would otherwise prefer to refrain from making additional public disclosures. [158]

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Other factors may also dissuade issuers from offering more forward-looking disclosure. In a report to the President and Congress summarizing the practical impact of the Litigation Reform Act a year after its enactment, the SEC indicated that the "quality and quantity of forward-looking disclosure [had] not significantly improved," despite the formal safe harbor. [159] The SEC identified a number of factors underlying corporate reluctance to increase disclosure, including:

- the lack of judicial guidance as to the sufficiency of the required "meaningful" cautionary language;
- the potential exposure to liability under state law, where comparable safe harbors may not exist;
- fear of liability in SEC enforcement actions, where the federal safe harbor is unavailable;
- a concern that including a complete list of cautionary statements might prove cumbersome or "water down" the company's disclosures; and
- fear of damaged credibility should projections prove wrong. [160]

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Some commentators have suggested that more recent developments have addressed at least some of the concerns outlined by the SEC. [161] For example, case law has offered some guidance on the definition of "meaningful" disclosures, and the Securities Litigation Uniform Standards Act ("SLUSA") has precluded most state law securities class actions. [162] The SEC staff indicated that it would continue to study the safe harbor and consider whether additional steps might be desirable to encourage more disclosure and improve the quality of the accompanying cautionary language, but it has not released any updated reports to date. [163]

[6] State Securities Laws

In addition to federal securities laws, state "blue sky" laws also prohibit sales of securities by means of material misstatements or omissions. The Uniform Securities Act disclosure provision is patterned after § 12(a)(2) of the Securities Act, proscribing the use of untrue statements and material omissions in connection with an offer or sale of securities. [164] The civil damages remedies in the Uniform Securities Act likewise are modeled on those in the Securities Act. [165] In 1996, Congress expressly reaffirmed its intention that state remedies with respect to securities fraud or misrepresentation should remain intact, despite recent legislation pre-empting state law with respect to registration and related matters. [166] Two years later, however, Congress severely limited the ability of private parties to bring securities fraud class actions in state court by passing SLUSA. [167]

Footnotes

28 *See* §§ 3.02 and 3.04.

29 Liabilities connected with deficient disclosure in private offerings and secondary market transactions are discussed in §§ 11.04 and 11.05[1], respectively.

30 As discussed in Chapter 3, sales of securities to the public require preparation of a prospectus, which is part of a registration statement filed with, and declared effective by, the SEC. The prospectus must contain detailed financial and other information specified by the SEC.

31 *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (applying the *TSC Industries* standard of materiality to action brought under § 10(b) of the Exchange Act and Rule 10b-5 thereunder). For a discussion of the "bespeaks caution" doctrine, under which cautionary language in a prospectus may render alleged misstatements or omissions immaterial as a matter of law, *see* § 11.03[1][c]. For a discussion of certain qualitative considerations in assessing materiality, *see* § 11.04[2][a].

32 *See Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967); *see also DeMaria v. Andersen*, 318 F.3d 170, 178 (2d Cir. 2003) (finding § 11 standing for aftermarket purchasers).

33 *See In re Global Crossing, Ltd. Securities Litigation*, 313 F. Supp. 2d 189 (S.D.N.Y. 2003) (plaintiffs in aftermarket purchaser suits pursuant to § 11 were required to plead and to prove that their shares were traceable to the initial distribution, although a mere good faith allegation that the shares were traceable was sufficient); *see also Krim v. Pcorder.com, Inc.*, 402 F.3d 489 (5th Cir. 2005) (rejecting investors' attempt to satisfy the tracing requirement through statistical evidence that demonstrated the high probability (over 99%) that at least some of their stock was traceable to the tainted public offering, and reasoning that this type of statistical standing would expand the scope of potential § 11 claimants beyond the statutory language or intent); *In re FleetBoston Financial Corp. Securities Litigation*, 253 F.R.D. 315, 347–51 (D.N.J. 2008) (following *Global Crossing* and *Krim* and holding that plaintiff has no standing to bring a § 11 claim unless he can satisfy the tracing requirement, and further holding that this showing must be made with respect to a sufficient number of plaintiffs to satisfy the numerosity requirement for class action certification).

34 *See Westinghouse Electric Corp. v. '21' International Holdings, Inc.*, 821 F. Supp. 212, 218 (S.D.N.Y. 1993). A statutory exception exists for situations in which the purchaser bought the securities after the issuer made available to its securities holders an earnings statement covering at least 12 months after the effective date of the registration statement. *See* § 11(a) of the Securities Act. Under these circumstances, the plaintiff must show actual reliance on the alleged misstatements or omissions in the registration statement. *See In re Petrobras Securities Litigation*, 116 F. Supp. 3d 368, 386 (S.D.N.Y. 2015). For this reason, it has become customary practice for underwriting agreements to include an issuer commitment to make such an earnings statement generally available. *See* § 3.02[5][b], Note 323. Reasoning based on this exception, and disagreeing with the general statements in *Westinghouse*, the Eleventh Circuit in *APA Excelsior III L.P. v. Premiere Technologies, Inc.*, 476 F.3d 1261, 1271–77 (11th Cir. 2007), held that a plaintiff who entered into a binding agreement to purchase securities before a defective registration statement was issued had to prove that it had in fact relied on the defective registration statement.

35 The defendant may limit a plaintiff's damages by showing that the decline in the value of the security is due to something other than the material misstatement or omission. *See* § 11(e) of the Securities Act.

36 § 11(a) of the Securities Act.

37 § 11(a)(1) of the Securities Act. Generally, the registration statement must be signed by the issuer, its principal executive officer, its principal financial officer, its controller or principal accounting officer and a

majority of its directors. For a foreign issuer, the registration statement also must be signed by the issuer's authorized representative in the United States. *See* § 6(a) of the Securities Act.

38 *See* § 11(a)(2) and (3) of the Securities Act.

39 The term underwriter is broadly defined, but does not include brokers "whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors'or sellers'commission." § 2(a)(11) of the Securities Act. An underwriter's liability is generally limited by § 11(e) to the total offering price of securities that it underwrites unless the underwriter receives a benefit that is disproportionate to the amount of securities it underwrites and is not shared by the other underwriters. Unlike their European counterparts, U.S. underwriters will not agree to joint and several liability in public offerings because, in the event of litigation, they could be found liable for the entire amount of the offering and then would have to seek contribution from those who were also at fault. *See* § 3.02[1][a].

Although § 11(e) generally has been interpreted to limit an underwriter's liability in an offering to the securities it has agreed to underwrite in that offering, *see Special Situations Fund, III v. Cocchiola*, Fed. Sec. L. Rep. (CCH) ¶94,459 (D.N.J. Aug. 3, 2007) (holding that, as a matter of law, § 11(e) of the Securities Act limits the liability of an individual underwriter to the securities underwritten by that underwriter, and rejecting the contention that § 11(e) limits "the liability of an underwriter to the shares that particular underwriter personally distributed to the public"), in *In re WorldCom, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶93,139 n.8 (S.D.N.Y. Mar. 14, 2005), the court speculated *in dictum* that, in light of the broad definition of "underwriter" under the Securities Act, the amount of securities "underwritten" by a lead underwriter in an offering for purposes of § 11(e) "may be greater than the amount formally allocated to that underwriter" and refused to interpret § 11(e) to exempt underwriters from the joint and several liability provisions of the Securities Act.

Issuers and sellers outside the United States sometimes provide a "success fee" that may only be for the benefit of the global coordinators or lead managers of the offering. In the context of a U.S. registered offering, an underwriter's limitation of liability under § 11(e) could be lost unless all the underwriters receive the fee on a *pro rata* basis or non- *pro rata* fees are distributed by the syndicate rather than by the issuer or other seller. *See* § 3.02[4][h].

In addition to the statutory liability to which underwriters may be exposed under § 11 and the other sections discussed in this chapter, they may be subject to fiduciary duty claims by issuers in connection with their role in the pricing of securities. *See* § 3.06[2][b], Note 662.

Plaintiffs in some of the recent MBS litigation have sued rating agencies and argued that they were "underwriters" of the offerings based on the view that the evaluations and ratings were necessary steps in the distribution of the MBS. Courts have rejected the argument and held that rating agencies do not fit the statutory definition of underwriters. *See In re Lehman Brothers Mortgage-Backed Securities Litigation*, 650 F.3d 167 (2d Cir. 2011). The court in *Lehman Brothers* concluded that underwriter liability under § 11 only extends to those who participate in purchasing securities with a view towards distribution, or in offering or selling securities for an issuer in connection with a distribution, but did not extend to other persons who merely provide services that facilitate the participation of others in such undertakings.

40 Liability of such experts (including accountants, engineers and appraisers) extends only for material misstatements and omissions in the report or valuation prepared or certified by them for inclusion in the registration statement (an "expertized" part of the registration statement). § 11(a)(4) of the Securities Act.

There is no question that Congress, in repealing Rule 436(g) under the Securities Act (which provided that a credit rating was not part of a registration statement within the meaning of the Securities Act) intended § 939G of the Dodd-Frank Act to bring rating agencies into the scope of § 11 as "experts." The response of the rating agencies has been to refuse to consent to the use of their ratings in registration statements.

41 *See* § 15 of the Securities Act. Control person liability under § 15 is actually secondary or derivative liability; a claim against a control person must be predicated upon an underlying violation of the securities laws by a primary violator who was under the control of the § 15 defendant.

42 *See* § 15 of the Securities Act and Rule 405 thereunder.

43 Note that this is a statutory defense under § 15 of the Securities Act, not a defense to the primary § 11 violation. *See generally Donohoe v. Consolidated Operating & Products Corp.*, 30 F.3d 907, 911 (7th Cir. 1994) (noting that § 20(a) of the Exchange Act and § 15 of the Securities Act are "parallel, though control person liability is limited [in § 15] to actions under sections 11 and 12 of that Act"). *See infra* Notes 221 and 222 for a discussion of control person liability in the context of § 20(a) of the Exchange Act.

44 *See, e.g.*, *Bresson v. Thomson McKinnon Securities, Inc.*, 641 F. Supp. 338, 342 (S.D.N.Y. 1986); *Anderson v. Clow (In re Stac Electronics Securities Litigation)*, Fed. Sec. L. Rep. (CCH) ¶97,807 (S.D. Cal. Sept. 17, 1993), *withdrawn*, 89 F.3d 1399 (9th Cir. 1996), *cert. denied*, 520 U.S. 1103 (1997).

45 *See* § 11(a) of the Securities Act.

46 *See, e.g.*, *Greenwald v. Integrated Energy, Inc.*, 102 F.R.D. 65, 71 (S.D. Tex. 1984) ("[W]hat investors knew or should have known on a particular date is a matter for proof at trial.").

47 Defendants other than the issuer may also invoke two other statutory defenses, which are rarely used: (i) that the defendant had resigned prior to the effective date and advised the SEC and the issuer that he or she would not be responsible for the registration statement or (ii) that the registration statement became effective without his or her knowledge and he or she so advised the SEC and gave "reasonable public notice." §§ 11(b)(1) and 11(b)(2) of the Securities Act.

48 [Reserved.]

49 § 11(b)(3)(A) of the Securities Act. A similar standard applies for a due diligence defense by an expert with respect to an expertized portion of a registration statement. *See* § 11(b)(3)(B) of the Securities Act.

50 § 11(c) of the Securities Act.

51 *See* § 3.06 for a discussion of the investigation conducted in order to establish the due diligence defense.

52 *See* § 11(b)(3)(C) of the Securities Act. The same showing is necessary with respect to portions of the registration statement that purport to be made on the authority of official government documents or statements of U.S. or foreign government officials. *See* § 11(b)(3)(D) of the Securities Act. In the context of international securities transactions, such information is most commonly included in the registration statements of non-U.S. issuers that are government related or government owned, including in particular, registration statements of foreign governments or political subdivisions thereof registered under Schedule B of the Securities Act. Such information is also sometimes included in foreign private issuer offerings where U.S. investors are believed to require background information about the domestic context in which the issuer functions. *See* § 3.05[1].

53 *See In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 673 (S.D.N.Y. 2004) (stating that a red flag consists of "[a]ny information that strips a defendant of his confidence in the accuracy of those portions of a registration statement premised on audited financial statements"). In *WorldCom*, the court refused to grant the defendant underwriters summary judgment on claims brought under §§ 11 and 12 of the Securities Act. The underwriters had argued that their reliance defense under § 11 entitled them to summary judgment on claims alleging that WorldCom's audited financial statements contained materially misleading information. In rejecting their argument, the court found that disputed facts suggested red flags existed that should have caused the underwriters to question the reliability of WorldCom's audited financial statements and conduct a further investigation. In particular, the court noted that certain cost ratios reported by WorldCom were significantly lower than equivalent ratios at its two closest competitors and that WorldCom's reported assets may have been doubtful in light of the general telecommunications downturn and asset impairments that its competitors had taken to their core networks during the period under review. *See In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 678–81 (S.D.N.Y. 2004).

Unaudited financial information is not considered to be expertized, and therefore the defendant must have conducted a reasonable investigation to establish the higher threshold due diligence defense. *See In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004). In *WorldCom*, the court confirmed that a comfort letter does not expertize unaudited interim financial statements and rejected the underwriters' contention, on a motion for summary judgment, that an underwriter's due diligence investigation of accounting issues is *per se* reasonable when it rests on an auditor's review of unaudited interim financial statements and a SAS 72 comfort letter (at least in the absence of any red flags and in the context of integrated disclosure for shelf registration statements). The court acknowledged, however, that receipt of a comfort letter would constitute "important evidence" at trial of the reasonableness of an underwriter's investigation. *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 682–83 (S.D.N.Y. 2004); *see also* Rule 436(c) under the Securities Act. For a further discussion of due diligence in the context of the SEC's integrated disclosure framework and the guidance provided by Rule 176 under the Securities Act, *see infra* Note 58 and accompanying text.

54 *See Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

55 *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968).

56 *See Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968). Other courts have also indicated that an inside director (who has or should have intimate knowledge of the issuer) would have difficulty in establishing a due diligence defense. *See, e.g.*, *In re WorldCom, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶93,137 (S.D.N.Y. Mar. 21, 2005) (noting more searching inquiry is required by inside directors, in contrast to outside directors, to establish a due diligence defense under § 11 of the Securities Act); *In re Livent, Inc. Noteholders Securities Litigation*, 355 F. Supp. 2d 722, 733 (S.D.N.Y. 2005) ("As inside directors, with intimate knowledge of corporate affairs and the transactions that were accounted for in a materially misleading manner, [defendants] must put forward evidence that the misleading information was incorporated notwithstanding their reasonable efforts to ensure the Registration Statement's accuracy."); *Laven v. Flanagan*, 695 F. Supp. 800, 811–12 (D.N.J. 1988); *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 577–78 (E.D.N.Y. 1971). Clearly, no director could establish his or her defense by proof that he or she simply read the registration statement, and reliance on other professionals such as auditors and underwriters will not absolve a director of the director's obligation to conduct his or her own due diligence inquiry. *See In re WorldCom, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶93,137 (S.D.N.Y. Mar. 21, 2005) (noting that "[t]he SEC has clarified that directors are not excused from performing a meaningful due diligence investigation due to the involvement of professionals, such as underwriters and auditors, in a given securities offering"). Outside directors may be able to rely on the due diligence investigation and the related "negative assurance" letter delivered by issuer's counsel to the underwriters, although in appropriate circumstances, directors may be required to question management more closely and consult the company's auditors and underwriters. *See In re WorldCom, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶93,137 (S.D.N.Y. Mar. 21, 2005); *see also SEC v. Chancellor Corp.*, SEC Litigation Release No. 19177 (Apr. 11, 2005) (announcing a settlement with a number of defendants, including an outside director who allegedly failed in his responsibility to address fraud at the Chancellor Corporation by ignoring clear warning signs of ongoing improprieties and failing to ensure the accuracy of the company's public filings).

57 *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 685 (S.D.N.Y. 1968).

58 Rule 176 was promulgated to address due diligence in the context of a shelf registration, *see* § 3.02[6], but it can be analogized to other circumstances in which a reasonable investigation is required. The introduction of the integrated disclosure framework and shelf registration greatly accelerated the timetable on which securities offerings could be completed, increasing the pressure on underwriters to complete their diligence on issuers within a compressed timeframe. Some had asked the SEC to create a diligence safe harbor to alleviate concerns over the ability of underwriters to conduct a reasonable investigation under these conditions. In proposing Rule 176, however, the SEC declined to create a safe harbor and made clear its view that the new disclosure framework had not substantively altered the diligence obligations of underwriters. *See* SEC Release No. 33-6335 (Aug. 6, 1981); *see also In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 685 (S.D.N.Y. 2004) (stating that as a result of the introduction of the integrated disclosure framework and shelf registration "[t]he processes through which and the timing in which due diligence is performed have changed, but the ultimate test of reasonable conduct in the specific circumstances of an offering remains unchanged").

59 An advisory committee appointed by the SEC to study various issues arising under the Securities Act and its rules noted the limitations of Rule 176 in providing meaningful guidance regarding the respective due

diligence responsibilities of underwriters, outside directors and other "monitors," and recommended additional elaboration upon the factors courts may consider as indicia of "reasonable investigation" and/or "reasonable care." SEC, REPORT OF THE ADVISORY COMMITTEE ON THE CAPITAL FORMATION AND REGULATORY PROCESSES, Appendix B, at 95–100 (July 24, 1996). The SEC proposed in its so-called Aircraft Carrier Release, which has since been withdrawn, an expansion of Rule 176 that would have addressed the "reasonableness" standards under §§ 12(a)(2) and 11 for underwriters' due diligence investigation when conducting an expedited offering. SEC Release No. 33-7606 (Nov. 3, 1998), *as amended*, SEC Release No. 33-7606A (Nov. 13, 1998). In 1992, a report prepared by a task force of the American Bar Association recommended changes to Rule 176 on the ground that the listed factors were not sufficient to protect underwriters. *See Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws*, as submitted to the ABA, Sec. of Bus. L., Comm. on Federal Regulation of Securities (July 10, 1992), which is discussed in § 3.02[6].

60 *See also* § 11.03[5] discussing certain safe harbors for forward-looking statements principally under the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (the "Litigation Reform Act").

61 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318 (2015).

62 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1326 (2015).

63 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1327 (2015).

64 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1328-29 (2015).

65 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1328 (2015).

66 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1329 (2015).

67 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1330 (2015).

68 *Tongue v. Sanofi*, 816 F.3d 199 (2d Cir. 2016).

69 *Tongue v. Sanofi*, 816 F.3d 199, 211–13 (2d Cir. 2016).

70 *Tongue v. Sanofi*, 816 F.3d 199, 212 (2d Cir. 2016).

71 *See* § 11.03[5] for discussion of the qualified safe harbor for forward-looking statements enacted as part of the Securities Litigation Reform Act.

72 *See In re Amdocs Ltd. Securities Litigation*, 390 F.3d 542 (8th Cir. 2004) (affirming dismissal of plaintiffs' complaint, holding that the "bespeaks caution" doctrine rendered Amdoc's representations about its customer demand immaterial as a matter of law because of the accompanying warnings about market erosion); *see also In re Worlds of Wonder*, 814 F. Supp. 850, 866 (N.D. Cal. 1993) (noting, in context of § 10(b) of the Exchange Act, that adequate cautionary language will negate an inference of *scienter*); *Halperin v. eBanker USA.COM, Inc.*, 295 F.3d 352, 357–59 (2d Cir. 2002) (holding statements in an offering memorandum as to the issuer "intend[ing] to endeavor" to register securities were rendered not misleading as a matter of law by the numerous cautionary statements that the securities were subject to restrictions and that registration could not be assured). By contrast, in *Hunt v. Alliance North American Government Income Trust, Inc.*, 159 F.3d 723, 724–25 (2d Cir. 1998), the Second Circuit held that the prospectus's cautionary language as to the fund manager's intention to use hedging techniques did not provide an affirmative defense to fraudulent misrepresentation claims as a matter of law because the lack of liquidity made it impossible to use the hedging techniques. *See also Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 5 (2d Cir. 1996), *cert. denied*, 520 U.S. 1264 (1997); *Gasner v. Board of Supervisors*, 103 F.3d 351, 358 (4th Cir. 1996); *In re Westinghouse Securities Litigation*, 90 F.3d 696, 707 (3d Cir. 1996); *Anderson v. Clow (In re Stac Electronics Securities Litigation)*, 89 F.3d 1399, 1408 (9th Cir. 1996), *cert. denied*, 520 U.S. 1103 (1997); *Saltzberg v. TM Sterling/Austin Associates, Ltd.*, 45 F.3d 399 (11th Cir. 1995); *cf. Livid Holdings v. Salomon Smith Barney*, 403 F.3d 1050 (9th Cir. 2005) (declining to apply the bespeaks caution doctrine to alleged misrepresentations of historical fact in a notice statement to a potential investor).

73 *See, e.g.*, *Rubinstein v. Collins*, 20 F.3d 160, 169 (5th Cir. 1994).

74 *See, e.g.*, *P. Stolz Family Partnership L.P v. Daum*, 355 F.3d 92, 96–97 (2d Cir. 2004).

75 *Iowa Public Employees' Retirement System v. MF Global, Ltd.*, 620 F.3d 137 (2d Cir. 2010).

76 *Rubin v. MF Global, Ltd.*, 634 F. Supp. 2d 459, 468–72 (S.D.N.Y. 2009), *rev'd sub nom. Iowa Public Employees' Retirement System v. MF Global, Ltd.*, 620 F.3d 137 (2d Cir. 2010).

77 *Iowa Public Employees' Retirement System v. MF Global, Ltd.*, 620 F.3d 137, 142 (2d Cir. 2010).

78 *Iowa Public Employees' Retirement System v. MF Global, Ltd.*, 620 F.3d 137, 143 (2d Cir. 2010). For further discussion of what constitutes a forward-looking statement under statutory safe harbors, *see* § 11.03[5].

79 *In re Facebook, Inc., IPO Securities & Derivative Litigation*, 986 F. Supp. 2d 487, 511 n.23 (S.D.N.Y. 2013).

80 In a recent decision interpreting the disclosure obligations imposed by Item 303 of Regulation S-K, the Second Circuit has held that "Item 303 requires the registrant to disclose only those trends, events, or uncertainties that it actually knows of when it files the relevant report with the SEC" and "[i]t is not enough that it should have known of the existing trend, event, or uncertainty." *Indiana Public Retirement System v. SAIC, Inc.*, 818 F.3d 85, 95 (2d Cir. 2016).

81 *In re WorldCom, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶92,857 (S.D.N.Y. June 28, 2004).

82 *In re WorldCom, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶92,857 (S.D.N.Y. June 28, 2004).

83 *See, e.g.*, *Police Retirement System of St. Louis v. Intuitive Surgical, Inc.*, 759 F.3d 1051, 1060 (9th Cir. 2014) ("Statements of mere corporate puffery, vague statements of optimism like ‘good,’ ‘well-regarded,’ or other feel good monikers, are not actionable because professional investors, and most amateur investors as well, know how to devalue the optimism of corporate executives."); *Indiana State District Council of Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc.*, 583 F.3d 935, 944 (6th Cir. 2009) ("Courts have consistently found immaterial a certain kind of rosy affirmation commonly heard from corporate managers and numbingly familiar to the marketplace—loosely optimistic statements that are so vague, so lacking in specificity, or so clearly constituting the opinions of the speaker, that no reasonable investor could find them important.").

84 *Indiana Public Retirement System v. SAIC, Inc.*, 818 F.3d 85, 97–98 (2d Cir. 2016); *but see In re Goldman Sachs Group, Inc. Securities Litigation*, 868 F. Supp. 2d 261, 279–80 (S.D.N.Y. 2012) (declining to dismiss claims as puffery where issuer allegedly made "repeated assertions that it complies with the letter and spirit of the law, values its reputation, and is able to address ‘potential’ conflicts of interest" because "they involve ‘misrepresentations’ of existing facts").

85 *See* § 11(e) of the Securities Act. Under no circumstances can the plaintiff recover more than the price at which the security was offered to the public. *See* § 11(g) of the Securities Act.

86 *See NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, 693 F.3d 145 (2d Cir. 2012). In *NECA-IBEW*, the court further held that a plaintiff could recover the loss in value of a debt security—in that case, a residential mortgage-backed security—under § 11 even where no scheduled coupon payments on the security had been missed.

87 *See* § 11(e) of the Securities Act; *see, e.g.*, *Collins v. Signetics Corp.*, 605 F.2d 110, 114 (3d Cir. 1979); *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 586 (E.D.N.Y. 1971).

88 *See* § 11(f) of the Securities Act.

89 *See* § 11(e) of the Securities Act; *supra* Note 39. However, in *In re WorldCom, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶93,139 (S.D.N.Y. Mar. 14, 2005), the court rejected the objection of JP Morgan Securities Inc. (an underwriter defendant) to a settlement agreement between the lead plaintiff and the other defendants that would both bar any post-settlement contribution from settling defendants and also included a judgment reduction formula that could require a nonsettling defendant to pay more than the value of its allocated share of securities after judgment was entered after trial. The court found the judgment reduction formula was permissible, particularly in light of the fact that the Litigation Reform Act replaced joint and several liability with proportionate liability in the case of § 11 violations by outside directors, but did not do so for underwriters. *See infra* Note 94. According to the court, adoption of JP Morgan Securities Inc.’s judgment reduction proposal to limit the liability of underwriters to merely a proportionate share of underwriter liability would serve to reduce the plaintiff's rightful recovery. Further, the court held that the bar on subsequent

contribution claims, despite the existence of contractual provisions enabling contribution, provided an important incentive for defendants to settle.

90 *See* § 11.03[1][e][ii].

91 *See* § 11(f) of the Securities Act; § 11.03[1][e].

92 *See, e.g.*, *In re Continental Airlines*, 203 F.3d 203, 215–16 (3d Cir. 2000); *First Golden Bancorp. v. Weiszmann*, 942 F.2d 726, 728 (10th Cir. 1991); *Riverhead Savings Bank v. National Mortgage Equity Corp.*, 893 F.2d 1109, 1116 (9th Cir. 1990); *Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101, 1104–06 (4th Cir. 1989).

93 Item 512(h) of Regulation S-K under the Securities Act; *see* § 3.02[4][c].

94 *See, e.g.*, *Lucas v. Hackett Associates, Inc.*, 18 F. Supp. 2d 531, 535–36 (E.D. Pa. 1998); *Eichenholtz v. Brennan*, 52 F.3d 478, 483 (3d Cir. 1995); *In re Professional Financial Management, Ltd.*, 683 F. Supp. 1283, 1285 (D. Minn. 1988 *); Kilmartin v. H.C. Wainwright & Co.*, 637 F. Supp. 938, 940 (D. Mass. 1986); *Laventhol, Krekstein, Horwath & Horwath v. Horwitch*, 637 F.2d 672, 676 (9th Cir. 1980), *cert. denied*, 452 U.S. 963 (1981); *Odette v. Shearson, Hammill & Co.*, 394 F. Supp. 946 (S.D.N.Y. 1975); *see also In re Healthsouth Corp. Securities Litigation*, 572 F.3d 854, 860 (11th Cir. 2009) (Litigation Reform Act case recognizing holdings of *Eichenholtz* and related cases).

95 Such indemnification is commonplace in underwriting agreements involving registered offerings. The contractual indemnifications generally also run to officers, directors and controlling persons of the underwriters because of the potential liability of these parties under the Securities Act.

96 The practice with respect to such indemnification varies. Where securityholders are affiliates of the issuer, and thus subject to the registration requirements of the Securities Act, they frequently negotiate a contractual right to cause the issuer to register their securities for sale (so-called "registration rights"). Such registration rights agreements frequently require the related underwriting agreement to include the issuer's indemnification not only of the underwriters, but also of the selling securityholders, against liabilities arising out of material misstatements or omissions in the registration statement.

97 *See Globus v. Law Research Services, Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970) (underwriter not entitled to indemnification where it had actual knowledge of misstatement in registration statement and showed "wanton indifference" to its obligations); *see also Nelson v. Quimby Island Reclamation District Facilities Corp.*, 491 F. Supp. 1364, 1381 (N.D. Cal. 1980) (indemnification against actual wrongdoing, as contrasted with negligent conduct, is considered void). In some foreign jurisdictions, such as England and Germany, indemnification agreements are enforceable. Thus, in drafting cross-border agreements, some parties choose to have their contracts governed by the laws of these countries. U.S. courts, however, still may be reluctant to enforce indemnification provisions in the context of U.S. public offerings. The agreement, therefore, should contain a forum selection clause providing for enforcement of the agreement in another jurisdiction.

98 *Compare Eichenholtz v. Brennan*, 52 F.3d 478, 484 (3d Cir. 1995), *In re Olympia Brewing Co. Securities Litigation*, 674 F. Supp. 597, 610–14 (N.D. Ill. 1987), *Stratton Group, Ltd. v. Sprayregen*, 466 F. Supp. 1180, 1185 n.4 (S.D.N.Y. 1979), *Odette v. Shearson, Hammill & Co., Inc.*, 394 F. Supp. 946, 956–57 (S.D.N.Y. 1975), and *Columbia Savings & Loan Association v. American International Group, Inc.*, Fed. Sec. L. Rep. (CCH) ¶98,179 (S.D.N.Y. Mar. 18, 1994) (no indemnification) *with Adalman v. Baker, Watts & Co.*, 599 F. Supp. 752, 754 (D. Md. 1984), *McLean v. Alexander*, 449 F. Supp. 1251, 1266 n.49 (D. Del. 1978), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979), and *In re Motel 6 Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶90,927 (S.D.N.Y. Mar. 28, 2000) (indemnification might be permitted under certain circumstances).

99 This section is the only provision in the Securities Act that expressly provides for contribution. Contribution rights are expressly provided under §§ 9(e) (manipulation of security prices) and 18(b) (liability for misleading statements in filings) of the Exchange Act and have been judicially implied in connection with liability under other provisions of the securities laws, notably Rule 10b-5 under the Exchange Act. *See Musick, Peeler & Garrett v. Employers Insurance of Wausau*, 508 U.S. 286, 294–98 (1993).

100 § 11(f) of the Securities Act. The Litigation Reform Act, Pub. L. No. 104-67, § 201(a), 109 Stat. 737 (1995),

added § 21D(g)(2) of the Securities Act.

101 *See* Item 511 of Regulation S-K under the Securities Act. The SEC has taken the position that insurance policies' indemnification of officers and directors that includes coverage for disgorgement and other fines is against public policy, and since April 2003, the SEC has included language in its settlement agreements with individuals who were alleged to have committed fraud to prevent those individuals from using insurance or indemnification policies to pay civil fines. Deborah Solomon, *SEC Considers Stronger Sanctions—Companies Urge Panel Not to Let Holder Nominees Be in Official Proxy Data*, WALL ST. J., June 16, 2003. In 2004, the SEC levied a $25 million fine against Lucent Technologies for failure to cooperate with a fraud investigation, the then-largest penalty ever imposed against a corporation for failure to cooperate. Ken Belson, *Lucent Fined $25 Million by SEC in Fraud Case*, N.Y. TIMES, May 18, 2004. The noncooperation penalty was levied in part because after reaching a settlement agreement in connection with the fraud investigation, Lucent expanded the scope of employees that could be indemnified against the SEC enforcement action. The SEC stated that such conduct is contrary to the public interest. *SEC v. Lucent Technologies Inc.*, SEC Litigation Release No. 18715 (May 17, 2004). Although not an SEC enforcement proceeding, members of the WorldCom board of directors who agreed to settle class-action claims arising out of the WorldCom accounting scandal were required, as a condition of the settlement, to pay a significant portion of the settlement amount personally. They were prevented from relying exclusively on their directors' liability insurance. *See In re WorldCom, Inc. Securities Litigation*, Master File No. 02 Civ. 3288 (S.D.N.Y. Mar. 21, 2005) (order granting preliminary approval of settlement with 12 WorldCom directors). Directors settling class-action claims arising out of the Enron litigation also agreed to pay a portion of their agreed settlement amount personally. *See In re Enron Corp. Securities Litigation*, Civil Action No. H-01-3624 (Feb. 7, 2005) (order granting preliminary approval of settlement with outside directors of Enron). These developments indicate that a greater effort is being made to hold directors personally responsible for financial irregularities at the companies they oversee.

102 § 13 of the Securities Act.

103 *See In re Adelphia Communications Corp. Securities & Derivative Litigation*, No. 03 MD 1529 (LMM), 2005 WL 1278544, at *18 (S.D.N.Y. May 31, 2005); *Westinghouse Electric Corp. v. '21' International Holdings, Inc.*, 821 F. Supp. 212, 222 (S.D.N.Y. 1993); *but see Pension Trust Fund for Operating Engineers v. Mortgage Asset Securitization Transactions, Inc.*, 730 F.3d 263 (3d Cir. 2013) (holding that a plaintiff need not plead compliance with § 11's statute of limitations because it is an affirmative defense).

104 *See In re Adelphia Communications Corp. Securities & Derivative Litigation*, No. 03 MD 1529 (LMM), 2005 WL 1278544, at *18 (S.D.N.Y. May 31, 2005); *In re Integrated Resources Real Estate Ltd. Partnerships Securities Litigation*, 815 F. Supp. 620 (S.D.N.Y. 1993).

105 *See Chapman v. ChoiceCare Long Island Term Disability Plan*, 288 F.3d 506, 512 (2d Cir. 2002); *Wasco Products, Inc. v. Southwall Technologies, Inc.*, 435 F.3d 989, 991 (9th Cir. 2006).

106 *See Lampf, Pleva, Lifkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991). In *Lampf*, the Court held that "[t]he 1-year period, by its terms, begins after discovery of the facts constituting the violation, making tolling unnecessary [and] [t]he 3-year limit is a period of repose inconsistent with tolling." Courts have generally followed *Lampf* in declining to apply equitable tolling doctrines to securities law claims. *See, e.g.*, *Whirlpool Financial Corp. v. GN Holdings, Inc.*, 67 F.3d 605, 610 n.3 (7th Cir. 1995) (rejecting plaintiff's argument that the statute of limitations for its claims under § 12(a)(2) should be equitably tolled because "the plain import of the Supreme Court's decision in [*Lampf*] is that 'when knowledge or notice is required to start the statute of limitations running, there is no room for equitable tolling'"); *Sterlin v. Biomune Systems*, 154 F.3d 1191 (10th Cir. 1998) (discussing *Lampf* and acknowledging its holding that equitable tolling does not apply to the limitations periods contained in the securities laws); *Gardner v. Investors Diversified Capital, Inc.*, 805 F. Supp. 874 (D. Colo. 1992) (holding that equitable tolling of statute of limitations is inapplicable to claims under § 12(a)(1)); *Arioli v. Prudential-Bache Securities, Inc.*, 792 F. Supp. 1050 (E.D. Mich. 1992) (holding that doctrine of equitable tolling does not apply to claims under §§ 12(a)(2) and 15 of the Securities Act); *Del Sontro v. Cendant Corp., Inc.*, 223 F. Supp. 2d 563, 573 (D.N.J. 2002) ("It is clearly established that equitable tolling is inapplicable to the one-and-three year limitation

periods of securities fraud actions."). Some post- *Lampf* courts, however, have continued to suggest that equitable tolling may be available with respect to the statute of limitations periods applicable to claims under the Securities Act. *See, e.g.*, *Dodds v. Cigna Securities, Inc.*, 12 F.3d 346, 350, 352 (2d Cir. 1993) (stating, in an action asserting claims under both § 12(a)(2) of the Securities Act and § 10(b) of the Exchange Act, that "[i]f the defendants actively prevented [plaintiff] from discovering the basis of her claim, then the statute would be tolled for the period of concealment," but that the doctrine of "[e]quitable tolling will stay the running of the statute of limitations only so long as the plaintiff has 'exercised reasonable care and diligence in seeking to learn the facts which would disclose fraud'") (citation omitted). The case law is also clear that equitable tolling is *not* available with respect to the statute of repose period. *See Ma v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 597 F.3d 84, 88 n.4 (2d Cir. 2010) (holding that in contrast to statutes of limitations, which are "often subject to tolling principles," "a statute of repose *extinguishes* a plaintiff's cause of action after the passage of a fixed period of time, usually measured from one of the defendant's acts"); *Caviness v. Derand Resources Corp.*, 983 F.2d 1295, 1301 (4th Cir. 1993) (holding that to apply "tolling principles to extend the three-year period of § 13 would require [a court] to ignore the plain meaning of the language that says 'in no event' and defeat the very purpose of a statute of repose"). Courts have disagreed, however, concerning whether class action tolling applies to the statute of repose. *Compare Police & Fire Retirement System of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95, 101 (2d Cir. 2013) (holding class action tolling does not apply to the three-year statute of repose) *and Stein v. Regions Morgan Keegan Select High Income Fund, Inc.*, 821 F.3d 780 (6th Cir. 2016) *with Joseph v. Wiles*, 223 F.3d 1155, 1168 (10th Cir. 2000) (holding class action tolling is a form of legal tolling that can apply to the statute of repose).

107 *P. Stolz Family Partnership L.P. v. Daum*, 355 F.3d 92, 99 (2d Cir. 2004).

108 *P. Stolz Family Partnership L.P. v. Daum*, 355 F.3d 92, 103–04 (2d Cir. 2004); *see also* Rule 430B(f)(1), (2), (4) under the Securities Act (providing effective dates, for purposes of § 11 liability, for shelf registration statements for offerings made pursuant to a prospectus supplement).

109 Section 12(a)(2) establishes a cause of action (other than in offerings exempt from registration under §§ 3(a)(2) or 3(a)(14)) against sellers who make material misstatements or omissions "by means of a prospectus." Interpreting this language in light of the Securities Act's other references to prospectuses, the Supreme Court in *Gustafson v. Alloyd Co., Inc.*, held that § 12(a)(2) only applies to public offerings of securities by an issuer or controlling shareholder, and not to private offerings. *See Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995); *see also* § 11.04[1].

110 By contrast with § 11, under which investors' rights turn on when information is deemed part of the relevant registration statement and the time of the registration statement's effectiveness, liability for § 12(a)(2) purposes is based on the information conveyed to investors at or prior to the time of sale (*i.e.*, at or prior to the time the investment decision is made). As a result, even if information is deemed part of the registration statement as of the time of sale and thus subject to § 11, the information will not be taken into account for § 12(a)(2) purposes unless it was conveyed to investors at or prior to the time of sale. *See* Rule 159 under the Securities Act. Conversely, information conveyed to investors at or prior to the time of sale that is not deemed a part of the registration statement at the time of its effectiveness will not be subject to § 11. *See* SEC Release No. 33-8591 (July 19, 2005).

As part of the Securities Offering Reforms, the SEC clarified that information contained in a prospectus supplement is deemed part of the registration statement to which it relates. Outside the shelf registration statement context, pricing information filed under Rule 430A under the Securities Act is deemed part of the relevant registration statement as of the time it was declared effective. For shelf takedowns, the date on which the information is deemed included in the relevant registration statement is the earlier of the date the supplement is first used (*i.e.*, first made available to an underwriter or any prospective purchaser) and the date and time of the first contract of sale of securities to which the supplement relates. In all other cases, the supplement is deemed included in the registration statement, pursuant to Rule 430B or Rule 430C under the Securities Act, as applicable, on the day it is first used.

For purposes of § 11 liability in a shelf takedown, the date on which a prospectus supplement is deemed part of the registration statement constitutes a new effective date for issuers and underwriters. Unless a registration statement is updated by a prospectus supplement filed to provide updating information pursuant to § 10(a)(3) of the Securities Act or by a prospectus supplement reflecting fundamental changes in the information set forth in the registration statement, a prospectus supplement will not create a new effective date for directors or signing officers of the issuer. *See Federal Housing Finance Agency v. HSBC North America Holdings Inc.*, 987 F. Supp. 2d 369, 375, at *4 (S.D.N.Y. 2013) (holding that "a prospectus supplement containing information representing a fundamental change in the information provided in the registration statement creates § 11 liability for directors based on that new information"). Similarly, the effective date for auditors and other experts will not change with the filing of a prospectus supplement, unless it contains new audited financial statements, a new report or opinion or other information requiring the filing of a consent under § 7 of the Securities Act.

111 The term "prospectus" is defined in § 2(a)(10) of the Securities Act to include virtually every written offer for the purchase of a security, and therefore any offering document used in connection with a public offering may give rise to § 12(a)(2) liability. It is unclear whether § 12(a)(2) liability may arise in connection with public offerings outside the United States exempt from Securities Act registration under Regulation S. *Cf. Sloane Overseas Fund, Ltd. v. Sapiens International Corp.*, 941 F. Supp. 1369, 1376 (S.D.N.Y. 1996); *see also* § 11.10[3] & Note 677 for a discussion of the extraterritorial scope of the Securities Act.

112 § 12(a)(2) of the Securities Act; *cf*. § 11 of the Securities Act, which creates liability for omissions without the limiting language concerning the applicable circumstances.

113 *See Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995).

114 Where the alleged misstatement or omission is made prior to distribution of the final prospectus or offering document (whether orally or in preliminary offering documents), the fact that the errors were corrected in the final documents will not be sufficient to defeat liability if the defendants made no special efforts to bring the corrected information to the purchaser's attention before the sale. Courts have repeatedly stated that purchasers are not charged with constructive knowledge in a § 12(a)(2) claim, and must only show that they had no actual knowledge of the misstatements or omissions. *See MidAmerica Federal Savings & Loan Association v. Shearson/American Express, Inc.*, 886 F.2d 1249, 1256 (10th Cir. 1989) (broker-dealer liable despite distribution of corrected prospectus, where plaintiff did not actually read prospectus until after sale); *see also Casella v. Webb*, 883 F.2d 805, 809 (9th Cir. 1989) ("[C]onstructive knowledge cannot bar a purchaser's recovery under section 12[(a)](2)" where plaintiffs relied on oral representations of the seller that were contrary to statements contained in the offering memorandum, which the plaintiffs had not read and of which the plaintiffs did not have actual knowledge.).

115 *See Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1227 n.8 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981). The court noted that more proof might be required if the disclosure violation was oral and made to an individual purchaser, because spoken words "lack continuing vitality and are unlikely to affect the general market price of a security."

116 This definition of "seller" derives from *Pinter v. Dahl*, 486 U.S. 622, 647 (1988), which construed that term under § 12(a)(1). *See Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1307 (10th Cir. 1998); *In re NationsMart Corp. Securities Litigation*, 130 F.3d 309, 319 (8th Cir. 1997); *In re Westinghouse Securities Litigation*, 90 F.3d 696, 715–16 (3d Cir. 1996); *Commercial Union Assurance Co. v. Milkin*, 17 F.3d 608, 616 (2d Cir. 1994). In *In re Deutsche Telekom AG Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶91, 703 (S.D.N.Y. Feb. 20, 2002), a district court found that a selling shareholder in an initial public offering was not a "seller" for purposes of § 12(a)(2) because it neither passed title to the plaintiffs nor solicited the plaintiffs' purchases. *See* § 4.12[5], Note 461.

117 *See, e.g.*, *In re Chaus Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶95,646 (Nov. 20, 1990), *dismissed on other grounds*, 801 F. Supp. 2d 1257 (S.D.N.Y. 1992) (reasoning that such facts, if true, would support a conclusion that the defendants solicited sales, and thus were "sellers").

118 § 15 of the Securities Act; *see* § 11.03[1][b].

119 *See, e.g.*, *Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1127 (2d Cir. 1989) (aiding and abetting liability under § 12(a)(2) would be anomalous in light of rejection of such liability under § 12(a)(1) in

Pinter v. Dahl, 486 U.S. 622 (1988)).

120 *See Davis v. Avco Financial Services, Inc.*, 739 F.2d 1057, 1068 (6th Cir. 1984), *cert. denied*, 470 U.S. 1005, *cert. denied*, 472 U.S. 1012 (1985). The court identified five factors relevant to the issue of what care is required: (i) the nature and extent of the seller's participation in the offering, (ii) whether the seller had access to information that would permit examination of the statements made in the offering, (iii) the seller's relative skill in testing such statements, (iv) its financial interest in the transaction and (v) the relationship, if any, between the seller and the purchaser.

121 *See, e.g.*, *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1228 (7th Cir. 1980) (defense required underwriter to investigate issuer's books and records and accountants' work papers, where such an investigation would have uncovered a fraud by both parties). This result has been criticized by many who argue that the standard of care under § 12(a)(2) was intended to be less demanding than that required by § 11. *See John Nuveen & Co., Inc. v. Sanders*, 450 U.S. 1005, 1009 (1981) (Powell, J., dissenting from denial of *certiorari*); *Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws*, as submitted to the ABA, Sec. of Bus. L., Comm. on Federal Regulation of Securities (July 10, 1992) (urging that *Sanders* be confined to its facts and the courts recognize the "significant distinction between 'reasonable investigation' and 'reasonable care' that the words of the statute imply" in §§ 11 and 12(a)(2) of the Securities Act, respectively).

122 *See* § 11.03[1][e].

123 The Securities Litigation Reform Act. Most of the provisions of the Litigation Reform Act have been incorporated into the Exchange Act as §§ 21D and 21E and into the Securities Act as §§ 27 and 27A, as well as into various liability provisions of the Exchange Act and the Securities Act.

124 *See* § 12 of the Securities Act.

125 *See* § 13 of the Securities Act; *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995).

126 However, the definition of "*bona fide* offering" is not germane to the period of repose for § 12(a)(2) claims, which is simply three years after the sale of the security in question. *See* § 13 of the Securities Act; *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995).

127 *See* § 8(b) of the Securities Act. This is largely a theoretical issue in the context of public offerings, because in most cases companies include a "delaying legend" on the cover page of the registration statement that delays the effective date until the SEC declares the registration statement effective.

128 *See* § 8(d) of the Securities Act. The SEC takes the position that it may issue a stop order even if the registrant has abandoned the proposed securities offering and has sought to withdraw the registration statement. *See In re Matter of Advanced Chemical Corp.*, 47 S.E.C. 1012 (Feb. 9, 1984).

129 A plaintiff may pursue simultaneously his or her remedies under Rule 10b-5 under the Exchange Act and §§ 11 and 12(a)(2) of the Securities Act. *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 380–87 (1983).

130 *See* § 4.10[4] for a discussion of the duty to correct or update previous communications. Liability for forward-looking statements, like liability for other statements or omissions concerning an issuer, can attach not only in the context of a registered public offering under §§ 11 and 12(a)(2) of the Securities Act, but also in the context of a private placement or secondary market transaction under § 10(b) of the Exchange Act and Rule 10b-5 thereunder, § 18 of the Exchange Act and § 17(a) of the Securities Act. Forward-looking statements also are subject to liability under state antifraud law. *See* §§ 11.03[6] and 11.04[4].

131 *See* § 4.10[6]. Although Regulation FD does not apply to foreign private issuers, they sometimes comply with it both as a matter of best practice and to reduce the risk that selective disclosure would be challenged as a violation of the insider trading prohibitions under the Exchange Act.

132 *See* §§ 11.03[1][c].

133 A "forward-looking statement" is defined as:

> A statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure or other

financial items;

A statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;

A statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the SEC;

Any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B) or (C);

Any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or

A statement *containing* a projection or estimate of such other items as may be specified by rule or regulation of the SEC.

See § 27A(i)(1) of the Securities Act and § 21E(i)(1) of the Exchange Act. This definition of forward-looking statement is substantially the same as that set forth in Rule 175(c) under the Securities Act and Rule 3b-6(c) under the Exchange Act. Certain courts have taken an expansive view of what constitutes a forward-looking statement. *See, e.g.*, *Harris v. Ivax Corp.*, 182 F.3d 799 (11th Cir. 1999) (holding that (i) a statement grammatically in the present tense can be forward-looking if its truth or falsity is discernible only after it is made and (ii) a list of statements meant to explain an economic forecast should be treated as entirely forward-looking even if it includes both forward-looking and non-forward-looking (factual) items); *In re Columbia Laboratories, Inc. Securities Litigation*, 144 F. Supp. 2d 1362, 1368 (S.D. Fla. 2001) (Present-tense statements reflecting optimism and expectations about a future event are forward-looking statements under the Litigation Reform Act because they are "'assumptions underlying or relating to' the 'plans and objectives of management.'") (citations omitted); *In re Splash Technology Holdings, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶91,250 (N.D. Cal. Sept. 29, 2000) ("A present-tense statement can qualify as a forward-looking statement as long as the truth or falsity of the statement cannot be discerned until some point in time after the statement is made."); *see In re SeaChange International, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶92,682 (D. Mass. Feb. 6, 2004) (holding that statements were "clearly forward-looking in nature and therefore [fell] squarely within the safe harbor provisions of the [Litigation Reform Act]" despite a news release issued two days after the offering revealing an award to a competitor of a material contract and a material decline in segment sales of a key product; and despite issuer knowledge of meritorious patent infringement suit against key product revealed one month after the offering). *See also Iowa Public Employees' Retirement System v. MF Global, Ltd.*, 620 F.3d 137 (2d Cir. 2010), discussed in § 11.03[1][c], for an analysis of the distinction between forward-looking statements and statements of historical fact.

134 In practice, because specifically identifying each forward-looking statement is impractical, issuers generally include in their disclosure documents a disclaimer (i) stating that such documents contain forward-looking statements and (ii) containing a brief description of what constitutes a forward-looking statement.

135 Issuers have generally sought to meet the "accompanied by" requirement by including in their disclosure documents a risk factors section containing specific cautionary language and by including cross-references to such section in other parts of the same document. While there has been little guidance from the courts, commentators on the Litigation Reform Act generally agree that the use of a cross-reference in one document containing forward-looking statements to another document containing cautionary language is not sufficient to meet the "accompanied by" requirement.

136 Materiality in this context refers to the difference between predicted results and the actual results (*i.e.*, "differ materially"), the materiality of the falsity (*i.e.*, "materially false or misleading") and the materiality of the forward-looking statement itself. *See Rosenzweig v. Azurix Corp.*, 332 F.3d 854 (5th Cir. 2003); *Rombach v. Chang*, 355 F.3d 164 (2d Cir. 2004).

137 § 27A(c)(1) of the Securities Act and § 21E(c)(1) of the Exchange Act; *see, e.g.*, *Slayton v. American Express Co.*, 604 F.3d 758, 773–77 (2d Cir. 2010) (noting that this inquiry is "case-specific" and applying doctrine to facts of the case to affirm dismissal of complaint).

138 At least four circuit courts have held that dismissal under the first prong may be appropriate without any inquiry into the defendant's knowledge of the risks associated with the forward-looking statements—even where the defendant had actual knowledge of the statements' falsity. *See Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.*, 594 F.3d 783, 795 (11th Cir. 2010) (holding that "an allegation of actual knowledge of falsity will not deprive a defendant of protection by the statutory safe harbor if his forward-looking statements are accompanied by meaningful cautionary language"); *Employers Teamsters Local Nos. 175 and 505 Pension Fund Trust v. Clorox*, 353 F.3d 1125, 1133 (9th Cir. 2004); *Southland Securities Corp. v. INSpire Insurance Solutions Inc.*, 365 F.3d 353 (5th Cir. 2004); *Miller v. Champion Enterprises, Inc.*, 364 F.3d 660 (6th Cir. 2003); *Harris v. Ivax Corp.*, 182 F.3d 799, 803 (11th Cir. 1999) ("[I]f a statement is accompanied by 'meaningful cautionary language,' the defendants' state of mind is irrelevant."); *see also Slayton v. American Express Co.*, 604 F.3d 758, 771–72 (2d Cir. 2010).

139 *See In re Nash Finch Co. Securities Litigation*, 502 F. Supp. 2d 861 (D. Minn. 2007) ("[C]autionary language cannot be 'meaningful' when defendants know that the potential risks they have identified in fact already occurred, and the positive statements they are making are false."); *Limantour v. Cray Inc.*, 432 F. Supp. 2d 1129, 1147 (W.D. Wash. 2006) ("However, a forward looking statement may be actionable if it was made with actual knowledge that the statement was false or misleading."); *Schaffer v. Evolving Systems, Inc.*, 29 F. Supp. 2d 1213, 1224 (D. Colo. 1998) (holding that press release could not benefit from safe harbor even though it was accompanied by adequate cautionary language because "the safe harbor provision provides no refuge for [d]efendants who make statements with 'actual knowledge' of their falsity"). This position, however, appears inconsistent with the statute, because it treats the two prongs of the safe harbor as if they were conjunctive. The Committee Report accompanying the Litigation Reform Act clearly contemplates that the two prongs create "alternative analys[e]s." H.R. Conf. Rep. 104-369, at 44 (1995). On its face, the first prong of the Litigation Reform Act allows issuers and their officers, directors, employees and underwriters to obtain summary judgment in private civil suits based on false projections because the factual question of whether the projections were made with actual knowledge of their falsity is not determinative of liability. *See* H.R. Conf. Rep. No. 104-369, at 44 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730 (stating that for the purposes of the first prong of the safe harbor "[c]ourts should not examine the state of mind of the person making the statement"); *see, e.g.*, *In re Splash Technology Holdings, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶91,250 (N.D. Cal. Sept. 29, 2000).

140 *See, e.g.*, *Slayton v. American Express Co.*, 604 F.3d 758, 772 (2d Cir. 2010) (recognizing Congress instructed courts not to look at intent for the first prong, but noting ambiguity as to how to determine which statements convey substantive information); *Lormand v. U.S. Unwired, Inc.*, 565 F.3d 228, 246–47 (5th Cir. 2009) (cautionary language is not meaningful if it is only "very vague and general" and did not "disclose the specific risks and their magnitude"); *Institutional Investors Group v. Avaya, Inc.*, 564 F.3d 242, 256 (3d Cir. 2009) (affirming dismissal of certain allegations protected by the safe harbor, after noting that cautionary language must be "extensive and specific" and "substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge" (citations omitted)).

141 The "bespeaks caution" doctrine is "shorthand for the well-established principle that a statement or omission must be considered in context, so that accompanying statements may render it immaterial as a matter of law." *In re Donald J. Trump Casino Securities Litigation*, 7 F.3d 357, 364 (3d Cir. 1993), *cert. denied*, 510 U.S. 1178 (1994); *see* § 11.03[1][c]. In order to qualify cautionary statements as "meaningful" under the bespeaks caution doctrine, issuers must disclose any assumptions on which their projections are based and make the statements specific, prominent, easy to find and specifically tailored to the issuer's business—general boilerplate warnings not specifically tailored to an issuer's business will not suffice. *See, e.g., Slayton v. American Express Co.*, 604 F.3d 758, 772 (2d Cir. 2010); *Institutional Investors Group v. Avaya, Inc.*, 564 F.3d 242, 256 (3d Cir. 2009); *Southland Securities Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 372 (5th Cir. 2004). *See* § 11.03[1][c].

142 H.R. Conf. Rep. No. 104-369, at 43–46 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730. Nevertheless, "[f]ailure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor." H.R. Conf. Rep. No. 104-369, at 44 *; see*

Ehlert v. Singer, 245 F.3d 1313 (11th Cir. 2001); *In re XM Satellite Radio Holdings Securities Litigation*, 479 F. Supp. 2d 165 (D.C. Cir. 2007) (calling the "bespeaks caution" doctrine the "judicially-created counterpart" of the statutory safe harbor).

Although some courts have stated that the safe harbor provision codified the "bespeaks caution" doctrine and that the two doctrines are essentially coextensive, the Congressional Record belies this conclusion. *Compare In re Dura Pharmaceuticals, Inc. Securities Litigation*, 452 F. Supp. 2d 1005, 1033 (S.D. Cal. 2006) ("The Ninth Circuit has held the [Litigation Reform Act]'s safe harbor provision codified the judicially-created bespeaks caution doctrine.") (citing *Employers Teamsters Local Nos. 175 & 505 Pension Trust Fund v. Clorox Co.*, 353 F.3d 1125, 1132 (9th Cir. 2004)) *with* H.R. Conf. Rep. No. 104-369, at 43–46 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730 ("The Conference Committee does not intend for the safe harbor provisions to replace the judicial 'bespeaks caution' doctrine or to foreclose further development of that doctrine by the courts."). *See also Payne v. DeLuca*, 433 F. Supp. 2d 547, 561 (W.D. Pa. 2006) ("Enactment of the [Litigation Reform Act's] safe harbor provision did not do away with the judicially created 'bespeaks caution' doctrine.").

143 *Asher v. Baxter*, 377 F.3d 727 (7th Cir. 2004).

144 *Asher v. Baxter*, 377 F.3d 727, 734 (7th Cir. 2004).

145 *Asher v. Baxter*, 377 F.3d 727, 734 (7th Cir. 2004).

146 *Asher* has been followed by courts in the Seventh Circuit as well as in other circuits. *See, e.g.*, *Central Laborers' Pension Fund v. SIRVA, Inc.*, No. 04 C 7644, 2006 WL 2787520, at *23 (N.D. Ill. Sept. 22, 2006); *State of New Jersey and its Division of Investment v. Sprint Corp.*, No. 03-207-JWL, 2004 WL 1960130, at *10 (D. Kan. Sept. 3, 2004); *Ong v. Sears, Roebuck & Co.*, 388 F. Supp. 2d 871 (N.D. Ill. 2004).

147 *Harris v. IVAX Corp.*, 182 F.3d 799 (11th Cir. 1999). On the surface, the Seventh Circuit's decision in *Asher* contains some language that echoes *Harris*, as the court in *Asher* acknowledged that the safe harbor provision does not require "prescience" or "prevision" or allow plaintiffs to plead "fraud by hindsight" based on circumstances that could not have been known at the time of the disclosure. The difference between the two opinions is not necessarily in the scope of the safe harbor, but how the court should apply the safe harbor at the pleadings stage.

148 *Harris v. IVAX Corp.*, 182 F.3d 799, 807 (11th Cir. 1999) (internal quotations omitted).

149 *See, e.g.*, *In re AMDOCS Ltd. Securities Litigation*, 390 F.3d 542 (8th Cir. 2004); *see also Asher v. Baxter*, 377 F.3d 727 (7th Cir. 2004).

150 § 27A(c)(2) of the Securities Act and § 21E(c)(2) of the Exchange Act. It should be noted that these cross-reference procedures available for oral forward-looking statements may not be sufficient for the purposes of invoking the safe harbor if the oral statements later are put in writing and such writing is not "accompanied by meaningful cautionary statements." Accordingly, where an issuer posts a transcript or audio recording of a conference call on its website, the cross-referenced document containing the meaningful cautionary statements also should be available on the website.

151 § 27A(c)(3) of the Securities Act and § 21E(c)(3) of the Exchange Act.

152 The safe harbor does not protect against civil or criminal enforcement actions brought by the SEC or the DOJ. *See* § 27A(c)(1) of the Securities Act and § 21E(c)(1) of the Exchange Act (limiting the safe harbor to "private actions").

153 The safe harbor does not protect against actions alleging fraud under state law, although in some jurisdictions similar results may be obtained under the "bespeaks caution" doctrine developed by the federal courts and adopted by some state courts. This doctrine shields defendants from liability based on projections and other "soft" or forward-looking statements if accompanied by meaningful disclaimers or disclosures of risk; the doctrine generally does not shield those who make statements with knowledge of their falsity. The Congressional Conference Committee Report for the Litigation Reform Act states that the safe harbor is not intended to replace the "bespeaks caution" doctrine or to foreclose further development of that doctrine by the courts. S. Rep. No. 104-98, at 15–18 (1995). *See* § 11.03[1][c] for a further

discussion of the "bespeaks caution" doctrine. SLUSA mitigates the risk of securities fraud actions in state court by requiring most class action securities fraud suits based on state law to be brought in federal court under federal law. *See* § 11.09[1][a].

154 *See* § 27A(a)(1) of the Securities Act and § 21E(a)(1) of the Exchange Act.

155 *See* § 27A(b) of the Securities Act and § 21E(b) of the Exchange Act. Forward-looking disclosures provided pursuant to Item 11 of Form 20-F (Quantitative and Qualitative Disclosures About Market Risk), however, are within the statutory safe harbors for all types of issuers and transactions. *See* § 3.08[7].

Where the Litigation Reform Act does not apply in the contexts referred to above, issuers can rely on Rule 175 under the Securities Act and Rule 3b-6 under the Exchange Act. Under those rules, a forward-looking statement that proves to be incorrect will not be considered a material misstatement or omission under the securities laws unless the plaintiff can show that it "was made or reaffirmed without a reasonable basis or was disclosed other than in good faith." The plaintiff bears the burden of proving that the statement does not fall within the Rule 175(a) or Rule 3b-6(a) safe harbor. *See, e.g.*, *Roots Partnership v. Land's End, Inc.*, 965 F.2d 1411 (7th Cir. 1992); *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509 (7th Cir. 1989). This safe harbor is available for forward-looking statements contained in any document filed with the SEC made (i) by or on behalf of an issuer that is subject to the reporting requirements of the Exchange Act or that is filing a registration statement under the Securities Act or §§ 12(b) or 12(g) of the Exchange Act or (ii) by an outside reviewer retained by such an issuer.

156 *See* § 4.10[4] for a discussion of circuit courts' disagreement concerning whether a duty to update previous communications exists.

157 *See* § 27A(d) of the Securities Act and § 21E(d) of the Exchange Act.

158 Several studies have examined whether the quantity or quality of written forward-looking disclosures increased after the enactment of the Litigation Reform Act. The studies reached different conclusions. In the first study, the SEC staff analyzed litigation conducted in the first year after the passage of the Litigation Reform Act. Although the staff cautioned that the lack of substantial jurisprudence interpreting the Act made it "too soon to draw definitive conclusions about the impact of the Reform Act on the effectiveness of the securities laws and on investor protection," the report concluded that the quality and quantity of disclosures had not significantly improved since the enactment of the safe harbor provision. *See* SEC, Office of the General Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, at 26–27 (Apr. 1997). The second study, published by the New York City Bar Association, concluded that while cautionary language has become standard in corporate disclosures, the substantive quantity or quality of disclosures had not increased. *See* Committee on Securities Regulation *, A Study of Current Practices: Forward Looking Statements and Cautionary Language After the 1995 Private Securities Litigation Reform Act*, RECORD OF THE NEW YORK CITY BAR ASSOC., Vol. 53, No. 6, Nov. (Dec. 1998) at 723, 726. The third study, published in the Journal of Accounting Research, reached the opposite conclusion, finding that the quantity of disclosures had increased without any significant decrease in their accuracy. Marilyn F. Johnson et al., *The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information By High-Technology Firms*, 39 J. ACCT. RES. 297, 318, 322 (2001) ("[T]he evidence presented above indicates that there was a significant increase in the level of voluntary disclosure during the post-Act period, and that this increase appears to be a direct response to the reduced legal exposure for forward-looking statements. [W]e find that the safe harbor had no adverse impact on the quality of forward-looking information released by management.").

Studies have also tracked the number of securities class actions filed over recent years. In January 2016, NERA Economic Consulting released its assessment of securities class action filing activity in 2015. The 234 securities class action filings in 2015 represented the highest level since 2008, and an increase of 8% from 2014. The study further noted that the number of publicly listed companies in the United States has decreased substantially over time, meaning that an average company was almost 70% more likely to be the target of a securities class action between 2010 and 2015 than in the first five years after the passage of the Litigation Reform Act. *See* NERA Economic Consulting, *Recent Trends in Securities Class Action Litigation: 2015 Full-Year Review*.

159 *See* SEC, Office of the General Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, at 3 (Apr. 1997).

160 *See* SEC, Office of the General Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, at 26–27 (Apr. 1997).

161 *See* Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 928 (2003). *See also* § 11.09[1][a].

162 *See* Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 928 (2003).

163 *See* SEC, Office of the General Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, at 28 (Apr. 1997).

164 *See* § 101(2) of the Uniform Securities Act.

165 *See* § 410(a)(2) of the Uniform Securities Act. Control persons are liable under the Uniform Securities Act to the same extent as those they control, subject to the same basic defenses set forth in § 15 of the Securities Act. *See* § 410(b) of the Uniform Securities Act.

166 *See* § 18(c)(1) of the Securities Act, *as amended* by the NSMIA; *see also* § 11.02[3].

167 *See* § 11.09[1][a]. On the other hand, in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Manning*, the Supreme Court held that a defendant could not remove to federal court an action asserting state law claims based in part on an alleged breach of a duty imposed by a regulation under the Exchange Act, notwithstanding that § 27 of the Exchange Act provides that federal courts have exclusive jurisdiction "of all suits … brought to enforce any liability or duty created by [the Exchange Act] or the rules or regulations thereunder," because the plaintiff in that case could "prevail on those [state law] claims without proving that the alleged breach of an Exchange Act duty … actually occurred" and those [state law] claims therefore did not "necessarily raise a federal issue." *See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Manning*, 136 S. Ct. 1562, 1568, 1575 (2016). Instead, the Supreme Court held that state law claims are removable to federal court under § 27 of the Exchange Act only if they "arise under" the Exchange Act, meaning that the "state-law action necessarily depends on a showing that the defendant breached the Exchange Act." *See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Manning*, 136 S. Ct. 1562, 1567–69 (2016).

U.S. Regulation of the International Securities and Derivatives Markets, § 11.04, LIABILITIES CONNECTED WITH DISCLOSURE IN PRIVATE OFFERINGS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 11.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Like the registered public offerings discussed in the preceding section, private offerings of securities in the United States (including offerings under Rule 144A under the Securities Act) also can give rise to liability for improper disclosures under U.S. federal and state securities laws, with remedies ranging from actions by private parties for damages to injunctive actions by the SEC and criminal prosecutions by the DOJ. In general, however, the legal standards under federal law for imposing such liability are higher in the private offering context than for registered public offerings: in the case of private suits, the plaintiff must demonstrate that the defendant acted recklessly or with fraudulent intent, and must also prove that he or she relied on the defendant's wrongful conduct to his or her detriment. The distinctions between the standards applicable to public and private offerings were clarified by the Supreme Court in *Gustafson v. Alloyd Co., Inc.*, [168] which—as discussed in § 11.04[1]—held that § 12(a)(2) of the Securities Act, with its lower burden of proof required for liability, [169] does not apply outside the public offering context. The two federal provisions that do apply to disclosure violations in private offerings, § 10(b) of the Exchange Act and Rule 10b-5 thereunder and § 17 of the Securities Act, are examined below in § 11.04[2] and [3], respectively. The relevant provisions of state securities law are addressed in § 11.04[4].

[1] *Gustafson* and Securities Act § 12(a)(2)

Although a purchaser in a private placement does not have any rights under § 11 of the Securities Act (relating to misstatements or omissions in a registration statement), [170] it was believed widely that such purchasers could take advantage of the remedies afforded by § 12(a)(2) of the Securities Act, which imposes

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liability on securities sellers for misstatements or omissions in prospectuses or oral communications made in the offer or sale of a security. (Indeed, many had thought that § 12(a)(2) also applied to secondary market transactions.) The

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Supreme Court's 1995 decision in *Gustafson* held the opposite, that § 12(a)(2) does not apply at all to private placements or secondary market transactions. [171] The breadth of the Court's holding was unexpected, particularly as applied to private placements. As a result of the *Gustafson* decision, a plaintiff who purchases securities in a private placement or in a secondary market transaction will be forced to pursue its claims based on federal law under the more rigorous standards of Rule 10b-5 (discussed in § 11.04[2])—which applies to private and secondary market transactions as well as public offerings—as well as under any applicable state securities laws. [172]

The *Gustafson* decision went a long way toward addressing concerns of securities market participants about inadvertent liability in connection with private placements and secondary market transactions. Although consideration still will have to be given to reputational issues, state securities laws and the common law, the potential remedies under state and common law are less likely to provide the basis, especially in the context of international offerings, for the nationwide class actions and other large-scale proceedings that have marked securities law litigation under the federal securities laws. [173]

By changing the standards for liability in private placements and secondary market transactions, *Gustafson* led some participants to reexamine the nature of the documentation used in these transactions or the procedures employed in executing them. However, the core business reasons that motivate due diligence (*e.g.*, reputational concerns and investor expectations), as well as the desire to be able to protect against possible evolution of liability standards under, for example, Rule 10b-5, and to dispose quickly of litigation alleging defective disclosure, have combined to result in continued substantial due diligence in Rule 144A offerings. [174]

Despite *Gustafson's* expansive holding, some courts have nonetheless left open the possibility of § 12(a)(2) liability in Rule 144A and Regulation S offerings. [175] Notably, in the Enron civil litigation, the court denied an underwriter's

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motion to dismiss the § 12(a)(2) claim, holding that notwithstanding exemption from registration under Regulation S or Rule 144A, there were circumstances whereby an offering could be found public for the purposes of § 12(a)(2). [176] The court, in particular, noted the absence of a statutory definition of "public offering," the wide distribution (although limited to qualified institutional buyers in the United States) and the listing of the securities on the Luxembourg Stock Exchange as factors that made it inappropriate to dismiss the underlying claim since there was a possibility that, through the admission of further evidence, the

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plaintiffs could establish that the offering was a public offering, actionable under § 12(a)(2). [177]

[2] Exchange Act § 10(b) and Rule 10b-5

The catch-all antifraud provisions of the Exchange Act, § 10(b) and Rule 10b-5 thereunder, have become by far the most significant remedy for disclosure violations in securities transactions, both for the SEC and for private litigants. The provisions themselves do not create a private right of action; the Exchange Act speaks only of civil and administrative remedies by the SEC, and possible criminal prosecution. However, the courts have long held that buyers or sellers of securities have an implied right to recover damages based on violations of § 10(b) and Rule 10b-5. [178] The elements of a claim under these provisions are discussed below, as are the parties who may be held liable as defendants and the remedies that may be available.

[a] Elements of Claim

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder are broadly written: § 10(b) proscribes the use of "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of any security, and Rule 10b-5 specifies three categories of conduct that qualify as violations. These are (i) employing any "device, scheme, or artifice to defraud," (ii) making any untrue statement of material fact or failing to state a material fact "necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" [179] and (iii) engaging in any "act, practice, or course of business" that operates as a "fraud or deceit."

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Information is deemed material for purposes of the second prong if there is a substantial likelihood that a reasonable investor would have viewed its disclosure as significantly altering the "total mix" of available information, and would consider it important in deciding whether to purchase or sell stock. [180] Whether or not misstatements or omissions are material may involve qualitative as well as quantitative judgments. In Staff Accounting Bulletin No. 99, the SEC offered guidelines to registrants and independent auditors in evaluating the materiality of misstatements identified in the audit process or preparation of financial statements. [181] The SEC emphasized that registrants should not assume that the misstatement or omission of items that fell below a certain quantitative threshold (*e.g.*, 5%) was immaterial for disclosure purposes. [182] While a numerical threshold can provide a starting point for determining the materiality of an item, such an assessment also must include "the factual context in which the user of financial statements would view the financial statement item." [183] Thus, some of the qualitative factors that must be considered are:

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate, and, if so, the degree of imprecision inherent in the estimate;
- whether the misstatement masks a change in earnings or other trends;
- whether the misstatement hides a failure to meet the consensus expectations of the analysts for the enterprise;
- whether the misstatement changes a loss into income or *vice versa*;

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- whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability;
- whether the misstatement affects the registrant's compliance with regulatory requirements;
- whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements;
- whether the misstatement has the effect of increasing management's compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation;
- whether the misstatement concerns a segment or other portion of the registrant's operations or profitability; and
- whether the misstatement involves concealment of an unlawful transaction. [184]

The SEC also cautioned that where financial statements contained multiple misstatements, registrants should consider first each misstatement separately and second the aggregate effect of all misstatements. The effect of the misstatement of an individual amount that causes the financial statements as a whole to be materially misstated cannot be eliminated by the inclusion of other misstatements whose effect diminishes the impact of the original misstatement. Conversely, financial statements may be rendered materially misleading even though no individual misstatement is material. [185]

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Courts have also found that the alleged misstatement or omission of items falling below a certain quantitative threshold can be qualitatively material if those items concern a particular product, division, or segment of an issuer's business that has independent significance for investors, such as a product or segment that is the company's original niche, its iconic or eponymous business, or that is critical to its reputation, revenue or growth. [186]

More recently, the Supreme Court rejected the contention that the materiality of adverse event reports in the pharmaceutical context can be reduced to the binary question of whether an issuer knew of a statistically significant number of such event reports. In *Matrixx Initiatives v. Siracusano*, [187] the plaintiffs challenged as materially misleading a drug manufacturer's statements touting the safety of its anti-cold medication, because the manufacturer knew of a large number of reports concerning adverse health effects of such medication. The drug manufacturer argued that plaintiffs did not adequately plead the materiality of the alleged misstatements because the complaint did not allege that the manufacturer knew of a statistically significant number of such adverse health reports. The Supreme Court, relying on *Basic*, rejected this contention and affirmed the Ninth

Circuit's refusal to dismiss the complaint, noting that a bright-line rule that would turn on the existence of a statistically significant number of adverse effect reports would "artificially exclude information that would otherwise be considered significant to the trading decision of a reasonable investor." [188] The Court instead reaffirmed that assessing the materiality of an adverse event report is a "fact-specific inquiry that requires consideration of the source, content, and context of the reports." [189]

The disclosure standard under Rule 10b-5 is identical to that under § 12(a)(2) of the Securities Act: liability is predicated upon a misstatement or upon omission of a material fact that makes an included statement misleading. [190] The remaining elements of the claim differ, however, in significant ways. Unlike under § 12(a)(2), where the defendant must establish that it acted with reasonable care, [191] a plaintiff bringing a claim under Rule 10b-5 must plead conduct by

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the defendant giving rise to "a *strong inference* of *scienter*." [192] For Rule 10b-5 purposes, "*scienter*" is defined as an intent to defraud, deceive or manipulate, [193] with courts generally agreeing that recklessness constitutes "*scienter*" as well. [194]

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Mere negligence is not sufficient to state a cause of action under Rule 10b-5. [195] Recklessness has been defined as "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." [196] Under this definition, which has been adopted by the majority of circuits and applied to claims of material misstatements as well as omissions, [197] the danger of "misleading buyers must be actually known or so obvious that any reasonable man would be legally bound …[and that the conduct in question must be] more egregious than even 'white heart/empty head' good faith." [198]

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In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Supreme Court addressed the level of specificity that a plaintiff must plead in order to satisfy the "strong inference of *scienter*" standard on a motion to dismiss. [199] The Court held that a complaint must meet a two-pronged test: its allegations of *scienter* must be both "cogent" and "at least as compelling as any opposing inference of nonfraudulent intent." In applying this test, the reviewing court must consider not only the inferences urged by the plaintiff, but also competing inferences rationally drawn from the facts of the complaint and any other sources that a court may consider on a motion to dismiss. By requiring courts to consider competing inferences of *scienter* (*i.e.*, "innocent" or "nonculpable" inferences), the effect of the Court's ruling will be to trigger more rigorous scrutiny of plaintiffs' pleadings and, in some cases, earlier dismissal.

The decision in *Tellabs* was also significant for its discussion of the analytical approach that a reviewing court should take when determining whether the "strong inference of *scienter*" is adequately pled. The Court stated that the allegations of the complaint should be assessed "holistically," rather than in isolation. In other words, the Court rejected approaches that afforded determinative significance to specific allegations of the complaint (*e.g.*, motive and opportunity) and instructed lower courts to review complaints in their entirety to determine "whether all the facts alleged, taken collectively, give rise to a strong inference of *scienter*," not whether any individual allegation, scrutinized in isolation, meets that standard.

The plaintiff in a private action under Rule 10b-5 (as contrasted with an SEC enforcement action) also must show that he or she relied on the defendant's wrongful conduct and that the conduct was the proximate cause of the investment loss. [200] These elements of a Rule 10b-5 claim are sometimes referred to as transaction causation and loss causation.

Transaction causation is akin to reliance, and requires only an allegation that "but for the defendant's wrongdoing, the plaintiff would not have incurred the harm of which he complains." [201] There are two important exceptions, however, to the need for a plaintiff to prove reliance.

The first exception applies only in cases alleging material omissions. In such a case, courts have held that proof of the materiality of the omission gives

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rise to a presumption of the plaintiff's reliance. [202] This exception to proving reliance originates from the U.S. Supreme Court's decision in *Affiliated Ute v. United States*. [203] That case involved a failure to disclose material information in a context in which there were face-to-face transactions between the defendant-bankers and the plaintiff-investors. Based on these transactions, and the relationship between the bankers and the investors, the Court found that the bankers had a duty to disclose material information to the investors. The Court held that, in light of this duty, "positive proof of reliance is not a prerequisite to recovery. This obligation to disclose and the withholding of a material fact establish the requisite element of causation in fact." [204]

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The second exception—the so-called "fraud-on-the-market" theory—applies to transactions in securities that trade in the open market. In circumstances where there is an organized and efficient market for the securities—*i.e.*, the securities trade on a major stock exchange, are heavily traded, are followed by a number of analysts, and generally move in response to the release of material information about the issuer—the court may presume that the market price reflects the information available about the issuer, and a material misstatement or omission will be deemed to have affected the market price of the stock. [205] This presumption allows those who traded on the basis of the artificially inflated or depressed market price to recover the difference between the price paid or received and the price at which the stock would have been trading in the absence of the defendant's material misstatement or omission. [206] If the defendant can establish that the plaintiff in fact did not rely on the misstatement or omission or that the defendant's misstatement or omission did not affect the market price of the security, then the presumption of reliance is rebutted. [207] In an important decision in *In re Initial Public Offering Securities Litigation*, [208] the Second Circuit

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concluded that the "fraud-on-the-market" theory is inapplicable to initial public offerings because the market for IPO shares is not efficient.

In *Halliburton Co. v. Erica P. John Fund, Inc.*, the Supreme Court considered whether to overrule or substantially modify the "fraud-on-the-market" theory, in light of recent scholarship that called into question the economic underpinnings of the theory. [209] The Court ultimately reaffirmed the theory under the principle of *stare decisis*, but noted that the presumption of reliance could be rebutted by a showing that the alleged misrepresentation had no "price impact," and held that "defendants must be afforded an opportunity before class certification to defeat the presumption [of reliance] through evidence that an alleged misrepresentation did not actually affect the market price of the stock." [210] On remand, the district court in *Halliburton* concluded that the defendants successfully defeated the presumption of reliance with respect to certain alleged misstatements by submitting an event study that showed there was no statistically significant price reaction on particular days when the truth about those alleged misstatements was revealed to the market. [211]

The Eighth Circuit has further held that a defendant can rebut the fraud-on-the-market presumption by demonstrating that the allegedly misleading statements did not affect the price of the issuer's securities at the time of the alleged misstatements. [212] Other courts, however, have rejected attempts to rebut the presumption of reliance unless defendants "demonstrate a complete lack of price impact." [213]

Loss causation, unlike transaction causation, is concerned primarily with causation instead of reliance. It is a fact-based inquiry akin to common law proximate cause. In order for a private plaintiff under Rule 10b-5 to show loss causation, he must demonstrate that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security. [214]

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In 2005, a unanimous Supreme Court raised the bar in Rule 10b-5 suits, holding that given the common law roots of this implied private right of action and the pleading requirements under the Litigation Reform Act, private plaintiffs pursuing Exchange Act fraud claims must plead and prove more than just price inflation at the time of purchase in order to satisfy the "loss causation" element. The Supreme Court expressly rejected the Ninth Circuit's "inflated share price approach" to proving causation and loss, pursuant to which the mere allegation in a complaint that the price of a security "on the date of purchase was inflated because of the misrepresentation" was sufficient to plead and, when later established, also sufficient to prove loss causation because the injury was understood to occur at the time of the transaction. [215] The Supreme Court found this approach to be at odds with the logic and the policies behind the securities laws, because under the "inflated share price approach," private securities actions would operate largely as a "partial downside insurance policy," [216] since an initially inflated purchase price would not invariably lead to an economic loss. The Supreme Court held that to prevail in a 10b-5 suit, a private plaintiff must plead and prove that the defendant's fraud caused "an economic loss." [217]

Thus, given the foregoing discussion of the elements required for the successful prosecution of a 10b-5 claim, issuers organizing private placements in the United States, or investment bankers participating in such placements, should consider a number of factors in determining what level of disclosure is appropriate to avoid liability. First, because the *scienter* standard includes reckless as well as intentional disclosure violations, an underwriter is unlikely to be able to

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avoid liability by doing no investigation and therefore not "knowing" of the misstatement or omission. Investment bankers associated with a private placement may be found to have impliedly represented that they have performed a customary "business diligence" investigation. [218] This investigation would probably be required to include pursuing internal inconsistencies or "red flags" that become apparent, but in all likelihood does not require the full "legal" or "documentary" diligence necessary for public offerings where proof of *scienter* is not required for disclosure liability. [219]

Second, issuers and sellers should examine the circumstances of the particular private placement to determine what level of disclosure is necessary. In some cases, such as a private placement associated with an initial offering in the capital markets by a non-U.S. issuer, the scope of disclosure appropriately may be quite close to that for an offering registered with the SEC. In other cases, involving for example an offering of debt securities under Rule 144A by a seasoned, "world-class" non-U.S. company that has been a frequent issuer in the international markets, disclosure that substantially follows the issuer's prior practice in the international markets might be appropriate. In particular, less detailed disclosure may be required for offerings of investment-grade debt than for equity. For debt offerings, investors generally are willing to place as much reliance on rating agencies as on the underwriters.

[b] Who May Be Liable

[i] *Standing and Contribution*

Although the plaintiff in a Rule 10b-5 action must demonstrate that it was an actual purchaser or seller of the security to have standing to sue, it may sue defendants other than the purchaser or seller with whom it dealt. [220] There is no requirement of privity in Rule 10b-5 actions. Rather, the Rule extends liability to

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"any person, directly or indirectly" who commits fraud or intentionally or recklessly provides misleading disclosure "in connection with the purchase or sale of any security."

In addition, § 20(a) of the Exchange Act imposes control person liability for violations of its provisions. The control person is liable to the same extent as those who directly committed the offense, [221] unless it can show that it "acted in good faith and did not induce the act or acts constituting the violation or cause of action." [222] Section 10(b) and § 20(a) claims must be pled in the alternative because a party cannot be held liable under both sections for the same conduct. [223]

Further, Congress amended the Exchange Act to provide that in cases in which more than one person violated the Exchange Act and contributed to the plaintiff's damages, each person is liable only for a portion of the total damages based on the percentage of responsibility that the jury attributes to that person. This provision, which carves out an exception for cases of "knowing" securities fraud, is discussed in § 11.03[1][e][ii].

[ii] *Secondary Actor Liability*

The SEC may bring enforcement actions against parties (often called "secondary actors") who "aid and abet" violations of Rule 10b-5 or other provisions of the Exchange Act, meaning that they provide substantial assistance to others in accomplishing the securities violation despite knowledge that the others' conduct violates the law. [224] The SEC staff has said that using an aiding and abetting

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theory to pursue "enablers" of fraud—secondary actors such as lawyers, accountants, bankers and non-management directors—is an important part of the Commission's enforcement program, and it has brought enforcement actions accordingly. [225]

By contrast, the Supreme Court has held that private investors may not bring suit against aiders and abettors under Rule 10b-5. [226] The Court's elimination of aiding and abetting liability in private actions also calls into question private investors' previously accepted ability to sue employers under the doctrine of "*respondeat superior*," [227] which permits the imposition of strict liability on employers for the fraudulent acts of their employees if the employees were acting within the scope of their employment. [228] This issue may arise not only in the

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context of actions against employers, but also actions against parent corporations on the basis of the actions of their subsidiaries. [229]

In a pair of more recent decisions, the Supreme Court has further curtailed the ability of private plaintiffs to pursue claims against secondary actors as primary violators rather than as aiders and abettors. In *Stoneridge Investment v. Scientific-Atlanta, Inc.*, the Supreme Court considered whether secondary actors can be liable under a "scheme" liability theory. [230] Following *Central Bank*, private litigants seeking to reach secondary actors attempted to pursue claims using the previously untapped "scheme to defraud" prongs of Rule 10b-5—namely Rule 10b-5(a) and (c). [231] Although initial district court decisions suggested that

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this "scheme" theory may support broad Rule 10b-5 liability against secondary actors such as lawyers, accountants and financial institutions, subsequent decisions narrowed the application of Rule 10b-5(a) and (c) to circumstances in which the defendant actually made use of an allegedly deceptive device or contrivance. [232] In *Stoneridge*, while the Supreme Court stopped short of completely eliminating scheme liability in the case of secondary actors, it established a test that may be difficult for plaintiffs to meet as a practical matter. The Court held that plaintiffs bringing Rule 10b-5(a) and (c) claims must demonstrate that they specifically relied on the defendants' acts or statements when making their investment decisions. It went on to reject liability against secondary actors (here, counterparties to sham transactions) where the secondary actors did not make it "necessary or inevitable" that the primary actor would defraud investors by issuing false financial statements. [233] As the Court explained, it was the primary actor, not the secondary actors, "that misled its auditor and filed fraudulent statements; nothing [the secondary actors] did made it necessary or inevitable for [the primary actor] to record the transactions as it did."

In *Stoneridge*, the shareholder-plaintiff had brought claims against two equipment vendors who allegedly participated with Charter Communications in a fraudulent "wash sale" scheme. The complaint alleged that the vendor-defendants had sold equipment (cable television set-top boxes) to Charter with the understanding that Charter would pay an extra $20 per unit and the vendors would return the extra funds to Charter through advertising fees. Even though the complaint alleged that the vendor-defendants were aware that they were engaged in a scheme with the purpose of inflating Charter's apparent revenues, the Eighth Circuit held that no violation of any subsection of Rule 10b-5 could be pled against defendants who "did not issue any misstatement relied upon by the investing public" and were not "under a duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition." The Supreme Court affirmed this decision. [234] Following *Stoneridge*, a number of circuit courts adopted or reaffirmed their prior holdings that a primary violation only exists if the actor makes a false or misleading statement and it was publicly attributable to him at the time of dissemination. [235]

Expanding on its decision in *Stoneridge*, the Supreme Court has further narrowed the reach of the § 10(b) private cause of action in *Janus Capital Group, Inc. v. First Derivative Trader*. [236] In *Janus*, the Court held that the investment adviser to a mutual fund could not be liable in a private action under § 10(b) for allegedly false statements contained in prospectuses issued by the mutual fund, even though the investment adviser wrote the allegedly misleading prospectuses. In *Janus*, the Court described the issue as what it means to "make" a statement under Rule 10b-5(b), and held that the "maker" of a statement is "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." [237] Applying this test, the Court held that the mutual fund, not the investment adviser, was the "maker" of the challenged statements, because the fund was the entity with "ultimate authority" over the prospectuses, bore the statutory obligation to (and did) file the prospectuses with the SEC and the prospectuses were attributed to the fund and not the adviser.

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Since *Janus*, lower courts have disagreed on whether *Janus* forecloses liability against investment banks acting as placement agents or underwriters for statements attributed to the issuer in offering documents. [238] Courts have also disagreed concerning whether the Supreme Court's reasoning in *Janus* only applies to legally independent third parties, or also extends to corporate officers. [239]

[c] Remedies

A private party prevailing in an action under Rule 10b-5 is entitled to recover its out-of-pocket loss, [240] generally the difference between the "true" value of the securities (the price at which they would have traded absent the fraud) and the price paid or received by the plaintiff. [241] Alternatively, some courts permit plaintiffs to recover subsequent price declines that were a foreseeable materialization of the risk concealed by the fraudulent statement, even if

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those losses would exceed the price inflation that existed on the original transaction date, which would have reflected only the *risk* of an adverse development rather than its actual occurrence. [242] The determination of damages under these principles can be quite complicated, often requiring the use of economic models and expert testimony to distinguish between losses caused by the fraud and those attributable to other factors, including factors generally affecting the economy and the company's industry or those specifically affecting the company but not related to the fraud. [243] In response to the difficulty of making this distinction, and the potential for thus greatly overestimating plaintiff damages, Congress established an upper limit, or cap, on damages for claims arising under the Exchange Act "in which the plaintiff seeks to establish damages by reference to the market price." [244] The recovery limit is calculated as the difference between the price paid or received by the plaintiff for the securities and the mean trading price of the same securities during the three months following corrective disclosure to the market. [245] Moreover, pursuant to a 1995 amendment to the Exchange Act, a system of "proportionate liability" that apportions liability based on "the percentage of responsibility" of each violator applies to virtually all violations of the Exchange Act, essentially eliminating joint and several liability for such violations except where statements or omissions were made with actual knowledge of falsity, rather than mere recklessness. [246]

The SEC may sue for injunctive relief under § 10(b) and Rule 10b-5, or to prohibit (permanently or temporarily) any person who violated these provisions from acting as an officer or director of any public company. [247] The SEC may also seek civil penalties in amounts ranging from $8,156 to $178,156 for natural persons or $81,559 to $890,780 for corporations, depending on the egregiousness of the defendant's conduct, or disgorgement of the defendant's gain from its actions, whichever is greater. [248] Finally, the DOJ may seek criminal sanctions (including substantial fines or imprisonment in the case of natural persons) for willful violations of the antifraud or other provisions of the Exchange Act. [249]

[d] Statutes of Limitations and Repose

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There is no statute of limitations applicable to actions brought by the SEC under § 10(b) of the Exchange Act and Rule 10b-5 thereunder for injunctive relief or disgorgement. [250] As discussed in § 11.07[1][a], the Sarbanes-Oxley Act created new statutes of limitations and repose for private claims under § 10(b) and Rule 10b-5—the earlier of two years from the date of "discovery of the facts constituting the violation" or five years from the date of the violation. [251]

In *Merck & Co., Inc. v. Reynolds*, the Supreme Court interpreted the text of this statute of limitations and rejected the notion that § 1658's limitations period begins to run at the point that plaintiffs should begin investigating their claim, as opposed to the date when plaintiffs should actually discover their claim. [252] *Merck* involved a Rule 10b-5 allegation that pharmaceutical company Merck knowingly misrepresented the risk of heart attack associated with its drug Vioxx. Relying on Second Circuit precedent, the district court dismissed the complaint on statute of limitations grounds, holding that the plaintiffs should have been alerted by three events constituting "inquiry notice" to the possibility of the misrepresentations more than two years prior to the filing of the complaint, but failed to undertake a reasonably diligent investigation at that time. The Third Circuit reversed, holding that although the three events constituted "storm warnings," they did not suggest that Merck had acted with *scienter*, and therefore they did not put plaintiffs on "inquiry notice," triggering a duty to investigate further. Rejecting the applicability of "inquiry notice," the Supreme Court noted that while "terms such as 'inquiry notice' and 'storm warnings' may be useful to the extent that they identify a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating.…the limitations period does not begin to run until the plaintiff thereafter discovers or a reasonably diligent plaintiff would have discovered 'the facts constituting the violation,' including *scienter*—irrespective of whether the actual plaintiff undertook a reasonably diligent investigation." [253]

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The Court further held that *scienter* is among the "facts constituting the violation" that plaintiffs must actually or constructively discover before the statute of limitations begins to run on their Rule 10b-5 claims. In so holding, the Court pointed out the special heightened pleadings requirements applicable to the *scienter* element in Rule 10b-5 cases under the Litigation Reform Act. Specifically, plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," and the complaint will give rise to such a "strong inference" only where it demonstrates that it is "at least as likely" as not that the defendant acted with the relevant knowledge or intent. [254] Accordingly, the Court held that "[i]t would therefore frustrate the very purpose of the discovery rule in this provision—which, after all, specifically applies only in cases 'involv[ing] a claim of fraud, deceit, manipulation, or contrivance,'—if the limitations period began to run regardless of whether a plaintiff had discovered any facts suggesting scienter." [255] The Court rejected Merck's argument that this holding would give life to stale claims or subject defendants to liability for acts taken long ago, pointing to the five-year repose period as adequately addressing these concerns. The Court specifically declined to address whether or what other elements of a Rule 10b-5 claim, such as reliance, loss and loss causation, qualify as "facts constituting the violation" for purposes of determining when the limitations period begins to run.

Building on *Merck*, the Second Circuit has held that a fact is not deemed "discovered" for purposes of commencing the statute of limitations until a reasonably diligent plaintiff would have sufficient information about that fact to adequately plead it in a complaint. [256] Therefore, the statute of limitations on a Rule 10b-5 claim does not begin to run until a reasonably diligent plaintiff would have uncovered enough information about the defendant's knowledge or intent to establish a strong inference of *scienter*.

[3] Securities Act § 17(a)

The Securities Act contains a broad antifraud provision, § 17(a), which closely mirrors the language of Rule 10b-5 under the Exchange Act. [257] Although

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the Securities Act is primarily concerned with the regulation of new public offerings, the Supreme Court has held that § 17(a) is applicable to the seller in private placements and secondary market trading as well. [258]

Though the language of § 17(a) is very similar to that of Rule 10b-5, [259] most actions under its provisions do not require proof of the defendant's *scienter*, a significant burden in Rule 10b-5 actions. Instead, negligence in disclosure generally will suffice as a basis for imposing liability under § 17(a). [260] To prevent § 17(a) from being used as an end-run around Rule 10b-5's requirements, however, almost all courts have held that § 17(a) does not provide a private right of action. [261] Therefore, only the SEC may enforce § 17(a) provisions [262] and only the DOJ may institute criminal proceedings for willful, as opposed to negligent, violations.

[4] State Securities Laws

State securities laws—the so-called "blue sky" laws—are another possible source of liability with respect to offering documents used in private placements. All U.S. states (other than New York) have statutes that allow investors to sue to rescind transactions or recover damages when securities are sold by means of

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materially misleading offering documents. [263] In approximately 35 states, including a number with a significant institutional investor base, the standard of actionable conduct is comparable to the reasonable care standard under § 12(a)(2) of the Securities Act. However, state securities laws are unlikely to provide a basis for the nationwide class actions or other large-scale proceedings that have marked securities law litigation under the federal securities laws. [264]

Footnotes

168 *See Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995).

169 *See* § 11.03[2] for discussion § 12(a)(2) of the Securities Act.

170 Courts have affirmed that there is no § 11 liability in the case of a Rule 144A offering. *See In re Levi Strauss & Co. Securities Litigation*, 527 F. Supp. 2d 965, 975 (N.D. Cal. 2007); *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 258 F. Supp. 2d 576, 619 (S.D. Tex. 2003) (holding that there is no liability under § 11 for a Rule 144A offering because (i) a registration statement is an essential element of a § 11 claim and (ii) a Rule 144A offering is expressly exempt from the requirement that a registration statement be filed in connection with an offering); *In re Livent, Inc. Noteholders Securities Litigation*, 151 F. Supp. 2d 371, 430 (S.D.N.Y. 2001) (holding that in the case of a Rule 144A offering, the offering memorandum, although similar on its face to a prospectus, is not a registration statement within the meaning of the Securities Act and therefore no § 11 liability attaches). Courts have also held that the banks acting as initial purchasers in Rule 144A offerings have no § 11 liability for registered A/B exchanges effected subsequent to the Rule 144A offerings because they are not "directly involved in the preparation of

the registration statement or in the subsequent exchange for registered securities of unregistered securities that the initial purchasers no longer held." *In re Livent, Inc. Noteholders Securities Litigation*, 151 F. Supp. 2d 371, 432 (S.D.N.Y. 2001); *see also American High-Income Trust v. AlliedSignal*, 329 F. Supp. 2d 534, 541–42 (S.D.N.Y. 2004) ("To import underwriter liability for entities that serve as initial purchasers prior to an [A/B exchange] would render Rule 144A ineffective for a very substantial number of securities transactions, and defeat the capital market financing objectives the Rule 144A exemption was designed to achieve." (internal quotations and citations omitted)); *In re Safety-Kleen Corp. Bondholders Litigation*, No. C/A 3:00-1145-17, 2002 WL 32349819 (D.S.C. Mar. 27, 2002) (rejecting plaintiff's contention that both the Rule 144A offering and the subsequent A/B exchange should be seen as one "integrated transaction" subject to § 11 liability, holding that as outlined in the SEC's *amicus curiae* brief to the court, this proposed integration would undercut the policy behind the provision of a 144A exemption). The *Safety-Kleen* court also found no basis for damages in an A/B exchange, because the securities being exchanged are identical. *See In re Safety-Kleen Corp. Bondholders Litigation*, No. C/A 3:00-1145-17, 2002 WL 32349819 (D.S.C. Mar. 27, 2002).

The district court in *In re HealthSouth Securities Litigation* asked the SEC to submit an *amicus curiae* brief addressing whether an underwriter that participates in a Rule 144A offering and a subsequent A/B exchange should continue to enjoy an exemption from the registration process if the transaction is structured as a Rule 144A offering and A/B exchange for the purpose of obtaining the registration exemption and avoiding potential § 11 liability for a Rule 144A offering statement that they knew to be fraudulent or otherwise misleading. *See* Brief of *Amicus Curiae* of the SEC, *In re HealthSouth Securities Litigation*, No. 03-CV-1500 (N.D. Ala. Nov. 28, 2006). The SEC reiterated the position it took in *Safety-Kleen*, rejecting the plaintiffs' "integration" argument. The SEC went on to argue that the applicability of the registration exemption should turn on the substance of the transaction (*i.e.*, whether it meets the qualifications for Rule 144A or "is a sham designed to create the illusion that it should be exempt"). *See* Brief of *Amicus Curiae* of the SEC at 8, *In re HealthSouth Securities Litigation*, No. 03-CV-1500 (N.D. Ala. Nov. 28, 2006). The purported reason that the defendants sought the exemption would not be controlling because there is "nothing inherently nefarious about seeking to avoid Commission review or the possibility of Section 11 or 12(a)(2) liability." *See* Brief of *Amicus Curiae* of the SEC at 9, *In re HealthSouth Securities Litigation*, No. 03-CV-1500 (N.D. Ala. Nov. 28, 2006). The SEC argued that examining such intent would defeat the expectations of capital market participants, lead to uncertain standards and apply an erroneously broad interpretation to Preliminary Note 3 to Rule 144A, which provides that the Rule 144A exemption "is not available with respect to any transaction or series of transactions that, although in technical compliance with this section, is part of a plan or scheme to evade the registration provisions of the Act." Preliminary Note 3 to Rule 144A under the Securities Act. Thus, the SEC argued that Preliminary Note 3 requires courts to look beyond the structure of the transaction to its substance (to see, *i.e.*, whether the QIBs are "mere conduits for unregistered sales to the public") but "there is no precedent for making the exemption question turn solely on offeror motives that are independent of the substance of the transaction."

See also Randall W. Bodner & Peter L. Welsh, *Institutional Buyer Beware: Recent Decisions Reinforce Narrow Range of Remedies Available to QIBs in Rule 144A Offerings*, 36 SEC. REG. & L. REP. (BNA) 38, 1728 (Sept. 27, 2004); § 11.03[1] for discussion of § 11 of the Securities Act.

171 *See Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 562 (1995). Specifically, the Court held that the term "prospectus" as used in § 12(a)(2) means a prospectus used in a public offering by an issuer or a controlling person, not offering documents used in private offerings or secondary market transactions.

172 *See* § 11.04[4].

173 *See* § 11.09[1][a] for a discussion of class action lawsuits.

174 *See* § 7.02[3].

175 In the context of Rule 144A offerings, some courts have rejected a bright-line rule that a Rule 144A offering memorandum is never a "prospectus" soliciting the public purchase of securities. *See AAL High Yield Bond Fund v. Ruttenberg*, No. Civ. A. 00-C-1404-S, 2001 WL 34372980 (N.D. Ala. Sept. 30, 2001) (holding that

an inquiry into the marketing strategies involved, the scope of the offering and the "sophistication of the offerees" is warranted because the line between public offerings and private placements is unclear); *see also Steed Finance LDC v. Nomura Securities International, Inc.*, Fed. Sec. L. Rep. (CCH) ¶91,552 (S.D.N.Y. Sept. 20, 2001) (denying defendant's motion to dismiss the complaint and holding that it is not suitable at the pre-discovery stage to determine whether a private placement with a simultaneous public offering could be considered an integrated offering because factors such as the sophistication of the offerees and the actual information provided to them are crucial in making that determination).

However, several more recent decisions have questioned whether § 12(a)(2) liability can arise out of a Rule 144A offering. *See In re Merrill Lynch Auction Rate Securities Litigation*, Nos. 09 MD 2030 (LAP), 10 Civ. 0124 (LAP), 2012 WL 1994707, at *7 (S.D.N.Y. June 4, 2012) ("Because Rule 144A provides a safe harbor from the registration requirements of the 1933 Act for private resales of restricted securities to QIBs, Plaintiff's Section 12 claim must be dismissed with prejudice as a matter of law."); *In re Refco, Inc. Securities Litigation*, 503 F. Supp. 2d 611, 626 (S.D.N.Y. 2007) (holding that "offerings under Rule 144A are by definition nonpublic, and offering memoranda distributed in connection with such offerings cannot give rise to Section 12(a)(2) liability" (citing *American High-Income Trust v. AlliedSignal*, 329 F. Supp. 2d 534, 543 (S.D.N.Y. 2004)); *AIG Global Securities Lending Corp. v. Banc of America Securities LLC*, 254 F. Supp. 2d 373, 389 (S.D.N.Y. 2003) ("There is no dispute that both the 1998-1 and 1998-2 securities were sold through private offerings, made pursuant to Rule 144A. Consequently, the defendants cannot be held liable under § 12(a)(2) of the Securities Act, and the plaintiffs' claim under § 12(a)(2) is dismissed.").

In the context of Regulation S offerings, *see Sloane Overseas Fund, Ltd. v. Sapiens International Corp.*, 941 F. Supp. 1369 (S.D.N.Y. 1996) (denying defendant's motion to dismiss the complaint and holding that despite the applicability of Regulation S, the "wide distribution of the Offering Circular" made an offering public and hence subject to § 12(a)(2) liability). The *Sapiens* decision, however, may be distinguishable because it was unclear whether the offering in fact was eligible for the Regulation S exemption.

Without initially ruling on the ultimate issue of whether § 12(a)(2) liability can lie in a Rule 144A or Regulation S offering, the court in *In re Enron Corporation Securities, Derivative & ERISA Litigation* noted that plaintiffs seeking to pursue such claims on behalf of a class must, at a minimum, meet certain threshold standing requirements. *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 529 F. Supp. 2d 644, 718–20 (S.D. Tex. 2006). In *Enron*, the court dismissed the plaintiff's § 12(a)(2) claims based on Rule 144A and Regulation S offerings because the lead plaintiff had not produced a party with standing to sue the defendants. The court noted that § 12(a)(2) requires privity between the seller and the investor, which means that a class representative can only represent other investors who bought the same securities from the same seller. In a subsequent decision, however, the court in *In re Enron Corporation Securities, Derivative & ERISA Litigation* held that "[b]ecause no prospectus is required" for offerings pursuant to Rule 144A and Regulation S, "such offerings cannot give rise to Section 12(a)(2) liability." *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 761 F. Supp. 2d 504, 532 (S.D. Tex. 2011).

176 *See In re Enron Corp. Securities, Derivative & ERISA Litigation*, 310 F. Supp. 2d 819 (S.D. Tex. 2004).

177 *See In re Enron Corp. Securities, Derivative & ERISA Litigation*, 310 F. Supp. 2d 819, 864 (S.D. Tex. 2004).

178 *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983) ("The existence of [an] implied remedy [under § 10(b) and Rule 10b-5] is simply beyond peradventure.").

179 Because the Rule 10b-5 standard is defined in terms of active misstatements or omissions, it is generally inapplicable to situations in which no affirmative disclosure statements are made at all (other than in the context of a duty to update challenge, as discussed in § 11.03[5]). In such situations, the investors'remedies are limited more, for example, to pursuing claims against broker-dealers under the "shingle theory." *See* § 11.05[3][b] (discussing liability based on implied representations underlying broker-dealer recommendations). In the context of undocumented offerings, investors generally are required to sign letters explicitly disavowing reliance on any such recommendations. *See* § 10.04. Note, though, that once a statement is made, the speaker may be liable for omitting material information that would have been

necessary to make the statement not misleading.

180 *See Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988); *see also Cooperman v. Individual Inc.*, 171 F.3d 43, 49 (1st Cir. 1999). It is unclear whether the market's failure to react to a disclosure of a misrepresentation is determinative of whether that misrepresentation is material. The Ninth Circuit has held that materiality cannot be determined as a matter of law solely based upon the market's failure to react, and it requires a fact specific inquiry, *see No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920 (9th Cir. 2003), whereas the Third Circuit has held that the failure of a disclosed misrepresentation to affect the stock price permits a court to determine that the misrepresentation is immaterial as a matter of law, *see Merck & Co., Inc. Securities Litigation*, 432 F.3d 261 (3d Cir. 2005); *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000).

181 SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999), Fed. Sec. L. Rep. (CCH) ¶75,563. Although the SEC has been willing to opine on the materiality of misrepresentations, for the purposes of liability under the Exchange Act courts will determine materiality by asking whether a piece of information was important to a reasonable investor, not to the SEC. *United States v. Berger*, 473 F.3d 1080 (9th Cir. 2007) (applying "reasonable investor" materiality standard to § 32(a) action); *United States v. Tarallo*, 380 F.3d 1174, 1182 (9th Cir. 2004) (same under § 10(b)).

182 For a discussion of the history of quantitative versus qualitative approaches to making materiality decisions, *see* John M. Fedders, *Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard*, 48 CATH. U. L. REV. 41 (1998).

183 *See* SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999), Fed. Sec. L. Rep. (CCH) ¶75,563, at 64,219-4.

184 *See* SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999), Fed. Sec. L. Rep. (CCH) ¶75,563, at 64,219-4.

185 Even if a misstatement is immaterial, the inaccurate recording of such an item may, under certain circumstances, constitute a violation of the securities laws. *See* SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999), Fed. Sec. L. Rep. (CCH) ¶75,563, at 64,219-4; *see also* Letter from Donald T. Nicolaisen, Chief Accountant, SEC, to AICPA (Feb. 7, 2005) (providing SEC guidance on lease accounting and disclosures). In the letter the SEC staff states that, with respect to lease accounting, if a registrant has not been in compliance with the standards of the Financial Accounting Standards Board, it must "assess the impact of the resulting errors" and restate its financial statements if the error was material or disclose that the "errors were immaterial to prior periods." Moreover, in a speech on May 3, 2005 before the American Academy of Actuaries, the SEC Chief Accountant stated that the SEC will require companies to restate their financial statements for all structured transactions that are aimed at improving the appearance of earnings and that do not have an otherwise legitimate business purpose, regardless of whether the improper accounting is material or not. *See* Rachel McTague, *SEC's Nicolaisen Says Restatement Required for Transactions Without Business Purpose*, BANKING REPORT (BNA) (May 9, 2005).

186 *Hutchinson v. Deutsche Bank Securities Inc.*, 647 F.3d 479 (2d Cir. 2011).

187 *Matrixx Initiatives v. Siracusano*, 131 S. Ct. 1309 (2011).

188 *Matrixx Initiatives v. Siracusano*, 131 S. Ct. 1309, 1319 (2011) (quoting *Basic v. Levinson*, 485 U.S. 224, 236 (1988)).

189 *Matrixx Initiatives v. Siracusano*, 131 S. Ct. 1309, 1321 (2011) (quoting *Basic v. Levinson*, 485 U.S. 224, 236 (1988)).

190 As a result of the amendments to the Exchange Act enacted by the Litigation Reform Act, plaintiffs now must specify at the outset of litigation precisely which statements are alleged to be misleading and the reasons why they are misleading. *See* § 21D(b)(1)(B) of the Exchange Act.

191 *See* § 11.03[2][b].

192 The Litigation Reform Act requires that plaintiffs plead specific facts "giving rise to a strong inference that the defendant acted with the required state of mind"; conclusory assertions of intent will no longer suffice to survive a motion to dismiss. § 21(D)(b)(2) of the Exchange Act.

193 *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

194 *See, e.g.*, *In re Silicon Graphics Inc. Securities Litigation*, 183 F.3d 970, 977 (9th Cir. 1999) (interpreting the Litigation Reform Act to require "that the evidence must create a strong inference of, at a minimum, ' *deliberate recklessness*'" (emphasis added)); *Citibank, N.A. v. K-H Corp.*, 968 F.2d 1489 (2d Cir. 1992); *Akin v. Q-L Investments, Inc.*, 959 F.2d 521 (5th Cir. 1992); *see also In re Lernout & Hauspie Securities Litigation*, 208 F. Supp. 2d 74 (D. Mass. 2002) (holding that "alleged GAAP violations combined with the magnitude of overstatement of revenue are sufficient to create a strong inference of *scienter* via recklessness").

Although courts generally agree that an allegation of recklessness will suffice under the Litigation Reform Act, the precise definition of the plaintiff's burden remains the subject of a split among the Circuits. The Second Circuit has held that the Litigation Reform Act did not change pre-Act pleading requirements followed in that Circuit. Under those requirements, a plaintiff could satisfy his or her burden by showing that a defendant had either a "motive and opportunity" to commit fraud or "strong circumstantial evidence of conscious misbehavior or recklessness." *See, e.g.*, *Novak v. Kasaks*, 216 F.3d 300 (2d Cir.), *cert. denied*, 531 U.S. 1012 (2000) (discussing plaintiff's burden of pleading *scienter* under the Litigation Reform Act and holding that the Act did not change the pre-existing Second Circuit standard). Although the Third Circuit had agreed with the Second in *In re Advanta Corp. Securities Litigation*, 180 F.3d 525, 534 (3d Cir. 1999), the Third Circuit reversed course in light of the Supreme Court's opinion in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), and held that allegations of motive and opportunity "may no longer serve as an independent route to scienter." *Institutional Investors Group v. Avaya*, 564 F.3d 242, 277 (3d Cir. 2009). This reasoning was based on the Seventh Circuit's approach to the question in *Makor Issues & Rights, Ltd. v. Tellabs*, 437 F.3d 588, 601 (7th Cir. 2006), which the Supreme Court did not address. The Second Circuit has reaffirmed the *Novak* approach even after *Tellabs*. *See, e.g.*, *ECA & Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 198–99 (2d Cir. 2009).

The Ninth and Eleventh Circuits, by contrast, have held that the Litigation Reform Act did not merely codify the Second Circuit's standard, and those courts have held that mere "motive and opportunity" will not satisfy the plaintiff's burden. *In re Silicon Graphics, Inc. Securities Litigation*, 183 F.3d 970 (9th Cir. 1999) (representing the strictest interpretation among the circuits of the Litigation Reform Act's *scienter* pleading standard and concluding that the Act raised the *scienter* pleading standard to now require deliberate recklessness); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1285–86 (11th Cir. 1999); *see also Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1034 n.13 (9th Cir. 2002) (citing cases discussing the standard). *But see No. 84 Employer-Teamster Joint Council Pension Trust Fund v. American West Holding Corp.*, 320 F.3d 920 (9th Cir. 2003) (reinstating a securities fraud case after finding that the plaintiff adequately pled materiality and reliance despite the dissenting judge's comments that the holding improperly lowers plaintiffs' burdens under the Litigation Reform Act). Other courts have followed a case-by-case analysis that may consider a showing of motive and opportunity persuasive, depending on the circumstances of the case. *See, e.g.*, *Ottmann v. Hangar Orthopedic Group, Inc.*, 353 F.3d 338, 343 (4th Cir. 2003); *Florida State Board of Administration v. Green Tree Financial Corp.,* 270 F.3d 645, 659–60 (8th Cir. 2001); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550–52 (6th Cir. 2001) (*en banc*); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195–96 (1st Cir. 1999).

Plaintiffs in some cases have attempted to plead *scienter* by demonstrating that the defendants made erroneous certifications in connection with the preparation of the company's periodic reports containing financial statements. However, the circuit courts that have considered whether such certifications (required by §§ 302 and 906 of the Sarbanes-Oxley Act) are, by themselves, sufficient to plead *scienter* have uniformly concluded that they are only "probative of *scienter* if the person signing the certification was severely reckless in certifying the accuracy of the financial statements." *Garfield v. NDC Health Corp.*, 466 F.3d 1255 (11th Cir. 2006); *see also Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981 (9th Cir. 2009); *In re Ceridian Corporation Securities Litigation*, 542 F.3d 240 (8th Cir. 2008); *Central Laborers' Pension Fund v. Integrated Electrical Services Inc.*, 497 F.3d 546 (5th Cir. 2007).

195 *See Aaron v. SEC*, 446 U.S. 680, 690, 695 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976).

196 *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977), *cert. denied*, 434 U.S. 875

(1977) (quoting *Franke v. Midwestern Oklahoma Development Authority*, 428 F. Supp. 719 (W.D. Okla. 1976)).

197 *See, e.g.*, *In re Daou Systems, Inc.*, 411 F.3d 1006 (9th Cir. 2005) (severe recklessness in which the danger of misleading buyers or sellers is known or should have been known satisfies *scienter)*; *City of Monroe Employees Retirement System v. Bridgestone Corp.*, 399 F.3d 651 (6th Cir. 2005) (strong inference of recklessness by a manufacturer was sufficient to plead *scienter*); *Ferris, Baker Watts, Inc. v. Ernst & Young, LLP*, 395 F.3d 851 (8th Cir. 2005) (*scienter* is satisfied by an extreme departure from standards of ordinary care); *SEC v. U.S. Environmental Inc.,* 114 F. App'x 426 (2d Cir. 2004) (finding that the defendant violated § 10(b) because he knew or should have known of a windfall scheme); *In re Alpharma Inc. Securities Litigation*, 372 F.3d 137 (3d Cir. 2004) (plaintiffs did not sufficiently allege that executives acted recklessly in violation of Rule 10b-5); *Southland Securities Corp. v. INSpire Insurance Solutions, Inc.*, 365 F.3d 353 (5th Cir. 2004) (*scienter* was not established because the plaintiffs could not establish that the company representatives knew or should have known of fraud); *Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338 (4th Cir. 2003) (recklessness suffices in pleading *scienter* in a § 10(b) claim).

198 *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977).

199 *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).

200 Reliance, however, is not a required element of SEC enforcement actions for violations of Rule 10b-5 under the Exchange Act. *See United States v. Vilar,* 729 F.3d 62, 88–89 (2d Cir. 2013) ("the long-established law of our Circuit, and nearly every other circuit, is that, when the government (as opposed to a private plaintiff) brings a civil or criminal action under Section 10(b) and Rule 10b-5, it need only prove, in addition to scienter, materiality … and not actual reliance").

201 *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 685 (7th Cir.), *cert. denied*, 496 U.S. 906 (1990); *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 157 n.1 (2d Cir. 2007).

202 The contrary also is true: When abundant disclaimers and other cautionary language render alleged misstatements or omissions immaterial under the "bespeaks caution" doctrine, *see* § 11.03[1][c], the courts generally consider that reliance on the misstatements or omissions would be unreasonable.

The courts have generally held that it would be inconsistent with § 29(a) of the Exchange Act, which precludes anticipatory waivers of Exchange Act protections such as § 10(b), to find a nonreliance provision to bar, as a matter of law, the assertion of a 10b-5 claim. Instead, a nonreliance provision should be taken into account as one evidentiary factor in determining whether the plaintiff reasonably relied on the accuracy of information provided to it. Whether reliance by the plaintiff was "reasonable" depends on a number of factors, including (i) whether the plaintiff had the opportunity to detect the fraud, (ii) the sophistication of the plaintiff, and (iii) the plaintiff's access to the relevant information. *Staub v. Vaisman and Co., Inc.*, 540 F.2d 591, 598 (3d Cir. 1976). Courts have reached different results in applying this analysis. *Compare AES v. Dow Chemical Co.*, 325 F.3d 175 (3d Cir. 2003) (finding § 29(a) of the Exchange Act precludes contractual waiver of duties imposed by Rule 10b-5; parties had agreed seller had no responsibility for materials furnished in connection with the sale of a business, only with respect to representations and warranties in the purchase and sale agreement and attached exhibits), *and Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966) (stating a party cannot contract to avoid Rule 10b-5 responsibilities because it would defeat the purpose of the Exchange Act and undermine Rule 10b-5 and § 29(a)), *with Harsco v. Segui*, 91 F.3d 337 (2d Cir. 1996) (disclaimer of Rule 10b-5 obligations related to oral representations was effective where the parties explicitly stated in the contract to only be bound by the contract terms because the waiver did not eviscerate the contracting parties' Rule 10b-5 duties). *Cf. Vacold LLC v. Cerami*, 545 F.3d 114, 122 (2d Cir. 2008) (refusing to give effect to contractual language purportedly waiving Rule 10b-5 liability altogether).

203 *Affiliated Ute v. United States*, 406 U.S. 128 (1972).

204 *Affiliated Ute v. United States*, 406 U.S. 128, 153–54 (1972); *see also Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 384 (5th Cir. 2007) ("For us to invoke

the Affiliated Ute presumption of reliance on an omission, a plaintiff must (1) allege a case primarily based on omissions or non-disclosure and (2) demonstrate that the defendant owed him a duty of disclosure."). In *Regents*, the plaintiffs, who were Enron investors, brought Rule 10b-5(a) and (c) claims against certain banks, alleging that the banks had entered into transactions with Enron that allowed Enron to misstate its financial condition. Despite the fact that the plaintiffs made no allegation that the banks owed them a fiduciary duty, the district court held that the *Affiliated Ute* presumption should apply because the bank had a "duty not to engage in a fraudulent 'scheme.'" *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 529 F. Supp. 2d 644, 683 (S.D. Tex. 2006). The Fifth Circuit reversed, holding that the Affiliated Ute presumption does not apply because "where the plaintiffs had no expectation that the banks would provide them with information, there is no reason to expect that the plaintiffs were relying on their candor." *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007).

205 Whether the market for the security was actually "efficient" is a threshold question for a court considering whether to apply this presumption. If the market is not efficient, then the market price cannot be presumed to reflect all material information—including material misinformation—about an issuer and its securities. *See Freeman v. Laventhol & Horwath*, 915 F.2d 193, 198 (6th Cir. 1990). The First Circuit has defined an efficient market as "one in which the market price of the stock *fully reflects all* publicly available information." *In re PolyMedica Corp. Securities Litigation*, 432 F.3d 1 (1st Cir. 2005). In its decision, the First Circuit acknowledged that this can be a difficult determination for a court to make, but further counseled that an efficient market responds "so quickly to new information that ordinary investors cannot make trading profits on the basis of such information." Further, in *Gariety v. Grant Thornton, LLP*, 368 F.3d 356 (4th Cir. 2004), the Fourth Circuit held that a district court cannot certify a class under the "fraud-on-the-market" theory until the court conducts a "rigorous analysis" and finds that the doctrine actually applies. *See also In re American International Group Inc. Securities Litigation*, 265 F.R.D. 157, 181 (S.D.N.Y. 2010) (holding that *In re Initial Public Offering Securities Litigation*, 471 F.3d 24, 42 (2d Cir. 2006), "requires a district court to make a 'definitive assessment'…[regarding the applicability of] the fraud-on-the-market presumption"), *rev'd on other grounds*, 689 F.3d 229 (2d Cir. 2012).

206 The U.S. Supreme Court adopted this "fraud-on-the-market" theory in *Basic, Inc. v. Levinson*, 485 U.S. 224, 243–44 (1988) (selling shareholders satisfied reliance requirement by claim that they sold their shares into a market artificially depressed by Basic's false statements that no merger negotiations were underway).

207 *See, e.g.*, *In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1115–16 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990) (no liability under Rule 10b-5 for the defendant's omission because the nondisclosed information had been made available to the market through widespread press reports, so the market price was not affected by the defendant's omission), *overruled on other grounds by Rubke v. Capitol Bancorp*, 551 F.3d 1156 (9th Cir. 2009).

208 *In re Initial Public Offering Securities Litigation*, 471 F.3d 24 (2d Cir. 2006).

209 *See Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014).

210 *See Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2417 (2014).

211 *See Erica P. John Fund, Inc. v. Halliburton Co.*, 309 F.R.D. 251 (N.D. Tex. 2015).

212 *See IBEW Local 98 Pension Fund v. Best Buy Co.*, 818 F.3d 775 (8th Cir. 2016).

213 *In re Goldman Sachs Group, Inc. Securities Litigation*, 2015 WL 5613150, at *6 (S.D.N.Y. Sept. 24, 2015); *see also Strougo v. Barclays PLC*, 312 F.R.D. 307, 323–27 (S.D.N.Y. 2016) (holding the defendant did not "me[e]t their burden of proving *lack of* price impact" despite identifying evidence that the securities' prices did not "show a statistically significant increase … on any of the alleged misstatement dates" and that "other factors contributed to the price decline").

214 In the research analyst context, in order to adequately plead loss causation the plaintiff must demonstrate that corrective disclosure regarding the falsity of stock recommendations was the cause of the decline in stock value that the plaintiff claims as his loss. *See Lentell v. Merrill Lynch & Co. Inc.*, 396 F.3d 161 (2d Cir. 2005), *cert. denied*, 546 U.S. 935 (2005) (holding that nonclient investors had failed to establish loss causation in suit against investment bank analysts over allegedly misleading research reports because they

did not demonstrate that the loss was both foreseeable and that it was caused by the "materialization of the concealed risk"); *Swack v. Credit Suisse First Boston*, 230 F.R.D. 250 (D. Mass. 2005) (granting motion for class certification for claims alleging violations of §§ 10(b) and 20(a) of the Exchange Act based on allegedly false and misleading research reports that, in the court's analysis, were tied to the artificial inflation of the price of the company's stock); *DeMarco v. Lehman Bros., Inc.*, 222 F.R.D. 243 (S.D.N.Y. 2004) (denying defendant's motion to dismiss and holding that the plaintiff had sufficiently pled loss causation by alleging that the disclosure of negative information led to stock decline); *In re Merrill Lynch Tyco Research Securities Litigation*, No. 03 CV 4080 (MP), 2004 WL 305809 (S.D.N.Y. Feb. 18, 2004) (granting defendant investment banks' motion to dismiss and holding that the plaintiff-investor failed to adequately plead loss causation because no evidence was proffered to show that statements in an analyst report were the foreseeable cause of a decline in the stock price); *In re Salomon Analyst AT&T Litigation*, 350 F. Supp. 2d 455 (S.D.N.Y. 2004) (holding that plaintiff adequately pled loss causation because he demonstrated not only artificial price inflation but also a "causal chain linking their losses to the alleged fraud"), *vacated on other grounds, In re Salomon Analyst Metromedia Litigation*, 544 F.3d 474 (2d Cir. 2008).

215 *See Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933, 938 (9th Cir. 2003), *rev'd*, 544 U.S. 336 (2005) ("[L]oss causation does not require pleading a stock price drop following a corrective disclosure or otherwise. It merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause.").

216 *See Dura Pharmaceuticals, Inc., v. Broudo*, 544 U.S. 336 (2005).

217 *See Dura Pharmaceuticals, Inc., v. Broudo*, 544 U.S. 336 (2005).

218 *See* § 11.05[3][b] for a discussion of the so-called "shingle theory" under which this implied duty to investigate arises.

219 Business diligence generally involves meetings with the issuer's senior management to learn about the business, meeting with the issuer's independent accountants to discuss the issuer's accounts and its internal control systems and review and discussion of the offering document while it is being drafted. In contrast, legal or documentary diligence consists of an all-encompassing review of the corporate and other documents relating to the issuer and its business. Whereas business diligence is designed in large part to facilitate an understanding of the issuer and to determine what disclosure is necessary or appropriate for both marketing and legal reasons, a substantial portion of legal or documentary diligence is undertaken principally for verification purposes, *i.e.*, to establish that there is nothing in the issuer's files to suggest inaccuracies in the offering document or to indicate a need for additional disclosure.

220 *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754–55 (1975). The standing requirement bars three principal groups of potential plaintiffs from suit: (i) potential purchasers, except for those holding a contractual right to purchase the security, (ii) securities holders who allegedly decided not to sell because of some fraud, and (iii) shareholders, creditors and others related to an issuer who suffered loss in the value of their investment due to the alleged fraud. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737–38 (1975).

Additionally, in *Ontario Public Service Employees Union Pension Trust Fund v. Nortel Networks Corp.*, 369 F.3d 27 (2d Cir. 2004), the Second Circuit effectively added a fourth class to the group of potential plaintiffs that lack the requisite standing under Rule 10b-5. The court held that the shareholders of one company, JDS, did not have standing to sue another company, Nortel, under Rule 10b-5 for material misstatements that affected JDS. Pursuant to *Blue Chip Stamps*, shareholders were barred from pursuing a securities fraud claim against a company of which they were not (or had not been) equity holders. However, Nortel and JDS had a strong business relationship and announced in press releases during early 2001 that they would be engaging in a $2.5 billion asset-for-stock sale (JDS's laser business for Nortel stock). Plaintiffs, who were holders of JDS stock, alleged that Nortel knowingly made materially misleading statements in the press releases that led to a significant loss in revenue for JDS. Nonetheless, the court held that the implied private right of action under Rule 10b-5 is not an unfettered right, but has limitations that are aimed at protecting companies from abusive litigation. The plaintiffs argued that the phrase "in connection with the purchase or sale of *any* security" includes securities of companies affected by the offending company's misrepresentation. The court rejected this expansive construction of Rule 10b-5, reasoning instead that "any security" refers to all types of securities that are owned by (in this case) equity holders and not "*any affected company's* securities."

221 Courts take different approaches to the question whether § 20(a) of the Exchange Act requires a person to exercise, or simply possess, the power to control. *Compare Harrison v. Dean Witter Reynolds, Inc.*, 79 F.3d 609, 614 (7th Cir. 1996) (using a two-part test according to which the plaintiff "must establish, first, that the defendant … actually participated in (*i.e.*, exercised control over) the operations of the corporation in general; then he or she must prove that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he or she need not prove that this later power was exercised") *with Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1065 (9th Cir. 2000) ("[I]n order to prove [as opposed to simply make out] a *prima facie* case under § 20(a), a plaintiff must prove … that the defendant exercised actual power or control over the primary violator…."). The Second Circuit's standard, which simply requires the plaintiff to show "control of the primary violator by the plaintiff," *Boguslavsky v. Kaplan*, 159 F.3d 715, 720 (2d Cir. 1990), has been interpreted by one district court not to require proof that control was exercised. *See Dietrich v. Bauer*, 126 F. Supp. 2d 759 (S.D.N.Y. 2001).

In addition, all of the circuit courts to consider directly the issue have held that the group pleading doctrine has not survived the enactment of the Litigation Reform Act. Under the court-created doctrine, group published information, such as annual reports and press releases, are attributable to the officers and directors with day-to-day control in the company, regardless of their participation in the actual documents. *Winer Family Trust v. Queen*, 503 F.3d 319 (3d Cir. 2007); *Financial Acquisition Partners, L.P. v. Blackwell*, 440 F.3d 278, 287 (5th Cir. 2006); *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602–03 (7th Cir. 2006), *vacated on other grounds*, *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308 (2007). These courts have held that the presumption created by the group pleading doctrine is inconsistent with the heightened pleading standards of the Litigation Reform Act. Despite these rulings, the group pleading doctrine continues to survive in some districts. *See Loreley Financing (Jersey) No. 3 Ltd. v. Wells Fargo Securities, LLC*, 797 F.3d 160, 172 n.7 (2d Cir. 2015) (recognizing that "numerous district courts in our Circuit" have concluded that the doctrine remains viable after the Reform Act, but declining to resolve the issue).

222 § 20(a) of the Exchange Act. Courts are split over whether the plaintiff has the burden of proving culpable participation or whether the defendant has the burden of proving good faith. *Compare Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1065 (9th Cir. 2000) (the plaintiff does not have the burden of proof; the defendant may assert a good faith defense) *with SEC v. First Jersey Securities, Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996) (the plaintiff must "show that the controlling person was in some meaningful sense a culpable participant in the fraud perpetrated by the controlled person," and the burden only shifts to the defendant once the plaintiff has made out a *prima facie* case (internal quotation marks and citation omitted)).

223 *See In re Adelphia Communications Corp. Securities & Derivative Litigation*, 398 F. Supp. 2d 244, 261–62 (S.D.N.Y. 2005) (citing *In re Scholastic Corp. Securities Litigation*, 252 F.3d 63, 72 (2d Cir. 2001)).

224 The SEC's authority to pursue aiders and abettors was codified explicitly in § 104 of the Litigation Reform Act, which amended § 20 of the Exchange Act to provide that the SEC could bring an action against "any person that knowingly provides substantial assistance" to a primary violator of the securities laws. In response to several decisions holding that secondary actors could only be liable for aiding and abetting securities fraud to the extent that they had actual knowledge of the fraud, the Dodd-Frank Act further amended § 20 of the Exchange Act to cover persons who either "knowingly or recklessly" provide substantial assistance to primary violators of the securities laws. *See* § 929O of the Dodd-Frank Act.

225 *See* Stephen M. Cutler, then-Director of SEC Enforcement, The Themes of Sarbanes-Oxley as Reflected in the SEC's Enforcement Program (Sept. 20, 2004); *SEC v. Steckler*, SEC Litigation Release No. 19385 (Sept. 21, 2005). In one demonstration of the Division of Enforcement's increased use of aiding and abetting charges against "enablers," the SEC has filed aiding and abetting actions against 30 individuals

who allegedly assisted U.S. Foodservice, Inc. (a subsidiary of Royal Ahold) in a scheme to overstate revenues by as much as $700 million. The complaints against these individuals, who were vendors who supplied U.S. Foodservice, allege that they assisted the fraudulent scheme by submitting false confirmation letters to the company's auditors. *See SEC Charges Seven Individuals with Aiding and Abetting Financial Fraud at Royal Ahold's U.S. Foodservice Subsidiary for Signing and Returning False Audit Confirmations*, SEC Litigation Release No. 19454 (Nov. 2, 2005); *Nine Individuals Charged by the Securities and Exchange Commission with Aiding and Abetting Financial Fraud at Royal Ahold's U.S. Foodservice Subsidiary for Signing and Returning False Audit Confirmations*, SEC Litigation Release No. 19034 (Jan. 13, 2005). As part of a $22 million settlement agreement, the SEC found that KPMG LLP caused and willfully aided and abetted Xerox Corp.'s fraud, reporting and recordkeeping violations. *SEC v. KPMG LLP*, SEC Litigation Release No. 19191 (Apr. 19, 2005). Time Warner Inc. agreed to a $300 million penalty to settle charges by the SEC of fraud and aiding and abetting fraud by others in connection with its use of fraudulent "round-trip" transactions that boosted its online advertising revenue. *SEC v. Time Warner Inc.*, SEC Litigation Release No. 19147 (Mar. 21, 2005). J.P. Morgan Chase & Co. settled charges by the SEC for $135 million that it aided and abetted Enron's manipulation of its reported financial results through a series of complex structured financing transactions called "prepays." *SEC v. J.P. Morgan Chase & Co.*, SEC Litigation Release No. 18252 (July 28, 2003). Citigroup Inc. also paid $120 million to settle similar charges brought by the SEC that it aided and abetted violations by Enron and Dynegy Inc. *In re Citigroup*, SEC Admin. Proc. 3-11192 (July 28, 2003).

226 *See Central Bank v. First Interstate Bank*, 511 U.S. 164, 178, 190–92 (1994).

227 *See, e.g.*, *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1576–77 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991) (pre- *Central Bank v. First Interstate Bank* case holding that the control person provision of the Exchange Act was "intended to supplement, not to supplant, the common law theory of '*respondeat superior*' as a basis for vicarious liability in securities cases").

228 *Compare In re Parmalat Securities Litigation*, 594 F. Supp. 2d 444, 450 (S.D.N.Y. 2009); *Seolas v. Bilzerian*, 951 F. Supp. 978 (D. Utah 1997), and *Pollack v. Laidlaw Holdings*, *Inc.*, Fed. Sec. L. Rep. (CCH) ¶98,741 (S.D.N.Y. May 3, 1995) (holding that *respondeat superior* theory survives *Central Bank v. First Interstate Bank*), *with In re Prudential Insurance Co.*, 975 F. Supp. 584 (D.N.J. 1996), *ESI Montgomery County, Inc. v. Montenay International Corp.*, Fed. Sec. L. Rep. (CCH) ¶99,345 (S.D.N.Y. Jan. 23, 1996), and *Pitten v. Jacobs*, 903 F. Supp. 937, 950 (D.S.C. 1995) (holding that *Central Bank v. First Interstate Bank's* elimination of private aiding and abetting suits also eliminated private actions for *respondeat superior*).

Courts have also reached differing conclusions on the related question of whether the fraudulent intent of an employee acting for his own benefit can be attributed to his employer. Some courts have applied the common law adverse interest exception to prevent imputation of *scienter* under those circumstances. *See, e.g.*, *Kaplan v. Utilicorp United, Inc.*, 9 F.3d 405, 407 (5th Cir. 1993) ("the knowledge and actions of employees acting adversely to the corporate employer cannot be imputed to the corporation"). The Ninth Circuit, however, has cast doubt on whether the adverse interest exception is viable in securities litigation, by concluding that an employer cannot benefit from the exception when facing claims filed by an innocent third-party investor. *In re ChinaCast Education Corporation Securities Litigation*, 809 F.3d 471 (9th Cir. 2015).

229 *See In re Alstom SA Securities Litigation*, 454 F. Supp. 2d 187, 213–16 (S.D.N.Y. 2006). In *Alstom*, plaintiffs brought securities law claims against Alstom S.A. and several of its subsidiaries based on an alleged accounting fraud and related misleading public statements. The plaintiffs argued that the corporate parent should be liable for the acts of its subsidiaries under a *respondeat superior* or agency theory, but the court decided that it did not need to reach these arguments. Instead, the court found that the plaintiffs had pled facts to support a veil-piercing theory of liability based on the allegations of dominion and control exercised by the parent over its subsidiaries. *See also In re Parmalat Securities Litigation*, 375 F. Supp. 2d 278 (S.D.N.Y. 2005) (allowing plaintiffs to proceed under agency theory of liability).

230 *Stoneridge Investment v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

231 The provisions of Rule 10b-5(a) and (c) state, in relevant part, that it is unlawful for "any person, directly or indirectly …(a) to *employ any device, scheme, or artifice to defraud*… or (c) to *engage in any act, practice or course of business which would operate as a fraud or deceit* upon any person, in connection with the purchase or sale of any security." Rule 10b-5 under the Exchange Act (emphasis added); *see, e.g.*, *In re Enron Securities, Derivatives & ERISA Litigation*, 439 F. Supp. 2d 692 (S.D. Tex. 2006) (dismissing claims brought under Rule 10b-5(a) and (c)); *In re Parmalat Securities Litigation*, 376 F. Supp. 2d 472 (S.D.N.Y. 2005) (rejecting defendants' argument that Rule 10b-5(a) and (c) can only apply to "manipulative" acts and holding that these subsections only require the plaintiff to plead that a defendant's specific deceptive act was part of a scheme that had an effect on the plaintiff-investors); *In re AOL Time Warner, Inc. Securities & ERISA Litigation*, 381 F. Supp. 2d 192 (S.D.N.Y. 2004) (allowing plaintiff to proceed under Rule 10b-5(a) and (c)); *Cooper v. Pickett*, 137 F.3d 616 (9th Cir. 1997) (reversing district court's dismissal of complaint, holding that *Central Bank* does not preclude secondary actor liability for participation in a fraudulent scheme); *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398 (N.D. Cal. 1995) (refusing to dismiss suit pursuant to Rule 10b-5(c) against accountants for their involvement in misrepresentations made by issuer).

232 The early trend, in which courts were reluctant to grant summary judgment in favor of defendants facing "scheme" allegations, is typified by *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 235 F. Supp. 2d 549, 581–688 (S.D. Tex. 2002) ("*Enron I*"). The court refused to dismiss claims against lawyers, accountants and financial institutions and adopted the position taken by the SEC in its *Amicus Curiae* brief that secondary actors can be held liable as primary violators if they create a misrepresentation, for example, by writing documents or portions of documents containing misrepresentations that will be given to investors. The court held that *Central Bank's* preclusion of aider and abettor liability did not shield all secondary actors from liability, particularly given the broader provisions of Rule 10b-5(a) and (c). *See also Pioneer Insurance Co. v. Chase Securities*, 2002 U.S. Dist. LEXIS 7562 (N.D. Okla. Mar. 28, 2002) (adopting report and recommendation of the magistrate judge that a law firm could be a primary violator if its negative assurance letters, which were addressed to investors, contained misrepresentations); *In re Lernout & Hauspie Securities Litigation*, 208 F. Supp. 2d 74 (D. Mass. 2002) (holding that Belgian auditor's drafting, signing and publication of clean audit report included in corporate filings with the SEC was sufficient to trigger primary liability when those filings were "rife with false and misleading information"); *see also In re Parmalat Securities Litigation*, 376 F. Supp. 2d 472 (S.D.N.Y. 2005) (denying a motion to dismiss 10b-5(a) and (c) claims).

More recent decisions have suggested that these earlier decisions improperly exposed secondary actors to liability for conduct that amounted to no more than aiding and abetting. In fact, in one of these more recent decisions, the same district court that denied a defendant's motion for summary judgment in *Enron I* noted that the case law and legal standards had evolved in the intervening years. *See In re Enron Securities, Derivative & ERISA Litigation*, 439 F. Supp. 2d 692 (S.D. Tex. 2006). Here, the court granted defendant's motion and dismissed Rule 10b-5(a) and (c) claims against a secondary actor (here, a bank that had been a counterparty to various transactions that Enron had used to misstate its financial condition). In fact, the court explicitly repudiated its ruling in *Enron I* insofar as that ruling would permit securities fraud claims to be brought against those who only aid and abet the fraud. The court distinguished between secondary actors who are counterparties to economically substantive transactions with primary violators (even if the transactions may become "deceptive" because of the way the primary violator characterizes or discloses them) and parties who engage in inherently deceptive conduct.

233 *Stoneridge Investment v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 161 (2008).

234 *Stoneridge Investment v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 161 (2008).

235 *See In re DVI, Inc. Securities Litigation*, 639 F.3d 623, 648–49 (3d Cir. 2011) (holding, in a "decision … guided by *Stoneridge*," "that a plaintiff cannot invoke the fraud-on-the-market presumption of reliance in a private action under Rule 10b-5(a) and (c) unless the deceptive conduct has been publicly disclosed and attributed to the actor"); *Affco Investments 2001, L.L.C. v. Proskauer Rose, L.L.P.*, 625 F.3d 185, 193–195 (5th Cir. 2010) (concluding, after analyzing *Stoneridge*, that "explicit attribution is required to show reliance under section 10(b)"); *Pacific Investment Management Co. LLC v. Mayer Brown LLP*, 603 F.3d 144, 152–

58 (2d Cir. 2010) (reaffirming prior "attribution" standard as "consistent with *Stoneridge*").

236 *Janus Capital Group, Inc. v. First Derivative Trader*, 131 S. Ct. 2296 (2011).

237 *Janus Capital Group, Inc. v. First Derivative Trader*, 131 S. Ct. 2296, 2302 (2011).

238 *Compare In re Fannie Mae 2008 Securities Litigation*, 891 F. Supp. 2d 458, 484 (S.D.N.Y. 2012), *aff'd*, 525 F. App'x 16 (2d Cir. 2013) (holding underwriter did not "make" alleged misstatements in the offering materials under Janus because "[a]ny role [the underwriter] served in the drafting process, or in preparing and publishing the offering materials, is insufficient to impose primary liability under Janus" and "it is absolutely clear that [the issuer], not [the underwriter], had ultimate authority over statements made in its SEC filings incorporated by reference in the offering materials") with *In re Puda Coal Securities Inc., Litigation*, 30 F. Supp. 3d 261, 267 (S.D.N.Y. 2014) (holding underwriters could be liable under Janus based on allegations they "actively participated in creating" the prospectus and "draft[ed] it jointly with [the issuer's] management," had a formal agreement with the issuer requiring the prospectus to be "in a form approved by" the underwriter, and "communicated their involvement with the prospectus to the investing public" by prominently displaying their names on the prospectus, soliciting investors for the offering and distributing the prospectus).

239 *Compare Glickenhaus & Co. v. Household International Inc.*, 787 F.3d 408, 425 (7th Cir. 2015) ("[n]othing in Janus limits its holding to legally independent third parties" and "[t]he Court's interpretation [in Janus] applies generally, not just to corporate outsiders") with *City of Pontiac General Employees' Retirement System v. Lockheed Martin Corp.*, 875 F. Supp. 2d 359, 374 (S.D.N.Y. 2012) (stating *Janus* "addressed only whether third parties can be held liable for statements made by their clients … and has no bearing on how corporate officers who work together in the same entity can be held jointly responsible on a theory of primary liability").

240 The plaintiff also may seek to rescind the contract or defend against an action by the other party for the contract's enforcement. *See* § 29(b) of the Exchange Act (contracts made in violation of the Exchange Act are voidable under certain conditions); *Aimis Art Corp. v. Northern Trust Securities, Inc.*, 641 F. Supp. 2d 314, 319 (S.D.N.Y. 2009) (noting that "appropriate grounds for damages in § 10(b) actions are not limitless, and courts have required plaintiffs to choose between rescinding a transaction and being paid restitution on the one hand and holding the defrauder to the bargain and recovering out-of-pocket losses resulting from the fraudulent transaction on the other hand" (citation omitted)); *Regional Properties, Inc. v. Financial & Real Estate Consulting Co.*, 678 F.2d 552, 558 (5th Cir. 1982).

241 In *Acticon AG v. China North East Petroleum Holdings Ltd.*, 692 F.3d 34 (2d Cir. 2012), the Second Circuit held that a plaintiff's out-of-pocket losses under Rule 10b-5 are not eliminated where the share price rebounds to the plaintiff's purchase price after the final alleged corrective disclosure. The court indicated, however, that any price recovery that represented the market's reactions to the disclosure of the alleged fraud, rather than an unrelated gain, could offset the plaintiff's recoverable loss.

242 *See, e.g.*, *Ohio Public Employees Retirement System v. Federal Home Loan Mortgage Corp.*, 830 F.3d 376 (6th Cir. 2016) (collecting cases). In the securities litigation against BP arising out of the 2010 Deepwater Horizon oil spill, however, the Fifth Circuit held that such materialization of the risk damages could only be awarded to a plaintiff who would not have purchased the relevant security had it known the true nature of the allegedly concealed risk. *See Ludlow v. BP, P.L.C.*, 800 F.3d 674, 690 (5th Cir. 2015). The plaintiffs in that case alleged that BP misstated the efficacy of its safety procedures, which created an impression that the risk of a spill was lower than it actually was, and that this concealed risk materialized when the later spill occurred. The plaintiffs sought damages based on the price declines caused by the spill itself, notwithstanding that the inflation on the dates that they purchased securities only reflected the increased risk of a spill and not the full materialization of that risk. Without addressing the viability of the materialization of the risk measure of damages in general, the Fifth Circuit reasoned that full materialization of the risk damages "would prove a windfall" for an investor who "might have purchased the stock even assuming the true risk," since such an investor would have suffered the same eventual loss had they purchased at a lower price. Instead, the Fifth Circuit held that the appropriate damages measure for such

an investor is "based on the inflated price she paid." The Fifth Circuit thus limited full materialization of the risk damages to investors who would not have purchased the security at all had they known the true risk, in order to compensate them for the materialization of a risk that they otherwise would not have taken.

243 For example, one court has stated that damages based on the gross economic loss in the value of the plaintiff's stock portfolio over the period in which the fraud was perpetrated should be reduced by the average percentage decline in the Standard & Poor's Index or some other well-recognized index, since the defendant should have "no general responsibility for the general decline in economic conditions." *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 49 n.22 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978). Another court has approved the jury's valuation of the stock absent the fraud (the issuer's overvaluation of inventory and sales) based on expert testimony, although the "actual response of the market" following the disclosure must be taken into account. *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566, 577–78 (2d Cir.), *cert. denied*, 459 U.S. 838 (1982). The Seventh Circuit, however, has held that a plaintiff can recover all of the company-specific securities price declines over an extended period of time under a so-called "leakage theory" if its expert "testifies that no firm-specific, nonfraud related information contributed to the decline in stock price during the relevant time period and explains in nonconclusory terms the basis for this opinion." *Glickenhaus & Co. v. Household International, Inc.*, 787 F.3d 408, 422 (7th Cir. 2015).

244 § 21D(e)(1) of the Exchange Act. This provision only limits damages; it does not provide an alternate formulation for calculating damages.

245 *See* § 21D(e) of the Exchange Act. *See generally* Lewis D. Lowenfals & Alan R. Bromberg, *Compensatory Damages in Rule 10b-5 Actions: Pragmatic Justice or Chaos?*, 30 SETON HALL L. REV. 1083, 1113 (2000) ("This allowance for a 'bounce back' in price should yield a more accurate and fairer estimate of the stock's true value and therefore a more accurate measure of the deviation from this true value and the resulting damages caused by the fraud.").

246 *See* § 21D(f)(2) of the Exchange Act. Defendants who settle an action under the Exchange Act are insulated from contribution claims by nonsettling defendants, and nonsettling defendants receive a credit against any adverse judgment at trial for the greater of the amount of any settlements or the percentage of responsibility of the settling defendants. The system of proportionate liability should reduce the exposure of defendants, such as accounting firms, that frequently play relatively insignificant roles in the issuer's misdeeds, but historically risked verdicts in the full amount of the plaintiff's recoverable damages, subject only to the right to seek contribution.

247 *See* § 21(d)(1) and (2) of the Exchange Act.

248 *See* § 21(d)(3) of the Exchange Act; SEC Release No. 33-10104 (June 27, 2016). The SEC, however, has imposed substantial civil penalties on companies and individuals for fraud violations. *See, e.g.*, *SEC v. WorldCom Inc.*, SEC Litigation Release No. 18219 (July 7, 2003) (fining WorldCom Inc. $2.25 billion); Press Release, SEC, SEC and U.S. Attorney Settle Massive Financial Fraud Case Against Adelphia and Rigas Family for $715 Million (Apr. 25, 2005); *SEC v. Time Warner Inc.*, SEC Litigation Release No. 19147 (Mar. 21, 2005) (fining Time Warner Inc. $300 million).

249 *See* § 32(a) of the Exchange Act.

250 *See SEC v. Rind*, 991 F.2d 1486, 1491–92 (9th Cir.), *cert. denied*, 510 U.S. 963 (1993) (reasoning that SEC actions serve the public purpose of deterring wrongdoing, rather than the private purpose of compensating individuals for their losses). However, the SEC is still subject to a five-year statute of limitations for the enforcement of "any civil fine, penalty or forfeiture, pecuniary or otherwise." *See* 28 U.S.C. § 2462; *see also* § 11.09[2][d].

251 28 U.S.C. § 1658(b). Prior to the adoption of the Sarbanes-Oxley Act, private actions were required to be commenced within one year of the discovery of the violation but no later than three years after its occurrence. *See Lampf, Pleva, Lifkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991).

252 *Merck & Co., Inc. v. Reynolds*, 130 S. Ct. 1784 (2010).

253 *Merck & Co., Inc. v. Reynolds*, 130 S. Ct. 1784, 1798 (2010). Courts have reached different conclusions concerning whether *Merck's* rejection of an "inquiry notice" approach applies equally to the separate statute

of limitations applicable to claims under §§ 11 and 12(a)(2) of the Securities Act. *Compare Pension Trust Fund for Operating Engineers v. Mortgage Asset Securitization Transactions, Inc.*, 730 F.3d 263 (3d Cir. 2013) (applying *Merck* to claims under the Securities Act) *with Lighthouse Financial Group v. Royal Bank of Scotland Group*, PLC, 902 F. Supp. 2d 329 (S.D.N.Y. 2012) (declining to apply *Merck* to claims under the Securities Act).

254 § 21D(b)(2) of the Exchange Act.

255 *Merck & Co., Inc. v. Reynolds*, 130 S. Ct. 1784, 1796 (2010) (citation omitted).

256 *See City of Pontiac General Employees' Retirement System v. MBIA, Inc.*, 637 F.3d 169 (2d Cir. 2011).

257 Section 17(a) of the Exchange Act provides that it is "unlawful for any person in the offer or sale of any securities" to: (i) "employ any device, scheme, or artifice to defraud," (ii) "obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading," or (iii) "engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

258 *See United States v. Naftalin*, 441 U.S. 768, 778 (1979).

259 The section differs from Rule 10b-5 in two potentially significant respects. First, it applies only to the "offer or sale" of a security, rather than the purchase or sale. Second, its reference to "offers" as well as "sales" might be read to reach "offerees" in addition to actual purchasers, as required by Rule 10b-5.

260 The sole exception is an action under § 17(a)(1), prohibiting the use of any device, scheme or artifice to defraud, which does require proof of *scienter. See Aaron v. SEC*, 446 U.S. 680, 695–96 (1980).

261 *See, e.g.*, *Maldonado v. Dominguez*, 137 F.3d 1, 7 (1st Cir. 1998); *Finkel v. Stratton Corp.*, 962 F.2d 169, 175 (2d Cir. 1992); *Sears v. Likens*, 912 F.2d 889, 893 (7th Cir. 1990); *Newcome v. Esrey*, 862 F.2d 1099, 1107 (4th Cir. 1988); *In re Washington Public Power Supply Systems Securities Litigation*, 823 F.2d 1349, 1358 (9th Cir. 1987); *Brannan v. Eisenstein*, 804 F.2d 1041, 1043 n.1 (8th Cir. 1986); *Landry v. All American Assurance Co.*, 688 F.2d 381, 391 (5th Cir. 1982). The only exception is the Sixth Circuit, which has found § 17(a) to imply a private right of action for purchasers. *See Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 492 (6th Cir. 1990). The Supreme Court has never addressed the issue. *See Aaron v. SEC*, 446 U.S. 680, 689 (1980).

262 Among other things, the SEC has the authority to seek to enjoin any person who violated the antifraud provisions of § 17(a)(1) of the Securities Act from acting as an officer or director of a public company. *See* § 20(e) of the Securities Act.

263 *See* §§ 11.02[3] and 11.03[6]; *see also* § 101(2) of the Uniform Securities Act (proscribing fraudulent acts and incomplete or misleading disclosure in connection with the offer, sale or purchase of "any security, directly or indirectly"). Although some courts had interpreted New York's "blue sky" law, which does not provide a private right of action, as preempting all private common law claims alleging non-intentional misstatements or omissions in the sale of securities, *see, e.g.*, *Castellano v. Young & Rubicam*, 257 F.3d 171 (2d Cir. 2001), the New York Court of Appeals has since held that such claims are not preempted. *See Assured Guaranty (UK) Limited v. J.P. Morgan Investment Management Inc.*, 18 N.Y.3d 341 (2011).

264 Pursuant to SLUSA, most securities fraud class actions can no longer be based on state law. *See* § 11.09[1][a].

U.S. Regulation of the International Securities and Derivatives Markets, § 11.05, LIABILITIES CONNECTED WITH SECONDARY MARKET TRANSACTIONS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 11.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

The U.S. securities laws closely regulate a number of different aspects of the secondary market for securities and provide a range of civil, administrative and criminal penalties for market participants who violate federal law. In addition to proscribing false or misleading disclosure in connection with secondary market transactions, as discussed below in § 11.05[1], the securities laws also prohibit trading in securities, in breach of certain fiduciary or similar duties, while knowingly in possession of material nonpublic information ("insider trading"), as well as other types of market conduct aimed at or with the effect of manipulating the price of securities on or off of a national securities exchange. These issues are examined in § 11.05[2] and [3], respectively. Finally, § 11.05[3] also addresses special standards of conduct that have been carved out by the SEC and the courts for broker-dealers and investment advisers as a means of enhancing customer protection under the securities laws.

[1] Disclosure Violations

Liabilities can arise in connection with disclosure in secondary market transactions in a number of situations. First, broker-dealers and other trading participants may be liable for material misstatements or omissions in connection with everyday resales of securities, such as oral misrepresentations about the quality of a security or events likely to affect its value. Second, broker-dealers may be liable for misstatements about securities made prior to a trade, for

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example in research reports circulated to customers. Finally, issuers may be liable for material misstatements or omissions in company filings or press releases.

The statutory provisions from which these liabilities may arise, § 17(a) of the Securities Act and §§ 10(b) and 18 of the Exchange Act, are discussed below.

[a] Securities Act § 17(a)

First, § 17(a) of the Securities Act applies to secondary market offers and sales as well as primary offerings (public or private). As discussed in § 11.04[3], § 17(a) bars conduct by the seller intended to defraud, or with the effect of defrauding, others in the offer or sale of any securities, including but not limited to the making of false statements and material omissions. Disclosure violations under § 17(a) may generally be proved without demonstrating the defendant's *scienter*, but almost all courts have held that enforcement actions are reserved to the SEC and that there is no private right of action under § 17(a) of the Securities Act. [265]

[b] Exchange Act § 10(b) and Rule 10b-5

Liability for deficient disclosure in secondary transactions may also attach by virtue of § 10(b) of the Exchange Act and Rule 10b-5 thereunder, and the vast majority of litigation involving disclosure issues in the secondary markets has been brought under this Rule. [266] This catch-all antifraud provision has been widely used by private parties and the SEC alike as a remedy for misstatements and material omissions, both written and oral, in connection with purchases and sales of securities. [267] As discussed in § 11.04[2][b], there is no privity

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requirement in Rule 10b-5 actions. Thus, a plaintiff is not limited to suing the purchaser or seller with whom he or she dealt. The plaintiff must demonstrate, among other things, that the defendant acted intentionally or recklessly and the plaintiff relied to its detriment on the defendant's actions, although the latter showing has been eased significantly by certain presumptions (such as the "fraud-on-the-market-theory," discussed above) adopted by the courts. A more detailed discussion of Rule 10b-5, including the elements of a claim, the parties who may be liable and the remedies available, is included in § 11.04[2].

[c] Exchange Act § 18

In addition to the implied right of action under Rule 10b-5 for defective disclosure in almost any form, the Exchange Act includes a narrower, but express, right of action for false or misleading statements or omissions [268] in certain applications, reports or documents filed pursuant to the Exchange Act or its associated rules, whether filed with the SEC or with a national securities exchange. [269] As explained in § 4.02, the Exchange Act compels initial

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registration and periodic reporting obligations for many companies, domestic and foreign, [270] including such common filings as annual reports on Form 10-K for U.S. issuers and annual reports on Form 20-F for non-U.S. issuers. The Exchange Act also imposes reporting obligations when a party's voting equity ownership of a public company exceeds 5%. [271]

Under § 18 of the Exchange Act, any person who buys or sells securities in reliance on misstatements or omissions in filed documents may bring a claim against any person responsible for those statements; there is no requirement of privity between plaintiff and defendant. Recovery under § 18 is difficult, however, because although the plaintiff need not prove the defendant's *scienter* to establish a claim (as it must under Rule 10b-5), it must demonstrate that it actually relied on the misstatement or omission. The "fraud-on-the-market" presumption of reliance in Rule 10b-5 litigation, discussed in § 11.04[2][a], has not been extended to claims under § 18. [272] The plaintiff must also show that the price at which it purchased or sold was affected by the defendant's misstatement or omission, and that its loss was caused by such misstatement or omission. Finally, the plaintiff must establish that it did not know of the misstatement or omission at the time it purchased or sold the securities. [273]

The claim is made even more difficult by the availability to the defendant of an affirmative defense against liability, if it can show it acted in good faith and without knowledge of the material misstatement or omission. [274] To rebut this

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defense, the plaintiff in effect may be required to make at least some showing that the defendant acted with *scienter*.

Because of the difficulties in establishing a § 18 claim, the provision is rarely used. [275] Rather, plaintiffs generally opt to pursue their remedy under Rule 10b-5, which remains available to them for disclosure deficiencies in filed documents despite the existence of an express cause of action under § 18. [276] The growth of litigation under Rule 10b-5 and the paucity of cases under § 18 illustrate how U.S. courts have implied statutory rights if express rights prove ineffective, especially in the context of claims for fraud.

[2] Insider Trading

The Exchange Act provides tough sanctions for those guilty of "insider trading," the purchase or sale of securities by certain persons while knowingly in possession of material nonpublic information relating to those securities. Like many other provisions of the U.S. securities laws, the prohibition against insider trading extends to non-U.S. persons trading in U.S. markets, even in the securities of non-U.S. issuers. [277] The SEC and the courts also have made clear that liability extends beyond those who directly trade while possessing material nonpublic information to those who disclose such information to others ("tippers") and in some instances to the recipients of their disclosure ("tippees"). These three categories of potential offenders are discussed in § 11.05[2][a]. Two enforcement provisions, which authorize civil actions by contemporaneous traders and stiff penalties in actions by the SEC, are examined in § 11.05[2][b] and [c], respectively.

[a] Exchange Act § 10(b) and Rule 10b-5

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[i] *Liability of Traders*

A party who trades on material nonpublic information may be liable under certain circumstances under § 10(b) of the Exchange Act and Rule 10b-5 thereunder, which proscribe fraudulent and manipulative conduct in general. [278] In 2000, Congress amended § 10(b) to clarify that insider-trading rules cover trading not just in garden-variety securities, but also in "securities-based swap agreements…." [279]

An unsettled issue in insider trading law has been what, if any, causal connection must be shown between the trader's possession of inside information and

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his or her trading. The SEC has argued that trading while in "knowing possession" of the information creates liability. The contrary view is that for liability to attach a trader must be shown to have "used" the information for trading.

The Supreme Court has variously described an insider's violations as trading "on" or "on the basis of" material nonpublic information, but has not addressed the use/possession distinction. In recent years, three courts of appeals have addressed the issue, each reaching different results. In *United States v. Teicher*, [280] the Second Circuit suggested that "knowing possession" is sufficient to trigger insider trading liability. In *SEC v. Adler*, [281] the Eleventh Circuit held that in civil enforcement proceedings, the government may rely on a "strong inference" that one who traded while in possession of material nonpublic information actually used such information, and the trader can then attempt to rebut that inference by adducing evidence that the information was not used. Finally, in *United States v. Smith*, [282] the Ninth Circuit held that, in a criminal case, the government must prove that the suspected insider trader actually used material nonpublic information in deciding whether to buy or sell.

In 2000, the SEC adopted Rule 10b5-1, which is designed to address this unsettled issue. [283] Adopting an approach similar to the *Adler* decision, the Rule states the general principle that insider trading liability arises when a person trades while "aware" of material nonpublic information, but also provides two affirmative defenses to liability in circumstances where it is clear that a trade was not made "on the basis of" the material nonpublic information. The first affirmative defense applies if:

- a person had, before becoming aware of material nonpublic information, (i) entered into a binding contract to purchase or sell, (ii) provided instructions to another person to purchase or sell for the instructing person or (iii) adopted a written plan for trading;
- the contract, instruction or plan (i) specified the amount of, price of, and date on which the securities were to be purchased or sold, (ii) provided a written formula or computer program for determining the amount of, price of and date on which the securities were to be purchased or sold or (iii) did not permit the person to exercise any subsequent influence over how, when or whether to effect purchases or sales, and no person exercising such influence was aware of the material nonpublic information when doing so; and

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- the purchase or sale occurred pursuant to the contract, instruction or plan. [284]

This defense would only be available if the contract, instruction or plan was entered into in good faith and not as part of a plan or scheme to evade Rule 10b5-1.

In the wake of scandals involving the back-dating of corporate executives' stock options, Linda Chatman Thomsen, then Director of the SEC's Division of Enforcement, indicated that the SEC would begin looking more closely at trading conducted under plans pursuant to Rule 10b5-1. [285] These comments were prompted by two studies that Thomsen said suggested that "the Rule is being abused" by executives whose Rule 10b5-1 trades are outperforming "control" trades by executives who are not trading under 10b5-1 plans. [286] Calls for the SEC to review 10b5-1 plans have persisted over time in light of the perceived abuse of such plans. [287]

Rule 10b5-1 also provides a separate affirmative defense for entities. This defense, similar to an insider trading defense already available to entities such as broker-dealers in other contexts but not limited to such entities, would be available to an entity that can show that the individual making a decision to trade on behalf of the entity was not aware of the material nonpublic information and that the entity had implemented reasonable policies and procedures, such as information barriers and restricted lists, to prevent insider trading.

In construing whether any particular insider trading conduct is fraudulent under Rule 10b-5, the courts have adopted two theories, [288] each predicated on a

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breach of a duty owed by the defendant by reason of a fiduciary or similar relationship of trust and confidence. Unlike the rules dealing with insider trading in some non-U.S. jurisdictions, including the European Union, a duty to abstain from trading does not arise under Rule 10b-5 from mere possession of material nonpublic information. [289]

The first general theory of liability is that certain insiders of a corporation—directors, officers and key employees—owe a fiduciary duty to the corporation's current and prospective shareholders. [290] That duty is breached when they buy or sell the corporation's securities while knowingly in possession of material nonpublic information. [291] Insiders therefore have a duty to disclose the information or to abstain from trading. [292] Although directors and officers of the corporation whose securities are traded are always insiders, temporary insider status has been accorded to persons such as underwriters, lawyers, accountants and financial advisers who gain access to material nonpublic information in the conduct of the corporation's business, if there is an expectation that the information disclosed to them will be kept confidential. [293]

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Such temporary insiders must also refrain from trading in the absence of disclosure. [294]

The second theory of insider trading liability is one of misappropriation. This theory, which was upheld by the Supreme Court in *United States v. O'Hagan*, [295] "protects the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect the corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders." [296] Under the misappropriation theory, a person violates Rule 10b-5 when he or she misappropriates material nonpublic information in breach of a fiduciary or similar relationship of trust and confidence with the person (who may not be the issuer or anyone connected with the issuer) who entrusted him or her with the information, and uses that information, without disclosing such use to the source, for his or her personal benefit in a securities transaction. The "predicate act of fraud may be perpetrated on the source of the nonpublic information, even though the source may be unaffiliated with the buyer or seller of securities." [297] Under the misappropriation theory, the courts have found violations of Rule 10b-5 based upon a financial columnist's breach of duty to his newspaper, [298] a copyholder's breach of duty to his employer printing company, [299] an investment banker's breach of duty to his firm, [300] an attorney's breach of duty to his law firm, [301] a wife's breach of "trust and confidence" to her husband [302] and even a psychiatrist's breach of duty to his patient. [303]

A settled insider trading action brought by the SEC against Barclays Bank PLC demonstrates some of the issues that financial institutions must consider in light of their multiple relationships with their clients and customers. [304] In *Barclays*, the bank obtained material nonpublic information about various distressed

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corporations by virtue of its participation in the corporations' creditors' committees. As a commercial lender to the corporations, the bank learned information about the debtors subject to either express or implied promises of confidentiality. As is common, Barclays also traded in the securities of some of these corporations. The SEC's settlement with Barclays suggests that the bank failed to create and enforce adequate information barriers between the individuals who served on the creditors' committees and the individuals who engaged in the securities trading. [305]

Overall, however, the question of what circumstances give rise to the duty of trust or confidence in nonbusiness relationships has remained unsettled. In an effort to clarify this matter, the SEC promulgated Rule 10b5-2 under the Exchange Act, [306] which contains a "nonexclusive list of three situations in which a person has a duty of trust or confidence for purposes of the ‘misappropriation’ theory." [307] The first situation exists when a person has agreed to keep information confidential. The second circumstance is one in which the overall relationship between two persons, taking into consideration their "history, pattern, or practice of sharing confidences," [308] gives rise to an expectation of confidentiality. Third, a person also owes a duty of trust and confidence when that person receives material nonpublic information from a spouse, parent, child or sibling, unless it is shown affirmatively, based on the facts and circumstances of that family relationship, that there was no reasonable expectation of confidentiality. [309]

The SEC's ability to use Rule 10b5-2 to redefine the scope of the duty owed by outsiders to the person or entity that entrusted them with material nonpublic information, however, was called into question in *SEC v. Cuban*. [310] In

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Cuban, the SEC brought insider trading charges against billionaire Mark Cuban. The SEC alleged that Cuban violated § 10(b) of the Exchange Act when he sold stock in a company (Mamma.com) in which he owned a 6.3% share, after the company informed him that it intended to conduct an equity offering that would dilute Cuban's holdings. Cuban and Mamma.com had entered into an agreement that Cuban would keep information of the upcoming offering confidential, but the agreement did not specify that he would not trade on the information. During a conversation with Mamma.com's CEO, Cuban received more information about the potential sale and allegedly expressed his belief that he could no longer sell the shares after receiving such information. Cuban then sold his shares and avoided losses of about $750,000 when Mamma.com announced the equity offering and the stock price declined.

The SEC argued that an agreement between two parties can give rise to a duty that can be the basis for a misappropriation theory of liability. The district court agreed that, as a theoretical matter, under *Chiarella* and *O'Hagan* an agreement could indeed constitute the basis of a finding of a duty not to trade. In other words, a fiduciary duty is *not* required to establish the misappropriation theory. [311] However, the district court disagreed that the agreement at issue, or the conversation with the CEO, was sufficient to create such a duty because Cuban only promised to keep the information confidential, not to refrain from trading on it, and because his own belief that he could not sell could not give rise to such a promise. [312] Moreover, to the extent the SEC argued that Rule 10b5-2 imposed on Cuban the fiduciary duty to refrain from trading on material nonpublic information based solely on a confidentiality agreement, [313] the district court held the Rule exceeded the SEC's authority because § 10(b) does not allow it to impose liability on the basis of a confidentiality agreement lacking a non-use component. [314]

The SEC then appealed this ruling to the Fifth Circuit, which vacated the opinion of the district court after disagreeing with the district court's reading of the complaint. The Fifth Circuit interpreted Cuban's conversation with the CEO as creating a plausible inference of an agreement not to trade on the information, and thus declined to reach the question of the legality of Rule 10b5-2. [315] Following remand to the district court, the case proceeded to a jury trial, after which Cuban was found not liable for insider trading. [316]

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Another case exemplifies the willingness of the SEC and the courts to look at theories of liability for insider trading that fall outside the traditional scope of the "insider" and "misappropriation" theories. In *SEC v. Dorozhko*, [317] the SEC brought insider-trading charges against a computer hacker who had obtained electronic access to a company's earnings report the day before it was released and traded on that information. Because the defendant was neither an insider nor owed a fiduciary duty to the source of the information or the company whose stock he traded, the Second Circuit found that the case did not fit either the breach of fiduciary duty or misappropriation theories. Thus, the court turned to the "deceptive device" language of § 10(b) of the Exchange Act and concluded that the defendant could be held liable under a so-called "straight-forward theory of fraud" if the district court on remand determined that the computer hacking at issue was "deceptive in that the defendant misrepresented who he was to gain access. Without such a misrepresentation, however, there would be no liability under § 10(b)." [318] Importantly, the court once again reiterated that "a fiduciary duty [is not a] requirement as an element of every violation of § 10(b)." [319]

[ii] *Liability of Tippers and Tippees*

An insider who abstains from trading on the basis of material nonpublic information but "tips" other investors by passing material nonpublic information to them can also be liable under Rule 10b-5 if the insider's disclosure is considered to be fraudulent. The courts have held that tips made in return for a personal benefit [320] are a breach of an insider's duty to his corporation and therefore fraudulent. [321] The benefit may be direct, such as pecuniary gain, or indirect, such

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as a "reputational benefit that will translate into future earnings" [322] or the satisfaction of having bestowed a "gift of confidential information to a trading relative or friend." [323] The "tipper" under these circumstances is liable for the profit made or losses avoided by the "tippee" (the recipient of material nonpublic information) even though the tipper may not have traded at all. [324] The misappropriation theory has also been used against tippers, based on a showing that the tipper owed a duty of confidentiality to the source from whom he or she learned the nonpublic information. [325]

A tippee is liable for insider trading only when (i) the tipper has breached his fiduciary duty to corporate shareholders or to the source of his or her information by disclosing the information to the tippee [326] and (ii) the tippee knows or should know that there has been such a breach. [327] As discussed above, the tipper

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has breached his or her fiduciary duty if he or she will benefit, directly or indirectly, from the disclosure of the information. In order to recover against a tippee, the plaintiff must show that the tippee knew the tipper benefited from the disclosure and so breached the tipper's duty to the corporation or the source of the information. The Supreme Court has rejected the notion that the mere receipt of material nonpublic information by a tippee creates a duty to disclose or abstain similar to that placed on the source of the information. [328]

Recently, the Supreme Court resolved a circuit split concerning the nature of the personal benefit that a tipper must receive to establish liability under the misappropriation theory by reaffirming its ruling in *Dirks* that "a tippee breaches a fiduciary duty by making a gift of confidential information to a 'trading relative.'" [328.1]

Previously, in *United States v. Newman*, the Second Circuit overturned the insider trading convictions of two remote tippees (meaning individuals who received nonpublic information from another tippee, rather than from the original tipper) where the personal benefits identified by the government included that the tippers and initial tippees "had known each other for years," attended business school together and worked together, "sought career advice and assistance" from each other, and/or "were family friends that had met through church and occasionally socialized together." [329] The Second Circuit concluded that "the mere fact of a friendship, particularly of a casual or social nature" is insufficient to establish the requisite personal benefit, which instead requires "proof of a meaningful close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly value nature." [329.1]

In another case involving a remote tippee, however, the Ninth Circuit "decline[d] to follow" *Newman* to the extent it could be read as holding "that evidence of a friendship or familial relationship between tipper and tippee, standing alone, is insufficient to demonstrate that the tipper received a benefit." [330] Instead, relying on the Supreme Court's statement in *Dirks* that "the elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend," the Ninth Circuit affirmed the conviction of a remote tippee where the tipper and initial tippee were relatives.

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The Supreme Court unanimously agreed with the Ninth Circuit's interpretation, concluding that an insider receives a personal benefit by gifting confidential information to a trading relative or friend even if there is no exchange of something of pecuniary or similar value. [331.1] In reaching this conclusion, the Court held that to the extent *Newman* interpreted the personal benefit requirement to include that the tipper receive something of a pecuniary or similarly valuable nature in exchange for the tip, such an interpretation was "inconsistent with *Dirks*." [331.2] While the Court's decision in *Salman* resolved the "narrow issue" of whether a gift of confidential information to a trading relative constitutes a personal benefit, [331.3] the Court reiterated *Dirks'* warning “that [d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts. [331.4]

[b] Exchange Act § 20A

The Insider Trading and Securities Fraud Enforcement Act of 1988 (the "Insider Trading Act") [332] created § 20A of the Exchange Act, which expressly permits a right of action by those trading at the same time as the defendant, even though the defendant owes them no strict legal duty. Congress left it to the courts to decide when trading is contemporaneous within the meaning of § 20A. [333]

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The limitations period for actions under § 20A is five years, running from "the date of the last transaction that is the subject of the violation." [334] Total damages are limited to the profit gained (or loss avoided) by the defendant in the transactions that are the subject of the violation and any recovery will be further reduced by any amount required to be "disgorged" or forfeited to the SEC pursuant to an SEC injunctive action. [335] Control persons may be liable for the actions of those they control, but not solely on the basis of an employment relationship. [336]

[c] Exchange Act § 21A

This provision, also part of the Insider Trading Act and its predecessor statute, the Insider Trading Sanctions Act ("ITSA"), [337] gives the SEC increased power to impose civil penalties with respect to insider trading. Prior to the enactment of § 21A of the Exchange Act, insider traders could receive only the penalties broadly applicable to other violations of the Exchange Act, namely the greater of their pecuniary gain and a flat penalty between $5,000 and $100,000, depending on the egregiousness of their conduct. [338] Under § 21A, the SEC may now seek civil penalties of up to three times the profit gained (or loss avoided) as a result of the violations. [339] Profits or losses are measured by reference to the price at which the securities were trading at the point the material nonpublic information had been digested by the market, without regard to how the price behaved subsequently. [340]

In addition, the SEC may seek civil penalties from control persons [341] up to the greater of $1,978,690 and three times the profits of the person under their

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control, if the controlling person knew of, or recklessly disregarded indications of, the controlled person's violations. [342]

The limitations period for penalty actions under § 21A is five years, running from the date of purchase or sale. [343]

[3] Manipulation

In addition to proscribing misleading disclosure and insider trading, the Exchange Act contains a number of provisions designed to bar manipulative market conduct on or off an exchange. These provisions, and the types of conduct that may constitute violations, are discussed below.

[a] Exchange Act § 9

Under § 9(a) of the Exchange Act, persons are prohibited from manipulating the price of a security listed on a national securities exchange in certain specified ways. These include, among other things, (i) effecting transactions in securities with no change in beneficial ownership, or engaging in "matched" purchases and sales of securities, to create a misleading appearance of active trading (so-called "wash trades"), (ii) effecting a series of transactions in a security to inflate or depress the price of the security in order to induce others to purchase or sell and (iii) effecting a series of transactions for the purpose of "pegging," "fixing" or "stabilizing" the price of securities. [344] The common thread among these prohibited practices is that each is "intended to mislead investors by artificially affecting market activity." [345]

Section 9(e) of the Exchange Act creates an express private right of action for violation of the provisions of § 9(a). Anyone who purchased or sold a security at a price affected by the defendant's manipulations may recover damages. However, the plaintiff is required to prove not only that the manipulative activity occurred, but also that (i) the activity was willfully conducted, [346] (ii) the plaintiff

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relied on such activity [347] and (iii) the price at which the plaintiff purchased or sold the security was affected by the manipulative activity. The statute of limitations for § 9(e) claims is one year from discovery of the facts constituting the cause of action, but in no event more than three years from the violation. [348]

Because of the plaintiff's difficult burden of proof under § 9(e), as well as the court's authority to assess reasonable costs against either party litigant, [349] very few private claims have been brought under § 9(e). The SEC has sought injunctive relief, and criminal proceedings have been instituted, however, for manipulative activities proscribed by § 9(a). The types of activities that the SEC and the DOJ have targeted under § 9(a)—many of which also violate § 10(b) of the Exchange Act and Rule 10b-5 thereunder—include "wash trades," in which a single party controls both sides of the same transaction; [350] "marking the close," which occurs when a party executes the last trade of the day at a price higher than the previous trade, for example to support the stock price in a declining market; [351] reporting of nonexistent trades by stock exchange specialists to create a false appearance of trading activity; [352] and the purchase of a significant block of shares at a premium in order to manipulate the price of a stock. [353]

[b] Exchange Act Rule 10b-5

Part of Rule 10b-5 under the Exchange Act, its catch-all antifraud provision, proscribes the use of "any manipulative or deceptive device" in contravention of SEC rules and regulations in connection with the purchase or sale of any security, whether or not registered on a national exchange. The SEC and private litigants have made broader use of Rule 10b-5 than § 9 of the Exchange Act in

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cases of manipulative conduct because of the slightly lower burden of proof under Rule 10b-5. The rule has been used, for example, in situations [354] involving matched trades and "wash sales," [355] "marking the close," [356] circular trading or other devices to artificially inflate stock prices by creating an appearance of an active market, [357] the entry of artificial bid and ask quotes on Nasdaq to manipulate market prices, [358] the use of large leveraged long positions to drive up prices and squeeze holders of short positions [359] and the paying of kickbacks to brokers for recommending the stock of a company controlled by defendants. [360] The rule has also been used by the SEC and the courts to impose liability on broker-dealers under the so-called "shingle theory," which states that a broker-dealer, by "hanging out a shingle"— *i.e.*, presenting itself as a market professional to potential customers—implicitly represents that it will deal fairly and professionally with its customers. [361] The Second Circuit, however, extended the reasoning of the Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivatives Traders* to the manipulation context, and held that a defendant can only be held liable for market manipulation under Rule 10b-5 if he or she communicated misleading information to potential buyers. [362]

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The specific elements of a claim under Rule 10b-5, as well as the remedies available, are discussed in detail in § 11.04[2].

[c] Regulation M

Adopted in 1996 and replacing old Rules 10b-6, 10b-6A, 10b-7, 10b-8 and 10b-21 (known as the "Prior Trading Rules") under the Exchange Act, Regulation M is intended to preclude manipulative conduct by persons with an interest in the outcome of an offering, while easing some of the inefficiencies and unnecessary costs imposed by the far broader Prior Trading Rules (*e.g.*, by eliminating trading restrictions for underwriters of actively traded securities).

As discussed more extensively in § 2.04[10], Rules 101 and 102 of Regulation M restrict, subject to certain exceptions and for certain "restricted periods" pegged to the time of pricing, bids for and purchases of securities in distribution by underwriters, issuers, selling securityholders and their respective broker-dealer affiliates participating in the distribution. [363] Rule 101, which governs underwriters and their affiliates, excludes from its coverage more actively traded securities and other specified securities and transactions, and excuses *de minimis* transactions, provided that a distribution participant had in place written policies and procedures reasonably designed to achieve compliance with the regulation. The rule also recognizes "information barriers" between the underwriter and its affiliates, thereby narrowing the scope of persons subject to its strictures. Rule 102, which covers issuers, selling securityholders and their affiliates, allows these parties to engage in market activities prior to the applicable restricted period and permits (during the restricted period) certain specified transactions, for example, bids and purchases of odd-lots.

Rule 103 of Regulation M governs passive market-making by Nasdaq market-makers participating in a distribution and is designed to maintain liquidity in situations where a market-maker otherwise might be required to withdraw from the market pursuant to Rule 101. Rule 104 of Regulation M prohibits actions to stabilize the price of a security to facilitate an offering, subject to certain specified exceptions. Finally, subject to certain exceptions, Rule 105 of Regulation M prohibits persons who sold equity securities short during a five-day period prior to the pricing of a registered firm commitment offering for securities of the same class from purchasing securities in the offering, regardless of whether the offered securities are intended to be used to cover the prior short sale. [364]

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The SEC monitors compliance and brings proceedings to enforce Regulation M and its associated rules, [365] but like the predecessor Prior Trading Rules it is generally considered that there is no implied private right of action for violations. [366]

Footnotes

265 *See* § 11.04[3].

266 Many of the actions initiated by the SEC and private litigants in response to corporate scandals are predicated on § 10(b) and Rule 10b-5 thereunder. For example, the SEC enforcement action that produced a $500 million settlement payment (reduced from the pre-bankruptcy settlement amount of $1.51 billion) for wrongdoing involving WorldCom's overstatement of its income by $9 billion was brought under § 10(b) and Rule 10b-5. *See SEC v. WorldCom Inc.*, SEC Litigation Release No. 18147 (May 19, 2003); *see also* Press Release, SEC, The Honorable Jed Rakoff Approves Settlement of SEC's Claim for a Civil Penalty Against WorldCom (July 7, 2003). The main Enron-related class action lawsuit also alleged violations of § 10(b) and Rule 10b-5 . *See In re Enron Corp. Securities, Derivative & ERISA Litigation*, 235 F. Supp. 2d 549, 581–688 (S.D. Tex. 2002).

267 Notably, the SEC has brought Rule 10b-5 actions against foreign issuers for making false statements to the U.S. market. *See In re E.ON AG*, SEC Release No. 34-43372 (Sept. 28, 2000), in which the SEC imposed a cease and desist order on E.ON AG (formerly Veba, a German company and a foreign private issuer) for violating "Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by deliberately issuing a series of materially false and misleading statements over a month-long period in which it denied the existence of any merger discussions or negotiations." *In re E.ON AG*, SEC Release No. 34-43372 (Sept. 28, 2000). The order states that "[w]here jurisdictional requirements are met … there is no safe harbor for foreign issuers from violations of the antifraud provisions of the U.S. federal securities laws. The [SEC] will not apply a different standard with respect to foreign issuers commenting on merger discussions or negotiations. When a foreign issuer voluntarily avails itself of the opportunities in the U.S. capital markets, it must adhere to the U.S. federal securities laws." *In re E.ON AG*, SEC Release No. 34-43372 (Sept. 28, 2000); *see also* § 4.10[3]. In addition, foreign issuers have not been entirely immune to the recent wave of corporate scandals. Among other companies, Ahold NV and Vivendi Universal S.A. have faced investigations by the SEC and the DOJ for accounting and related disclosure issues. *See* Deborah Ball, *Ahold Will Shave $880 Million Off Profit Due To Irregularities*, WALL ST. J., May 9, 2003; Martin Peers, *SEC Upgrades Vivendi Probe, Raising Stakes for French Firm*, WALL ST. J., Nov. 20, 2002; John Carreyrou, *U.S. Attorney Opens Vivendi Probe*, WALL ST. J., Nov. 5, 2002. Ahold and Vivendi have settled with the SEC, although the SEC has continued to investigate and charge individuals who participated in the fraudulent schemes. *See SEC v. Royal Ahold*, SEC Litigation Release No. 18929 (Oct. 13, 2004) (stating that Ahold would not be fined by the SEC, in part because of the company's cooperation and in part because of the parallel investigation in the Netherlands, where Ahold eventually paid a $10 million fine); *SEC v. Vivendi Universal, S.A.*, SEC Litigation Release No. 18523 (Dec. 24, 2003) (stating that Vivendi consented to pay a $50 million civil monetary penalty). Section 11.10[1]–[3] discusses jurisdiction over foreign defendants and the extraterritorial scope of the federal securities laws.

268 Although § 18 of the Exchange Act does not refer specifically to omissions, they have been deemed included in its proscription of materially misleading statements. *See, e.g.*, *In re Caesars Palace Securities Litigation*, 360 F. Supp. 366 (S.D.N.Y. 1973).

269 *See Fischman v. Raytheon Manufacturing, Co.*, 188 F.2d 783, 788 (2d Cir. 1951). Section 18 does not apply to documents filed pursuant to the Securities Act, rather than the Exchange Act, including Forms F-3 and associated prospectuses. *See In re Alstom SA*, 406 F. Supp. 2d 433, 481 (S.D.N.Y. 2005). Certain Exchange Act filings, including certain types of Forms 8-K, are likewise exempted from Section 18 liability by SEC regulations. *In re Alstom SA*, 406 F. Supp. 2d 433, 481 (S.D.N.Y. 2005).

270 Of specific importance to foreign issuers are Form 20-F registration statements filed, for example, in connection with a stock exchange listing (without making a concurrent primary offering). Section 18 of the Exchange Act would apply not only to an initial Form 20-F filing but also to post-listing (or post-public offering) filings (*i.e.*, the Form 20-F annual report filings of a foreign issuer, *see* § 4.03[2][a]). Under SEC regulations, however, Exchange Act filings on Forms 6-K are generally exempt from § 18 liability. *See In re Alstom SA*, 406 F. Supp. 2d 433, 481 (S.D.N.Y. 2005).

271 *See* § 6.02[2].

272 *See Ross v. A.H. Robins Co.*, 607 F.2d 545, 552–53 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Cohen v. Stevanovich*, No. 09 Civ. 4003, 2010 U.S. Dist. LEXIS 66010, at *41 (S.D.N.Y. July 1, 2010); *In re M.D.C. Holdings Securities Litigation*, 754 F. Supp. 785, 798 (S.D. Cal. 1990).

273 *See* § 18(a) of the Exchange Act. The statute of limitations is one year after discovery of the facts constituting the cause of action, but no more than three years from the violation. § 18(c) of the Exchange Act. Damages are also measured in the same way as under Rule 10b-5. *See Harris v. American Investment Co.*, 523 F.2d 220 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976); § 11.04[2][c]. Section 18(b) of the Exchange Act expressly recognizes the right of defendants held liable under the provision to seek contribution from others who could likewise have been held liable had they been sued.

274 § 18(a) of the Exchange Act.

275 *See F.N. Wolf & Co. v. Estate of Neal*, Fed. Sec. L. Rep. (CCH) ¶95,805 (S.D.N.Y. Feb. 25, 1991) (citing *Ross v. A.H. Robins Co.*, 607 F.2d 545, 552 (2d Cir. 1975)).

276 *See Ross v. A.H. Robins Co.*, 607 F.2d 545, 556–57 (2d Cir. 1975).

277 Extraterritorial application of the law has been deemed necessary to "protect domestic investors who have purchased foreign securities on American exchanges and to protect the domestic securities market from the effects of improper foreign transactions in American securities." *Schoenbaum v. Firstbrook*, 405 F.2d 200, 206 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969), *abrogated on other grounds by Morrison v. National Australia Bank*, 130 S. Ct. 2869 (2010). The SEC has increasingly pursued overseas parties for insider trading violations. *See, e.g.*, *SEC v. Hui*, SEC Litigation Release No. 16220 (July 26, 1999) (complaint); *SEC v. Heden*, 51 F. Supp. 2d 296 (S.D.N.Y. 1999); *SEC v. Euro Security Fund*, Fed. Sec. L. Rep. (CCH) ¶90,433 (S.D.N.Y. Feb. 16, 1999); *SEC v. Cavanagh*, 1 F. Supp. 2d 337 (S.D.N.Y. 1998), *aff'd*, 155 F.3d 129 (2d Cir. 1998); *SEC v. Morris*, SEC Litigation Release No. 14381 (Jan. 17, 1995); *SEC v. Tinajero*, SEC Litigation Release No. 12974 (Sept. 11, 1991) (final judgment); *SEC v. Foundation Hai*, SEC Litigation Release No. 12535 (July 6, 1990) (final judgment). In *Morrison v. National Australia Bank Limited*, however, the Supreme Court limited the extraterroritorial reach of the federal securities laws, *see* § 11.10[3], and lower courts have begun to apply this new approach in the insider trading context. *See, e.g.*, *United States v. Martoma*, No. S1 12 Cr. 973 (PGG), 2013 WL 6632676 (S.D.N.Y. Dec. 17, 2013).

278 *See, e.g.*, *SEC v. Waksal*, SEC Litigation Release No. 19039 (Jan. 19, 2005). Under the terms of the settlement, Sam and Jack Waksal were held jointly and severally liable for disgorgement of over $2 million in illegal loss avoidance and Sam Waksal was liable for a civil penalty of over $3 million and barred from serving as an officer or director of any public company. *See also SEC v. Computer Associates International, Inc.*, SEC Litigation Release No. 18891 (Sept. 22, 2004).

279 *See* Commodity Futures Modernization Act, Appendix E, Pub. L. No. 106-554, § 303(d)(1), 114 Stat 2763, 2763A-454 (2000); 15 U.S.C § 78j(b). Under § 206B of the Gramm-Leach-Bliley Act ("GLBA"), in turn, a "security-based swap agreement" is a swap agreement "of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein." GLBA, Pub. L. No. 106-102, § 206B, 113 Stat. 1338 (1999). The SEC more recently brought a case against a securities analyst who tipped off a client that a company was going to issue debt, which was expected to increase the price of certain credit-default swaps whose reference entity was the company at issue. *See SEC v. Rorech*, 720 F. Supp. 2d 367 (S.D.N.Y. 2010). The defendants argued that the new provisions did not apply to trades in those credit-default swaps, arguing that the price of the CDS was not "based on" the price, yield, value or volatility of the underlying securities, but rather on a basis point negotiation between the buyer and seller of the CDS, and affected by many factors, including the strength of the economy and the market's assessment of the referenced company's credit risk. The district court rejected this argument and held that two material terms of the CDS were "based on" the price, yield, value or volatility of the underlying securities. First, the court noted the price of the CDS was "based on" such factors because it was "clear … that a fundamental part of [the] decision [to purchase the CDS] was the spread or yield (or, inversely, the price) of the deliverable [securities]." *SEC v. Rorech*, 720 F. Supp. 2d 367, 407 (S.D.N.Y. 2010). Generally, the court held, because the price, yield, and value of the underlying securities were

"critical" to the price of the CDSs, trading in such instruments squarely fit within the statutory definition. *SEC v. Rorech*, 720 F. Supp. 2d 367, 407 (S.D.N.Y. 2010). The district court also noted that § 9.9 of the ISDA agreement governing the swaps required the CDS-buyer to deliver the covered securities to the counterparty if a credit event occurred, but also allowed the counterparty to subtract the price of such securities if the CDS-buyer failed to deliver them. *SEC v. Rorech*, 720 F. Supp. 2d 367, 408 (S.D.N.Y. 2010). Thus, the court held, "a material provision" of the CDS was "based on" the price of the underlying security for purposes of § 206B. Note that the charges against Rorech were ultimately dismissed on the grounds that the SEC could not establish the misappropriation theory, which is discussed below.

280 *See United States v. Teicher*, 987 F.2d 112 (2d Cir.), *cert. denied*, 510 U.S. 976 (1993).

281 *See SEC v. Adler*, 137 F.3d 1325, 1337–39 (11th Cir. 1998).

282 *See United States v. Smith*, 155 F.3d 1051, 1066–69 (9th Cir. 1998).

283 SEC Release No. 33-7881 (Aug. 10, 2000).

284 Trading plans permitted by Rule 10b5-1 have proven useful to insiders by allowing them to establish trading programs that do not depend on the availability of window periods. *See* § 5.05[7].

285 *See* Linda Chatman Thomsen, Director, SEC Division of Enforcement, Remarks at the 2007 Corporate Counsel Institute (Mar. 8, 2007).

286 Michael Siconolfi and Jean Eaglesham, *SEC is Pressed to Revamp Executive Trading Plans*, WALL ST. J., May 9, 2013; Alan Jagolinzer, *Do Insiders Trade Strategically Within the SEC Rule 10b5-1 Safe Harbor?* (Stanford Graduate School of Business, Working Paper, Dec. 6, 2006); Jane Sasseen, *A Closer Look at Trades By The Top Brass: Some Execs May Be Abusing An SEC "Safe Harbor" Rule on Insider Stock Sales*, BUS. WEEK, Nov. 13, 2006, at 40; Jane Sasseen et al., *Insiders With A Curious Edge: How Corporate Executives Seem To Be Violating The Spirit, If Not The Letter, Of A Rule Intended To Prevent Insider Trading*, BUS. WEEK, Dec. 18, 2006. Professor Jagolinzer's study found that 10b5-1 plans were regularly initiated in anticipation of negative disclosures and terminated in anticipation of positive disclosures. Trades by 10b5-1 plan participants outperformed those of non-participating colleagues by an average of six percent.

287 *See, e.g.*, Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Elisse B. Walter, Chairman, SEC (Dec. 28, 2012) (requesting that the SEC consider pursuing interpretive guidance or amending Rule 10b5-1 to require Rule 10b5-1 plans to adopt several protocols and guidelines to limit reported abuses).

288 There is no statute that defines "insider trading" or explicitly prohibits it. Insider trading is a common law offense derived from judicial interpretations of several overlapping statutory and regulatory prohibitions, mainly Rule 10b-5. In the United Kingdom and elsewhere in the European Union, the offense has been defined and insider trading banned specifically by statute. *See* EU Regulation 596/2014 on market abuse (market abuse regulation) (Apr. 16, 2014). Although the SEC historically resisted such efforts in the United States, it adopted Rules 10b5-1 and 10b5-2 to clarify and strengthen the law of insider trading, and Regulation FD (Fair Disclosure), which deals with the issue of selective disclosure. *See* SEC Release No. 33-7881 (Aug. 15, 2000). Regulation FD, including recent enforcement activity, is discussed in § 4.10[6].

289 *See Chiarella v. United States*, 445 U.S. 222, 228–29 (1980) (failure to disclose material nonpublic information cannot be fraudulent absent a duty to disclose). *See also* Edward Greene & Olivia Schmid, *Duty Free Insider Trading?*, 2 COLUM. BUS. L. REV. 369 (2013).

290 In an issue of first impression, the Second Circuit recently held that "the fiduciary-like duty against insider trading under section 10(b) is imposed and defined by federal common law" rather than state or foreign law. *See Steginsky v. Xcelera Inc.*, 741 F.3d 365 (2d Cir. 2014). The Second Circuit concluded that the relevant duty springs from federal law because "looking to idiosyncratic differences in state law"—in that case, the law of the Cayman Islands, which allegedly did not impose a duty on insiders to disclose material information before trading— "would thwart the goal of promoting national uniformity in securities markets."

291 Material information is information "which [is] reasonably certain to have a substantial effect on the market

price of the security if disclosed." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), and *cert. denied*, 404 U.S. 1005 (1971) (citations omitted). Information is considered nonpublic until the relevant markets have had an opportunity to fully digest the information. In a heavily traded issue, this will usually require that the price of the company's shares have stabilized after the initial disclosure of the information.

292 Since insiders owe a duty of loyalty to the corporation, which requires that disclosure of such information be made at the appropriate time and in the best interest of the corporation, it is often said that insiders only have a duty to abstain from trading. *See SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), and *cert. denied*, 404 U.S. 1005 (1971) (citations omitted).

293 *See Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983); *see also SEC v. Falbo*, 14 F. Supp. 2d 508 (S.D.N.Y. 1998) (independent contractor); *SEC v. Softpoint, Inc.*, 958 F. Supp. 846 (S.D.N.Y. 1997), *aff'd without opinion*, 159 F.3d 1348 (2d Cir. 1998) (consultant); *SEC v. Franco*, SEC Litigation Release No. 11206 (D.D.C. Aug. 26, 1986) (public relations advisor).

294 "Information barriers" restricting the dissemination and misuse of material nonpublic information allow a financial institution's trading and investment management departments to trade in securities although the underwriter's corporate finance department has material nonpublic information concerning the issuer of such securities. *See* § 14.07[1][b] for a discussion of the "information barriers" required of broker-dealers; *see also* Rule 10b5-1 under the Exchange Act.

295 *United States v. O'Hagan*, 521 U.S. 642 (1997).

296 *United States v. O'Hagan*, 521 U.S. 642, 653 (1997) (internal quotations omitted).

297 *See United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992).

298 *See United States v. Carpenter*, 791 F.2d 1024, 1026 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

299 *See SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

300 *See United States v. Newman*, 664 F.2d 12 (2d Cir. 1981).

301 *See United States v. O'Hagan*, 521 U.S. 642 (1997).

302 *See SEC v. Lenfest*, 949 F. Supp. 341 (E.D. Pa. 1996).

303 *See United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990).

304 *SEC v. Barclays Bank PLC*, SEC Litigation Release No. 20132 (May 30, 2007).

305 The *Barclays* case also demonstrated the SEC's apparent willingness to pursue cases even where a bank has entered into non-reliance letters, or so-called "big boy letters," with its trading counterparties. These letters involve an acknowledgment by the counterparty that it is aware that the insider may have material nonpublic information and it still wants to proceed with the transaction. Although these letters may provide some defenses in private civil litigation, *see AES Corp. v. Dow Chemical Co.*, 325 F.3d 174 (3d Cir. 2003); *McCormick v. Fund American Companies, Inc*., 26 F.3d 869 (9th Cir. 1994); *Jensen v. Kimble*, 1 F.3d 1073 (10th Cir. 1993), *Barclays* suggests that the SEC has not adopted the position that a non-reliance letter absolves a trading party of insider trading exposure to government regulators. *See also supra* Note 202.

306 *See* SEC Release No. 33-7881 (Aug. 15, 2000).

307 SEC Release No. 33-7881 (Aug. 15, 2000), 65 Fed. Reg. 51,716, 51,730 (Aug. 24, 2000).

308 SEC Release No. 33-7881 (Aug. 15, 2000), 65 Fed. Reg. 51,716, 51,738 (Aug. 24, 2000).

309 According to the SEC, the only federal appellate court decision on this point— *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992)—took an unduly narrow view of when a duty of confidence arises in the context of family and other personal relationships. *Chestman* held that in the absence of an express agreement of confidentiality or a pre-existing pattern of sharing business confidences, there is not a sufficient basis in such a relationship to establish the duty to support a criminal conviction under the misappropriation theory. SEC Rule 10b5-2 broadens and in effect reverses the result of *Chestman*.

310 *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated*, 620 F.3d 551 (5th Cir. 2010).

311 *SEC v. Cuban*, 634 F. Supp. 2d 713, 724–27 (N.D. Tex. 2009).

312 *SEC v. Cuban*, 634 F. Supp. 2d 713, 727–28 (N.D. Tex. 2009).

313 *See* Rule 10b5-2(b)(1) (creating duty of confidence for purposes of misappropriation theory "[w]henever a person agrees to maintain information in confidence" without requiring that the person also agree to not trade on the information).

314 *SEC v. Cuban*, 634 F. Supp. 2d 713, 728–31 (N.D. Tex. 2009).

315 *SEC v. Cuban*, 620 F.3d 551 (5th Cir. 2010).

316 *SEC v. Cuban*, SEC Litigation Release No. 22855 (Oct. 23, 2013).

317 *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009).

318 *SEC v. Dorozhko*, 574 F.3d 42, 48–51 (2d Cir. 2009).

319 *SEC v. Dorozhko*, 574 F.3d 42, 48 (2d Cir. 2009).

320 *See Dirks v. SEC*, 463 U.S. 646, 663–64 (1983). No liability attaches if the disclosure is made for corporate rather than personal benefit.

321 Until the fall of 2000, the issue of selective disclosure had been exclusively considered under the analysis applicable to securities fraud, particularly insider trading under Rule 10b-5 under the Exchange Act. This approach had focused on whether a corporate insider, by selectively disclosing material nonpublic information to analysts and institutional investors, may be exposed to "tipper" liability for insider trading. The Supreme Court, in *Dirks v. SEC*, 463 U.S. 646 (1983), held that the insider must receive some direct or indirect "personal benefit" from the disclosure in order for liability to attach to the tipper or tippee. The *Dirks* decision was widely construed as providing considerable latitude to insiders who made selective disclosure to analysts, and to the analysts (and their clients) who received selectively disclosed information and acted on it.

The SEC's recognition of the difficulties it faced in proving "personal benefit" under Rule 10b-5 led to its decision to adopt Regulation FD (Fair Disclosure), which became effective in October 2000, and abandon exclusive reliance on Rule 10b-5 to regulate selective disclosure to analysts. *See* SEC Release No. 33-7881 (Aug. 15, 2000). Regulation FD generally requires an issuer that has selectively disclosed material nonpublic information to promptly disclose that information publicly. The requirements of Regulation FD, which do not apply to foreign private issuers, and enforcement activity thereunder, are addressed in more detail in § 4.10[6].

322 *SEC v. Stevens*, No. 91 Civ. 1869 (S.D.N.Y. Mar. 19, 1991) (insider trading proceeding settled by the SEC, involving the CEO's disclosure of information to analysts to enhance his reputation); *see* § 4.10[7] (discussing *Dirks* and *Stevens* in the context of selective disclosure to analysts).

323 *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 311 n.21 (1985) (citing *Dirks v. SEC*, 463 U.S. 646, 663–64 (1983)).

324 The SEC has taken the position that a tipper is liable even if the tippee never actually trades, assuming it was reasonably foreseeable at the time the information was provided that the tippee would trade. It is unclear whether the courts will impose liability under these circumstances, except in the tender offer context, where the "reasonably foreseeable" test is codified in Rule 14e-3 under the Exchange Act. *See* § 11.06[4].

325 A tipper is liable under the misappropriation theory for disclosing nonpublic information even if he or she did not specifically know that the tippee would trade on it, so long as the tipper knew he or she was breaching his or her own duty to maintain the confidentiality of the information. *See United States v. Libera*, 989 F.2d 596 (2d Cir.), *cert. denied*, 510 U.S. 976 (1993).

326 *See United States v. Chestman*, 947 F.2d 551, 567–71 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992) (reversing the conviction of a tippee-defendant where there was an insufficient showing that the tipper owed a duty of confidence to his source, a family member). In *Chestman*, the court held that fiduciary relationships are "marked by the fact that the party in whom confidence is reposed has entered into a relationship in which he or she acts to serve the interests of the party entrusting him or her with such

information." Courts have noted that a fiduciary duty cannot be unilaterally imposed by entrusting an individual with confidential information, but an explicit acceptance of a duty of confidentiality must be present in order for misappropriation liability to attach. *See United States v. Cassese*, 273 F. Supp. 2d 481 (S.D.N.Y. 2003) (finding that despite the existence of an unexecuted confidentiality agreement, the relationship between the parties was not a fiduciary one because it was not marked by "*de facto* control" and "dominance" or entailing "discretionary authority and dependency" but was rather an arm's-length relationship that was insufficient to trigger misappropriation liability); *see also United States v. Kim*, 184 F. Supp. 2d 1006 (N.D. Cal. 2002) (granting a motion to dismiss and holding that even though confidential information was regularly exchanged between the defendant and a fellow member of a social club and despite the fact that there was a signed confidentiality agreement, no fiduciary relationship was formed).

327 *See Dirks v. SEC*, 463 U.S. 646, 660 (1983).

328 *See Dirks v. SEC*, 463 U.S. 646, 664 (1983). As discussed above, the Supreme Court's position is contrary to that taken in other jurisdictions, such as the United Kingdom, where a duty to abstain arises from mere possession of material nonpublic information.

328.1 *Salman v. United States*, 137 S. Ct. 420, 427–28 (2016) (citing *Dirks*, 463 U.S. at 664 (1983)).

329 *See United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

329.1 *See United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014).

330 *See United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015).

331 [Reserved.]

331.1 *Salman v. United States*, 137 S. Ct. 420, 424 (2016).

331.2 *Salman v. United States*, 137 S. Ct. 420, 427–28.

331.3 *Salman v. United States*, 137 S. Ct. 420, 427.

331.4 *Salman v. United States*, 137 S. Ct. 420, 429 (2016) (quoting *Dirks v. SEC*, 463 U.S. 646, 664 (1983)).

332 *See* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988).

333 The courts have not offered any definitive rules on this subject since the passage of the Insider Trading Act. *See In re Microstrategy, Inc. Securities Litigation*, 115 F. Supp. 2d 620, 662–63 (E.D. Va. 2000). The *Microstrategy* court summarized the state of the law regarding this question, noting that the decisions from various circuits are not uniform. "[C]ourts … have applied varying definitions of contemporaneity, ranging from requiring that the investor trade on the same date as did the insider, to allowing as much as a month to pass between the trades, with at least one court even holding that 'the term "contemporaneously" may embrace the entire period while relevant nonpublic information remained undisclosed.'" *In re Microstrategy, Inc. Securities Litigation*, 115 F. Supp. 2d 620, 662–63 (E.D. Va. 2000) (footnote call numbers omitted) (quoting *In re American Business Computers Corp. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶98,839 at 93,055 (S.D.N.Y. Feb. 24, 1994)). However, the trend among some courts has been to "adopt a restrictive reading of the term 'contemporaneous' at least with respect to shares heavily traded on a national exchange." *In re Microstrategy, Inc. Securities Litigation*, 115 F. Supp. 2d 620, 662–63 (E.D. Va. 2000) (quoting *In re AST Research Securities Litigation*, 887 F. Supp. 231, 233 (C.D. Cal. 1995)). Nor is the prior case law—to which Congress referred in the legislative history—entirely clear. *See, e.g.*, *Wilson v. Comtech Telephone Corp.*, 648 F.2d 88, 94 (2d Cir. 1981) (defendant not liable to the plaintiff who traded a month after the defendant's trading); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 241 (2d Cir. 1974) (defendant liable to those who traded "during the same period" in which the defendant traded); *O'Connor & Associates v. Dean Witter Reynolds, Inc.*, 559 F. Supp. 800, 803 n.4 (S.D.N.Y. 1983) (defendant liable to the plaintiffs who traded during the week after the defendant's trades, but not to those who traded before him or his tippees).

334 § 20A(b)(4) of the Exchange Act. In *Johnson v. Aljian*, the Ninth Circuit held that a case may proceed under § 20A within the five-year limitations period even if the underlying Rule 10b-5 violation is time-barred—and even if the time-barred Rule 10b-5 violation was the *sole* underlying violation. *Johnson v. Aljian*, 490 F.3d

778 (9th Cir. 2007).

335 *See* § 20A(b)(1) and (2) of the Exchange Act.

336 *See* § 20A(b)(3) of the Exchange Act.

337 *See* Insider Trading Sanctions Act, Pub. L. No. 98-376, 99 Stat. 1264 (1984).

338 *See* § 21(d)(3)(B) of the Exchange Act. This penalty range applied to natural persons; the range for corporate defendants was $50,000 to $500,000. § 21(d)(3)(B) of the Exchange Act; *see also* SEC Release No. 33-7361 (Nov. 1, 1996).

339 *See* § 21A(a)(2) of the Exchange Act.

340 *See* § 21A(f) of the Exchange Act.

341 The definition of control persons under § 21A, like that under § 20A, is narrower than that applicable (under § 20(a)) in determining control person liability with respect to other provisions of the Exchange Act. Among other things, an employer would not be liable under § 21A "solely by reason of employing" the insider trader. *See* § 21A(b)(2) of the Exchange Act.

342 *See* § 21A(a)(3) of the Exchange Act; SEC Release No. No. 33-10104 (June 27, 2016). If the control person is a broker-dealer or an investment adviser and knowingly or recklessly failed to establish, maintain or enforce the "information barriers" required by § 15(f) of the Exchange Act or § 204A of the Advisers Act, *see* §§ 14.07[1][b] and 16.13, he or she is likewise liable for up to $1,525,000 or treble profits. § 21(b)(1)(B) of the Exchange Act. If the controlled person's violation was tipping material nonpublic information and not trading on it, the profits used for the damages calculation are those of the tippee. § 21A(a)(3) of the Exchange Act.

343 *See* § 21A(d)(5) of the Exchange Act.

344 § 9(a) of the Exchange Act.

345 *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 476 (1977).

346 *See, e.g.*, *Baum v. Phillips, Appel & Walden, Inc.*, 648 F. Supp. 1518, 1530 (S.D.N.Y. 1986), *aff'd*, 867 F.2d 776 (2d Cir.), *cert. denied*, 493 U.S. 835 (1989) (§ 9 actions require proof of *scienter*).

347 *See Baum v. Phillips, Appel & Walden, Inc.*, 648 F. Supp. 1518, 1529–30 (S.D.N.Y. 1986), *aff'd*, 867 F.2d 776 (2d Cir. 1989), *cert. denied*, 493 U.S. 835 (1989) (reading the reliance requirement into a § 9 claim by reference to legislative history, despite the statute's silence on the issue).

348 Defendants are provided an express right of contribution against fellow wrongdoers for civil liability imposed under § 9(e) of the Exchange Act.

349 *See* § 9(e) of the Exchange Act.

350 *See, e.g.*, *United States v. Gilbert*, Fed. Sec. L. Rep. (CCH) ¶98,244 (S.D.N.Y. July 23, 1981), *aff'd*, 668 F.2d 94 (2d Cir. 1981), *cert. denied*, 456 U.S. 946 (1982) (conviction and sentencing of defendant who used multiple accounts with broker-dealers to manipulate the price of stock through "wash" trades and matched orders).

351 *See, e.g.*, *SEC v. Broumas*, SEC Litigation Release No. 12999 (Sept. 27, 1991). *See generally SEC v. Masri*, 523 F. Supp. 2d 361 (S.D.N.Y. 2007) (describing allegations of "marking the close" trades as a mechanism of market manipulation in a case brought pursuant to § 10(b) of the Exchange Act).

352 *See* SEC Release No. 34-13453 (Apr. 19, 1977).

353 *See SEC v. Drexel Burnham Lambert Inc.*, SEC Litigation Release No. 11859 (Sept. 7, 1988) (alleging that Ivan Boesky made large purchases of Wickes common stock at Michael Milken's direction to cause the stock to close within a certain price range so that Wickes, a client of Milken's, could call its outstanding convertible preferred stock for conversion).

354 Many of these same situations could have given rise as well to liability under § 9(a) of the Exchange Act. *See* § 11.05[3][a].

355 *See SEC v. Malenfant*, SEC Litigation Release No. 13339 (Aug. 17, 1992); *SEC v. Sonic Electric Energy*

Corp., SEC Litigation Release No. 13076 (Nov. 4, 1991).

356 *See In re Myron S. Levin*, SEC Release No. 34-31124 (Sept. 1, 1992).

357 *See SEC v. D'Onofrio*, SEC Litigation Release No. 13627 (May 6, 1993); *SEC v. Militano*, SEC Litigation Release No. 12870 (June 4, 1991); *see also SEC v. Militano*, 773 F. Supp. 589 (S.D.N.Y. 1991), *summary judgment granted*, Fed. Sec. L. Rep. (CCH) ¶98,330 (S.D.N.Y. June 23, 1994).

358 *See SEC v. Lorin*, SEC Litigation Release No. 12707 (Nov. 20, 1990); *see also SEC v. Lorin*, 877 F. Supp. 192 (S.D.N.Y 1995), *aff'd in part, vacated in part*, 76 F.3d 458 (2d Cir. 1996); *SEC v. Lorin*, SEC Litigation Release No. 12893 (June 24, 1991); *SEC v. Lorin*, SEC Litigation Release No. 13050 (Oct. 17, 1991).

359 *See SEC v. Steinhardt Management Co.*, SEC Litigation Release No. 14358 (Dec. 16, 1994).

360 *See SEC v. Shull*, SEC Litigation Release No. 14441 (Mar. 15, 1995).

361 Under this theory, broker-dealers have been deemed to represent, among other things, that they: (i) have an "adequate and reasonable basis" for recommending securities to their customers, which necessitates a "reasonable investigation" of the security, (ii) will not recommend securities that they know or should know are not suitable for their customers, (iii) will not sell or purchase securities at prices unrelated to the market price, or with an excessively high mark-up, and (iv) will not churn a customer's account (*i.e.*, trade the customer's securities excessively in order to increase commissions). *See Hanly v. SEC*, 415 F.2d 589, 596–97 (2d Cir. 1969). Broker-dealers have been held liable under the "shingle theory" where they knew their recommendation was false, or disregarded obvious inconsistencies or other negative information of which they were on notice. *See, e.g.*, *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809 (11th Cir. 1989); *Cook v. Avien, Inc.*, 573 F.2d 685 (1st Cir. 1978); *In re Allen R. Asker*, SEC Admin. Proc. File No. 3-7401 (Mar. 14, 1992); *In re Lester Kuznetz*, SEC Release No. 34-23525 (Aug. 12, 1986). *See generally* § 14.07[1][a].

362 *Fezzani v. Bear, Stearns & Co.*, 716 F.3d 18 (2d Cir. 2013) (citing *Janus Capital Group, Inc. v. First Derivatives Traders*, 131 S. Ct. 2296 (2011)).

363 As under old Rule 10b-6, a "distribution" is defined for purposes of Regulation M as any offering of securities that is "distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods." *See* Rule 100 of Regulation M under the Exchange Act.

364 *See* SEC Release No. 34-56206 (Aug. 6, 2007).

365 *See* § 3.02[8] for a discussion of violations of Regulation M in the context of public offerings.

366 *See*, *e.g.*, Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 44–46 (1977) (denying Rule 10b-6 standing to a tender offeror seeking to sue a target company for market manipulations that caused it to lose the opportunity to gain control, and suggesting that there might not be any implied right of action under Rule 10b-6 under the Exchange Act).

U.S. Regulation of the International Securities and Derivatives Markets, § 11.06, LIABILITIES CONNECTED WITH TENDER AND EXCHANGE OFFERS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 11.06 (11th and 12th Editions 2014-2017)
11th and 12th Editions

The Exchange Act provides a series of remedies for fraudulent, deceptive or manipulative practices in connection with tender or exchange offers. [367] First, as addressed briefly in § 11.06[1], the broad antifraud provisions of Rule 10b-5 apply to purchases and sales of securities in connection with these offers. In addition, the Williams Act amendments to the Exchange Act, and principally §§ 13(d) and 14(d) and (e) of the Exchange Act, specifically target perceived abuses of the tender offer process by mandating certain types of disclosure and creating causes of action for improper disclosure and other forms of deceit. These provisions are addressed in § 11.06[2]. Finally, as examined in § 11.06[4], Rule 14e-3 under the Exchange Act prohibits insider trading in the context of tender offers, supplementing the general prohibitions on insider trading under Rule 10b-5 discussed in § 11.05[2].

[1] Exchange Act § 10(b) and Rule 10b-5

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit a wide range of fraudulent, deceptive and manipulative practices in connection with the purchase or sale of securities, including purchases pursuant to tender or exchange offers. As discussed in § 11.04[2][a], a plaintiff bringing a private action under Rule 10b-5 must generally demonstrate that the defendant acted recklessly or with fraudulent intent, [368] that the plaintiff relied on the defendant's conduct in making a purchase or sale of securities, and that the conduct caused injury to the plaintiff in some measurable way. The SEC may also seek injunctive relief or civil penalties for violations of Rule 10b-5 or, in the case of willful conduct, ask the DOJ to bring criminal charges against the alleged violator.

[2] Exchange Act §§ 13(d) and 14(d) and (e)

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The Williams Act, a set of amendments to the Exchange Act enacted in 1968, was intended to increase regulation of, and thereby reduce the incidence of abuses in, the tender offer process. The legislation was aimed at reducing the "undue pressure on shareholders to act hastily and to accept an offer, before management or any other group has an opportunity to present opposing argument or competing offers." [369]

The principal enforcement provisions added by the Williams Act are §§ 13(d) and 14(d) and (e) of the Exchange Act. As discussed in § 6.02[2], § 13(d) generally requires any person (or group acting in concert) who acquires more than 5% of the outstanding voting stock of a publicly held corporation to file a disclosure statement revealing, among other things, the identity of the acquiror, the source and amount of the funds used in making its purchases, the number and percentage of shares it holds, the purpose of the acquisition, including whether it intends to acquire control of the issuer's business and, if so, any plans to liquidate the issuer or effect any similar extraordinary transaction, and the nature of any arrangements the acquiror has with respect to the issuer's securities. [370] Section 14(d) requires similar disclosure by any offeror prior to commencing a tender

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offer. Section 14(e) sets forth a general prohibition against fraudulent, deceptive or manipulative devices, including materially misleading statements or omissions, in the tender offer context.

The courts have generally permitted private actions for injunctive relief (including corrective disclosure) for violations of the reporting requirements of §§ 13(d) and 14(d), but have not extended the private right of action to suits for monetary damages. [371] To obtain an injunction, such as one prohibiting further acquisition of shares by the defendant or voting of shares, the plaintiff must demonstrate that the reporting violation was material [372] and that it was linked to

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plaintiff's injury. [373] If the plaintiff seeks a preliminary injunction, as is often the case in fast-moving tender offers, it must also demonstrate that it would be irreparably harmed without the injunction. In many cases, the court may issue only interim relief pending corrective disclosure by the defendant.

The courts generally have implied a private right of action for violations of § 14(e) by would-be acquirors. [374] Such actions may permit money damages in certain circumstances, as well as injunctive relief. [375] The damage remedy is available to the target company and its shareholders, whether tendering or non tendering, [376] but may not be brought by unsuccessful tender offerors against the successful bidder. [377] The plaintiff in a § 14(e) action must prove that the defendant made material misstatements or omissions, that the defendant acted either intentionally or with reckless disregard for the truth, and that the plaintiff actually relied on the misstatement or omission. [378]

[3] Exchange Act Rule 14d-10

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Although Rule 14d-10 under the Exchange Act, the so-called "best price rule," [379] had been an important basis for tender offer litigation, recent amendments to the rule are likely to substantially reduce the number of lawsuits brought under the implied private right of action created by this provision. [380]

When the SEC adopted Rule 14d-10 in 1986, the stated purpose of the rule was to advance the principle of nondiscrimination in tender offers. Since then, the best price rule had been used increasingly in shareholder litigation in which plaintiffs claimed that amounts paid (by the bidder or by the target) to target executives as retention bonuses or pursuant to golden parachutes, consulting agreements, noncompetition agreements, new equity grants or similar arrangements actually constituted additional payments for the executive's shares. In 2006, the SEC adopted amendments to establish that these arrangements are outside the scope of the best price rule and "clarify that the provisions of the rule apply only with respect to the consideration offered and paid for securities tendered in a tender offer." [381] The SEC noted that such clarification was necessary because conflicting judicial decisions and potentially onerous litigation exposure had substantially chilled tender offer activity. [382]

Prior to the 2006 amendments, Rule 14d-10 provided that "[n]o bidder shall make a tender offer" unless, among other requirements, "[t]he consideration paid to any security holder *pursuant to* the tender offer is the highest consideration paid to any other security holder during such tender offer" (emphasis added). The amended rule focuses on the price paid "for securities tendered in the tender offer," not the price paid "pursuant to the tender offer." Thus, the amended provision reads: "[t]he consideration paid to any security holder *for securities tendered in* the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer" (emphasis added). Also, the amended rule includes an explicit exemption for employment compensation as long as the compensation is for past services and the amount paid is not determined by the number of shares tendered. The amended rule also includes a safe harbor provision for arrangements approved by a properly constituted committee of the involved companies' boards of directors.

[4] Exchange Act Rule 14e-3

Rule 14e-3 under the Exchange Act, promulgated by the SEC under § 14(e) of the Exchange Act, specifically targets insider trading in the tender offer context. It provides that once a bidder has taken a "substantial step or steps to commence, or has commenced, a tender offer," it is unlawful for anyone (other than the bidder or its agents) to trade in the securities sought in the tender offer on the basis of material nonpublic information that such person knows or should know has been obtained directly or indirectly from the bidder or the target. Rule 14e-3 also makes it unlawful for persons connected with the tender offeror or target, such as their officers, directors, employees or advisers—or those who have reason to know the information was misappropriated from such persons—to tip the material nonpublic information to others. The soon-to-be tender offeror does not have a general duty to disclose its intention to make a tender offer and may therefore purchase securities knowing that it plans to make a tender offer before announcing the offer; however, any such purchase may, if sufficiently large, be subject to the reporting requirements of § 13(d) of the Exchange Act and other federal laws. [383]

Like Rule 10b-5, Rule 14e-3 has been interpreted as creating a private right of action. [384] However, within its limited context of tender offers, [385] Rule 14e-3 prohibits a broader range of conduct than does Rule 10b-5. Unlike Rule 10b-5, Rule 14e-3 does not require proof of fraud or breach of fiduciary duty by the defendant. [386] Rule 14e-3 was promulgated in part to respond to the Supreme

Court's decision in *Chiarella v. United States*, [387] which limited insider trading liability to those breaching a fiduciary duty. In *Chiarella*, the court rejected the "parity of information" approach, which deemed trading to be fraudulent whenever the trader possessed material information not generally available to the public. The court instead held that there must be a breach of a fiduciary duty or other relationship of trust and confidence before the law imposes a duty to disclose information or abstain from trading. In *Chiarella*, an employee of a financial printer discovered nonpublic information while printing corporate takeover bids and then used that information to trade at a profit. The court held that the employee did not have a fiduciary duty to disclose his knowledge to the target shareholders. This decision thus created a gap in the coverage afforded by Rule 10b-5, necessitating the enactment of Rule 14e-3.

Rule 14e-3 also prohibits the communication of inside information to others— "tipping"—where it is "reasonably foreseeable" that the tip might result in trading by the tippee, whether or not trading actually occurs. It is unclear whether Rule 10b-5 would be interpreted to extend this broadly. [388]

Rule 14e-3 does contain a defense, or "safe harbor," for financial institutions that conduct both trading and corporate finance activities. These companies may avoid liability by showing both that (i) the person who made the investment decision on behalf of the company was not actually in possession of the material information and (ii) the company had implemented procedures, such as "information barriers," to prevent those persons making investment decisions from obtaining inside information. [389]

Footnotes

367 *See* § 9.05 for a more general discussion of regulation of tender and exchange offers.

368 The "safe harbor" created by the Litigation Reform Act for certain projections and other forward-looking statements made by issuers or underwriters does not apply to statements made in the context of a tender offer or a going-private transaction. *See* § 11.03[5].

369 Senate Committee on Banking and Currency, Hearings Before the Subcommittee on Securities on S. 510, 90th Cong., 1st Sess. 21 (1967).

370 An investor that crosses the 5% threshold is normally required to report on Schedule 13D such holdings within ten days of the purchase that put it over the threshold. *See* Rule 13d-1 under the Exchange Act. However, certain "qualified institutional investors" ("QIIs") may file short-form Schedule 13G within ten days if the securities are not acquired "with any purpose, or with the effect of, changing or influencing the control of the issuer, or in connection with … any transaction having that purpose or effect," so long as certain other requirements are met. Rule 13d-1(c) under the Exchange Act. Moreover, if the QII acquired no more than 10% of the shares of the company "for investment purposes in the ordinary course of business," and not with the intent of influencing control of the issuer, it may delay filing of short-form Schedule 13G

until 45 days after the end of the calendar year in which it made its purchase (and then only if it continued to own more than 5% at the end of the calendar year). Rule 13d-1(b) under the Exchange Act.

The SEC took a strong stance under § 13(d) of the Exchange Act and Rule 13d-1 thereunder against a merger arbitrage hedge fund that had acquired more than 5% of the voting stock of a company. *See In the Matter of Perry Corp.*, Admin. Proc. File No. 3-13561 (July 21, 2009) ("*Perry*"). In *Perry*, the hedge fund was engaged in a strategy known as "merger arbitrage," which consisted of holding long the stock of a suspected target company and holding short the stock of the acquiror. However, when it became apparent that the acquiror's shareholders would vote down the merger, Perry began to purchase stock in the acquiror (without liquidating its short position) in order to use the shares to influence the merger vote, and at the same time entered into a total return swap that effectively eliminated the economic risk of ownership of the shares. When Perry exceeded the 5% threshold of the acquiror's shares, it took the position that it did so in the ordinary course of business and not for the purpose of effecting a change of ownership in the acquiror. Further, because its holdings did not cross the 10% threshold, Perry did not file short-form 13G, intending to wait until 45 days after the end of the calendar year to do so. On these facts, the SEC imposed a fine of $150,000 and entered a cease and desist order. The SEC ruled that whenever a merger arbitrage fund holds stock to affect the outcome of a merger vote, it does not purchase the stock in the ordinary course of business and thus cannot avail itself of the short-form Schedule 13G option. Instead, it must file Schedule 13D within ten days of its purchases exceeding 5% of the acquiring company.

In *Perry*, the SEC adopted a broad reading of § 13(d). It stated that both §§ 13(d) and 13(g) of the Exchange Act are "broad disclosure statutes" that go beyond "mere ‘technical’ reporting provisions." *In the Matter of Perry Corp.*, Admin. Proc. File No. 3-13561 (July 21, 2009). Rather, the SEC stated, the provisions are the "pivot" of a regulatory scheme that "may represent the only way that corporations, their shareholders and others can adequately evaluate … the possible effects of a change in substantial shareholdings." *In the Matter of Perry Corp.*, Admin. Proc. File No. 3-13561 (July 21, 2009) (citing *SEC v. Drexel Burnham Lambert, Inc.*, 837 F. Supp. 587, 607 (S.D.N.Y. 1993)). The SEC further explained that § 13(d) served the broad purposes of: "(i) providing adequate disclosure and other protections to stockholders in connection with takeover attempts, such as tender offers, and corporate repurchases, and (ii) providing adequate disclosure to stockholders in connection with any substantial acquisition of securities within a relatively short period of time." *In the Matter of Perry Corp.*, Admin. Proc. File No. 3-13561 (July 21, 2009) (citing Exchange Act Release No. 13291, 42 Fed. Reg. 12,342, 12,343 n.2 (Mar. 3, 1977)); *see also* Chapter 6.

371 *See generally Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 57 (1975) (discussing availability of injunctive relief under § 13(d) of the Exchange Act); *see, e.g.*, *Motient Corp. v. Dondero*, 529 F.3d 532, 536 (5th Cir. 2008) ("We agree with the district court that there is no private cause of action for money damages under Section 13(d)."); *Florida Commercial Banks v. Culverhouse*, 772 F.2d 1513, 1519 (11th Cir. 1985) (holding that there is a private right of action to seek corrective disclosure); *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 714–15 (5th Cir. 1984); *Indiana National Corp. v. Rich*, 712 F.2d 1180, 1184–85 (7th Cir. 1983); *Dan River, Inc. v. Unitex, Ltd.*, 624 F.2d 1216, 1224 (4th Cir. 1980), *cert. denied*, 449 U.S. 1101 (1981); *GAF Corp. v. Milstein*, 453 F.2d 709, 720–21 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972) (private actions under § 13(d)); *E.ON AG v. Acciona, S.A.*, 468 F. Supp. 2d 559, 573 (S.D.N.Y. 2007) (private actions under § 14(d)); *Milstein v. Huck*, 600 F. Supp. 254, 263 (E.D.N.Y. 1984); *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983) (private actions under § 14(d)). *But see Liberty National Insurance Holding Co. v. Charter Co.*, 734 F.2d 545, 570–71 (11th Cir. 1984) (holding that there is no private right of action available under either statute where an issuer seeks injunctive relief requiring the shareholder to divest shares and to refrain from voting its shares, pending divestiture).

372 *See Transcon Lines v. A.G. Becker, Inc.*, 470 F. Supp. 356, 376 (S.D.N.Y. 1979); *see also Treadway Companies v. Care Corp.*, 490 F. Supp. 660, 663–65 (S.D.N.Y.), *aff'd in relev. part, rev'd in part*, 638 F.2d 357, 380 (2d Cir. 1980).

373 *See Stirling v. Chemical Bank*, 382 F. Supp. 1146, 1151–52 (S.D.N.Y. 1974), *aff'd*, 516 F.2d 1396 (2d Cir.

1975); *Washburn v. Madison Square Garden Corp.*, 340 F. Supp. 504, 508 (S.D.N.Y. 1972).

374 The effect of the Sarbanes-Oxley Act on the statute of limitations for private rights of action, including those under § 14(e), is discussed in § 11.07[1][a].

375 *See, e.g.*, *Plaine v. McCabe*, 797 F.2d 713, 717 n.7 (9th Cir. 1986); *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 716 (5th Cir. 1984); *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 370–71 (6th Cir. 1981). *But see Liberty National Insurance Holding Co. v. Charter Co.,* 734 F.2d 545, 570–71 (11th Cir. 1984) (no private right of action for issuers seeking drastic injunctive relief).

376 *See, e.g.*, *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 596 (5th Cir. 1974); *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937, 946 (2d Cir. 1969). Shareholders who decided not to tender due to fraudulent misrepresentations have standing because, unlike § 10(b) of the Exchange Act, § 14(e) contains no language limiting claims to situations involving the actual purchase or sale of securities. *See Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 38–39 (1977).

377 *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 35 (1977). In some cases, unsuccessful offerors have been permitted to bring injunctive actions under § 14(e), on the theory that such actions result in "clear benefit" to the shareholders of the target. *See, e.g.*, *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 371–72 (6th Cir. 1981); *Humana, Inc. v. American Medicorp, Inc.*, 445 F. Supp. 613, 616 (S.D.N.Y. 1977). *But see Astronics Corp. v. Protective Closures Co.*, 561 F. Supp. 329, 332–33 (W.D.N.Y. 1983) (casting doubt about the validity of these cases in light of subsequent legal developments).

378 *See Panter v. Marshall Field & Co.*, 646 F.2d 271, 283–84 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Chris-Craft Industries v. Piper Aircraft Corp.*, 480 F.2d 341, 373 (2d Cir.), *cert. denied*, 414 U.S. 910, and *cert. denied*, 414 U.S. 924 (1973).

379 In addition to the "best price rule," Rule 14d-10 also includes the companion "all holders rule," which provides that any tender offer must be "open to all security holders of the class of securities subject to the tender offer." This provision has not been the subject of private litigation to the same extent as the best price rule.

380 For an example of such a lawsuit, and the court's analysis of the private right of action created under Rule 14d-10, *see Epstein v. MCA, Inc.*, 50 F.3d 644, 652 (9th Cir. 1995), *vacated on other grounds*, 516 U.S. 367 (1996), and *Katt v. Titan Acquisitions, Ltd.*, 133 F. Supp. 2d 632, 640 (M.D. Tenn. 2000) (gathering authority).

381 SEC Release No. 34-54684 (Nov. 1, 2006).

382 Courts had adopted competing interpretations of the best price rule. Some courts followed the "bright line test," holding that a transaction that is entered into with an executive prior to the actual commencement of the tender offer can never be subject to the best price rule. *See, e.g.*, *Gerber v. Computer Associates International, Inc.*, 303 F.3d 126 (2d Cir. 2002); *Lerro v. Quaker Oats Co.*, 84 F.3d 239 (7th Cir. 1996); *Katt v. Titan Acquisitions, Ltd.*, 244 F. Supp. 2d 841 (M.D. Tenn. 2003); *In re Digital Island Securities Litigation*, 223 F. Supp. 2d 546 (D. Del. 2002); *Walker v. Shield Acquisition Corp.*, 145 F. Supp. 2d 1360 (N.D. Ga. 2001). Other courts followed the "integral part test," holding that any transaction integral or closely related to the tender offer can be subject to the best price rule. This test is ambiguous and its application is more difficult to predict. *See, e.g.*, *Epstein v. MCA. Inc.*, 50 F.3d 644 (9th Cir. 1995); *Millionerrors Investment Club v. General Electric Co. PLC*, Fed. Sec. L. Rep (CCH) ¶90,944 (W.D. Pa. Mar. 21, 2000).

383 Filings may be required, for example, under the Hart-Scott-Rodino Antitrust Improvements Act. *See* § 9.06.

384 The Sarbanes-Oxley Act creates a new statute of limitations for private rights of action under Rule 14e-3, which is discussed in § 11.07[1][a].

385 Rule 14e-3 is not applicable to insider trading connected with mergers or consolidations, which must be addressed, along with other types of insider trading, under Rule 10b-5. *See* § 11.05[2].

386 *Cf.* § 11.05[2]. The absence of a "breach of duty" element in Rule 14e-3 sparked challenges to its validity, with litigants contending that the SEC exceeded its rulemaking authority. The Supreme Court has since held, however, that Rule 14e-3 was validly promulgated, and that SEC prohibitions may sweep in

nonfraudulent acts and practices so long as the rule is "reasonably designed" to prevent fraudulent activity. *See United States v. O'Hagan*, 521 U.S. 642 (1997); *see also United States v. Chestman*, 947 F.2d 551, 557 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992).

387 *See Chiarella v. United States*, 445 U.S. 222 (1980).

388 *See* § 11.05[2][a][ii].

389 Rule 14e-3 under the Exchange Act. *See* § 14.07[1][b] for a discussion of "information barriers."

U.S. Regulation of the International Securities and Derivatives Markets, § 11.07, ENFORCEMENT RELATED PROVISIONS OF THE SARBANES-OXLEY AND DODD-FRANK ACTS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 11.07 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The Sarbanes-Oxley Act contains a number of provisions relevant to civil, administrative and criminal enforcement. Several of these provisions expand on the existing powers of the SEC under the Exchange Act and the Securities Act, while other provisions seek to stiffen penalties and eliminate perceived deficiencies in the previously existing enforcement scheme for corporate and securities fraud in light of the corporate scandals that preceded the passage of the Act.

[1] Civil Enforcement

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[a] Statute of Limitations for Securities Fraud

The Sarbanes-Oxley Act created a new statute of limitations for any private right of action involving a claim for fraud "in contravention of a regulatory requirement" under the securities laws of the earlier of two years from the date of discovery or five years from the date of the violation. [390] Although the Sarbanes-Oxley Act is not explicit about the claims that it intends to cover, the likely interpretation of this provision is that it will provide the applicable limitations period for securities claims only where the securities laws themselves do not expressly set out the limitations period. To determine whether the new statute of limitations applies, courts have noted that, by its terms, the provision only applies to "a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws." [391] Based on this limitation, courts have generally only applied the longer limitations period to claims that require a showing of fraudulent intent as an element of the cause of action. [392] Courts have noted that Congress used language that mirrors § 10(b) of the Exchange Act in § 804, when it could just as easily have made clear that the new limitations period applied to all actions under the securities laws. Thus, the new statute of limitations will likely not apply to causes of action pursuant to §§ 9 and 18 of the Exchange Act or §§ 11 and 12 of the Securities Act, [393] but likely applies to causes of action

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pursuant to § 10(b) of the Exchange Act. [394] The statute of limitations for claims under § 10(b) previously had been the earlier of one year from the date of discovery or three years from the date of violation. [395] Courts, however, have determined that the new statute of limitations does not apply to § 14 of the Exchange Act even though § 14 does not expressly set out the limitations period. [396]

[b] Debts Nondischargeable if Incurred in Violation of Securities Fraud Laws

The Sarbanes-Oxley Act also created an additional exception to the discharge of any individual bankruptcy debtor in a bankruptcy proceeding from any debt relating to any judgment, settlement or order resulting from the violation of the federal or state securities laws or regulations or common law fraud in connection with the purchase or sale of a security. [397]

[c] Whistleblower Protections and Incentives

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[i] *Civil Action to Protect Against Retaliation*

The Sarbanes-Oxley Act created a civil action to protect informants or whistleblowers from possible retaliation for providing assistance or information to federal regulatory or law enforcement agencies, any member or committee of Congress, or any other proceeding concerning alleged violations of any SEC rule, mail fraud, wire fraud, bank fraud, securities fraud or any federal law relating to fraud against shareholders. [398] Initially, the employee is required to show that the whistleblowing conduct was a "contributing factor" in the unfavorable personnel action and must file a claim with the Department of Labor within 90 days of violation. That period was extended to 180 days by the Dodd-Frank Act, and now allows an employee to bring a claim within 180 days of the date in which he or she became aware of the violation. [399]

The Department of Labor administers the employee's complaint, but the employee can bring a claim before a district court if a final decision is not issued by the Department of Labor within 180 days of filing the claim. The Sarbanes-Oxley Act authorizes the following remedies: reinstatement, back pay, interest, attorneys' fees, "any special damages sustained as a result of the discrimination" and "all relief necessary to make the employee whole." [400] It is unclear whether punitive damages are available. The Dodd-Frank Act clarified that a jury trial is available under such claims. [401] These rights may not be waived by any agreement or condition of employment, including by a predispute arbitration agreement. [402]

The Sarbanes-Oxley Act had limited these remedies mainly to employees who work for a publicly traded company or brokerage firm, including the

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employees of their private contractors and subcontractors. [403] The Dodd-Frank Act further expanded coverage to employees of any "nationally recognized statistical rating organization." [404] In addition, the Dodd-Frank Act created a private right of action for *any* employee (not just those of publicly traded companies) that is the subject of discharge, demotion, suspension, harassment, threats or any manner of discrimination in the terms and conditions of employment, for providing information to the SEC or making the disclosures required or protected under the Sarbanes-Oxley Act, the Exchange Act, or any other law or rule subject to the jurisdiction of the SEC. [405] However, in *Liu Meng-Lin v. Siemens AG*, the Second Circuit held that this provision of the Dodd-Frank Act does not apply extraterritorially, and declined to apply the provision where "the whistleblower, his employer, and the other entities involved in the alleged wrongdoing are all foreigners based abroad, and the whistleblowing, the alleged corrupt activity, and the retaliation all occurred abroad." [406]

[ii] *Whistleblower Incentives*

In addition to expanding the protections for whistleblowers as detailed above, the Dodd-Frank Act provided additional incentives in the form of monetary compensation. Section 922(a) of the Act added a new § 21F to the Exchange Act, which establishes the Securities and Exchange Commission Investor Protection Fund (the "SEC Fund"). [407] The SEC must deposit into the SEC Fund all moneys collected in proceedings enforcing the securities laws, to the extent not added to a disgorgement fund under § 308 of the Sarbanes-Oxley Act, [408] and to the extent the balance of the SEC Fund does not exceed $300 million. In addition, the SEC must deposit into the SEC Fund all funds from the

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§ 308 disgorgement funds that are not distributed to victims of securities law violations, unless the SEC Fund's balance exceeds $200 million. [409]

The new § 21F provides that, upon the completion of a successful administrative or judicial action that results in monetary sanctions exceeding $1,000,000, the SEC shall award to any whistleblower who voluntarily provided information not already known to the SEC an amount equal to no less than ten percent and no more than 30% of the total collected as monetary sanction in such enforcement action. [410] The determination of the proper award is left to the discretion of the SEC after consideration of certain guidelines listed in § 21F(c). Whistleblowers are given the opportunity to appeal the SEC's determination of whether or to whom to award any amount under this provision to the appropriate United States Court of Appeals. [411] As of August 2016, the SEC had awarded more than $107 million to 33 whistleblowers under its whistleblower program. [412]

[2] Regulatory Enforcement

[a] Disgorgement of Incentive Compensation Following Restatements

Section 304 of the Sarbanes-Oxley Act requires the chief executive officer and chief financial officer of an issuer to reimburse it for all bonuses and other incentive-based or equity-based compensation received, as well as all profits realized from sales of issuer securities, in the 12-month period following the first public issuance or filing of reported financial statements that are later restated due to material noncompliance with any financial reporting requirement as a result of misconduct. [413] The Ninth Circuit has held that this provision "allows the SEC to seek disgorgement from CEOs and CFOs even if the triggering restatement did not result from misconduct on the part of those officers." [414]

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The Dodd-Frank Act requires the SEC to direct national securities exchanges and associations to modify their listing standards to require new disgorgement policies from listed companies. Specifically, it requires that issuers with listed securities establish a clawback policy in the event of an accounting restatement that would recover incentive-based compensation received during the three-year period *preceding* the date of the restatement due to material noncompliance by the company with any financial reporting requirement under the federal securities laws. [415] The provision is required to apply to any current or former executive officer of the issuer (not just the CEO and CFO) "in excess of what would have been paid to the executive officer under the accounting restatement." [416] A showing of misconduct on the part of either the issuer or the officer is not required. [417]

[b] Restrictions on Persons Serving as Directors and Officers

Section 1105 of the Sarbanes-Oxley Act amended § 21C of the Exchange Act and § 8A of the Securities Act to authorize the SEC, in connection with a cease-and-desist proceeding, to issue an order barring any person who has violated § 10(b) of the Exchange Act or § 17(a)(1) of the Securities Act, as applicable, from acting as a director or officer of any issuer "if the conduct of that person demonstrates unfitness to serve as an officer or director." [418] Prior to these

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amendments to the Exchange Act and Securities Act, the SEC could only seek a bar in court. [419]

Section 305(a) of the Sarbanes-Oxley Act also amended § 21(d)(2) of the Exchange Act and § 20(e) of the Securities Act to provide that a U.S. federal court may, pursuant to a proceeding initiated by the SEC, bar any person who violates § 10(b) of the Exchange Act or § 17(a)(1) of the Securities Act from acting as an officer or director of any issuer, if such person's conduct demonstrates "unfitness" to serve as an officer or director of an issuer. Prior to these amendments, a court could only bar a person whose conduct demonstrated "substantial unfitness" to serve in such capacity.

Notably, the above amendments to the Securities Act and Exchange Act give the SEC and U.S. federal courts the power to determine the eligibility of foreign persons to serve on the boards of directors or as executive officers of foreign issuers that are SEC reporting companies.

[c] Equitable Relief

Section 305(b) of the Sarbanes-Oxley Act created a new § 21(d)(5) of the Exchange Act that states that the SEC may seek, and any federal court may grant, "any equitable relief that may be appropriate or necessary for the benefit of investors." Although both what specific power the Sarbanes-Oxley Act intended to bestow upon the SEC and the scope of those powers are unclear, the SEC has already invoked this provision in an enforcement proceeding to seek disgorgement of all compensation received after allegedly fraudulent conduct had occurred, not just the bonuses or other incentive-based or equity-based compensation that are subject to recapture under § 304. [420]

[d] Disgorgement Funds

Section 308 of the Sarbanes-Oxley Act provides that the SEC may, in any judicial or administrative matter in which the SEC obtains an order or settlement for disgorgement, cause any civil penalties to be paid to the disgorgement fund

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established for the benefit of the violation's victims. [421] The SEC may accept additional contributions to the fund. The Dodd-Frank Act, however, eliminated the requirement that the SEC obtain an order or settlement for disgorgement, and allows it to pay any civil penalties to a disgorgement or other fund established for the benefit of the violation's victims. [422]

[e] SEC Authority to Seek Order Freezing Certain Assets of an Issuer During an Investigation Involving Possible Federal Securities Law Violations

Section 1103 of the Sarbanes-Oxley Act authorizes the SEC to petition a U.S. federal court for a temporary order requiring an issuer of "publicly traded securities" to escrow any "extraordinary payments (whether compensation or otherwise)" that appear likely to the SEC to be made to any director, officer, partner, controlling person, agent or employee of the issuer during an investigation of such issuer or individual involving possible violations of the U.S. federal securities laws. A court may issue such an order after notice and an opportunity for a hearing, unless the court determines this requirement to be impracticable or contrary to the public interest. Section 1103 further provides that a court order would take effect immediately and remain in effect for 45 days, unless set aside or modified by a court. The initial order may also be extended by up to 45 additional days for "good cause shown." If, prior to the expiration of the order, the issuer or individual is charged with a federal securities law violation, § 1103 provides that the order will remain in effect until the conclusion of any related legal proceedings, subject to court approval and the right of the issuer or individual to petition the court. If no charges are brought prior to the order's expiration, the disputed payments (plus accrued interest) must be returned to the issuer or individual.

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Section 1103 raises interpretive issues with respect to scope, including the definition of "publicly traded securities," "extraordinary payments" and "good cause shown" and the duration of an order following the filing of charges relating to an alleged federal securities law violation. [423] Although the SEC sought and the Ninth Circuit Court of Appeals upheld a § 1103 order in *SEC v. Gemstar-TV Guide International, Inc.*, and the then-SEC Chairman signaled that the *Gemstar* decision would prompt increased § 1103 petitions, the SEC has made minimal use of this provision. [424]

[3] Enhanced Criminal Provisions Under the Sarbanes-Oxley Act

[a] Certification of Periodic Reports Containing Financial Statements

Section 906 of the Sarbanes-Oxley Act requires that each "periodic report containing financial statements filed by an issuer with the [SEC]" must be accompanied by a certification by the issuer's chief executive officer and chief financial officer (or equivalent thereof) that the report "fully complies with the requirements of § 13(a) or § 15(d) of the [Exchange Act] and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer." [425] Section 906, which is

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enforceable by the DOJ and not the SEC, imposes criminal liability for inaccurate certifications knowingly or willfully furnished. [426]

[b] Destruction, Alteration or Falsification of Records

The Sarbanes-Oxley Act added § 1519 to Title 18 of the U.S. Code, making it a crime to knowingly destroy, alter or falsify any record, document, or tangible object with the intent to impede, obstruct or influence a federal investigation or bankruptcy or in relation to or contemplation of any such matter, and amended existing § 1512 of Title 18 of the U.S. Code to apply to document destruction or alteration in any federal court or similar proceeding. [427] In each case, the maximum sentence is 20 years imprisonment. In a case concerning the prosecution of a commercial fisherman under this provision for tossing illegally harvested fish into the sea, the Supreme Court recently clarified that § 1519 "cover[s] only objects one can use to record or preserve information, not all objects in the physical world." [428]

[c] Destruction of Corporate Audit Records

The Sarbanes-Oxley Act added § 1520 to Title 18 of the U.S. Code, requiring (i) any accountant conducting an audit of an issuer to maintain work papers for a defined period and (ii) the SEC to promulgate rules regarding the retention

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of work papers and other documents. [429] In response, the SEC amended Regulation S -X to require accountants to retain work papers for seven years following their conclusion of an audit or review of an issuer's financial statements. [430] The maximum sentence for violation of the Sarbanes-Oxley Act's requirement or the SEC's rules thereunder is ten years' imprisonment.

[d] Securities Fraud

The Sarbanes-Oxley Act added § 1348 to Title 18 of the U.S. Code, making it a crime to defraud any person in connection with any security of an issuer. [431] This section does not contain the purchase or sale requirement contained in § 10(b) of the Exchange Act. [432] The maximum sentence is 25 years' imprisonment.

[e] Retaliation Against Informants

The Sarbanes-Oxley Act added § 1513 to Title 18 of the U.S. Code, making it a crime to retaliate against any person for providing information to a law enforcement officer. [433] The maximum sentence is ten years' imprisonment.

[f] Increased Maximum Penalties

The Sarbanes-Oxley Act increased the maximum sentence for mail and wire fraud from five to 20 years' imprisonment. [434] It also increased the maximum criminal penalties under the Exchange Act from $1 million to $5 million for individuals and from $2.5 million to $25 million for entities, and the maximum prison sentence from ten years to 20 years. [435] The Sarbanes-Oxley Act increased the penalties for a willful violation of ERISA's reporting and disclosure provisions to a fine of not more than $100,000 and imprisonment for not more than ten years. [436]

[g] Review by U.S. Sentencing Commission

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The Sarbanes-Oxley Act instructed the U.S. Sentencing Commission, which, as discussed further in § 11.09[3][d], sets the sentencing guidelines used by U.S. federal courts, to review the guidelines for obstruction of justice, criminal fraud and securities and accounting fraud related offenses, and to ensure that the sentencing guidelines reflect the nature of the offenses and penalties set forth in the Act. [437] In 2003, the Commission promulgated permanent amendments to reflect the provisions of the Sarbanes-Oxley Act. [439] These amendments, which became effective November 1, 2003, made permanent the temporary amendments and added several provisions. Together, the amendments increased the penalties and the scope of the current sentencing guidelines for corporate and serious white-collar frauds. Specifically, the amendments:

- significantly increased certain penalty enhancements for offenses affecting more than 50 victims;
- expanded the scope of certain penalty enhancements to cover offenses that substantially endanger (i) the solvency or financial security of an organization that at the time was publicly traded or had 1,000 or more employees, or (ii) the solvency or financial security of 100 or more victims (prior to the amendments, the enhancements applied only if the offense substantially jeopardized the safety and soundness of a financial institution);
- created a new penalty enhancement to cover violations of securities laws by officers or directors of publicly traded companies, registered broker-dealers and investment advisers;
- significantly increased penalties for offenses such as wire fraud and mail fraud;
- significantly increased penalties for offenses in which the loss exceeds $200 million (reduction in value of equity securities or other corporate assets is now a factor in measuring losses); and
- significantly increased penalties for obstruction of justice offenses and create new penalty enhancements to cover alteration or fabrication of substantial

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numbers of documents or objects, destruction of particularly probative documents or objects, or offenses that were extensive in scope, planning or preparation.

Footnotes

390 *See* § 804 of the Sarbanes-Oxley Act.

391 *See* § 804 of the Sarbanes-Oxley Act.

392 *See In re Alstom S.A.*, 406 F. Supp. 2d 402, 412 (S.D.N.Y. 2005) (noting that "Section 804 ‘by its plain text’ does not apply to claims under the securities laws that do not require any showing of fraudulent intent as an element of the cause of action" and holding that the new limitations period does not apply to § 11, § 12 or § 15 claims under the Securities Act or § 18 claims under the Exchange Act, but does apply to § 10(b) claims under the Exchange Act). In *Alstom*, the plaintiff contended that even though a § 11/§ 12 plaintiff need not plead fraud in all cases, the longer limitations should apply when a § 11/§ 12 plaintiff *does* plead fraud. The court rejected this argument in favor of a bright line rule that selects the statutory period based on the elements of the *prima facie* claim instead of the individual circumstances of the plaintiff's factual pleadings. *See also In re Pfizer Inc. Securities Litigation*, 584 F. Supp. 2d 621, 641–43 (S.D.N.Y. 2008) (holding that the extended Sarbanes-Oxley statute of limitations did not apply to § 18 claims because fraudulent intent is not an element of a *prima facie* case under that section).

393 Most courts to consider the issue have determined that the new statute of limitations does not apply to §§

11 and 12 of the Securities Act. *See In re Metropolitan Securities Litigation*, 532 F. Supp. 2d 1260, 1284 (E.D. Wash. 2007); *Cohen v. Northwestern Growth Corp.*, 385 F. Supp. 2d 935 (D.S.D. 2005); *In re Alamosa Holdings, Inc. Securities Litigation*, 382 F. Supp. 2d 832, 863–64 (N.D. Tex. 2005); *Ballard v. Tyco International*, Fed. Sec. L. Rep. (CCH) ¶93,242 (D.N.H. 2005) at 4; *Lawrence E. Jaffe Pension Plan v. Household International, Inc.*, Fed. Sec. L. Rep. (CCH) ¶92,713 (N.D. Ill. Mar. 22, 2004); *In re Merrill Lynch & Co. Research Reports Securities Litigation*, 272 F. Supp. 2d 243, 265 (S.D.N.Y. 2003); *In re Global Crossing Ltd. Securities Litigation*, 313 F. Supp. 2d 189, 195–97 (S.D.N.Y. 2003).

394 *See In re Exxon Mobil Corp. Securities Litigation*, 500 F.3d 189, 197 (3d Cir. 2007); *In re Brocade Communication Systems Inc. Derivative Litigation*, 615 F. Supp. 2d 1018, 1035–36 (N.D. Cal. 2009); *GVA Market Neutral Master Ltd. v. Veras Capital Partners Offshore Fund, Ltd.*, 580 F. Supp. 2d 321, 327 (S.D.N.Y. 2008); *In re Alstom S.A. Securities Litigation*, 406 F. Supp. 2d 402, 412 (S.D.N.Y. 2005); *In re AOL Time Warner Securities & "ERISA" Litigation*, Fed. Sec. L. Rep. (CCH) ¶92,812 at 27 (S.D.N.Y. 2004); *In re Merrill Lynch & Co. Research Reports Securities Litigation*, 272 F. Supp. 2d 243, 265 (S.D.N.Y. 2003).

395 *See* Elaine Buckberg *et al.*, National Economic Research Assoc., Inc., *Recent Trends in Securities Class Action Litigation: 2003 Early Update* (2004) (concluding that the Sarbanes-Oxley Act has had a limited impact upon securities litigation, despite the expansion of the statute of limitations). Assuming post-Litigation Reform Act levels, the research indicates that there is no "statistically significant" change in the level of litigation after the enactment of the Sarbanes-Oxley Act. There have been, however, fewer dismissals of cases by district courts. *But see* Price Waterhouse-Coopers LLP, *Securities Litigation Study* (2004) (finding that the Sarbanes-Oxley Act has led to a significant change in the level of litigation by "revealing even more securities violations, financial frauds, accounting irregularities and corporate ‘accounting melt-downs,’" while recognizing that in the future the Sarbanes-Oxley Act may work to deter financial frauds).

396 *See In re Exxon Mobil Corp. Securities Litigation*, 500 F.3d 189, 197 (3d Cir. 2007) (holding that the extended statute of limitations did not apply to § 14(a) claims for filing false proxy statements); *In re Maxim Integrated Products, Inc., Derivative Litigation*, 574 F. Supp. 2d 1046, 1072 (N.D. Cal. 2008); *Virginia M. Damon Trust v. North Country Financial Corp.*, 325 F. Supp. 2d 817, 823–25 (W.D. Mich. 2004); *In re Global Crossing Ltd. Securities Litigation*, 313 F. Supp. 2d 189, 195–97 (S.D.N.Y. 2003).

397 *See* § 803 of the Sarbanes-Oxley Act.

398 *See* § 806 of the Sarbanes-Oxley Act, creating new 18 U.S.C. § 1514A; *see also* Robert G. Vaughn, *America's First Comprehensive Statute Protecting Corporate Whistleblowers*, 57 ADMIN. L. REV. 1 (2005); *Carnero v. Boston Scientific Corp.*, Fed. Sec. L. Rep. (CCH) ¶92,910 (D. Mass. Aug. 27, 2004) (noting an absence of Congressional intent for extraterritorial application, the court declined to extend the protection of § 806 to an employee who was a foreign national and who worked exclusively overseas in the Argentinean subsidiary of a U.S. company); § 4.07[7][b] (discussing whistleblowers protection under the Sarbanes-Oxley Act).

399 *See* § 922(c) of the Dodd-Frank Act.

400 18 U.S.C. § 1514A(c)(1); *see, e.g.*, Joseph T. Hallihan, *WaMu Is Ordered to Rehire Staffer*, WALL ST. J., May 13, 2005, at A6 (reporting that the Labor Department ordered Washington Mutual to rehire Theresa Hagman, a former executive who raised questions about the loan granting process in Washington Mutual's construction-loan division, under the whistleblower provisions of the Sarbanes-Oxley Act).

401 *See* § 922(c) of the Dodd-Frank Act.

402 § 922(c) of the Dodd-Frank Act.

403 *See Lawson v. FMR LLC*, 134 S. Ct. 1158 (2014).

404 § 922(b) of the Dodd-Frank Act.

405 *See* § 922(a) of the Dodd-Frank Act. Lower courts have disagreed concerning whether the anti-retaliation protections of the Dodd-Frank Act only protect employees who provide information to the SEC or also extend to employees who only report violations internally. *Compare Asadi v. G.E. Energy (USA), LLC*, 720

F.3d 620 (5th Cir. 2013) ("Based on our examination of the plain language and structure of the whistleblower-protection provision, we conclude that the whistleblower-protection provision unambiguously requires individuals to provide information relating to a violation of the securities laws *to the SEC* to qualify for protection from retaliation.") *with Berman v. Neo@Ogilvy LLC*, 801 F.3d 145, 155 (2d Cir. 2015) (finding the language of the Dodd-Frank Act to be ambiguous and therefore deferring to the SEC's interpretation of the statute as creating a remedy for whistleblowers who report internally).

406 *Liu Meng-Lin v. Siemens AG*, 763 F.3d 175, 179-83 (2d Cir. 2014).

407 *See* § 922(a) of the Dodd-Frank Act.

408 *See* § 11.07[2][d].

409 *See* § 11.07[2][d].

410 *See* § 5.04[6] for a discussion of the whistleblower program implemented under § 21F of the Exchange Act.

411 *See* § 11.07[2][d].

412 *See* Press Release, SEC, SEC Whistleblower Program Surpasses $100 Million in Awards (Aug. 30, 2016).

413 This provision is discussed in greater detail in § 5.05[2].

414 *SEC v. Jensen*, 835 F.3d 1100, 1116 (9th Cir. 2016). Plaintiffs in various circuits have attempted to bring private actions against corporate officers under § 304 of the Sarbanes-Oxley Act. However, no court to date has recognized a private right of action under § 304. *See In re Goodyear Tire & Rubber Co.*, Fed. Sec. L. Rep. (CCH) ¶94,142 (N.D. Ohio Jan. 5, 2007); *In re Digimarc Corp.*, Civil No. 05-1324-HA (LEAD), 2006 WL 2345497, at *2 (D. Or. Aug. 11, 2006) ("That there is no private cause of action explicitly stated in [Sarbanes-Oxley Act § 304] is beyond dispute."), *aff'd in relevant part, In re Digimarc Corp. Derivative Litigation*, 549 F.3d 1223, 1233 (9th Cir. 2008) ("[W]e conclude that section 304 does not create a private right of action"); *In re BISYS Group Inc.*, 396 F. Supp. 2d 463 (S.D.N.Y. 2005) ("[T]he omission in Section 304 [of language explicitly authorizing private actions] appears to have been quite deliberate."); *In re Qwest Communications International, Inc. Securities Litigation*, 387 F. Supp. 2d 1130 (D. Colo. 2005) (holding that a stockholder lacked standing under § 304 and thus not reaching the issue of whether such a claim could be brought by a proper plaintiff).

415 *See* § 954 of the Dodd-Frank Act.

416 *See* § 954 of the Dodd-Frank Act. Although § 954 does not define "executive officer," the SEC has proposed a rule that includes a definition modeled on the definition of "officer" under § 16 of the Exchange Act, which covers "the issuer's president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer." SEC Release No. 34-75342 (July 1, 2015). The SEC's proposed rule further defines the recoverable amount as "the amount of incentive-based compensation received by the executive officer or former executive officer that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement," calculated on a pre-tax basis. SEC Release No. 34-75342 (July 1, 2015).

417 *See* § 954 of the Dodd-Frank Act.

418 *See, e.g.*, *SEC v. Symbol Technologies*, SEC Litigation Release No. 19086 (Feb. 17, 2005) (relating to consent of former Chief Accounting Officer and Senior Vice President of Worldwide Operations to permanent injunctive relief and officer-and-director bar); *see also* § 5.04[4] (discussing further orders barring persons from serving as directors and officers).

419 The Charity Aid, Recovery and Empowerment Act of 2003 (the "CARE Act"), which was passed by the Senate but never reached a vote in the House of Representatives, would have further expanded the SEC's power to act without court authority, including the ability to impose fines in administrative proceedings. S. 476, 108th Cong. (2003). The relevant provision of the CARE Act was previously introduced in the Senate as the SEC Civil Enforcement Act and incorporated in whole in the CARE Act. S. 183, 108th Cong. (2003).

420 *See SEC v. Kozlowski*, SEC Litigation Release No. 17722 (Sept. 12, 2002); § 5.04[3].

421 This provision was applied by the SEC in its $300 million settlement against Time Warner and its $500 million settlement against WorldCom. *See SEC v. Time Warner Inc.*, SEC Litigation Release No. 19147 (Mar. 21, 2005); *SEC v. WorldCom Inc.*, SEC Litigation Release No. 18147 (May 19, 2003). The former Chairman of the SEC also indicated he intended that the federal regulators' portion of the penalties in connection with the global settlement regarding analyst conflicts of interest be contributed under this provision to the distribution funds created by the settlement. *See* Global Research Analyst Settlement: Hearing Before the Senate Committee on Banking, Housing and Urban Affairs, 108th Cong. (May 7, 2003) (statement of William H. Donaldson, former Chairman, SEC). On June 5, 2003, the SEC announced the $22 million payment it will receive from its settlement with six senior executives of Xerox Corporation alleged to have participated in securities fraud will be paid into a court account pursuant to this provision. *See SEC v. Allaire*, SEC Litigation Release No. 18174 (June 5, 2003).

422 *See* § 929B of the Dodd-Frank Act.

423 Pursuant to § 1103 of the Sarbanes-Oxley Act, a California district court ordered Gemstar-TV Guide International, Inc. ("Gemstar") to freeze for 45 days the $37.64 million it agreed to pay its former Chief Executive Officer and Chief Financial Officer, whose accounting and disclosure practices during their tenure at Gemstar were being investigated by the SEC. *See SEC v. Yuen*, SEC Litigation Release No. 18135 (May 13, 2003). The Ninth Circuit, en banc, upheld the decision and declared that when determining the scope of an extraordinary payment, courts should be free to determine the proper context in which to evaluate such evidence as the size, purpose and circumstances of payments. The court held that Sarbanes-Oxley "does not compel any specific method of making the determination but allows for the consideration of a variety of factors." *SEC v. Gemstar-TV Guide International, Inc.*, 401 F.3d 1031 (9th Cir. 2005) (*en banc*), *cert. denied sub nom.*, *Yuen v. SEC*, 546 U.S. 933 (2005); *see also SEC v. Gemstar-TV Guide International, Inc.*, SEC Litigation Release No. 18760 (June 23, 2004).

HealthSouth Corp. also consented to an escrow of certain extraordinary payments to its executive officers and directors. *See SEC v. HealthSouth Corp.*, SEC Litigation Release No. 18044 (Mar. 20, 2003); *SEC v. HealthSouth Corp.*, 261 F. Supp. 2d 1298 (N.D. Ala. 2003).

424 *See SEC v. Gemstar-TV Guide International, Inc.*, 401 F.3d 1031 (9th Cir. 2005) (*en banc*), *cert. denied sub nom.*, *Yuen v. SEC*, 546 U.S. 933 (2005); *Testimony Before The House Committee On Financial Services Concerning The Impact Of The Sarbanes-Oxley Act*, by Former Chairman William H. Donaldson (Apr. 21, 2005).

425 The periodic reports for which this certification is required, the location of the certification and the other certification requirements of the Sarbanes-Oxley Act are discussed in further detail in § 5.03[7]. *See also supra* Note 194 (discussing whether certifications may be used to demonstrate *scienter* in civil litigation actions brought under § 10(b) of the Exchange Act and Rule 10b-5 thereunder).

426 The penalties include up to 20 years' imprisonment for anyone who "willfully" certifies such statements, or up to ten years' imprisonment for anyone who otherwise certifies such statements knowing that the report does not comport with all the relevant requirements. One peculiar aspect of the statute is that the penalties apply to non-compliance with the terms of the certification, but the statute does not explicitly provide that a failure to certify triggers liability.

427 *See* §§ 802 and 1102 of the Sarbanes-Oxley Act. Prior to the Sarbanes-Oxley Act, the general obstruction statute, 18 U.S.C. § 1503, prohibited a person from corruptly endeavoring to influence, obstruct or impede the due administration of justice, and the general tampering statute, 18 U.S.C. § 1512, prohibited one person from corruptly persuading another to destroy a document to prevent its use in an official proceeding. In 2002, Arthur Andersen was convicted under the then-existing 18 U.S.C. § 1512. The Supreme Court reversed the conviction in 2005 due to flawed jury instructions and remanded the case for further proceedings. *See Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005). The Sarbanes-Oxley Act amendments likely reflect Congressional concerns that the existing statutes were inadequate: § 1503 captured individuals acting alone, but required a pending proceeding, and § 1512 did not require a pending

proceeding, but failed to capture individuals acting alone. Both the amended § 1512 and the new § 1519 capture individuals acting alone and neither requires a pending proceeding. Amended § 1512 also applies beyond document destruction to include any conduct that corruptly "otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so." § 1102 of the Sarbanes-Oxley Act.

428 *See Yates v. United States*, 135 S. Ct. 1074 (2015).

429 *See* § 802 of the Sarbanes-Oxley Act.

430 *See* Rule 2-06 of Regulation S -X.

431 *See* § 807 of the Sarbanes-Oxley Act.

432 *See* § 11.04[2].

433 *See* § 1107 of the Sarbanes-Oxley Act.

434 *See* § 903 of the Sarbanes-Oxley Act.

435 *See* § 1106 of the Sarbanes-Oxley Act.

436 *See* § 904 of the Sarbanes-Oxley Act.

437 *See* §§ 805, 905, and 1104 of the Sarbanes-Oxley Act.

438 [Reserved.]

439 *See* U.S. Sentencing Commission, GUIDELINES MANUAL, App. C (2003).

U.S. Regulation of the International Securities and Derivatives Markets, § 11.08, ENFORCEMENT OF THE FOREIGN CORRUPT PRACTICES ACT

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 11.08 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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As discussed in § 4.08, the Foreign Corrupt Practices Act of 1977, [440] as amended by the Foreign Corrupt Practices Act Amendments of 1988 [441] and the International Anti-Bribery and Fair Competition Act of 1998 [442] (collectively, the "FCPA"), [443] comprises two sets of provisions that impose certain prohibitions and requirements on companies, referred to in the FCPA as "issuers," that have registered securities under the Exchange Act or are required to file reports under § 15(d) of the Exchange Act. One set prohibits the bribery [444] of foreign officials. [445] The other requires issuers to (i) maintain books, records and accounts

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which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer and (ii) devise and maintain an adequate system of internal accounting controls. [446] Enforcement of the two types of prohibitions is frequently in tandem because, as U.S. authorities explain, bribes are "often concealed under the guise of legitimate payments, such as commissions or consulting fees," and the "payment of bribes often occurs in companies that have weak internal control environments." [447] As discussed at § 11.08[5], the SEC and the DOJ have aggressively expanded FCPA enforcement over the last decade.

[1] Penalties for Violations of the FCPA

Both the antibribery and record keeping portions of the FCPA provide for criminal and civil penalties for violations of the Act. Settlement agreements

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resolving FCPA enforcement actions now often require defendants to appoint independent compliance monitors with broad authority to review corporate compliance with anticorruption laws.

[a] Antibribery Provisions

The FCPA's antibribery provisions provide for severe criminal penalties. Convicted individuals face imprisonment of up to five years and a fine of up to $250,000. [448] Convicted issuers are subject to fines of $2,000,000. [449] A court can also impose a fine equal to double the amount of gross gain or loss from the violation. [450]

In addition, the SEC may bring civil actions against issuers and individuals, which can result in a $19,787 fine for each violation. [451] When such criminal or civil fines are imposed on an officer, director, employee or agent of an issuer, the issuer may not pay the fine on behalf of the individual. [452]

[b] Accounting Provisions

An issuer that willfully violates the FCPA's accounting provisions is subject to a fine of up to $25 million. [453] An individual who willfully violates the accounting provisions can be fined up to $5 million and imprisoned up to 20 years. [454] The SEC can also impose disgorgement of profits and fines in civil actions under the FCPA accounting provisions, without regard to intent or negligence. [455]

[2] Injunctions

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The Exchange Act authorizes the SEC to issue a cease-and-desist order or to bring an action to obtain an injunction against any person, including an issuer, who has engaged or is about to engage in acts or practices that violate any part of the Exchange Act, including the FCPA. [456]

[3] Enforcement by the DOJ and the SEC

The SEC is responsible for civil enforcement of the FCPA with respect to issuers. The DOJ brings all criminal enforcement actions against issuers, as well as civil enforcement actions against non-issuers. Enforcement actions under the FCPA are not limited to domestic issuers. Foreign issuers are also subject to the reach of the FCPA, as seen in the recent SEC and DOJ actions brought against foreign issuer VimpelCom Limited, an Amsterdam-based company, for allegedly conspiring to pay more than $114 million in bribes to a government official in Uzbekistan to allow VimpelCom to operate in the Uzbek telecommunications market. [457] Similarly, the DOJ and SEC may bring enforcement actions against foreign subsidiaries of U.S. issuers in reliance on the jurisdictional provision of 15 U.S.C. § 78dd-3, which allows FCPA charges to be brought against any

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person that engages in any act in furtherance of a bribery scheme "while in the territory of the United States." [458]

The courts have held that there is no private cause of action for a violation of the FCPA. [459] However, a violation of the FCPA's antibribery provisions may be one basis for civil or criminal actions brought under RICO. [460] Also, some plaintiffs have attempted to frame § 10(b) claims around FCPA charges and investigations, alleging that the defendants failed to disclose the extent or nature of their potential FCPA violations. There has been a steady stream of securities and derivative shareholder lawsuits based on alleged FCPA violations in recent years. [461] Although many courts have rejected these claims, some have survived a defendant's motion to dismiss. In one recent case, a federal court in Texas refused to dismiss a class action alleging violations of the securities laws based on the company's failure to disclose the allegedly corrupt nature of its oil business in Angola, activity for which it was later investigated by the SEC and DOJ for potential FCPA violations. The court held that the plaintiffs adequately alleged that the company misrepresented its knowledge of the connection between its business partner and senior government officials in Angola. [462]

[4] Department of Justice Opinion Procedure

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Issuers and other parties subject to the FCPA may request opinions from the DOJ as to whether their prospective conduct would violate the antibribery provisions of the FCPA. [463] If such an opinion approves specified conduct, a rebuttable presumption exists in any action brought under the FCPA that the approved conduct does not violate the FCPA. [464] Documents and other materials submitted in connection with such requests are exempt from public disclosure. [465] This practice is infrequently used because (i) it may require a time-consuming submission, (ii) the transaction at issue, as well as any prior or future transactions between the parties, may come under greater government scrutiny, (iii) the DOJ's public release may identify the requesting party and the transaction or the media may identify the parties given the details in the opinion release, and (iv) the requesting party can often obtain similar comfort from outside counsel while maintaining the confidentiality of the parties and the transaction. [466] The DOJ has issued 12 opinions since 2008 and none since 2014. [467]

[5] Increased SEC and DOJ Enforcement of the FCPA

The last decade has seen a dramatic increase in enforcement actions under the FCPA, as well as an increase in fines and penalties levied for violations of the Act. In a keynote address in 2015, the Director of Enforcement at the SEC

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noted that 2015 had been "especially active" for the SEC, with 14 actions filed against entities and individuals for FCPA violations, resulting in $215 million of financial remedies. [468] In 2007, Baker Hughes paid $44 million to settle FCPA charges, which was, at the time, by far the largest FCPA sanction ever recorded. But subsequent FCPA penalties have soared into the hundreds of millions of dollars. [469] In the largest FCPA penalty ever imposed, in 2008 Siemens AG, a German company, and several of its subsidiaries were charged with fraudulent bookkeeping to mask bribes paid to government officials to secure lucrative contracts, throughout the course of many years and in dozens of different countries. The companies agreed to pay criminal fines totaling more than $450 million, and more than $350 million in disgorgement to the SEC. The case marked the first time the DOJ brought criminal charges for violation of the FCPA's internal controls provision. [470]

The prosecutions arising out of the Nigerian gas line case are illustrative of both the potential magnitude of FCPA cases and expanded FCPA jurisdiction. Starting in 1990, Technip S.A., a French company, Halliburton subsidiary Kellogg Brown & Root LLC ("KBR"), Snamprogetti Netherlands, a Dutch entity, and Japan Gas Corporation ("JGC") formed a joint venture to bid on contracts to construct natural gas lines on Bonny Island in Nigeria. They then hired a U.K. solicitor and a Gibraltar entity as "consultants" to pay bribes to Nigerian government officials. Over $180 million in bribes were paid, and the joint venture was awarded contracts worth over $6 billion. In February of 2009 in a settlement that eclipsed most of the previous fines imposed under the FCPA, KBR pled guilty to a five-count criminal information charging it with violations of the FCPA for payment of these bribes. The plea agreement required KBR to pay a

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$402 million fine. [471] KBR also settled civil FCPA charges with the SEC, agreeing to pay $177 million in disgorgement and to the imposition of a three-year independent monitor for FCPA compliance. [472]

In June of 2010, the SEC and DOJ charged Technip and another of its joint venture partners with violations of the FCPA antibribery, books and records and internal controls provisions. Technip agreed to pay $98 million to the SEC in disgorgement of profits, and a $240 million penalty to the DOJ under a two-year deferred prosecution agreement that required Technip to retain an independent compliance monitor for two years. [473]

And in July of 2010, the SEC and DOJ charged another of the joint venture partners, Snamprogetti and its Italian parent company (Eni S.p.A.) with violations of the FCPA in connection with the Nigerian officials bribe scheme. [474] The case is notable, in part, because the SEC charged Snamprogetti "as an agent of an issuer" for allegedly falsifying the issuer's (Eni's) books. This theory effectively permits the SEC to charge not just issuers, but also their subsidiaries in connection with the FCPA's books and records provisions. As part of its settlement with the SEC, Snamprogetti agreed to $125 million in disgorgement. [475] It also entered into a two-year deferred prosecution agreement with the DOJ that required it to pay a $240 million criminal penalty. [476]

The KBR-related cases also illustrate the DOJ's aggressive approach in expanding the reach of the FCPA's jurisdiction. In each of these prosecutions, the correspondent bank connection was one basis for jurisdiction. Specifically, the bribe funds were transferred from banks accounts in Amsterdam to the agents' account in Japan, Morocco or Switzerland. The DOJ did not allege that any relevant bank account was located in the United States, but rather simply that because the transactions were made in U.S. dollars they were transferred "via a correspondent bank account in New York, New York." [477] Effectively, this "correspondent bank account" theory of liability allows the U.S. government to reach most U.S. dollar transactions. This theory has not yet been challenged by a defendant in court.

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As the *Siemens*, *Technip* and *Snamprogetti* cases suggest, FCPA enforcement is not limited to U.S. companies. In fact, as of February 2016, eight of the top ten FCPA enforcement settlements were against foreign companies. [478] Moreover, the DOJ and SEC have been actively seeking cooperation of foreign government entities in enforcement of the FCPA. The Director of the SEC Enforcement Division has publicly attributed the

SEC's success in recent FCPA cases in part to its effective coordination with international regulators, noting the "tremendous increase in cooperation from other governments and better access to evidence in foreign countries." [479] The Assistant Attorney General of the DOJ Criminal Division has made similar remarks, stating that the DOJ "increasingly find[s itself] shoulder-to-shoulder with law enforcement and regulatory authorities in other countries," and affirming that "this international approach has dramatically advanced [its] efforts to uncover, punish and deter foreign corruption." [480]

While the DOJ routinely brings FCPA cases against non-issuers, in November 2010, the SEC for the first time brought FCPA charges against an entity that is neither a U.S. issuer nor affiliated with one, on the theory that it was "an agent of its issuer customers" in violating the FCPA. [481]

In addition, individual defendants have not been immune from this increased FCPA enforcement, with some of the actions leading to substantial fines and prison terms. The DOJ has increasingly touted the importance of individual accountability, describing it as a matter of "basic fairness" to a company's employees and shareholders, and noting that "nothing discourages corporate criminal activity like the prospect of people going to prison." [482] In the fall of 2015, the DOJ initiated an official policy to facilitate its ability to identify and pursue individuals involved in corporate misconduct, including by predicating *any* cooperation credit granted to a company on the company's provision of "all relevant facts about individuals involved in corporate misconduct." [483]

The DOJ has sought harsh sentences for those individuals charged. For example, in 2010, an individual was sentenced to 87 months in prison after

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pleading guilty to violating the FCPA by paying bribes to Panamanian government officials to secure maritime contracts and making a false statement to the FBI regarding how the bribe money was paid. This remains the longest prison sentence ever imposed on an individual for violating the FCPA, reflecting the DOJ's effort to deter foreign bribery through individual culpability. In announcing the sentence, prosecutors stated that the "sentence makes clear that this is a serious crime that the U.S. government is intent on enforcing." [484]

In 2012 and 2013, the DOJ brought FCPA charges against individuals associated with a broker-dealer in connection with a scheme to bribe a senior official of Venezuela's state economic development bank in exchange for bond trading work. The individuals pled guilty to conspiracy to violate the FCPA and admitted to paying over $5 million in bribes to the Venezuelan official and generating more than $60 million in commissions from the resulting trading business. The individuals were sentenced to prison terms from two to four years, and forfeitures ranging from $2.7 million to $11.9 million. [485] Notably, the Venezuelan official was also arrested in 2013 upon entering the United States and charged with money laundering and violations of the Travel Act (since the FCPA does not criminalize the recipient of bribe payments), to which she pled guilty and was sentenced to time served. [486]

In 2009, the SEC charged a parent corporation with violating the FCPA's antibribery, books and records, and internal control provisions in connection with bribes paid by its Brazilian subsidiary to Brazilian customs brokers. [487] Notably, the SEC also charged two of the company's executives as "control persons" within the meaning of § 20 of the Exchange Act, the first time the control person provision of the Exchange Act had been used against individuals in the FCPA

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context. The SEC did not allege that the executives participated in or knew of the violations, but instead based its control person liability charges on a "failure to supervise" theory. Each executive was required to pay a fine of $25,000.

Moreover, while the DOJ has long used deferred prosecution agreements as an enforcement tool under the FCPA, in May of 2011, the SEC announced its first-ever deferred prosecution pact under the FCPA, involving global steel pipe manufacturer Tenaris. [488] Under the agreement, the company would pay over $5 million in disgorgement and prejudgment interest, in an approach the SEC hopes will encourage cooperation by individuals and companies in the future. [489]

In 2012, the DOJ and SEC collaboratively published ("the FCPA GUIDE"), a comprehensive manual that provides guidance on a broad range of topics regarding the enforcement of and compliance with the FCPA. In addition to setting forth detailed information on the FCPA statutory requirements, THE FCPA GUIDE provides useful insight into the enforcement approaches and priorities of the DOJ and SEC.

On April 5, 2016, the DOJ announced a three-step "enhanced FCPA enforcement strategy," which stated that the DOJ was "committed to enhancing its efforts to detect and prosecute both individuals and companies" for violations of the FCPA. [490] In what it described as the "first and most important step in combatting FCPA violations," the DOJ announced it was increasing the number of

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staff for its FCPA unit by 50%, adding 10 new prosecutors and creating three new squads of FBI special agents dedicated to FCPA investigation and enforcement. For the second step of the new program, the DOJ announced that it was strengthening its coordination with foreign law enforcement officials in corruption cases, including by sharing leads and striving to share more effectively documents and witnesses. The third step of the strategy was the launch of a pilot program aimed at inducing more companies to self-report FCPA problems. To satisfy the pilot program's criteria, a company must:

- Make a voluntary self-disclosure, including by disclosing the matter before "an imminent threat" that the government will learn of the matter, making the disclosure "reasonably prompt[ly]" after the company discovers the matter, and disclosing all relevant facts known to the company, including concerning individual malfeasance.
- Provide "full cooperation," including by making timely disclosure of all facts relevant to the alleged wrongdoing, updating that disclosure in a timely manner, proactively offering information, preserving and providing relevant documents, translating relevant documents, making individuals available for interviews, detailing the sources of information, and "de-conflict[ing]" internal investigations.
- Make "timely and appropriate remediation," including by implementing a compliance program that is periodically reviewed and modified if necessary, establishing a culture of compliance, providing sufficient resources for the compliance function, which must be independent, retaining qualified and experienced compliance personnel, conducting risk assessments and tailoring the compliance program to meet those risks, auditing the compliance program, and implementing an appropriate reporting structure for compliance personnel.

If the company meets these requirements and disgorges any profits earned from the bribery scheme, the DOJ "may" (1) grant a 50% reduction from the bottom end of the sentencing guidelines fine range, (2) "generally" not require a monitor if the company has implemented an effective compliance program, and (3) "consider" a declination of prosecution based on a consideration of "countervailing interests," including whether the company has a history of misconduct or the incident involved large sums of money or senior management. On the other hand, companies that fully cooperate and conduct timely and appropriate remediation but fail voluntarily to disclose misconduct will receive "markedly less" credit than those that self-report, including at best a reduction of no more than 25% off the bottom of the Sentencing Guidelines fine range.

Footnotes

440 *See* Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (1977).

441 *See* Foreign Corrupt Practices Act Amendments of 1988, Pub. L. No. 100-418, Title V, Subtitle A, Part I, 102 Stat. 1107, 1415 (1988).

442 *See* International Anti-Bribery and Fair Competition Act of 1998, Pub. L. No. 105-366, 112 Stat. 3302 (1998) (the "1998 Amendments").

443 The FCPA is incorporated into the Exchange Act as §§ 13(b), 30A and 32(c) (penalties).

444 *See United States v. Kay*, 359 F.3d 738, 743 (5th Cir. 2004) (holding that invocation of the antibribery portion of the FCPA requires payments "that are intended to (1) influence a foreign official to act or make a decision in his official capacity, or (2) induce such an official to perform or refrain from performing some act in violation of his duty, or (3) secure some wrongful advantage to the payor" and that "[t]he FCPA … criminalizes these kinds of payments only if the result they are intended to produce—their *quid pro quo*—will assist (or is intended to assist) the payor in efforts to get or keep some *business*") (second emphasis added); *see also United States v. Kozeny*, 493 F. Supp. 2d 693, 705 (S.D.N.Y. 2007) (agreeing with *Kay* that "the FCPA's business nexus element was intended to be construed broadly").

Under the antibribery provisions, bribe payments must be made "corruptly," 15 U.S.C. § 78dd-1(a), § 78dd-2(a), § 78dd-3(a), which, according to the DOJ and the SEC, means made with an "an intent or desire to wrongfully influence the recipient," The Criminal Division of the DOJ and the Enforcement Division of the SEC, "A Resource Guide to the U.S. Foreign Corrupt Practices Act" 14 (Nov. 14, 2012) ("*FCPA Guide*").

445 The FCPA's antibribery provisions apply to issuers if the bribe occurs in connection with U.S. interstate commerce. 15 U.S.C. § 78dd-1(a). These provisions also apply to "domestic concerns," which are U.S. citizens, nationals and residents, and all companies that have their principal place of business in the United States or are organized under U.S. law. 15 U.S.C. § 78dd-2(h)(1). The antibribery provisions apply to domestic concerns regardless of whether the activity related to the bribe involves U.S. interstate commerce or has any other connection to the United States. 15 U.S.C. § 78dd-2(i). Finally, for persons or entities who are not issuers or domestic concerns, the antibribery provisions apply if they, or any person acting on their behalf, perform any part of the acts of bribery in connection with U.S. interstate commerce while in the territory of the United States. 15 U.S.C. § 78dd-3(a).

The FCPA defines the term "foreign official" as an "officer or employee of a foreign government or any department, agency, or instrumentality thereof," but does not define "instrumentality," "department" or "agency." *See* 15 U.S.C. § 78dd-2(h)(2). A decision by the Tenth Circuit found that the term "foreign officials" includes employees of state-owned companies. *See United States v. Esquenazi*, 752 F.3d 912 (11th Cir. 2014) (holding state-owned telecommunications company as an "instrumentality" of government and defining "instrumentality" as "an entity controlled by the government of a foreign country that performs a function the controlling government treats as its own"). Some DOJ prosecutions under the FCPA, such as the KBR-related actions described below, *see infra* Notes 478, 484, raise the specter that the DOJ views even certain minority ownership by a foreign government of a private entity to suffice to make that entity an "instrumentality" of a foreign government, and thus subject payments to employees of such entity to FCPA enforcement. *See also United States v. Alcatel-Lucent*, No. 10-cr-20907 (S.D. Fla. Dec. 27, 2010). Moreover, in September 2010, the DOJ issued an opinion procedure release that expanded the scope of who the DOJ would consider to qualify as a "foreign official" for FCPA purposes to include, in certain instances, otherwise private individuals or organizations who act on behalf of a foreign government, such as a "consultant" and its employees. *See* DOJ, Opinion Procedure Release No. 10-03 (Sept. 1, 2010).

446 § 13(b)(2) of the Exchange Act. The SEC has opined that the "reasonableness" standards contained in § 13(b)(2)–(7) of the Exchange Act should be "based not on a 'materiality' analysis but on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs." SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999), Fed. Sec. L. Rep. (CCH) ¶75,563. In determining whether a misstatement has resulted in a violation of § 13(b)(2), registrants should consider (i) the significance of the misstatement, (ii) how the misstatement arose, (iii) the cost of correcting the misstatement, and (iv) the clarity of authoritative accounting guidance with respect to the misstatement. These factors should be considered along with the ten other factors that should be assessed when making a determination of materiality. *See* § 11.04[2].

Under § 404 of the Sarbanes-Oxley Act, management is required to report on the adequacy of internal controls and auditors of those companies are required to provide an attestation on internal controls. *See* § 5.03[7][a][ii].

447 FCPA Guide at 39-40. *See, e.g.*, *In re Key Energy Services, Inc.*, SEC Release No. 78558 (Aug. 11, 2016) (employees made payments to a Pemex employee to induce him to provide advice, assistance and inside information, all in violation of the books and records and internal controls provisions).

448 *See* § 32(c)(2)(A) of the Exchange Act.

449 *See* § 32(c)(1)(A) of the Exchange Act.

450 *See* 18 U.S.C. § 3571.

451 *See* §§ 32(c)(1)(B) and 32(c)(2)(C) of the Exchange Act; SEC Release No. 33-10104 (June 27, 2016).

452 *See* § 32(c)(3) of the Exchange Act.

453 *See* § 32(a) of the Exchange Act. As with violations of the antibribery provisions, if a defendant derives a gain or causes a loss to another person by violating the accounting provisions, the defendant may be fined up to twice the amount of the gross gain or loss. *See* 18 U.S.C. § 3571(d).

454 *See* § 32(a) of the Exchange Act, which is discussed in § 11.07[3][f]. A defendant cannot, however, be imprisoned if he or she had no knowledge of the rule or regulation he or she is convicted of violating. § 32(a) of the Exchange Act.

455 These penalties may not exceed the higher of (i) the amount the defendant gained from the violation or (ii) an amount based upon the egregiousness of the violation, ranging from $8,156 to $178,156 for a natural person and from $81,559 to $890,780 for an issuer. *See* § 21(d)(3) of the Exchange Act; SEC Release No. 33-10104 (June 27, 2016).

456 *See* §§ 21C and 21(d)(1) of the Exchange Act.

457 The Dutch defendant, VimpelCom, was at the time of the regulatory action the sixth-largest telecommunications company in the world, and an issuer of publicly traded securities in the United States. To enter into and operate in the Uzbek telecommunications market, VimpelCom and its Uzbek subsidiary, Unitel, allegedly paid bribes to an Uzbek government official who had influence over the governmental body that regulated the telecom industry in Uzbekistan. Over a six-year period, VimpelCom and Unitel executives and employees allegedly funnelled bribe payments through a shell company beneficially owned by the Uzbek official. The DOJ charged VimpelCom with conspiracy to violate the antibribery and books and records provisions of the FCPA, and a separate count of violating the internal controls provisions of the FCPA. VimpelCom entered into a deferred prosecution agreement with the DOJ pursuant to which it agreed to pay a criminal penalty of $230 million, implement rigorous internal controls and retain an independent compliance monitor for three years. In related proceedings, VimpelCom settled with the SEC and the Public Prosecution Service of the Netherlands, agreeing to pay a total of $375 million in disgorgement of profits and prejudgment interest to be apportioned between the SEC and the Dutch prosecutors, with additional criminal penalties paid to the Dutch prosecutors. In total, VimpelCom paid over $795 million in criminal and regulatory penalties to the U.S. and Dutch authorities, making it one of the largest foreign bribery matters to date. The DOJ subsequently filed two civil complaints seeking a total of $850 million in forfeiture comprising the illegal bribes paid and property involved in the laundering of those bribe payments. *See* Press Release, DOJ, VimpelCom Limited and Unitel LLC Enter into Global Foreign Bribery Resolution of More Than $795 Million; United States Seeks $850 Million Forfeiture in Corrupt Proceeds of Bribery Scheme (Feb. 18, 2016).

458 *See, e.g.*, *United States v. Universal Leaf Tabacos Ltda.*, No. 3:10-cr-00225 (E.D. Va. 2010) (charging a wholly owned Brazilian subsidiary of a U.S. issuer with FCPA criminal violations on the jurisdictional basis of 15 U.S.C. § 78dd-3 for kickback payments facilitated in the territory of the United States to the Government of Thailand to secure the improper sale of leaf tobacco).

459 *See, e.g.*, *Lamb v. Phillip Morris, Inc.*, 915 F.2d 1024, 1027–30 (6th Cir. 1990), *cert. denied*, 498 U.S. 1086 (1991) (antibribery provisions); *Shields ex rel. Sundstrand Corp. v. Erickson*, 710 F. Supp. 686, 688 (N.D. Ill. 1989) (recordkeeping provisions).

460 *See* 18 U.S.C. §§ 1962–1968; *Environmental Tectonics v. W.S. Kirkpatrick, Inc.*, 847 F.2d 1052, 1063–64 (3d. Cir. 1988), *aff'd*, 493 U.S. 400 (1990); *see also, e.g.*, *Aluminum Bahrain B.S.C. v. Alcoa, Inc.*, No. 08-

cv-299 (W.D. Pa 2008) (aluminum production company, which pled guilty to violations of the FCPA for bribing government officials in Bahrain in order to induce the government-controlled metals company to overpay for raw materials, was thereafter sued by the government-controlled entity on allegations of common law fraud and RICO violations for subjecting the entity to fraud, bribery and overcharging). For a further discussion, *see* § 11.09[1][b].

461 *See, e.g.*, *City of Pontiac Gen. Emps.' Ret. Sys. v. Walmart Stores Inc. et al.*, No. 12-05162 (W.D. Ark. 2012) (putative securities fraud class action alleging company intentionally concealed the extent of possible bribery of Mexican officials and prior internal investigation in its regulatory filing on the subject); *City of Brockton Ret. Sys. v. Avon Prods. Inc. et al.*, 1:11-cv-04665 (S.D.N.Y. 2011) (putative derivative class action alleging company intended to mislead shareholders regarding bribes given to Chinese government officials to obtain licenses for direct sales operations).

462 *In re Cobalt Int'l Energy, Inc. Sec. Litig.*, 14-CV-3428 (NFA) (S.D. Tex. Jan. 19, 2016). *But see Glazer Capital Mgmt. v. Magistri*, 549 F.3d 736 (9th Cir. 2008) (dismissing a purported shareholder class action alleging misstatements in the company's merger agreement related to potential FCPA violations, on the basis that the complaint failed to meet the heightened pleading standard of the Litigation Reform Act for *scienter*).

463 *See* § 30A(e)(1) of the Exchange Act. The DOJ has issued regulations governing the opinion procedure at 28 C.F.R. §§ 80.1–80.16.

464 *See* § 30A(e)(1) of the Exchange Act.

465 *See* § 30A(e)(2) of the Exchange Act.

466 *See* Don Zarin, *Doing Business Under the Foreign Corrupt Practices Act*, CORPORATE LAW & PRACTICE HANDBOOK at 943 (Practicing Law Institute, 2006).

467 In one such release, a public U.S. multinational consumer products company planned to acquire a foreign company and its wholly-owned foreign subsidiary. During the pre-acquisition due diligence process, the U.S. company identified numerous likely improper payments by the target to foreign government officials and substantial weaknesses in internal controls and recordkeeping. For jurisdictional reasons, the payments did not appear to violate the FCPA. The DOJ opined that it would not bring an enforcement action for the pre-close conduct because the bribes did not appear to be FCPA violations when they were made. Foreign Corrupt Practices Act Review, Release No. 2014-02 (Nov. 7, 2014). *See* Foreign Corrupt Practices Act Review, Release No. 2012-02 (Oct. 18, 2012) ((U.S. non-profit adoption agencies propose to host foreign officials during visits to the United States, including officials with direct responsibilities relating to adoptions, to allow officials to learn more about the non-profit's work and see how adopted children from the foreign country have adjusted to life in the United States; the DOJ permits the reasonable and *bona fide* payments associated with trips); Foreign Corrupt Practices Act Review, Release No. 10-03 (Sept. 1, 2010) (DOJ takes no action against a company that hired a consultant to represent it before a foreign government with whom the consultant had extensive ties, given certain procedures put in place to ensure that the consultant was not conflicted and effectively acting as a "foreign official.").

468 Andrew Ceresney, Director of Enforcement Div., SEC, Keynote Address at American Conference Institute's 32nd International Conference on the Foreign Corrupt Practices Act (Nov. 17, 2015). In public remarks, the DOJ continually emphasizes its "commitment to the fight against foreign bribery" reflected in its "robust enforcement record" of more than 50 individual criminal convictions and 50 resolutions with companies in FCPA and FCPA-related cases between 2009 and 2014, with penalties and forfeitures approximating $3 billion. Leslie R. Caldwell, Asst. Att'y Gen., DOJ, Remarks at American Conference Institute's 31st International Conference on the Foreign Corrupt Practices Act (Nov. 19, 2014).

469 *See, e.g.*, Press Release, DOJ, Alstom Pleads Guilty and Agrees to Pay $772 Million Criminal Penalty to Resolve Foreign Bribery Charges (Dec. 22, 2014); Press Release, DOJ, Alcoa World Alumina Agrees to Plead Guilty to Foreign Bribery and Pay $223 Million in Fines and Forfeiture (Jan. 9, 2014); Press Release, DOJ, Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations and Agree to Pay $450 Million in Combined Criminal Fines; Coordinated Enforcement Actions by DOJ, SEC

and German Authorities Result in Penalties of $1.6 Billion (Dec. 15, 2008); Press Release, DOJ, Kellogg Brown & Root LLC Pleads Guilty to Foreign Bribery Charges and Agrees to Pay $402 Million Criminal Fine (Feb. 11, 2009).

470 *See* Press Release, DOJ, Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations and Agree to Pay $450 Million in Combined Criminal Fines (Dec. 15, 2008); *SEC v. Siemens Aktiengesellchaft*, SEC Litigation Release No. 20829 (Dec. 15, 2008).

471 *See* Press Release, DOJ, Kellogg Brown & Root LLC Pleads Guilty to Foreign Bribery Charges and Agrees to Pay $402 Million Criminal Fine (Feb. 11, 2009).

472 *See SEC v. Halliburton Co.*, SEC Litigation Release No. 20897A (Feb. 11, 2009).

473 *See* Press Release, DOJ, Technip S.A. Resolves Foreign Corrupt Practices Act Investigation and Agrees to Pay $240 Million Criminal Penalty (June 28, 2010); *SEC v. Technip*, Litigation Release No. 21578 (June 28, 2010).

474 *See SEC v. ENI, S.p.A. and Snamprogetti Netherlands B.V.*, SEC Litigation Release No. 21588 (July 7, 2010).

475 *See SEC v. ENI, S.p.A. and Snamprogetti Netherlands B.V.*, SEC Litigation Release No. 21588 (July 7, 2010).

476 *See* Press Release, DOJ, Snamprogetti Netherlands B.V. Resolves Foreign Corrupt Practices Act Investigation and Agrees to Pay $240 Million Criminal Penalty (July 7, 2010).

477 *See United States v. Kellogg Brown & Root LLC*, No. 4:09-cr-071 (S.D. Tex. Feb. 11, 2009).

478 *See* FCPA Blog, Here's our new Top Ten list, with VimpelCom landing sixth (Feb. 19, 2016).

479 Andrew Ceresney, Director of Enforcement Division, SEC, Keynote Address at American Conference Institute's 32nd International Conference on the Foreign Corrupt Practices Act (Nov. 17, 2015).

480 Leslie R. Caldwell, Asst. Att'y Gen., DOJ, Remarks at American Conference Institute's 31st International Conference on the Foreign Corrupt Practices Act (Nov. 19, 2014).

481 *See SEC v. Panalpina, Inc.*, SEC Litigation Release No. 21727 (Nov. 4, 2010).

482 Deputy Att'y Gen. Sally Quillian Yates, DOJ, Remarks at New York University School of Law Announcing New Policy on Individual Liability in Matters of Corporate Wrongdoing (Sept. 10 2015).

483 Deputy Att'y Gen. Sally Quillian Yates, DOJ, *Individual Accountability for Corporate Wrongdoing* (Sept. 2015).

484 *See* Press Release, DOJ, Virginia Resident Sentenced to 87 Months in Prison for Bribing Foreign Government Officials (Apr. 19, 2010). The co-conspirator was sentenced to more than three years in prison. *See* Press Release, DOJ, Virginia Resident Sentenced to 37 Months in Prison (June 25, 2010).

485 Press Release, DOJ, CEO and Managing Director of U.S. Broker-Dealer Sentenced for International Bribery Scheme (Mar. 27, 2015). For other representative examples of enforcement actions brought against individuals by the SEC and the DOJ, see Press Release, SEC, SEC Charges Former Software Executive With FCPA Violations 2015-165 (Aug. 12, 2015) (regional director of technology company charged with bribing Panamanian officials to secure government technology contracts consented to cease-and-desist order and disgorgement of over $90,000); *United States v. Garcia*, No. 3:15-cr-00366 (N.D. Cal. 2015) (sentenced to 22 months imprisonment in parallel DOJ criminal proceeding), and Garth Peterson, *SEC v. Peterson*, SEC Litigation Release No. 22346 (real estate investment adviser charged with acquiring real estate assets for himself and an influential Chinese government official ordered to disgorge $3.8 million); *United States v. Peterson*, No. 12-cr-224 (E.D.N.Y. 2012) (sentenced to nine months imprisonment in parallel DOJ criminal proceeding).

486 Press Release, DOJ, High Ranking Banking Official at Venezuelan State Development Bank Pleads Guilty in Manhattan Federal Court to Participating in Bribery Scheme (Nov. 18, 2013).

487 *See SEC v. Nature's Sunshine Products, Inc.*, SEC Litigation Release No. 21162 (July 31, 2009).

488 Under a deferred prosecution agreement such as that entered into with Tenaris, the SEC "agrees to forego

an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully and to comply with express prohibitions and undertakings during a period of deferred prosecution." *See* Press Release, SEC, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010). The use of a deferred prosecution agreement in this case was possible under the SEC's Cooperation Initiative, announced in January of 2010, with which the agency sought to establish incentives for individuals and companies to cooperate with investigations by streamlining the manner in which it will evaluate whether to credit cooperation and by expanding the set of enforcement tools available to the staff of the enforcement division to include cooperation agreements, deferred prosecution agreements and non-prosecution agreements. *See* Press Release, SEC, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010).

489 *See* Press Release, SEC, Tenaris to Pay $5.4 Million in SEC's First-Ever Deferred Prosecution Agreement (May 17, 2011). In 2013, the SEC entered into its first ever non-prosecution agreement in an FCPA matter involving Ralph Lauren Corporation as part of its 2010 Cooperation Initiative to incentivize cooperation in SEC investigations. *See* Press Release, SEC, SEC Announces Non-Prosecution Agreement with Ralph Lauren Corporation Involving FCPA Misconduct (Apr. 22, 2013). In the years following, the SEC has announced a number of deferred and non-prosecution agreements in FCPA matters where the companies self-reported misconduct promptly and cooperated extensively with the ensuing investigations. *See, e.g.*, Press Release, SEC, SEC Announces Two Non-Prosecution Agreements in FCPA Cases (June 7, 2016) (announcing NPAs with two unrelated U.S. companies whose foreign subsidiaries made bribe payments to Chinese officials).

490 *See* Andrew Weissmann, Chief, Fraud Section, Criminal Division, DOJ, The Fraud Section's Foreign Corrupt Practices Act Enforcement Plan and Guidance (Apr. 5, 2016).

U.S. Regulation of the International Securities and Derivatives Markets, § 11.09, ENFORCEMENT SCENARIOS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 11.09 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The previous sections have examined the principal sources of liability under the U.S. federal and state securities laws. This section highlights a number of common enforcement scenarios. In § 11.09[1], we address two common vehicles for civil enforcement: actions brought on behalf of a wide class of plaintiffs ("class actions") and private actions under the RICO statute. Issues concerning administrative enforcement are addressed in § 11.09[2], including general SEC powers to investigate and prosecute offenses and to seek a variety of forms of relief, such as injunctions and civil monetary penalties, as well as a recent series of actions against market professionals that were initially spearheaded by the states' attorneys general rather than the SEC. Finally, § 11.09[3] examines several different mechanisms available for criminal enforcement of the securities laws and briefly examines the provisions of federal law that relate to penalties for crimes committed by or on behalf of organizations.

[1] Civil Enforcement

[a] Class Actions

Class actions are civil suits brought by an individual plaintiff or a group of plaintiffs who seek to represent the interests of a much broader group of similarly situated parties (the "class"). The would-be class representative must demonstrate that questions of law or fact are common to the class (commonality), that those common claims of the class predominate over individual questions (predominance), that the claims asserted by the named plaintiffs are typical of the class (typicality), that the members of the class are so numerous that it would be impracticable to join each plaintiff in the suit (numerosity), that the class representative will adequately represent the interests of the class (adequacy), and that a class action is superior to other means of pursuing the claims (superiority). [491]

Class actions are prevalent in the United States, including in securities litigation (involving both domestic issuers and foreign issuers listed on U.S. exchanges), [492] and are often brought in situations where an individual plaintiff's claimed damages do not justify the substantial costs of litigating the claim, but where the total damages alleged to have been sustained by the class are

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extremely large, thereby making the suit worthwhile. [493] A typical example would be a class action on behalf of shareholders who purchased stock on the basis of allegedly misleading information published by the issuer in its annual report. Since in these cases there is no need to establish that each plaintiff relied on a particular statement (or, in a fraud-on-the-market case, that each plaintiff was even aware of the statement), [494] the elements of the claim are typically common to all members of the plaintiff class and appropriate for resolution in a class action suit. Because an adverse judgment before a single court binds the defendant with respect to all members of the class [495]—as opposed to a series of individual actions where the decisions of one court usually do not bind the others—class actions can pose a risk of substantial damages for defendants.

Most class litigation is brought pursuant to Fed. R. Civ. P. 23(b)(3), which requires a plaintiff to demonstrate that the criteria set forth above have been met, including numerosity, typicality, commonality, predominance, and adequacy. [496] A decision from the Second Circuit Court of Appeals in 2006 clarified the scope of inquiry and held that a court considering a motion for class certification must resolve any factual disputes relevant to each Rule 23 requirement, including an analysis of the evidence presented by all of the parties—an analysis that may necessarily reach the merits of the litigation. [497] This decision significantly

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increased the plaintiff's burden at the class certification stage of the litigation by rejecting earlier decisions that had suggested that the plaintiff was only required to make "some showing" that it could satisfy the requirements of Rule 23. [498]

A key issue in class certification motions filed in actions asserting claims under Rule 10b-5 is predominance and, in particular, whether plaintiffs are entitled to the presumption of reliance of *Basic v. Levinson*. [499] In the absence of such a presumption, individualized questions of reliance will predominate over common questions, making class certification inappropriate. In a recent line of decisions, the Supreme Court has held that plaintiffs do not bear the burden of directly proving loss causation, materiality, or price impact at the class certification stage in order to trigger the *Basic* presumption. [500] In *Erica P. John Fund, Inc. v. Halliburton Co.*, [501] the Supreme Court held that a securities class action plaintiff need not prove loss causation at the class certification stage because "[t]he fact that a subsequent loss may have been caused by factors other than the revelation of a mispresentation has nothing to do with whether an investor relied on the misrepresentation in the first place, either directly or presumptively through the fraud-on-the-market theory." Nonetheless, the Court left open the question whether a loss causation inquiry may be appropriate at the class certification stage to defeat another element of the Rule 23 showing, such as to demonstrate that the lead plaintiff's claims are not typical of those of the entire class, [502] or to rebut the *Basic* presumption of reliance by establishing that the alleged misrepresentation or omission had no impact on the price of the stock. [503]

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In *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*, the Supreme Court likewise held that securities class action plaintiffs need not prove materiality in order to obtain class certification. [504] Although the Supreme Court acknowledged that materiality is an essential predicate of the "fraud-on-the-market" theory underlying the *Basic* presumption of reliance, it concluded that the question of materiality is common to the class and that proof of materiality was therefore not needed to ensure that questions of law or fact common to the class would predominate over individual questions, as required by Rule 23(b)(3). And, in *Halliburton Co. v. Erica P. John Fund, Inc.*, the Supreme Court held that plaintiffs need not prove price impact directly at the class certification stage in order to invoke the fraud-on-the-market presumption because such a rule "would radically alter the required showing for the reliance element of the Rule 10b-5 cause of action." [505] However, as noted above, the Court nonetheless held that a defendant may introduce price impact evidence at the class certification stage either to counter a plaintiff's showing of market efficiency or to directly rebut the presumption. [506]

In several recent decisions arising outside the securities context, the Supreme Court has otherwise increased the burden on putative class plaintiffs to obtain class certification. In *Wal-Mart Stores, Inc. v. Dukes*, which involved a putative class action concerning employment discrimination, the Supreme Court held that a party seeking class certification must affirmatively demonstrate compliance with Rule 23 and that the trial court must conduct a rigorous analysis to determine if Rule 23(a)'s prerequisites have been satisfied. [507] The *Wal-Mart* Court observed that this inquiry could entail some overlap with the merits of the plaintiff's underlying claim, but stated "[t]hat cannot be helped." The Court further noted that the commonality requirement of Rule 23(a)(2) requires the claims of the class to depend upon a "common contention," which must be of such a nature as to be "capable of classwide resolution."

The Supreme Court expanded on its *Wal-Mart* decision in *Comcast Corp. v. Behrend*, which involved a putative class action alleging violations of the federal antitrust laws. [508] In *Comcast*, the putative class plaintiff originally alleged four theories of antitrust liability, but the district court subsequently rejected all

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but one of those theories. Nonetheless, the plaintiffs' damages model assumed that all four of the original theories were valid and did not attribute damages to any one particular theory. Under this circumstance, the Supreme Court held that the plaintiffs had failed to satisfy the predominance requirement of Rule 23(b)(3) because they did not establish "that damages are capable of measurement on a classwide basis."

Applying this precedent, the Fifth Circuit recently affirmed the denial of class certification in the securities litigation arising out of the explosion of BP's Deepwater Horizon drilling rig in the Gulf of Mexico. [509] The plaintiffs in that case (as is typical in securities class actions) alleged that the defendants made a number of misstatements and omissions. The plaintiffs also indicated that they would calculate class members' damages by use of an event study (as is also common in securities class actions). However, the plaintiffs did not offer a specific event study in connection with their class certification motion that was capable of isolating losses attributable to each of the individual misstatements and omissions alleged in the complaint. The Fifth Circuit therefore held that the plaintiffs had failed to satisfy their burden of "providing an adequate measure of class-wide damages under *Comcast*" because their damages model could not "be applied uniformly across the class."

With the passage of the Litigation Reform Act in 1995, Congress sought to reduce certain perceived abuses of the class action mechanism in securities lawsuits, particularly the common practice in which the class representative was merely a nominal party, or "professional plaintiff," selected and controlled by plaintiffs' counsel who filed the suit with little real financial stake in its outcome. [510] Specifically, the Litigation Reform Act mandates, for all class actions brought under the Securities Act or the Exchange Act, the appointment by the court of the "lead plaintiff," who will not necessarily be the original named plaintiff in the lawsuit and who, among other things, selects the plaintiffs' counsel. [511] The lead plaintiff will be the person deemed by the court

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most capable of adequately representing the interests of the class, and generally may not have served in this role in more than five class actions in any three-year period. A group may act as lead plaintiff, and claims may be aggregated in most circumstances in order for a group to be appointed lead plaintiff. [512] The statute includes a rebuttable presumption that the class member with the largest financial interest in the litigation should be designated as the lead plaintiff. [513] Congress intended to facilitate appointment of institutional investors as lead plaintiffs. [514] Although there was little change initially, [515]

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institutional investors increasingly are having a greater impact in securities class actions as the lead plaintiff. [516]

Shortly after the enactment of the Litigation Reform Act, many plaintiff's attorneys sought to avoid the Act's tougher pleading requirements and mandatory stays of discovery pending a defendant's motion to dismiss by filing securities class actions in state rather than federal court. Concerned that the state courts were now being used to frustrate the objectives of the Litigation Reform Act, in 1998, Congress passed SLUSA, which requires most class action securities fraud cases to be brought exclusively in federal court under federal law. [517] SLUSA prohibits a private party from bringing a covered class action in state or federal court based upon the statutory or common law of any state if the party alleges (i) an untrue statement or omission of material fact in connection with the purchase or sale of a covered security or (ii) that the defendant used a manipulative or deceptive device in connection with the purchase or sale of a covered security. [518] Any such action that is brought in state court can be removed

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to federal court and dismissed, and a federal court is required to dismiss any such action filed with it. Once a court decides that SLUSA does not authorize removal of an action to federal court, the case must be remanded; because this decision is jurisdictional, the remand may not be reviewed by the federal appellate courts. [519]

In *Merrill*, *Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, [520] the Supreme Court held that SLUSA authorized the removal and dismissal not only of claims for which federal law provides a remedy (*i.e.*, viable Rule 10b-5 claims), but also claims brought on behalf of holders of securities, which are not actionable under Rule 10b-5. [521] The Court held that this broad reading of the "in connection with the purchase or sale" requirement of SLUSA was consistent with the policies articulated in *Blue Chip Stamps*, by preventing plaintiffs from circumventing the federal prohibition on "holder" claims by filing their claims in state court. [522] In a recent decision arising out of the Allen Stanford Ponzi scheme, however, the Supreme Court held that the "covered security" requirement is not satisfied by the purchase or sale of uncovered securities that were falsely claimed to be backed by covered securities. [523] Instead, citing SLUSA's focus upon transactions in covered securities, the Supreme Court concluded that SLUSA preemption requires a fraudulent misrepresentation or omission that "is material to a decision by one or more individuals (other than the fraudster) to buy or to sell a 'covered security.'" In a case arising out of the Bernie Madoff Ponzi scheme, which alleged that certain feeder funds violated state law by making misrepresentations about their investments with Bernie Madoff and breached various

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duties owed to investors by failing to detect the Ponzi scheme, the Second Circuit has further held that SLUSA preclusion only applies when the state law claim is predicated on conduct by the defendant (rather than a third party), and that in circumstances where some but not all of the claims in an action are precluded by SLUSA courts may only dismiss the specific claims that are precluded by SLUSA and not the entire action. [524]

In a similar strategy to evade the heightened rigors of the Litigation Reform Act, plaintiffs have filed Securities Act class actions in state courts, arguing that claims based entirely on the Securities Act, without any state law claims, are not removable. Although courts have split on the question of whether a claim must be precluded by § 26(b) of SLUSA in order to be removable under § 26(c) of SLUSA, [525] several district courts have ruled that SLUSA eliminated state court jurisdiction over "covered class actions" brought under the Securities Act. [526] Under these rulings, the disagreement among the courts as to the scope of the *removal* provision of the Securities Act is irrelevant because defendants

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do not need to invoke the removal provision of the Securities Act to effect the removal of actions over which state courts lack jurisdiction. However, several courts have recently disagreed that state courts lack jurisdiction over class actions asserting Securities Act claims, including many district courts within the Ninth Circuit. [527]

As discussed below in § 11.10[4][a], SLUSA also prevents parties from obtaining discovery in parallel state court proceedings while discovery in the federal action is stayed. Section 101 of the Act empowers a federal court to stay discovery in private state court actions when it is "necessary in aid of [the court's] jurisdiction, or to protect or effectuate its judgments."

Furthermore, in 2005, Congress enacted the Class Action Fairness Act ("CAFA"), [528] which significantly alters federal court jurisdiction in class action cases and provides a powerful new tool to defendants. Federal courts under CAFA have original jurisdiction over class actions that seek more than $5 million in damages where any one defendant is a citizen of a state different from any one plaintiff. Thus, under CAFA, defendants may remove large interstate class actions from state to federal court that they could not have removed pursuant to the stricter requirements of federal diversity jurisdiction. [529] Additionally, even if class certification is later denied, CAFA allows the federal court to maintain jurisdiction over the suit.

There are some limitations, however, to this jurisdictional grant: CAFA does not apply to class actions where the primary defendants are states or state officials or where the number of proposed class members is less than 100. In

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addition, federal courts are required to remand class actions to state courts in certain cases when more than two-thirds of the class members are citizens of the forum state. Courts have also reached differing conclusions on whether CAFA permits the removal of Securities Act class actions, notwithstanding that § 22(a) of the

Securities Act otherwise prohibits the removal of actions filed in state court asserting Securities Act claims. [530]

Finally, the mortgage-backed securities ("MBS") litigation has generated a number of decisions regarding the scope of claims that can be asserted by putative class plaintiffs as a matter of constitutional and statutory standing. In these cases, many courts have held that class action plaintiffs can only bring claims related to the offerings or securities in which they personally invested. [531] In *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, [532] however, the Second Circuit held that a putative class plaintiff who invested in one offering may possess "class standing" to bring claims related to other offerings if both claims raise the same set of concerns. In *NECA-IBEW*, the court thus concluded that a putative class plaintiff who invested in securities from one MBS offering could represent a class containing investors in other securities from that offering, as well as investors in other MBS offerings, so long as all of the securities were backed by mortgages from the same originators. The Second Circuit further observed that purchasers of corporate debt securities from one offering likewise may have "class standing" to assert claims on behalf of investors in other debt securities from the same corporation if the offering documents all contained identical misrepresentations.

[b] RICO

Prior to 1995, one of the most common vehicles for civil enforcement of the securities laws stemmed from RICO. The Litigation Reform Act eliminated RICO liability for "conduct that would have been actionable as fraud in the purchase or sale of securities," unless the defendant actually has been criminally convicted in connection with the fraud. [533] This provision explicitly eliminated

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securities fraud (absent a conviction) as a predicate act for RICO liability. According to the Conference Committee report, it was also intended to preclude use of the RICO statute to impose liability under any other theories (such as wire or mail fraud) if the conduct relied upon would constitute securities fraud. The effect of the Litigation Reform Act provision is to remove the significant threat of RICO treble damages suits for what essentially are federal securities fraud claims.

[2] Regulatory Enforcement

In addition to the private enforcement mechanisms addressed above and elsewhere in this chapter, the SEC has wide powers to pursue and punish violations of the securities laws. The various weapons in its enforcement arsenal, which was enhanced by the Sarbanes-Oxley Act and the Dodd-Frank Act, are discussed below. The SEC has employed these weapons to attempt to achieve "real time" enforcement by initiating proceedings immediately upon discovery of violations. [534]

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In recent years, the SEC has also developed a number of computerized tools intended to detect early warning signs of suspicious activities. [535]

[a] Investigation and Prosecution

The SEC has broad powers to investigate past, existing or imminent violations of the securities laws. [536] This investigatory power includes the right to administer oaths, compel sworn testimony and require the production of documents by subpoena. [537]

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SEC administrative proceedings and civil actions commenced by the SEC are generally preceded by an investigation conducted by staff attorneys and other professionals in the SEC's Division of Enforcement. The SEC staff often requests that persons with information pertinent to a matter under investigation provide documents and testimony on a wholly voluntary basis. If such cooperation is not forthcoming, the staff requests the SEC to authorize a formal investigation. In a formal investigation, the staff is authorized to issue and enforce subpoenas.

Upon conclusion of the investigation, the Division of Enforcement recommends whether further action should be taken. If the Division plans to recommend that the SEC authorize commencement of proceedings, the Division will issue a notification, or Wells Notice, to individuals and companies to provide them an opportunity to explain their alleged wrongdoing and assure the SEC of attempts to rectify the violations. The SEC then decides whether to authorize the commencement of administrative or judicial proceedings. [538] SEC staff attorneys conduct administrative proceedings before a quasi-judicial administrative law judge employed by the SEC. [539] The administrative law judge conducts a hearing and then issues a decision. [540] The decision of the administrative law judge can be appealed to the SEC, and any final order of the SEC can be appealed to a federal appellate court. [541]

In recent years, the SEC has faced criticism for its increased reliance on internal administrative law judges, who have been perceived as providing a more favorable forum for the SEC than the federal courts. [542] Several defendants have

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challenged the constitutionality of the SEC's in-house judges in the proceedings pending against them, arguing that the judges were appointed in violation of the Appointments Clause or that the use of administrative proceedings violates their due process rights, and certain district courts have expressed the view that certain aspects of the in-house courts are "likely unconstitutional." [543] However, several circuit courts have dismissed similar challenges on jurisdictional grounds, ruling that defendants must complete the administrative process within the SEC before appealing to federal court, [544] and others have issued conflicting opinions on whether the SEC's administrative law judges' appointments are constitutional. [545] In response to this criticism, the SEC has provided additional guidance on when it considers bringing cases before its in-house courts, has increased the protections provided to defendants in its in-house proceedings, and has reduced its usage of in-house courts. [546]

Alternatively, the SEC can agree to settlements with the targets of its investigation before filing administrative or judicial proceedings. The SEC reached

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such settlements with many financial institutions concerning alleged securities law violations arising out of the 2008 financial crisis. [547] These settlement agreements generally require judicial approval, and have been the subject of increased judicial scrutiny. Most notably, in 2011, Judge Jed S. Rakoff of the Southern District of New York rejected a settlement agreement between the SEC and Citigroup, in which Citigroup agreed to disgorge $160 million in profits, plus $30 million in interest, and pay a civil penalty of $95 million. [548] For several reasons, Judge Rakoff concluded that the proposed settlement was "neither fair, nor reasonable, nor adequate, nor in the public interest." Most fundamentally, Judge Rakoff criticized the SEC's "long-standing policy—hallowed by history, but not by reason—of allowing defendants to enter into Consent Judgments without admitting or denying the underlying allegations." Judge Rakoff stated that such settlements fail to "provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified." Judge Rakoff further pointed to the "overriding public interest in knowing the truth," and rebuked the SEC for failing to fulfill its "duty, inherent in its statutory mission, to see that the truth emerges." Judge Rakoff also characterized the settlement at issue as imposing "only very modest penalties," which could be viewed "as a cost of doing business imposed by having to maintain a working relationship with a regulatory agency, rather than as any indication of where the real truth lies."

Although the Second Circuit Court of Appeals subsequently held that Judge Rakoff committed an abuse of discretion in rejecting the settlement, after concluding that "there is no basis in the law for the district court to require an admission of liability as a condition for approving a settlement between the parties" and that the SEC is not required to "establish the 'truth' of the allegations against a settling party as a condition for approving" a settlement, [549] the SEC

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nonetheless announced a new policy in 2013, under which it will require admissions of wrongdoing in certain cases. [550] Pursuant to this policy, the SEC requires companies to admit wrongdoing in certain settlements. [551]

[b] Injunctive Relief

The SEC has authority to enforce the securities laws by bringing suit in federal district court for injunctive relief. [552] The injunction—a court order compelling or prohibiting specified conduct of the defendant—is among the SEC's strongest weapons for enforcing compliance with the securities laws. [553] Generally, for injunctive relief to be ordered, the SEC must show there is a reasonable

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likelihood of a future violation. [554] The court will look at such factors as the nature of the violation (*e.g.*, whether a minor technical violation or a flagrant one) and defendant's past conduct to determine whether such a likelihood exists. [555]

The SEC also has the authority to request a federal court to enjoin any person who violated the antifraud provisions of § 17(a)(1) of the Securities Act or § 10(b) of the Exchange Act from acting as an officer or director of a public company. [556] The Sarbanes-Oxley Act, as discussed in § 11.07[2][b], makes it easier for the SEC to obtain such a court injunction.

[c] "Cease-and-Desist" Proceedings and Stop Orders

The SEC also has the authority to institute administrative proceedings to order a person to "cease and desist" committing or causing a present or future violation of the major U.S. securities laws. [557] The SEC may also, in connection with this cease-and-desist proceeding, issue an order barring any person who has violated § 10(b) of the Exchange Act or § 17(a)(1) of the Securities Act from acting as a director or officer of a public company.

Unlike the SEC's power to seek injunctive relief, these orders can be issued by the SEC in an administrative proceeding without seeking court action and do not require a showing of likelihood of future violation.

If the SEC determines that the alleged violation is likely to result in significant harm to investors or the public interest, it can enter a temporary order pending completion of the proceedings. [558] A temporary cease-and-desist order can only be entered against a "broker, dealer, investment adviser, investment company, municipal securities dealer, government securities broker, government securities dealer, or transfer agent" or any of their associated persons. The order,

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effective upon service, can be entered without giving the affected party notice and opportunity to be heard if the SEC determines that "notice and hearing prior to entry would be impracticable or contrary to the public interest." [559] Such orders are subject to judicial review within ten days. [560]

The SEC may also issue, after notice and hearing, an order, known as a "stop order," denying effectiveness to a registration statement if it appears inaccurate or incomplete in any material respect, or suspending the effectiveness of a registration statement if it contains a material misstatement or omission. [561]

[d] Civil Monetary Penalties and Disgorgement

The SEC has authority to bring an action in federal court to impose civil penalties for violations of any of the federal securities laws or any cease-and-desist order. [562] The SEC's penalty authority was limited prior to 1984, mainly consisting of a $100 per day assessment against issuers for reporting requirement violations. However, through the 1984 Insider Trading Sanctions Act, the 1988 Insider Trading and Securities Fraud Act, the Sarbanes-Oxley Act, and the Dodd-Frank Act, this power has gradually expanded. [563] The largest civil penalties are imposed for violations that involve "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" and where the violation "directly or indirectly resulted in substantial losses or created significant risk of substantial losses to other persons"; penalties for such violations are the greater of (i) $178,156 for individuals or $890,780 for corporations and (ii) the gross amount of the pecuniary gain to the defendant resulting from such violation. [564]

The SEC considers three core issues in the assessment of a monetary penalty: first, the type of violation, and notably the presence of a fraud element;

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second, the degree of harm or loss to investors (for a regulated entity, there is a greater degree of harm because of the danger of a public loss of confidence in the markets); and third, the extent of a violator's cooperation. [565] Additional

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considerations, such as recidivism, the relative sophistication or seniority of the party, evidence of personal enrichment, the violation's duration and the size of the entity or the net worth of the individual, are all important in computing the final monetary penalty. [566]

When considering the appropriateness of monetary sanctions against corporate defendants, the SEC staff has identified two primary considerations: (i) "[t]he presence or absence of a direct benefit to the corporation as a result of the violation" and (ii) the degree to which the penalty will recompense or further harm the injured shareholders; as well as several secondary considerations, including:

- the need to deter the particular type of offense;
- the extent of the injury to innocent parties;
- whether complicity in the violation is widespread throughout the corporation;
- the level of intent on the part of the perpetrators;
- the degree of difficulty in detecting the particular type of offense;
- presence or lack of remedial steps by the corporation; and
- extent of cooperation with the SEC and other law enforcement. [567]

Certain provisions authorizing the SEC to assess civil penalties contain explicit statutes of limitations, which fix the time in which the SEC must file actions seeking such penalties. For example, actions assessing civil penalties for insider trading must be brought within "5 years after the date of the purchase or sale." [568] Civil penalty provisions that do not contain specific statutes of limitations are subject to the default five-year statute of limitations contained in 28 U.S.C. § 2462, which begins to run on the date that the claim "first accrued." In *Gabelli v. SEC*, a unanimous Supreme Court rejected the SEC's argument that this default statute of limitations should not begin to run on claims that sound in fraud until the agency discovered or should have discovered the alleged wrongdoing, holding that the default statute of limitations for civil penalties begins to run on the date of the alleged wrongdoing and is not subject to the discovery rule. [569]

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The SEC also may seek the "disgorgement," or forfeiture, of profits arising from the defendant's violations. [570] Disgorgement is an equitable remedy within the discretion of the court, but is generally a powerful tool. [571] Courts have held, for example, that defendants in disgorgement actions may not plead defenses based on laches or the statute of limitations, because the SEC acts in the public interest. [572] Moreover, the government may seek disgorgement in addition to criminal sanctions for the same wrongful conduct: disgorgement orders do not constitute "punishment" for purposes of the Double Jeopardy Clause of the U.S. Constitution, provided that the amount ordered to be disgorged bears a rational relationship to the actual damages and costs caused by the defendant. [573] Under the Sarbanes-Oxley Act, the SEC has the authority to add any civil penalties obtained in connection with such disgorgement to the disgorgement fund. [574]

The SEC also has limited authority to impose civil penalties in certain administrative proceedings against persons who have willfully violated provisions of the securities laws if the penalty is "in the public interest." [575] Prior to the enactment of the Dodd-Frank Act, the SEC could only impose penalties in administrative proceedings against certain regulated entities, including broker-dealers and investment advisers. Section 929P of the Dodd-Frank Act, however, expanded the SEC's ability to impose civil penalties in administrative proceedings to encompass any person or company.

In the aftermath of the 2008 financial crisis, the DOJ has also pursued civil penalties against various banks, their executives, and the credit rating agencies

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under the Financial Institutions Reform, Recovery and Enforcement Act ("FIRREA"), which imposes civil penalties for violations of various criminal statutes, including the federal mail and wire fraud statutes, that "affect[] a federally insured financial institution." [576] Although the statute, which was enacted following the savings and loan crisis of the 1980s, was arguably intended to protect financial institutions from fraud committed by others that affected them, a number of district courts have permitted the government to pursue FIRREA claims against financial institutions themselves based on so-called "self-affecting" misconduct. [577] One of those cases subsequently proceeded to trial, which resulted in a verdict in favor of the government and the imposition of a $1.27 billion civil penalty, although the verdict was subsequently reversed on appeal based on the government's failure to prove fraudulent intent. [578] Prior to that reversal, however, a number of financial institutions agreed to multi-billion dollar settlements of similar FIRREA claims with the DOJ for alleged wrongdoing in connection with mortgages and mortgage-related securities in the years before the financial crisis. [579]

[e] Publication of Findings

The SEC has power under § 15(c)(4) of the Exchange Act to publish a report of the findings of administrative proceedings in connection with noncompliance with the registration, reporting or proxy requirements of the Exchange Act by issuers that are reporting companies under the Exchange Act. [580] It can also issue orders under § 15(c)(4) to bring conduct of the particular issuer into

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compliance with the securities laws. [581] In addition, the SEC has the power under § 21(a)(1) of the Exchange Act to publish reports concerning securities law violations it has investigated. The SEC primarily uses these so-called § 21(a) reports to publicize its view on matters for which enforcement proceedings have not been pursued or with respect to "novel or unique matters." [582]

[f] Enforcement Activities Against Market Professionals

By the fall of 2002, the SEC, the NASD (now known as FINRA), the NYSE and state attorneys general began cooperatively investigating the practices of financial institutions. These investigations resulted in several settlements related to analyst conflicts of interest issues and allocation practices in initial public offerings, such as "spinning," in which shares of an initial public offering that are expected to trade in the aftermarket at a premium are allocated to company executive officers and directors in order to induce those individuals to steer investment banking business to the underwriter.

Notably, in January 2002, Credit Suisse First Boston settled for $100 million with the NASD and the SEC to resolve a federal investigation of IPO allocation practices. [583] After more than six months of investigation by the Attorney General of the State of New York (the "NYAG"), a similar settlement agreement for a $100 million payment was reached between Merrill Lynch, Pierce, Fenner & Smith Incorporated and the NYAG in May 2001, regarding allegations that

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Merrill Lynch analysts issued misleading research related to the technology and Internet sectors, and that their research was influenced by investment banking relationships. [584]

Around the same time, the SEC, the NASD, the North American Securities Administrators Association ("NASAA"), the NYSE and attorneys general from a number of states, including New York, undertook a broader investigation of 12 prominent Wall Street banking firms with regard to research and IPO allocation practices, such as "spinning" in initial public offerings. During the course of these investigations, [585] damaging evidence was made public suggesting that the public recommendations of Wall Street analysts often did not reflect their firms' internal assessments of a company and that the independence of analysts was compromised by their firms' investment banking relationships with the same companies they were analyzing. In October 2002, the SEC, the NASD, the NASAA, the NYSE, the NYAG and various state securities regulators officially agreed to coordinate investigation and enforcement efforts, [586] and a global settlement between each of these regulators and ten of the financial institutions under investigation was announced on April 28, 2003 and was entered by the court on

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October 31, 2003. [587] A later settlement with the remaining two firms was announced on August 26, 2004. [588]

Under the terms of the settlements, the 12 firms were required to pay disgorgement and civil penalties totaling approximately $1.5 billion, which included Merrill Lynch's prior payment of $100 million in connection with its initial settlement with the NYAG. [589] Some of the money was used to create funds for investors, to pay for independent research and for investor education. [590] The settling firms also agreed to structural reforms to separate research and investment banking and to improve disclosure as to possible conflicts of interest. The 12 firms also entered into a voluntary agreement to restrict spinning in initial public offerings. A variety of different statutory provisions were invoked against the settling firms:

- Firms issuing fraudulent research reports were charged with violating § 15(c) of the Exchange Act.
- Firms issuing research reports that were not based upon principles of fair dealing and good faith and did not provide a sound basis for evaluating facts, contained exaggerated or unwarranted claims about the covered companies, and/or contained opinions for which there were not reasonable bases were charged with violating NYSE Rules 401, 472 and 476(a)(6) and then—NASD Rules 2110 and 2210 and states' ethics statutes.
- Firms receiving payments for research without disclosing such payments were charged with violating § 17(b) of the Securities Act as well as NYSE Rules 476(a)(6), 401 and 472, then—NASD Rules 2210 and 2110 and state statutes.
- Firms engaging in spinning of initial public offerings were charged with violating NYSE and NASD rules requiring adherence to high business standards and the recordkeeping provisions of § 17(a) of the Exchange Act, NYSE Rule 440 and NASD Rule 3110.
- All firms were alleged to have failed to maintain appropriate supervision over their research and investment banking operations in violation of NASD Rule 3010 and NYSE Rule 342.

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Two individual analysts were fined and agreed to an injunction against future securities laws violations and a bar on associating with a broker, dealer or investment adviser. [591] The settlements did not foreclose further actions against the 12 firms (or other firms or individuals) by regulatory or individual investors, and civil plaintiffs filed hundreds of class action complaints related to IPO allocation practices, which were settled in 2009 for $586 million. [592]

The SEC also has pursued actions against certain securities exchanges. In 2013, the SEC charged NASDAQ with securities law violations relating to the initial public offering of Facebook, during which a computer error caused more than 30,000 orders to remain stuck in the exchange's system for several hours without being executed or cancelled. [593] In its order against NASDAQ, the SEC charged that, despite widespread anticipation that the Facebook IPO would be among the largest in history, NASDAQ failed to correct the computer error and thereby violated its rule governing the price/time priority for executing trade orders. The SEC order further asserted that NASDAQ violated its rules by utilizing an unauthorized error account. NASDAQ agreed to settle the charges by paying a $10 million penalty.

[3] Criminal Enforcement

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Violations of the U.S. securities laws can also give rise to criminal prosecution by the DOJ [594] and, upon conviction, to sentences ranging from substantial fines to imprisonment. As in civil enforcement, there are multiple statutory provisions under which criminal charges may be brought. This section discusses several provisions within the securities laws themselves, as well as several general criminal statutes that are frequently applied in securities cases. It also discusses the federal guidelines applicable for sentencing corporations and other entities.

[a] Securities Law Provisions

The principal U.S. securities laws each authorize the commencement of criminal proceedings against persons who willfully violate certain provisions of these statutes. [595] The Securities Act, the Investment Company Act and the Advisers Act each provide for fines of up to $10,000, [596] and the Exchange Act provides for fines of up to $5 million for natural persons or $25 million for others. [597] Alternatively, fines may be fixed at twice the profit gained by the defendant or the loss inflicted on the victim, if this amount is greater than the statute would otherwise provide. [598] The DOJ may also seek imprisonment of up to five years for violations of the Securities Act, the Investment Company Act

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and the Advisers Act [599] or up to 20 years for violations of the Exchange Act. [600] Certain defenses to imprisonment are available for nonwillful, technical violations of rules and regulations under the Act if the defendant can prove that he or she had no actual knowledge of the rule or regulation at issue. [601]

Following significant economic downturns coupled with revelations of misconduct, prosecutors have reacted by vigorously prosecuting violations of the securities laws. In the late 1980s, prosecutors brought highly publicized and successful prosecutions of insider trading, market manipulation and other securities violations. [602] In the wake of Enron and the Sarbanes-Oxley Act, prosecutors aggressively investigated and prosecuted alleged misconduct related to accounting and disclosure issues, related-party transactions and insider trading. [603]

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Another wave of securities-related prosecutions targeted the back-dating of stock options. In the second half of 2006, over 100 companies acknowledged either internal or governmental investigations into potential backdating, a practice by which the exercise price of executives' stock options is set prior to the board meetings at which the options were awarded and at a lower price than the stock was trading on the day of the grant. [604] More recently, prosecutors have pursued a number of criminal prosecutions arising from the 2008 financial crisis, including actions concerning mortgage-related assets, Ponzi schemes, and insider trading. [605]

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These actions represent a further intensification of the prosecutions from the 1980s in terms of both the number of actions brought and the aggressiveness of prosecutors. [606]

It is not uncommon for separate civil and criminal proceedings brought by the government against the same defendant to proceed simultaneously. Although the SEC and the DOJ are separate and distinct governmental entities, they often cooperate to exert greater pressure on a defendant. In *United States v. Kordel*, the Supreme Court held that federal prosecutors may use evidence obtained in a civil action in prosecuting a related criminal proceeding, provided the civil action was not brought in "bad faith." [607] Moreover, in recent years, the DOJ and the SEC have also cooperated with other regulators at the state, federal, and international levels to investigate several recent securities-related scandals and negotiate large global settlements. [608] Further, the DOJ has itself pursued a number of civil actions alleging securities fraud in the years leading up to the 2008 financial crisis, including several actions relating to the marketing and sale of mortgage-backed securities. [609]

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And, more recently, several banks agreed to plead guilty to criminal charges concerning alleged rate manipulation. [610]

Some observers, however, sharply criticized the government for failing to prosecute more high-level executives for alleged wrongdoing in connection with the financial crisis. [611] In response to this criticism, on September 9, 2015, the Department of Justice issued new guidelines aimed at prioritizing its focus on individual responsibility in cases of both civil and criminal corporate wrongdoing. [612] The guidelines, which are set out in a memorandum from Deputy Attorney General Sally Quillian Yates, describe steps that the DOJ was taking to "strengthen" its "pursuit of individual corporate wrongdoing," including providing that:

- In order to qualify for any cooperation credit, corporations must provide to the DOJ all relevant facts relating to the individuals responsible for misconduct.
- Criminal and civil corporate investigations should focus on individuals from the inception of the investigation.
- Criminal and civil attorneys handling corporate investigations should be in routine communication with one another.
- Absent extraordinary circumstances or approved departmental policy, the DOJ will not release culpable individuals from civil or criminal liability when resolving a matter with a corporation.

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- DOJ attorneys should not resolve matters with a corporation without a clear plan to resolve related individual cases, and should memorialize any declinations as to individuals in such cases.
- Civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay.

A growing number of companies have entered into deferred prosecution agreements with the DOJ. In exchange for a deferral of prosecution, these companies often agree to the payment of large penalties, institute extensive internal corporate reforms and cooperate fully with federal ongoing or subsequent investigations. [613] Since the 1995 agreement with Prudential Securities Inc. over the fraudulent marketing of limited partnerships, [614] the DOJ has entered into deferred prosecution agreements with a significant number of companies—including Lloyds Banking Group, Credit Suisse, ABN AMRO, Bristol-Myers, Monsanto, Time Warner, InVision, American International Group Inc., Computer Associates, Canadian Imperial Bank of Commerce, Merrill Lynch, PNC Financial Services Corporation, Banco Popular De Puerto Rico, Barclays, UBS, HSBC, The Royal Bank of Scotland, JPMorgan, and Deustche Bank. [615] The DOJ

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reiterated its commitment to deferred prosecutions in December 2006, when Deputy Attorney General Paul J. McNulty issued a memorandum setting forth the factors that the Department would consider when determining whether to indict a corporation or offer a deferred prosecution agreement. [616] These factors largely echoed the factors set forth three years earlier in the Thompson Memo. [617] Moreover, a memorandum issued by Deputy Attorney General Mark R. Filip in 2008 explained that deferred prosecutions would be particularly useful tools in situations where a corporate conviction would result in significant collateral consequences on innocent third parties. [618]

[b] Mail and Wire Fraud

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The same conduct that violates provisions of the securities laws may also be recharacterized by prosecutors as violations of various other criminal statutes. Two general antifraud statutes, commonly known as the mail and wire fraud statutes, are used with particular frequency. [619] The former provides for criminal penalties for use of the U.S. postal system, [620] and the latter for use of interstate or foreign wire, radio or television communications, [621] in furtherance of a scheme to defraud. The allegedly fraudulent information need not have been placed in the mail or transmitted over the wires (such as facsimile or telephone) to be actionable under the mail and wire fraud statutes; use of the mails or interstate wires is simply the jurisdictional means necessary to invoke the federal laws. [622] Therefore, almost any conduct that could be characterized as fraud under the common law will violate the mail and wire fraud statutes, although unlike the common law action alleging fraudulent conduct, it is not necessary that the fraud be successful [623] or that the intended victims of the scheme have relied to their detriment on the alleged fraud. [624]

The mail and wire fraud statutes are intended to protect individual property rights, [625] including intangible property rights such as the "intangible right of honest services." [626] In *Carpenter v. United States*, the Supreme Court affirmed the conviction of R. Foster Winans, a columnist at *The Wall Street Journal*, who had schemed with brokers to trade in the securities of companies that were to be the subject of upcoming "Heard on the Street" columns. The Court held that *The Wall Street Journal* had an intangible "property right in keeping confidential and making exclusive use, prior to publication, of the schedule and contents of the 'Heard' columns" and that this property had been fraudulently misappropriated since Winans owed a fiduciary duty not to exploit confidential information obtained during his employment. [627]

The U.S. Supreme Court upheld the constitutionality of the "honest services law" while narrowing its scope to cases that involve bribery or kickback schemes. In *Skilling v. United States* [628] the Court held that a broader interpretation of the law, to include undisclosed self-dealing by a public official or private employee, would be unconstitutionally vague because the statute had been infrequently applied to such conflict-of-interest cases and because the term "honest services" was itself ambiguous. The Court also invoked the rule of lenity to construe the statute in favor of Skilling, the former CEO of Enron, given the perceived ambiguity in the law. The government had charged Skilling with conspiring to defraud its shareholders by lying about the company's financial health, and profiting by receiving salary and bonuses and selling Enron stock at an inflated price. Because the government did not "allege that Skilling solicited or accepted side payments from a third party in exchange for making these misrepresentations," the Court held that the "honest services law" could not serve as a basis for prosecuting Skilling. [629]

A defendant may be charged simultaneously with violating the mail or wire fraud statutes and with violating an antifraud provision under the U.S. securities laws; there is no requirement that prosecutors select one or the other criminal statute on which to base their case. [630] In order to be convicted under the mail or wire fraud statutes, the defendant must have acted intentionally or with reckless indifference to the truth. [631] Good faith is a defense to a charge of scheming to defraud if the defendant reasonably and actually believed in the sound basis of the representations made or the scheme proposed. [632] A mail or wire fraud conviction can result in fines of up to $250,000 for an individual, $500,000 for an

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organization, or twice the profit gained or loss avoided by the violation, [633] as well as up to 20 years' imprisonment. [634]

The Sarbanes-Oxley Act created a new securities fraud crime, the elements of which are similar to the existing mail and wire fraud crimes and which may be brought as an additional charge in fraud cases relating to securities. [635]

[c] Other Criminal Statutes

There are numerous other federal criminal statutes that may be applied to illegal activities in the securities marketplace. As discussed in § 11.09[1][b], the broad RICO statute allows for criminal and, in limited circumstances, civil enforcement of "fraud in the sale of the securities," so long as a "pattern" of such fraudulent acts can be shown. [636] It is also a crime in the United States to: (i) make false statements "in any matter within the jurisdiction of any department or agency of the United States," including the SEC, [637] (ii) engage in financial transactions with the proceeds of unlawful activities, with the intention of promoting those activities or concealing the nature or source of the proceeds ("money laundering"), [638] or (iii) structure financial transactions to avoid triggering certain cash reporting requirements of financial institutions. [639]

[d] Entity Sentencing Guidelines

As discussed previously, U.S. law sets forth a range of possible fines that can be imposed on corporations or others convicted of violating criminal statutes. While some of these laws provide for stiff penalties on their face, [640] others that originally contained lighter penalties have been superseded by a general penalty provision, enacted in 1984, which increased the possible fine for corporate

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defendants to the greater of $500,000 or twice the benefit gained by the defendant or the loss inflicted on the victim. [641] Even where the pecuniary benefit or loss is minimal, however, fines can nonetheless far exceed the $500,000 alternative amount because a single episode of criminal misconduct often entails the commission of multiple criminal acts, each of which can support the imposition of a separate penalty. [642]

In 1991, the U.S. Sentencing Commission, created by Congress in 1984 to devise guidelines to limit the discretion of judges in determining sentences, issued sentencing guidelines for criminal activities of corporations and other entities. [643] While these guidelines do not by themselves modify the maximum fines that the federal courts are authorized by statute to impose, they do furnish ranges within an existing fine authorization from which the court is recommended to select the appropriate sentence. [644] Importantly, they also provide significant incentives for corporations doing business in the United States, including non-U.S. corporations or U.S. subsidiaries of non-U.S. corporations, to adopt compliance and ethics programs to prevent and detect violations of federal criminal law by employees, by significantly reducing the applicable fines for corporations that have implemented such programs.

The operation of the sentencing guidelines is complex, involving the determination of a "base fine" amount based on various specified "offense levels," and the subsequent application of multipliers based on the particular characteristics of the organization, determined by its so-called "culpability score." This score may be increased (resulting in larger fines) for corporations with large numbers of employees, corporations where senior managers "participated in, condoned, or [were] willfully ignorant of the offense," corporations with prior histories of related criminal or civil violations, or corporations that attempted to obstruct justice while the misconduct at issue was being investigated. The culpability score may be decreased (resulting in lower fines) if the organization had in place "an effective compliance and ethics program," or if the organization is highly cooperative with prosecuting authorities, for example by voluntarily

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bringing the matter to the government's attention or promptly accepting responsibility for the criminal conduct. [645]

The sentencing guidelines for corporations set out various general criteria that a compliance and ethics program must satisfy to qualify as an "effective" one for purposes of reducing the organization's culpability score. These criteria include:

- the development, implementation and enforcement of standards and procedures "generally effective in preventing and detecting criminal conduct" and effective communication of these standards to all employees;
- knowledge by an organization's governing authority about the content and operation of the compliance and ethics program and the exercise of reasonable oversight with respect to the implementation and effectiveness of such a program;
- the promotion of an organizational culture that encourages ethical conduct and a commitment to compliance with the law;
- the designation of specific high-level personnel to oversee compliance and the delegation of day-to-day operational responsibility for the compliance and ethics program to specific individuals;
- the development of specific procedures to monitor compliance and report violations;
- the periodic evaluation of the effectiveness of the compliance and ethics program;
- the establishment and publication of a system whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation; and
- the promotion and consistent enforcement of the organization's compliance and ethics program through appropriate incentives to perform in accordance with the program and appropriate disciplinary measures for engaging in criminal conduct and/or for failing to take reasonable steps to prevent or detect criminal conduct. [646]

Footnotes

491 *See* FED. R. CIV. P. 23(a) and (b).

492 *See* PricewaterhouseCoopers LLP, 2015 Securities Litigation Study (Apr. 2016) (noting that 43 foreign-filers listed on U.S. exchanges were sued in U.S. private securities class actions in 2015, out of the total of 195 private securities class actions during the year). The report highlighted that the majority of actions against foreign filers were related to China and Canada-based entities, and that a disproportionate percentage of those cases involved accounting-related allegations.

493 Many corporate scandals have produced civil class actions. *See, e.g.*, *In re WorldCom, Inc. Securities Litigation*, 219 F.R.D. 267 (S.D.N.Y. 2003) (certifying putative class of "tens of thousands of investors" who asserted, among other claims, claims under §§ 11 and 12 of the Securities Act and § 10(b) of the Exchange Act arising out of the WorldCom accounting scandal); *In re Initial Public Offering Securities Litigation*, 241 F. Supp. 2d 281 (S.D.N.Y. 2003) (consolidated action involving 1,000 class action lawsuits against more than 300 issuers, more than 50 underwriters and various individuals alleging violations of § 10(b) of the Exchange Act and § 11 of the Securities Act in connection with undisclosed compensation in exchange for allocations in initial public offerings, "tie-ins" or laddering agreements (in which banks allocate IPO shares to investors based upon their commitment to purchase additional shares at fixed prices once public trading begins to inflate newly issued shares' values) with banks in order to receive allocations, and research analysts conflicts of interest); *In re Credit Suisse First Boston Corp. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶90,306 (S.D.N.Y. Oct. 19, 1998) (class action alleging violations of § 10(b) of the Exchange Act in connection with false research reports).

494 *See* §§ 11.03[2] and 11.04[2]. *But see In re Initial Public Offering Securities Litigation*, 471 F.3d 24 (2d Cir. 2006) (holding that fraud-on-the-market theory would not apply to claims based on alleged misstatements in connection with an initial public offering where there was no developed or efficient market for the stock).

495 The sole exception is for members of the class who choose to "opt out" of the class action proceedings,

preserving their right to sue separately but at the same time waiving their right to participate in the class action or share in the proceeds of its settlement or judgment. *See* FED. R. CIV. P. 23(c)(2).

496 *See* FED. R. CIV. P. 23.

497 *In re Initial Public Offering Securities Litigation*, 471 F.3d 24 (2d Cir. 2006). The court noted that the ultimate fact-finder would not be bound by the factual determinations made during the class certification proceedings.

498 *In re Initial Public Offering Securities Litigation*, 471 F.3d 24 (2d Cir. 2006) (quoting *Caridad v. Metro-North Commuter Railroad*, 191 F.3d 283 (2d Cir. 1999)).

499 *See* § 11.04[2][b].

500 *See* § 11.04[2][b].

501 *Erica P. John Fund, Inc. v. Halliburton Co.*, 132 S. Ct. 2179 (2011).

502 *See, e.g.*, *In re Flag Telecom Holdings, Ltd. Securities Litigation*, 574 F.3d 29, 39–41 (2d Cir. 2009) (holding that it was proper to deny certification of a class that included putative members who had sold the securities at issue before the truth regarding the alleged misstatements was revealed to the public because the plaintiffs "failed to demonstrate that any of the information that 'leaked' into the market prior to [the date plaintiffs sold their stock], revealed the truth with respect to the specific misrepresentations alleged" and thus their claims were not typical of those of the class members plaintiffs sought to represent).

503 In *Halliburton*, the issuer also defended the lower court's decision by arguing that the court's reliance on the evidence of lack of loss causation to uphold the denial of class certification was really a proxy for a determination that the alleged misrepresentations had no impact on the price of the securities at issue. *See Erica P. John Fund, Inc. v. Halliburton Co.*, 132 S. Ct. 2179, 2186–87 (2011). The Supreme Court refused to credit this interpretation of the lower court's decision, finding that the Fifth Circuit unequivocally rested on the lack of loss causation to uphold the denial of class certification. Nevertheless, as the Court explained in *Halliburton*, under *Dura Pharmaceuticals, Inc., v. Broudo*, 544 U.S. 336 (2005), a showing that the alleged misrepresentation did not cause a change in the price of the security defeats the *Basic* presumption of reliance. The Court also cited favorably the *In re Salomon Analyst Metromedia Litigation*, 544 F.3d 474 (2d Cir. 2008), decision, where the Second Circuit reiterated that a defendant could defeat the *Basic* presumption by establishing lack of price impact of the alleged misrepresentation or omission. Thus, after *Halliburton*, defendants may still use the lack of loss causation at the class-certification stage as one factor that may lead a court to conclude that an alleged misrepresentation had no impact on the price of the security at issue, thus defeating the *Basic* presumption of reliance.

504 *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*, 133 S. Ct. 1184 (2013).

505 *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014).

506 *See* § 11.04[2][a].

507 *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011).

508 *Comcast Corp. v. Behrend*, 133 S. Ct. 1426 (2013).

509 *Ludlow v. BP, P.L.C.*, 800 F.3d 674 (5th Cir. 2015).

510 *See, e.g., Iron Workers Local No. 25 Pension Fund v. Credit-Based Asset Servicing and Securitization, LLC*, 616 F. Supp. 2d 461, 463 (S.D.N.Y. 2009) (discussing the legislative history and purposes of the Litigation Reform Act as indicating clear intent to curtail "the vice of 'lawyer-driven' litigation"); *In re Nice Systems Securities Litigation*, 188 F.R.D. 206, 214–15 (D.N.J. 1999) (discussing the legislative history and purpose of the Litigation Reform Act). The Litigation Reform Act also mandates imposition of sanctions, presumed to be attorneys' fees and costs, against any parties or counsel found to have filed frivolous or abusive suits, and in the case of private class actions under the Exchange Act, specifically authorizes courts to require parties or their counsel to post bonds at the outset to cover any such fees or costs that may be imposed. *See* §§ 21D(c)(3) and 21D(a)(8) of the Exchange Act, respectively; §§ 27(c)(3) and 27(a)(8) of the Securities Act, respectively.

511 The lead plaintiff's choice of counsel, however, is subject to the court's approval. § 21D(a)(3)(B)(v) of the

Exchange Act. Equipped with this veto power, some courts now require lead counsel to be selected through a competitive bidding process . *See, e.g.*, *Sherleigh Associates LLC v. Windmere-Durable Holdings, Inc.*, 186 F.R.D. 669 (S.D. Fla. 1999); *In re Cendant Corp. Litigation*, 182 F.R.D. 144 (D.N.J. 1998). The Third Circuit Court of Appeals disagreed with the district court's use of a competitive bidding process in *Cendant*, however, but held that the use of the process was harmless error. *In re Cendant Corp. Litigation*, 264 F.3d 201 (3d Cir. 2001).

512 *See Burke v. Ruttenberg*, 102 F. Supp. 2d 1280 (N.D. Ala. 2000); *In re Cephalon Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶99,313 (E.D. Pa. Aug. 27, 1996). In *Weltz v. Lee*, 199 F.R.D. 129, 132 (S.D.N.Y. 2001), the court appointed an aggregate group of seven investors as lead plaintiff. However, the court also noted that there is an "outer limit to the number of plaintiffs allowed to proceed as lead plaintiff," citing cases in which groups of 137, 141 and 250 plaintiffs were deemed too large. Some courts have rejected aggregation altogether. *See, e.g.*, *Goldberger v. FXRE Group Ltd.*, Nos. 06-CV-3410 (KMK), 06-CV-3440 (GBD), 06-CV-3544 (KMK), 06-CV-4638 (KMK), 2007 WL 980417, at *4–5 (S.D.N.Y. Mar. 30, 2007). *See generally In re UBS Auction Rate Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶94,791 (S.D.N.Y. July 16, 2008) (permitting aggregation of seven class members and discussing split of authority on aggregation issue).

513 § 21D(a)(3)(B)(iii)(I)(bb) of the Exchange Act and § 27(a)(3)(B)(iii)(I)(bb) of the Securities Act. Although courts have been willing to apply this rebuttable presumption, they have also closely scrutinized aggregating plaintiff groups, questioning whether they are "simply an artifice cobbled together by cooperating counsel for the obvious purpose of creating a large enough grouping of investors to qualify as 'lead plaintiff,' which can then select the equally artificial grouping of counsel as 'lead counsel.'" *In re Razorfish, Inc. Securities Litigation*, 143 F. Supp. 2d 304, 308 (S.D.N.Y. 2001). *In Klugmann v. American Capital Ltd.*, Fed. Sec. L. Rep. (CCH) ¶95,318 (D. Md. Aug. 13, 2009), the court noted in *dicta* that aggregation of wholly unrelated plaintiffs solely for the purpose of totaling the largest losses was inappropriate, but accepted aggregation of three plaintiffs who each had, individually, larger losses than the other proposed lead plaintiff. In the Third Circuit, before appointing a lead plaintiff, the court must determine whether "the way in which a group seeking to become lead plaintiff was formed or the manner in which it is constituted would preclude it from fulfilling the tasks assigned to a lead plaintiff." *In re Cendant Corp. Litigation*, 264 F.3d 201, 266 (3d Cir. 2001). "If the court concludes that the group was created by counsel rather than class members, then 'the court should disqualify that movant on the grounds that it will not fairly and adequately represent the interests of the class.'" *In re Able Laboratories Securities Litigation*, 425 F. Supp. 2d 562, 567–68 (D.N.J. 2006) (quoting *In re Cendant Corp. Litigation*, 264 F.3d 201, 266 (3d Cir. 2001)).

514 *See* Max Berger, et al., *Institutional Investors as Lead Plaintiffs: Is There a New and Changing Landscape?*, 75 ST. JOHN'S L. REV. 31, 31 (2001) (citing H.R. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730).

515 In a 1997 report to the President and Congress, the SEC indicated that institutional investors had not become more active in securities class actions in the year following enactment of the Litigation Reform Act, and that such actions continued to be controlled by plaintiffs'law firms frequently representing smaller investors. The SEC suggested that "there are substantial disincentives for institutional investors considering intervention" in securities class actions, including the added costs of managing the litigation, the potential exposure of key personnel to discovery not only from defendants but also from other potential lead plaintiffs and the possibility of added liability in suits brought by other plaintiffs based on the lead plaintiff's class action litigation decisions. Some institutional investors have apparently concluded that they can obtain a better recovery and reduce exposure by opting out of the securities class and proceeding separately. As the SEC concluded, "[w]hether or not institutions will look beyond these disincentives remains to be seen." SEC, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, at 2, 51–52 (Apr. 1997), *reprinted in* 3 SECURITIES REFORM ACT LITIG. RPTR. 27, 56 (May 1998).

516 *See* Karen Donovan, *Legal Reform Turns a Steward Into an Activist*, N.Y. TIMES, Apr. 16, 2005 (noting

increased role of institutional investors, including public pension funds, under the Litigation Reform Act, and highlighting the role of then-New York state comptroller Alan Hevesi as representative of the lead plaintiff in the *WorldCom* class action); Richard B. Schmitt, *Accounting for Enron: Pension Funds, Not Lawyers, Drive Holder Suits*, WALL ST. J., Jan. 24, 2002; Max Berger, *et al.*, *Institutional Investors as Lead Plaintiffs: Is There a New and Changing Landscape?*, 75 ST. JOHN'S L. REV. 31 (2001). Several studies have found that class action settlements are higher when institutional plaintiffs are lead plaintiffs. James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter?: An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 100 COLUM. L. REV.101 (2006); Laura E. Simmons & Ellen M. Ryan, *Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2003* (Cornerstone Research, 2004).

517 SLUSA does not prohibit: (i) actions that are based on the statutory or common law of the state in which the issuer is incorporated and that involve (a) any communication with respect to the sale of the securities of the issuer that is made by or on behalf of the issuer to its equity holders and concerns decisions of those holders with respect to voting their securities, acting in response to a tender or exchange offer or exercising dissenters'or appraisal rights or (b) the purchase or sale of securities by the issuer exclusively from or to holders of equity securities of the issuer, (ii) actions involving a covered security brought by a state, its political subdivisions or a state pension plan, and (iii) actions seeking to enforce contractual agreements between an issuer and an indenture trustee.

518 § 101 of SLUSA, as incorporated into § 16 of the Securities Act. "Covered class action" is defined in § 16(f)(2) of the Securities Act as "any single lawsuit in which damages are sought on behalf of more than 50 persons," in which certain questions of law and fact predominate "without reference to issues of individualized reliance on an alleged misstatement or omission." This definition also applies to groups of lawsuits consolidated, joined or otherwise filed as a single action. Representative class actions are also covered by the definition. Section 16(f)(2)(B) of the Securities Act provides an exception for derivative actions. The term "covered security" is defined in § 16(f)(3) of the Securities Act by reference to § 18(b)(1) and (2) of the Securities Act, which defines "covered securities" as those "listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed or authorized for listing on the National Market System of the Nasdaq Stock Market," or "on a national securities exchange (or tier or segment thereof) that has listing standards that the Commission determines by rule (on its own initiative or on the basis of a petition) are substantially similar to the listing standards" of those exchanges. "A security of the same issuer that is equal in seniority or one that is a senior security to a security" described above, is also a "covered security." § 18(b)(1)(C) of the Securities Act.

519 *Kircher v. Putnam Funds Trust*, 547 U.S. 633 (2006).

520 *Merrill*, *Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006).

521 *See supra* Note 219 and accompanying text (discussing the judicially imposed limitations on standing in private litigation under § 10(b) of the Exchange Act and Rule 10b-5 thereunder, which require that a claim be brought by purchasers or sellers of securities and not by holders of securities).

522 *Merrill*, *Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006).

523 *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058 (2014).

524 *In re Kingate Management Limited Litigation*, 784 F.3d 128 (2d Cir. 2015).

525 *Compare Purowitz v. Dreamworks Animation SKG, Inc.*, C.A. No. CV 05-6090 MRP (VBKx), at 3–4 (C.D. Cal. Nov. 15, 2005), *Brody v. Homestore, Inc.*, 240 F. Supp. 2d 1122, 1124 (C.D. Cal. 2003), *and Alkow v. TXU Corp.*, Fed. Sec. L. Rep. (CCH) ¶92,495 (N.D. Tex. May 8, 2003) (all denying motions to remand), *with In re Tyco International, Ltd. Multidistrict Litigation*, 322 F. Supp. 2d 116, 118 (D.N.H. 2004), *Nauheim v. Interpublic Group of Cos.*, 2003 U.S. Dist. LEXIS 6266, at *1 (N.D. Ill. Apr. 15, 2003), *and In re Waste Management Inc. Securities Litigation*, 194 F. Supp. 2d 590 (S.D. Tex. 2002).

526 *Rovner v. Vonage Holdings Corp.*, Civil Action No. 07-178 (FLW), 2007 WL 446658, at *5 (D.N.J. Feb. 7, 2007) ("The Court agrees with those district courts which have found an interpretation of [§ 77v(a)] to require removal of only those securities class action cases raising state law claims to be irreconcilable with the congressional findings. Instead, I find that the plain language of the statute, coupled with the legislative

history and a healthy dose of common sense compel the conclusion that this class action, which alleges only federal Securities Act claims, was removable."); *see also Knox v. Agria Corp.*, 613 F. Supp. 2d 419 (S.D.N.Y. 2009) ("The narrow reading [of SLUSA] granting remand [over covered class actions that raise only Securities Act claims] creates a jurisdictional anomaly because it has the effect of prohibiting state securities fraud claims in state court, while allowing federal securities fraud class actions to be litigated there. It also does not make sense. SLUSA was intended to curtail the proliferation in state courts of securities fraud class actions (federal or state) beyond the reach of the [Litigation Reform Act]'s heightened pleading standards. Instead, the constricted approach threatens to spawn federal securities fraud class actions in state courts where they could proceed under the radar. That bizarre result would shift the center of gravity of federal securities fraud class actions under the 1933 Act from federal to state courts."); *In re Fannie Mae 2008 Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶95,531 (S.D.N.Y. Nov. 24, 2009) (agreeing with *Knox in dicta* because the court found that it had jurisdiction under a different statutory provision as well); *Rubin v. Pixelplus Co., Ltd.*, No. 06-CV-2964 (ERK), 2007 WL 778485, at *5 (E.D.N.Y. Mar. 13, 2007) ("[B]y enacting SLUSA Congress eliminated concurrent jurisdiction for covered class actions, which made federal court the sole venue for securities fraud class actions and effectively abolished state law causes of action for the types of cases at issue here.").

527 *See, e.g.*, *City of Warren Police and Fire Retirement System v. Revance Therapeutics, Inc.*, 125 F. Supp. 3d 917 (N.D. Cal. 2015) (stating that "[t]he Northern District of California has soundly rejected Defendants' position [that state courts lack jurisdiction over Securities Act class actions] in recent years" and the contrary position "appears to be emerging as the dominant view around the country and has almost uniformly been upheld by district courts since 2012"); *see also Niitsoo v. Alpha Natural Resources, Inc.*, 902 F. Supp. 2d 797 (S.D. W. Va. 2012); *Luther v. Countrywide Financial Corporation*, 125 Cal. Rptr. 3d 716 (Cal Ct. App. 2011).

528 Class Action Fairness Act, Pub. L. No. 109-2, 2119 Stat. 9 (2005) (codified at 28 U.S.C. § 1332(d)).

529 Diversity jurisdiction under 28 U.S.C. § 1332 requires that each plaintiff individually satisfy the $75,000 minimum amount in controversy requirement (meaning that a class action in which each plaintiff has an identical claim for $60,000 will not meet the requirement, even if there are 20 plaintiffs with an aggregate amount in controversy of $1,200,000). Also, diversity jurisdiction requires "complete diversity," meaning that none of the plaintiffs may be from the same state as any of the defendants (in the case of class actions, the court will look at the residence or domicile of the class representatives, not all class members). *See* 28 U.S.C. § 1332(a).

CAFA changes both of these rules. Instead of the individual $75,000 amount in controversy requirement, CAFA requires an aggregate amount of $5 million. Instead of "complete diversity," CAFA requires only that one class member be diverse from at least one defendant. CAFA only applies to class actions with greater than 100 class members. *See* 28 U.S.C. § 1332(d)(2)–(7).

530 *Compare Luther v. Countrywide Home Loans Servicing LP*, 533 F.3d 1031 (9th Cir. 2008) (holding that "CAFA's general grant of the right of removal of high-dollar class actions does not trump § 22(a)'s specific bar to removal of cases arising under the Securities Act of 1933") *with Katz v. Gerardi*, 552 F.3d 558 (7th Cir. 2009) ("disagree[ing] with *Luther* and hold[ing] that securities class actions covered by [CAFA] are removable").

531 *See, e.g.*, *Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Corp.*, 632 F.3d 762 (1st Cir. 2011); *In re Countrywide Financial Corporation Mortgage-Backed Securities Litigation*, 860 F. Supp. 2d 1062 (C.D. Cal. 2012); *Genesee County Employees' Retirement System v. Thornburg Mortgage Securities Trust 2006-3*, 825 F. Supp. 2d 1082 (D.N.M. 2011).

532 *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, 693 F.3d 145 (2d Cir. 2012), *cert. denied*, 133 S. Ct. 1624 (2013).

533 18 U.S.C. § 1964.

534 The SEC's real time enforcement initiative began at the end of 2001 alongside the Enron bankruptcy. As described by then-SEC Chairman Pitt, "[t]his policy aims to improve our protection of investors by moving

faster, or in real time, to bring enforcement actions. We seek to learn of violations quickly and, where investor interests are being disserved or abused, take immediate action to undo or halt the effects of misconduct." Remarks by SEC Chairman Harvey L. Pitt at the Directors' Education Institute, Duke University (Oct. 22, 2002). In one matter, the SEC brought a fraud action against an Internet investment scheme, operating under the name of Invest Better 2001, before it was able to identify the individual behind it. *See* Stephen M. Cutler, Recent SEC Enforcement Cases, 1344 PLI/Corp 991, 1009 (Nov. 2002). In another action against an oil and gas investment scam, the SEC brought an action and obtained an order within four days of learning of the scheme. *See* Press Release, SEC, SEC Halts $3.9 Million Oil & Gas Scheme; "Real-Time" Enforcement Initiative Cited (Dec. 3, 2001). In WorldCom, the SEC filed charges within 24 hours of WorldCom's initial restatement of its financial statements. *See* Seth Schiesel, *WorldCom Seems Close to Deal to Settle S.E.C.'s Fraud Case*, N.Y. TIMES, Nov. 5, 2002.

The SEC also has indicated that its enforcement will be influenced by the cooperation or lack of cooperation of a company it is investigating. *See* Harvey L. Pitt, Chairman, SEC, Remarks before the U.S. DOJ Corporate Fraud Conference (Sept. 26, 2002); *see also* Press Release, SEC, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010); *infra* Note 565. As further discussed below, the DOJ has also indicated that cooperation is an important factor in charging and sanctioning decisions. *See infra* Note 565.

In 2010, the SEC announced a "Cooperation Initiative," which included, *inter alia*, an expansion of the enforcement tools available to its staff to include cooperation agreements, deferred prosecution agreements and non-prosecution agreements. Under cooperation agreements, the enforcement division staff will normally agree to recommend to the SEC that a cooperator receive credit for his or her assistance to investigations or enforcement actions, if the cooperator provides "substantial assistance." Under a deferred prosecution agreement, the SEC "agrees to forego an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully and to comply with express prohibitions and undertakings during a period of deferred prosecution." *See supra* Note 488. Finally, under a non-prosecution agreement, which the SEC has indicated is appropriate under "limited and appropriate circumstances," the SEC "agrees not to pursue an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully and comply with express undertakings." *See* Press Release, SEC, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010). The SEC entered into its first-ever deferred prosecution agreement under the initiative in May 2011 in connection with an FCPA investigation. *See supra* Note 488. In December of 2010, the SEC entered into its first-ever non-prosecution agreement with Carters Inc., a clothing marketer, in connection with the financial fraud and insider trading of one of its top executives. The SEC indicated that it entered into the non-prosecution agreement given "the relatively isolated nature of the unlawful conduct, Carters' prompt and complete self-reporting of the misconduct to the SEC, its exemplary and extensive cooperation in the investigation, including undertaking a thorough and comprehensive internal investigation, and Carter's extensive and substantial remedial actions." Under the terms of the agreement, the company agreed to cooperate fully in any further investigation conducted by the SEC. The SEC filed civil enforcement proceedings against the officer. *See* Press Release, SEC, SEC Charges Former Carter's Executive With Fraud and Insider Trading (Dec. 20, 2010). The non-prosecution agreement can be found at http://www.sec.gov/litigation/cooperation/2010/carters1210.pdf.

535 *See, e.g.*, Press Release, SEC, SEC Announces Enforcement Initiatives to Combat Financial Reporting and Microcap Fraud and Enhance Risk Analysis (July 2, 2013) (discussing launch of several initiatives, including the Financial Reporting and Audit Task Force and the Center for Risk and Quantitative Analytics, in order to "increase the potential for uncovering financial statement and microcap fraud early" through the use of "analytical techniques and computing capacity with special expertise in data mining"); Jean Eaglesham, *Accounting Fraud Targeted*, WALL ST. J., May 27, 2013 (discussing several technological developments at the SEC, including fraud detection software that analyzes public filings and financial disclosures for "warning signs of earnings manipulation").

536 *See* § 20(a) of the Securities Act; §§ 21(a), 21(b) and 21(c) of the Exchange Act; §§ 42(a), 42(b) and 42(c)

of the Investment Company Act; §§ 209(a), 209(b) and 209(c) of the Advisers Act. The SEC invoked the investigative powers of § 21(a) of the Exchange Act as the basis for its June 2002 order requiring sworn statements by senior officers of 945 companies as to the accuracy of reports previously filed with the SEC. *See SEC Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Exchange Act*, File No. 4-460 (June 27, 2002). Shortly after the SEC announced this June 2002 order, the Chair and Vice Chair of the American Bar Association's Committee on Securities Regulation wrote a letter to the SEC stating their concerns with the use of this section, noting it was unclear whether § 21(a) sworn statements could be required outside the context of investigations of specific possible violations of securities laws and as such they were forming a task force to consider the scope of the SEC's § 21(a) authority. Letter from Stanley Keller & Dixie Lynn Johnson to Harvey Pitt, Chairman, SEC (July 15, 2002).

537 The SEC may invoke the power of the courts to compel such testimony and production of documents. *See* § 19(b) of the Securities Act; § 21(c) of the Exchange Act; § 42(c) of the Investment Company Act; § 209(c) of the Advisers Act.

538 Under § 929U of the Dodd-Frank Act, the SEC must either file such an action, or provide notice of its intent to not file such an action, within 180 days of issuing the Wells Notice, except for "certain complex actions," in which the SEC may receive one or more extensions of the 180-day period.

539 In 2003, the SEC amended its Rules of Practice to improve the timeliness of its administrative proceedings by imposing maximum time periods for administrative proceedings and appellate review. *See* SEC Release No. 33-8240 (June 11, 2003).

540 The administrative law judge is required to issue an initial decision, unless the SEC directs otherwise, in which case the administrative law judge recommends a decision and certifies the record to the SEC for a decision. *See* 5 U.S.C. § 557(b); 17 U.S.C. § 201.360.

541 *See* § 9(a) of the Securities Act; § 25(a)(1) of the Exchange Act; § 43(a) of the Investment Company Act; § 213(a) of the Advisers Act.

542 *See, e.g.*, Jean Eaglesham, *SEC Wins With In-House Judges*, WALL ST. J., May 6, 2015 (stating that the SEC enjoys "a home-court advantage … when it sends cases to its own judges rather than federal courts," which "is a practice the agency increasingly follows," and that the SEC has a "high success rate in appeals of its administrative law judges' rulings—the appeals its own commissioners hear"); Jean Eaglesham, *SEC Is Steering More Trials to Judge It Appoints*, WALL ST. J., Oct. 21, 2014 (describing "a marked shift at the [SEC] toward trying cases that are more complex before its administrative law judges," stating "[t]he agency's win rate in recent years is considerably higher in front of its administrative law judges than it is in jury trials" including because its administrative judges "found in its favor in every verdict for the [prior] 12 months," and observing that "[t]he move is creating a backlash among lawyers and defendants, who say in federal court they have more extensive rights to take witness testimony and collect evidence ahead of trial").

543 *See, e.g.*, *Duka v. SEC*, 124 F. Supp. 3d 287, 289 (S.D.N.Y. 2015) (holding that SEC administrative law judges' appointments are "likely unconstitutional in violation of the Appointments Clause" because they are "inferior officers" but were not appointed "by the President, courts of law, or department heads" as required by the Constitution); *Hill v. SEC*, 114 F. Supp. 3d 1297, 1319 (N.D. Ga. 2015) (concluding that the administrative law judge's "appointment is likely unconstitutional in violation of the Appointments Clause" because he "was not appointed by the President, a department head, or the Judiciary").

544 *See, e.g., Hill v. SEC*, 825 F.3d 1236, (11th Cir. 2016); *Tilton v. SEC*, 824 F.3d 276 (2d Cir. 2016); *Jarkesy v. SEC*, 803 F.3d 9 (D.C. Cir. 2015); *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015).

545 *Compare Raymond J. Lucia Companies, Inc. v. SEC*, No 15-1345, 2016 WL 4191191, at *3-7 (D.C. Cir. Aug. 9, 2016) (holding that the appointment of SEC administrative law judges does not violate the Appointments Clause because such judges do not "issue final decisions of the Commission"), *with Bandimere v. SEC*, No. 15-9586, 2016 WL 7439007 at *9 (10th Cir. 2016) (holding that "SEC ALJs are inferior officers who must be appointed in conformity with the Appointments Clause").

546 *See, e.g.*, SEC Release No. 34-78319 (July 13, 2016) (adopting amendments to Rules of Practice

applicable to in-house courts that provide defendants with more time to prepare for trial and permit additional depositions); Jean Eaglesham, *SEC Trims Use of In-House Judges*, WALL ST. J., Oct. 11, 2015 (stating that the SEC "has quietly pulled back on its use of in-house judges" and during the full fiscal year ended September 30, 2015, "the SEC used its internal tribunal for 28% of its contested cases, compared with 43% for the previous 12 months"); Jean Eaglesham, *SEC Gives Ground on Judges*, WALL ST. J., Sept. 24, 2015 (describing the "new rules, approved by a vote of the five commissioners who run the SEC, [that] would give defendants in cases sent by the agency to its own judges more of the legal protections offered in federal court," including easing deadlines and allowing defendants to get sworn testimony from witnesses before trial); Aruna Viswanatha, *SEC Issues Guidance on Venues for Cases*, WALL ST. J., May 8, 2015 (describing new SEC guidance that it considers bringing cases before its in-house courts based on factors including if the "matter involves old conduct or a continuing issue," and if the "case is likely to raise unsettled or complex legal issues about the federal securities laws").

547 *See, e.g.*, Press Release, SEC, SEC Charges Merrill Lynch With Misleading Investors in CDOs (Dec. 12, 2013) (announcing that Merrill Lynch agreed to pay $131.8 million to settle the SEC's charges); Press Release, SEC, SEC Charges Royal Bank of Scotland Subsidiary with Misleading Investors in Subprime RMBS Offering (Nov. 7, 2013) (announcing $150 million settlement); Press Release, SEC, UBS to Pay $50 Million to Settle SEC Charges of Misleading CDO Investors (Aug. 6, 2013) (announcing $50 million settlement); Press Release, SEC, SEC Charges J.P. Morgan and Credit Suisse With Misleading Investors in RMBS Offerings (Nov. 16, 2012) (announcing settlements totaling more than $400 million); Press Release, SEC, SEC Charges Mizuho Securities USA with Misleading Investors by Obtaining False Credit Ratings for CDO (July 18, 2012) (announcing $127.5 million settlement); Press Release, SEC, J.P. Morgan to Pay $153.6 Million to Settle SEC Charges of Misleading Investors in CDO Tied to U.S. Housing Market (June 21, 2011) (announcing $153.6 million settlement); Press Release, SEC, SEC Charges Citigroup and Two Executives for Misleading Investors About Exposure to Subprime Mortgage Assets (July 29, 2010) (announcing $75 million penalty).

548 *See SEC v. Citigroup Global Markets, Inc.*, 827 F. Supp. 2d 328 (S.D.N.Y. 2011).

549 *See SEC v. Citigroup Global Markets, Inc.*, 752 F.3d 285 (2d Cir. 2014).

550 *See, e.g.*, James B. Stewart, *S.E.C. Has a Message for Firms Not Used to Admitting Guilt*, N.Y. TIMES, June 21, 2013 (describing new policy as providing that there might be cases that "justify requiring the defendant's admission of allegations in our complaint or other acknowledgement of the alleged misconduct as part of any settlement" in order to increase deterrence).

551 *See, e.g.*, Press Release, SEC, JPMorgan Chase Agrees to Pay $200 Million and Admits Wrongdoing to Settle SEC Charges (Sept. 19, 2013) (announcing settlement of charges against JPMorgan concerning its attempt to hide losses from investments made by the so-called "London Whale" in its chief investment office, which included an admission of "the facts underlying the SEC's charges" as well as JPMorgan "publicly acknowledging that it violated the federal securities laws").

552 *See* § 20(b) of the Securities Act; § 21(d)(1) of the Exchange Act; § 42(d) of the Investment Company Act (including, in a proceeding in connection with transactions by an unregistered investment company, seeking equitable relief from the court to "take exclusive jurisdiction and possession" of the investment company); § 209(d) of the Advisers Act. The Sarbanes-Oxley Act amended § 21(d) of the Exchange Act to further clarify the right of the SEC to seek only equitable relief. *See* § 21(d) of the Exchange Act; *see, e.g.*, *SEC v. Goldman Sachs & Co.*, SEC Litigation Release No. 19051 (Jan. 25, 2005) (describing an injunction against certain IPO share allocation methodologies); *SEC v. Morgan Stanley & Co.*, SEC Litigation Release No. 19050 (Jan. 25, 2005); *SEC v. Bristol-Myers Squibb Co.*, SEC Litigation Release No. 18822 (Aug. 6, 2004) (describing an injunction against "channel-stuffing," a $100 million civil penalty and a $50 million shareholder fund).

553 The influence of the Sarbanes-Oxley Act and its emphasis on corporate governance is evidenced in several SEC civil injunctive actions. In *SEC v. Hollinger International, Inc.*, for example, the SEC filed a civil injunctive action alleging Hollinger's SEC filings contained misstatements regarding transfers of corporate

assets. Hollinger agreed to corporate governance reforms that included maintaining a special committee to investigate the alleged misconduct and to continue efforts to recover and maintain corporate assets. *SEC v. Causey*, SEC Litigation Release No. 18551 (Jan. 21, 2004). Another example of a financial reporting case in which the SEC imposed corporate governance reforms on an issuer through settlement is the settlement between the SEC and the Italian company Parmalat Finanziaria. The SEC, which had jurisdiction over Parmalat because it offered and sold debt (albeit privately) in the United States, imposed a settlement that incorporated elements of the Sarbanes-Oxley Act despite the fact that Parmalat had not made any public offerings in the United States, was not listed in the United States and was not even a foreign private issuer filing annual reports with the SEC on Form 20-F. The settlement provisions included corporate governance changes, adoption of by-laws providing for a shareholder-elected board that was independent with pre-set term limits, and the establishment of an internal Code of Conduct and Ethics. *See SEC v. Parmalat Finanziaria S.p.A*, SEC Litigation Release No. 18803 (July 28, 2004) (summarizing the allegations that Parmalat sold over $1 billion in bonds through private placements exempt from SEC registration, while systematically defrauding investors).

554 *See SEC v. Calvo*, 378 F.3d 1211, 1216 (11th Cir. 2004); *SEC v. Parklane Hosiery Co.*, *Inc.*, 558 F.2d 1083 (2d Cir. 1977).

555 *See SEC v. Steadman*, 967 F.2d 636, 647–48 (D.C. Cir. 1992); *SEC v. Lipson*, 129 F. Supp. 2d 1148 (N.D. Ill. 2001), *aff'd*, 278 F.3d 656 (7th Cir. 2002).

556 *See* § 20(e) of the Securities Act and § 21(d)(2) of the Exchange Act; *see, e.g.*, *SEC v. Computer Associates International, Inc.*, SEC Litigation Release No. 18891 (Sept. 22, 2004).

557 § 8A of the Securities Act; § 21C of the Exchange Act; § 9(f) of the Investment Company Act; § 203(k) of the Advisers Act.

558 *See* § 8A(c)(1) of the Securities Act.

559 *See* § 8A(c)(1) of the Securities Act.

560 *See* § 8A(d)(2) of the Securities Act.

561 §§ 8(b) and (d) of the Securities Act; *see* § 11.03[3].

562 *See* § 20(d) of the Securities Act; § 21(d)(3) of the Exchange Act; § 42(e) of the Investment Company Act; § 209(e) of the Advisers Act. *See*, *e.g.*, SEC v. Aragon Capital Management, SEC Litigation Release No. 19995A (Feb. 8, 2007); *SEC v. Royal Dutch Petroleum Co.*, SEC Litigation Release No. 18844 (Aug. 24, 2004). According to the SEC's order and complaint, Shell overstated proved reserves reported in its 2002 Form 20-F by 4.47 billion barrels of oil equivalent and overstated its future cash flows by approximately $6.6 billion.

563 *See* Stephen M. Cutler, Director, SEC Division of Enforcement, Speech at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004) (noting that under the current regulatory regime, both entities and individuals can be assessed significant monetary penalties aimed at achieving both general deterrence and accountability).

564 *See* § 20(d)(2)(C) of the Securities Act; SEC Release No. 33-10104 (June 27, 2016).

565 *See* Stephen M. Cutler, Director, SEC Division of Enforcement, Speech at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004); *see also* Ken Belson, *Lucent Fined $25 Million by SEC in Fraud Case*, N.Y. TIMES, May 18, 2004. In 2004, the SEC levied a $25 million fine against Lucent Technologies for failure to cooperate with a fraud investigation, the largest penalty ever imposed against a corporation for failure to cooperate. The noncooperation penalty was levied in part because after reaching a settlement agreement in connection with the fraud investigation, Lucent expanded the scope of employees that could be indemnified against the SEC enforcement action. The SEC stated that such conduct is contrary to the public interest. *SEC v. Lucent Technologies Inc.*, SEC Litigation Release No. 18715 (May 17, 2004). In contrast to the Lucent case, the SEC demonstrated the potential benefits of cooperation by settling financial fraud charges brought against Delphi Corporation without imposing a financial penalty. *SEC v. Delphi Corp.*, SEC Litigation Release No. 19891 (Oct. 30, 2006); *see also Report of Investigation*

Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, SEC Accounting and Auditing Enforcement Release No. 1470 (Oct. 23, 2001). The report explains the SEC's decision not to sue Seaboard Corp. for financial reporting problems. It details the steps that Seaboard took when an internal investigation uncovered financial irregularities and sets forth a variety of criteria that the SEC will consider when deciding whether to sue issuers in the context of financial reporting irregularities.

On January 13, 2010, the SEC's Office of Chief Counsel in the Enforcement Division issued a revised ENFORCEMENT MANUAL in which it discussed cooperation issues. *See* SEC Division of Enforcement, ENFORCEMENT MANUAL (Jan. 13, 2010) (*rev.* Feb. 8, 2011) ("ENFORCEMENT MANUAL"). The ENFORCEMENT MANUAL contains the SEC's new policy statement on cooperation by individuals in its investigations, *see* ENFORCEMENT MANUAL at 121–25, which became effective on January 19, 2010. *See* 17 C.F.R. § 202.12. Under 17 C.F.R. § 202.12, the SEC will determine "whether, how much, and in what manner to credit cooperation by individuals by evaluating four considerations." These considerations are: (i) the value and nature of the individual's assistance, (ii) the importance of the underlying matter, which includes consideration of the character of the investigation and the dangers to investors presented by such investigation, (iii) society's interest in holding the cooperating individual accountable, which includes consideration of the individual's culpability, and (iv) the appropriateness of cooperation credit given the individual's personal history or profile. 17 C.F.R. § 202.12. However, the ENFORCEMENT MANUAL clarifies that the policy statement and factors listed in 17 C.F.R. § 202.12 "are not listed in order of importance nor are … they intended to be all-inclusive or to require a specific determination in any particular case." ENFORCEMENT MANUAL at 125. Instead, the SEC vows to consider the unique facts and circumstances of every case and to accord appropriate weight to the principles set forth in 17 C.F.R. § 202.12 depending on such facts and circumstances.

The defendant company's cooperation with investigators is also an important factor in the context of federal prosecutions. Determining what a company must do to qualify for "cooperation" credit has been the subject of debate. In a 2003 Memorandum, Deputy Attorney General Larry D. Thompson outlined the principles of federal prosecution of business organizations, with the main focus of the memo being "increased emphasis on and scrutiny of the authenticity of a corporation's cooperation." Memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Jan. 20, 2003) ("Thompson Memo") (the memorandum was, in large measure, a reaffirmation of positions first outlined in a 1999 memorandum by then-Deputy Attorney General Eric Holder). The Thompson Memo (like the Holder memo) noted that one indicator of a company's cooperation is its willingness to waive the attorney-client privilege. Companies argued that this policy forced a difficult choice between waiving the privilege and being considered uncooperative.

In late 2006, the DOJ backtracked from the Thompson Memo; Deputy Attorney General Paul H. McNulty issued new guidance to prosecutors, directing that they consider a company's "timely and voluntary disclosure of wrongdoing and its willingness to cooperate" but restricting the prosecutors' discretion in seeking waivers of the attorney-client or attorney work product protections. Such waivers should only be sought upon a "legitimate need," and waiver "is not a prerequisite to a finding that a company has cooperated." Memorandum from Paul J. McNulty, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Dec. 12, 2006) ("McNulty Memo").

This position is consistent with other developments, such as the September 2006 hearings on Attorney-Client Privilege and Corporate Waivers before the Senate Judiciary Committee. The then-Chairman of the committee, Senator Arlen Specter, later introduced a bill called "The Attorney-Client Privilege Protection Act of 2007," which would go further than the McNulty Memo by prohibiting prosecutors from demanding or requesting privileged materials from companies under investigation. S. 186, 110th Cong., 1st Session (Jan. 4, 2007). In 2007, the American Bar Association submitted a letter in support of the bill to Senator Patrick J. Leahy, the chairman of the Senate Judiciary Committee. *See* Letter from Karen J. Mathis, American Bar Association, to Patrick J. Leahy, Chairman, Senate Judiciary Committee (June 4, 2007). A similar bill passed the House on November 12, 2007, *see* H.R. 3013, 110th Cong., 1st Session (Nov. 13, 2007), and was reintroduced to the Senate Judiciary Committee by Senator Specter on June 2008, but the bill did not leave the Committee. *See* S. 3217, 110th Cong., 2d Session (June 26, 2008); *see also* S. 445, 111th Cong., 1st Session (Feb. 13, 2009).

In 2008, the DOJ retreated still further, and, in a memorandum by Deputy Attorney General Filip, expressly prohibited prosecutors from requesting privilege waivers as a consideration of cooperation. Memorandum from Mark R. Filip, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Aug. 28, 2008) ("Filip Memo"). The Filip Memo noted that businesses and commentators had decried a culture of waivers.

After the DOJ issued the McNulty Memo, SEC Deputy Enforcement Director Peter Bresnan said that the SEC was "not contemplating any changes" to the guidelines set forth in the Seaboard policy. *See Federal News: SEC Enforcement*, 39 Sec. REG. AND LAW REPORTER (BNA) 122 (Jan. 29, 2007). However, the ENFORCEMENT MANUAL indicates the measures of a company's cooperation set forth in the Seaboard report serve as general principles but are not intended to limit the SEC's "broad discretion to evaluate every case individually, on its own unique facts and circumstances." ENFORCEMENT MANUAL at 126.

566 *See* Stephen M. Cutler, Director, SEC Division of Enforcement, Speech at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004).

567 Press Release, SEC, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006). The consequences of a company's failure to cooperate with the SEC was illustrated in the 2006 settlement with Morgan Stanley, in which the firm paid $15 million for failing to produce e-mail in the course of an investigation lasting from 2000 through 2005. The SEC alleged that Morgan Stanley had failed to produce documents requested by the staff because the firm failed to undertake diligent searches, overwrote back-up tapes and made misstatements about the documents it had preserved, the documents it had reviewed and the documents it had produced. *See SEC v. Morgan Stanley & Co.*, SEC Litigation Release No. 19693 (May 10, 2006). The settlement in this action was wholly independent of any sanction or settlement related to the facts underlying the SEC investigation that prompted the requests for e-mail productions.

568 *See* § 21A(d)(5) of the Exchange Act.

569 *See Gabelli v. SEC*, 133 S. Ct. 1216 (2013).

570 Although disgorgement is generally intended to force a defendant to give up the amount by which *he* was enriched by his wrongdoing, the Second Circuit Court of Appeals recently held that a defendant who commits insider trading, which resulted in a benefit to a third party, can be forced to disgorge the gains that accrued to that third party. *See SEC v. Contorinis*, 743 F.3d 296 (2d Cir. 2014) (affirming disgorgement award that required an individual to disgorge the profits that his employer earned from his insider trading).

571 *See, e.g.*, *SEC v. Tome*, 833 F.2d 1086, 1096 (2d Cir. 1987), *cert. denied*, 486 U.S. 1014 (1988). Recently, the SEC has sought disgorgement under § 21(d)(3) of the Exchange Act against two accounting firms for their respective roles in the Adelphia and Xerox accounting frauds. *See SEC v. KPMG LLP*, SEC Litigation Release No. 19191 (Apr. 19, 2005); *SEC v. Deloitte & Touche LLP*, SEC Litigation Release No. 19202 (Apr. 26, 2005).

572 *See SEC v. Toomey*, 866 F. Supp. 719, 724–25 (S.D.N.Y. 1992).

573 *See Hudson v. United States*, 522 U.S. 93 (1997); *United States v. Gartner*, 93 F.3d 633, 635 (9th Cir.), *cert. denied*, 519 U.S. 1047 (1996).

574 *See* § 308 of the Sarbanes-Oxley Act; § 11.07[2][d].

575 *See* § 21B of the Exchange Act; § 9(d) of the Investment Company Act; § 203(i) of the Advisers Act. As in judicial actions, the largest civil penalties are imposed for violations that involve fraud and cause substantial losses. Penalties are the greater of (i) $163,118 for individuals or $788,401 for corporations and (ii) the gross amount of the pecuniary gain to the defendant resulting from such violation. *See* SEC Release No. 33-10104 (June 27, 2016).

576 12 U.S.C. § 1833a.

577 *See, e.g., United States v. Wells Fargo Bank, N.A.*, 972 F. Supp. 2d 593 (S.D.N.Y. 2013); *United States v. Countrywide Financial Corporation*, 961 F. Supp. 2d 598 (S.D.N.Y. 2013); *United States v. Bank of New York Mellon*, 941 F. Supp. 2d 438 (S.D.N.Y. 2013).

578 *United States ex rel. O'Donnell v. Countrywide Home Loans, Inc.*, 822 F.3d 650 (2d Cir. 2016).

579 *See, e.g.*, Press Release, DOJ, Bank of America to Pay $16.65 Billion in Historic Justice Department Settlement for Financial Fraud Leading up to and During the Financial Crisis (Aug. 21, 2014) (announcing Bank of America "agreed to pay a $5 billion penalty" under FIRREA, which was "the largest FIRREA penalty ever"); Press Release, DOJ, Justice Department, Federal and State Partners Secure Record $7 Billion Global Settlement with Citigroup for Misleading Investors About Securities Containing Toxic Mortgages (July 14, 2014) (announcing settlement of claims concerning residential mortgage-backed securities, including "a $4 billion civil penalty—the largest penalty to date under [FIRREA]"); Press Release, DOJ, Justice Department, Federal and State Partners Secure Record $13 Billion Global Settlement with JPMorgan for Misleading Investors About Securities Containing Toxic Mortgages (Nov. 19, 2013) (announcing settlement including a $2 billion civil penalty for claims under FIRREA).

580 *See* § 4.02 for a discussion of issuers subject to Exchange Act registration and reporting.

581 However, § 15(c)(4) of the Exchange Act does not allow the SEC to impose orders of general future compliance with the securities laws. *See In re George C. Kern, Jr.*, SEC Release No. 34-29356 (June 21, 1991).

582 *See, e.g.*, *Report of Investigation re: Netflix, Inc., and Reed Hastings*, SEC Release No. 34-69279 (Apr. 2, 2013) (discussing the application of Regulation FD and Section 13(a) of the Exchange Act to the Netflix CEO's use of his personal Facebook page to announce company metrics where the company had not previously informed shareholders that it would use that Facebook page to disclose information); *Report of Investigation re: The Titan Corporation*, SEC Release No. 34-51283 (Mar. 1, 2005) (discussing the potential liability under §§ 10(b) and 14(a) of the Exchange Act for a military and intelligence subcontractor arising out of the company's disclosures contained in a merger agreement; the disclosure represented that the company had not violated the FCPA, and the SEC's § 21(a) report examined the company's duty to update disclosures made in merger agreements upon learning of contradictory material facts); *see also* Ralph C. Ferrara & Philip S. Khinda, *SEC Enforcement Proceedings: Strategic Considerations for When the Agency Comes Calling*, 51 ADMIN. L. REV. 1143, 1193 n.198 (1999) (citing, *inter alia, In re W.R. Grace & Co.*, SEC Release No. 34-39157 (Sept. 30, 1997); *Report of Investigation in the Matter of The Cooper Companies, Inc. as it Relates to the Conduct of Cooper's Board of Directors*, SEC Release No. 34-35082 (Dec. 12, 1994)).

583 *See SEC v. Credit Suisse First Boston Corp.*, SEC Litigation Release No. 17327 (Jan. 22, 2002).

584 The agreement, which resulted after the NYAG commenced an action in New York state court under the Martin Act, provided a $48 million payment to New York state and a $52 million payment to the other affected states, in addition to changes of Merrill Lynch's policies and organization to address analyst conflicts of interest. Unlike many states, New York has not adopted the Uniform Securities Act and retains its original "blue sky" statute, the Martin Act or General Business Law Article 23-A, which dates from 1921. *See* N.Y. GEN. BUS. LAW § 352 (McKinney's 1996 & Supp. 2010). Among the unique features of the Martin Act is that it grants the NYAG unusually broad investigatory powers and it does not require a showing of reliance or intent. There is no private right of action under the Martin Act. *See* Nicholas Thompson, *The Sword of Spitzer*, LEGAL AFFAIRS, May/June 2004 (discussing the history of the Martin Act and Spitzer's use of it in the mutual fund and other financial scandals); Carey S. Dunne, *Role of the States Attorneys General in Policing the Securities Markets*, in 34 TH Annual INSTITUTE OF SECURITIES REGULATION at 1081 (Practicing Law Institute, 2002).

585 During this time period, the SEC, the NYSE and the NASD were actively engaged in a series of rulemakings directed at analyst conflicts of interest. The SEC approved rules adopted by the NYSE and the NASD to address analyst conflicts of interest on May 8, 2002, and the NYSE and NASD proposed additional rules to the SEC at the end of May 2002. *See* § 14.07[5][a]. In some respects, these rules appear

to conflict with the terms of the Merrill Lynch settlement. *See* SEC Release No. 34-45908 (May 10, 2002) (order approving proposed rule changes); SEC Release No. 34-47110 (Dec. 31, 2002) (proposed rule changes). In addition, § 15D of the Sarbanes-Oxley Act invites additional rulemaking by the SEC largely along the lines of the rules previously adopted by the NYSE and the NASD. *See* § 14.07[5][b]. Simultaneously with the passage of the Sarbanes-Oxley Act, the SEC proposed Regulation AC, the final version of which was promulgated in February 2003. *See* SEC Release No. 33-8119 (Aug. 2, 2002) (solicitation of public comment); SEC Release No. 33-8193 (Feb. 20, 2003) (final rule). *See generally* § 14.07[5][c].

586 *See* Press Release, SEC, SEC, NY Attorney General, NYSE, NASD, NASAA Reach Agreement on Reforming Wall Street Practices (Oct. 23, 2002).

587 *See* Press Release, SEC, SEC Fact Sheet on Global Analyst Research Settlements (Apr. 28, 2003); § 14.07[5][b].

588 *See* Press Release, SEC, Deutsche Bank Securities Inc. and Thomas Weisel Partners LLC Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Aug. 26, 2004).

589 Press Release, SEC, SEC Fact Sheet on Global Analyst Research Settlements (Apr. 28, 2003).

590 *See generally* § 14.07[5] for a more detailed discussion of analyst conflicts of interest issues.

591 The NYAG concluded its involvement in the spinning investigation in July 2006 after reaching a $4.4 million settlement with a former executive who allegedly steered his company's investment banking business to Salomon Smith Barney in exchange for IPO allocations. This was the fifth settlement reached between an individual defendant and the NYAG; the total value of the settlements in these cases was over $10 million. *See* Press Release, NYAG, Telecom Exec Settles Final IPO Spinning Case (July 31, 2006). The NASD brought spinning-related charges against former Credit Suisse First Boston banker Frank P. Quattrone and imposed against him a lifetime ban from the securities industry. After several years of litigation, the Second Circuit Court of Appeals overturned Quattrone's conviction for obstruction of justice, the SEC revoked the lifetime ban and the NASD decided not to pursue the case against Quattrone. *See* Randall Smith & Paul Davies, *Quattrone Deal Drops All Charges, Allows His Return To Wall Street*, WALL ST. J., Aug. 23, 2006; Randall Smith, *IPO "Spinning" Is Under Fire; Securities Firms Are Charged*, WALL ST. J., Apr. 29, 2003.

The SEC in 2004 proposed amendments to Regulation M that could result in the adoption of a new Rule 106, which would expressly prohibit conditioning the award of allocations of offered securities on the receipt of consideration in addition to the stated offering price. SEC Release No. 33-8511 (Dec. 9, 2004) (solicitation of public comment). The comment period for the proposed amendments closed, and no action has been taken with respect to the proposed amendments.

592 *See In re Initial Public Offering Securities Litigation*, 671 F. Supp. 2d 467 (S.D.N.Y. 2009).

593 *See* Press Release, SEC Charges NASDAQ for Failures During Facebook IPO (May 29, 2013).

594 The SEC does not have authority to bring criminal proceedings, but may refer violations to the DOJ.

595 *See* § 24 of the Securities Act (any provision, including willful material misstatements or omissions in a registration statement); § 32 of the Exchange Act (willful or knowing material misstatements in any document required to be filed or any provision that states that a violation is unlawful); § 49 of the Investment Company Act (any provision, including willful material misstatements or omissions in a registration statement or document); § 217 of the Advisers Act (any provision); 18 U.S.C. § 1348 (any fraudulent act related to a public company's securities).

596 *See* § 24 of the Securities Act; § 49 of the Investment Company Act; § 217 of the Advisers Act. As a practical matter, prosecutors may actually seek fines of up to $500,000 per violation for corporate defendants under a separate statutory provision applicable to essentially all existing federal crimes. *See* 18 U.S.C. § 3571(c)(3).

597 *See* § 32(a) of the Exchange Act, which is discussed in § 11.07[3][f]. In contrast to criminal procedures in many other countries, which limit criminal prosecutions to individuals, corporations as well as their

employees are subject to indictment, conviction and criminal punishment in the United States. Misconduct by corporate employees is attributed to the corporation itself, regardless of the employee's managerial status or lack of it within the corporation, if the employee's conduct occurred within his "scope of employment" and if his conduct was intended to confer some benefit to the corporation, whether or not that benefit was the principal motivating factor for the employee or whether it actually accrues to the corporation.

598 *See* 18 U.S.C. § 3571(d).

599 *See* § 24 of the Securities Act; § 49 of the Investment Company Act; § 217 of the Advisers Act.

600 *See* § 32 of the Exchange Act, which is discussed in § 11.07[3][f].

601 *See* § 49 of the Investment Company Act; § 32(a) of the Exchange Act. *But see United States v. Sloan*, 399 F. Supp. 982, 985 (S.D.N.Y. 1975) ("The 'no knowledge' proviso was not intended to permit one who knowingly conspires to violate the general standard of conduct set forth in [the securities laws] to claim protection on the ground that he [or she] did not have knowledge of some specific rule or requirement promulgated thereunder.").

602 *See, e.g.*, Laurie Cohen, *Public Confession: Milken Pleads Guilty to Six Felony Counts and Issues an Apology*, WALL ST. J., Apr. 25, 1990; Laurie Cohen *, Lewis Pleads Guilty to Three Felony Counts*, WALL ST. J., Aug. 31, 1989; James Stewart, *Boesky is Slated to Plead Guilty to Felony Today*, WALL ST. J., Apr. 23, 1987; James Stewart, *The Drexel Settlement—Biting the Bullet: Drexel Agrees to Plead Guilty and Pay Out a Record $650 Million*, WALL ST. J., Dec. 12, 1988; James Stewart, *Levine Pleads Guilty, Agrees to Cooperate*, WALL ST. J., June 6, 1986.

603 Since Enron's collapse in December 2001, over 90 executives at more than 19 companies have been indicted for various kinds of financial fraud. The following are among the most prominent examples. At Enron, the prosecutorial focus has been on the use of special purpose entities to hide deteriorating results and produce misleading disclosures. Prosecutors won convictions against an Enron executive and former Merrill Lynch & Co. officials who had conspired to disguise a loan (of energy-generating barges) as a sale in order to permit Enron to book the profit on sale. Enron executives Jeffrey Skilling and Kenneth Lay were convicted on multiple criminal charges for their roles in the Enron fraud; however, Lay's conviction was revoked after he died before exercising his right to appeal. The Fifth Circuit Court of Appeals subsequently overturned some of the convictions against the Merrill Lynch executives. *See United States v. Brown*, 459 F.3d 509 (5th Cir. 2006), *cert. denied*, 550 U.S. 933 (2007). At HealthSouth, allegations make out a pattern of fraudulent accounting since the 1980s. Although the CEO, Richard Scrushy, was acquitted of accounting fraud charges, he was convicted of bribery, mail fraud and conspiracy in connection with bribes paid to obtain a seat on an influential state commission in Alabama. He also agreed to an $81 million settlement with the SEC. *SEC v. Scrushy*, SEC Litigation Release No. 20084 (Apr. 23, 2007). At WorldCom, as much as $11 billion in expenses were misclassified as capital expenditures. Former WorldCom Chairman Bernard Ebbers was sentenced to 25 years in federal prison for orchestrating that fraud, which toppled the telecommunications company he founded. *See* Ken Belson, *WorldCom Head Is Given 25 Years For Huge Fraud*, N.Y. TIMES, July 14, 2005. At Adelphia Communications, founders were convicted of taking more than $1 billion from the company and having misled investors and regulators. The founder John Rigas and his son (the Chief Financial Officer of Adelphia Communications) were sentenced to 20 and 15 years in prison, respectively. *See also United States v. Rigas*, No. S10CR.1236 (LBS), 2004 WL 2601084 (S.D.N.Y. Nov. 15, 2004); Press Release, DOJ, Adelphia Communications Agrees to Pay $715 Million to Government Victim Compensation Fund (Apr. 25, 2005) (announcing Adelphia Communications settlement with the DOJ and the SEC for the accounting fraud schemes that had defrauded investors). At Qwest Communications, the former Chief Executive Officer and eight other former Qwest officers and employees were prosecuted for engaging in a multifaceted fraudulent scheme designed to mislead the investing public about Qwest's revenue and growth. *See SEC v. Nacchio*, SEC Litigation Release No. 19136 (Mar. 15, 2005). At Tyco International, the former Chief Executive Officer and Chief Financial Officer were found guilty of looting the company of over $600 million. *See* Andrew Ross Sorkin, *Ex-Chief and Aide Guilty of Looting Millions at Tyco*, N.Y. TIMES, June 18, 2005.

604 An assistant director of the FBI said that the bureau was investigating potential options backdating practices at 55 companies as of October 2006. *See* Shaheen Pasha, *FBI Sees More Indictments From Backdating*, CNNMONEY.com, Oct. 12, 2006. The United States Attorney for the Northern District of California created a task force to investigate backdating allegations. *See* Press Release, DOJ, U.S. Attorney Kevin V. Ryan Creates Local Stock Option Backdating Task Force (July 13, 2006).

605 *See, e.g.*, Press Release, DOJ, SAC Capital Portfolio Manager Mathew Martoma Found Guilty In Manhattan Federal Court Of Insider Trading Charges (Feb. 6, 2014) (announcing conviction of former portfolio manager at SAC Capital for insider trading involving approximately $274 million in illegal profits and avoided losses); Press Release, DOJ, Former Credit Suisse Managing Director Sentenced In Manhattan Federal Court To 30 Months In Prison In Connection with Scheme To Hide Losses In Mortgage-Backed Securities Trading Book (Nov. 22, 2013) (discussing 30-month prison term, $1 million forfeiture, and $150,000 fine imposed on former Global Head of Structured Credit at Credit Suisse for hiding more than $100 million in losses in a mortgage-backed securities trading book); Press Release, DOJ, Manhattan U.S. Attorney Announces Guilty Plea Agreement With SAC Capital Management Companies (Nov. 4, 2013) (announcing agreement under which SAC Capital agreed to plead guilty to insider trading, pay a $1.8 billion penalty, cease accepting outside investor funds, and shut down operations as an investment adviser); Press Release, DOJ, Allen Stanford Convicted in Houston for Orchestrating $7 Billion Investment Fraud Scheme (Mar. 6, 2012) (announcing conviction of former chairman of Stanford International Bank for orchestrating a 20-year investment fraud scheme in which he misappropriated $7 billion from the bank to finance personal businesses); Press Release, DOJ, Hedge Fund Billionaire Raj Rajaratnam Found Guilty in Manhattan Federal Court of Insider Trading Charges (May 11, 2011) (discussing conviction of managing member of Galleon Management for insider trading following an eight-week trial); Press Release, DOJ, Bernard Madoff Sentenced to 150 Years in Prison (June 29, 2009) (announcing 150-year sentence and $170 billion forfeiture against Madoff in connection with Ponzi scheme).

606 *See, e.g.*, Jordan Maglich, *Once Reserved For Drug Crimes, Wiretapping Takes Center Stage in White Collar Prosecutions*, FORBES, May 21, 2013 (discussing increasing use of wiretaps by federal prosecutors to investigate and prosecute white-collar crime, and quoting U.S. Attorney Preet Bharara as stating that the "aggressive use of wiretaps is important" because "[i]t shows that we are targeting white-collar insider trading rings with the same powerful investigative tools that have worked so successfully against the mob and drug cartels").

607 *United States v. Kordel*, 397 U.S. 1, 6 (1970).

608 *See, e.g.*, Jessica Silver-Greenberg and Ben Protess, *JPMorgan Settlement Offers Look Into Mortgage Machine*, N.Y. TIMES, Nov. 19, 2013 (describing $13 billion settlement between JPMorgan Chase and the DOJ concerning the sale of mortgage-related securities, which included a $4 billion payment to the agency overseeing Fannie Mae and Freddie Mac, a $2 billion fine paid to federal prosecutors, $4 billion in mortgage borrower relief, and other payments to the National Credit Union Administration and state attorneys general in California, New York and Illinois); Ben Protess and Mark Scott, *Barclays Settles Regulators' Claims Over Manipulation of Key Rates*, N.Y. TIMES, June 27, 2012 (describing Barclays' agreement to pay $450 million in fines to resolve investigations relating to the alleged manipulation of LIBOR, including a $160 million penalty imposed by the DOJ, a $200 million penalty by the CFTC, and a $92.8 million fine by the Financial Services Authority in London).

609 *See, e.g.*, Landon Thomas Jr., *Jury Finds Bank of America Liable in Mortgage Case*, N.Y. TIMES, Oct. 23, 2013 (discussing verdict in civil trial filed by DOJ concerning alleged misstatements made in connection with mortgages sold by Countrywide to Fannie Mae and Freddie Mac); Press Release, DOJ, Department of Justice Sues Bank of America for Defrauding Investors in Connection with Sale of Over $850 Million of Residential Mortgage-Backed Securities (Aug. 6, 2013) (announcing filing of civil complaint against Bank of America alleging fraud in connection with sale of mortgage-backed securities in 2008); Press Release, DOJ, Department of Justice Sues Standard & Poor's for Fraud in Rating Mortgage-Backed Securities in the Years Leading Up to the Financial Crisis (Feb. 5, 2013) (announcing filing of civil lawsuit against S&P for allegedly issuing inflated ratings to mortgage-backed securities and collateralized debt obligations between

2004 and 2007 in order to defraud investors).

610 *See, e.g.*, Aruna Viswanatha, *Banks to Pay $5.6 Billion in Probes*, WALL ST. J., May 20, 2015 (describing several banks' agreements with the DOJ to pay fines and plead guilty to criminal charges concerning foreign-currency rate manipulation, after previously agreeing to pay fines regarding the same conduct with the CFTC, Federal Reserve, OCC, New York State Department of Financial Services, U.K. Financial Conduct Authority, and Swiss Financial Market Supervisory Authority).

611 *See, e.g.*, Jed. S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, N.Y. REV. OF BOOKS, Jan. 9, 2014 (stating that, "[i]n striking contrast with" past prosecutions during economic scandals and crises, "not a single high-level executive has been successfully prosecuted in connection with the recent financial crisis" and attributing the failure to other government priorities, the government's involvement in the circumstances that led to the financial crisis, and the shift towards prosecuting companies rather than individuals); Ben Protess & Susanne Craig, *Inside the End of the U.S. Bid to Punish Lehman Executives*, N.Y. TIMES, Sept. 8, 2013 (discussing internal pressure and criticism concerning failure to prosecute or sue executives from Lehman Brothers).

612 Memorandum from Sally Quillian Yates, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Sept. 9, 2015).

613 In exchange for the payment of penalties and institution of corporate reform, the DOJ in deferred prosecution agreements normally files a criminal information and stays prosecution for a set period of time, at the end of which the charges are dismissed if the corporation is in compliance with the terms of the deferred prosecution agreement. By contrast, under a non-prosecution agreement, the corporation also agrees to pay criminal penalties and institute certain types of corporate reforms, but the DOJ does not file a criminal information and instead promises not to prosecute the company for the conduct under investigation. The 2003 memorandum by Deputy Attorney General Thompson explicitly instructed prosecutors to consider whether non-prosecution agreements would be proper under certain circumstances. *See* Memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Jan. 20, 2003).

614 *See In re Prudential Securities Inc. Limited Partnerships Litigation*, Fed. Sec. L. Rep. (CCH) ¶98,978 (S.D.N.Y. Nov. 20, 1995) (where $110 million was awarded to plaintiff class).

615 *See also* Press Release, DOJ, Deutsche Bank's London Subsidiary Agrees to Plead Guilty in Connection with Long-Running Manipulation of LIBOR (Apr. 23, 2015) (announcing deferred prosecution agreement regarding role in manipulating LIBOR and Yen LIBOR); Press Release, DOJ, Manhattan U.S. Attorney and FBI Assistant Director-in-Charge Announce Filing of Criminal Charges Against and Deferred Prosecution Agreement with JPMorgan Chase Bank, N.A. in Connection with Bernard L. Madoff's Multi-Billion Dollar Ponzi Scheme (Jan. 7, 2014) (announcing $1.7 billion payment by JPMorgan); Press Release, DOJ, RBS Securities Japan Limited Agrees to Plead Guilty in Connection with Long-Running Manipulation of Libor Benchmark Interest Rates (Feb. 6, 2013) (where RBS Japanese subsidiary agreed to pay a $50 million fine and RBS parent company paid a $100 million penalty); Press Release, DOJ, UBS Securities Japan Co. Ltd. to Plead Guilty to Felony Wire Fraud for Long-Running Manipulation of LIBOR Benchmark Interest Rates (Dec. 19, 2012) (announcing penalties and fines of $500 million); Press Release, DOJ, HSBC Holdings Plc. and HSBC Bank USA N.A. Admit to Anti-Money Laundering and Sanctions Violations, Forfeit $1.256 Billion in Deferred Prosecution Agreement (Dec. 11, 2012) (announcing deferred prosecution agreement for willfully failing to maintain an effective anti-money laundering program, willfully failing to conduct due diligence on foreign correspondent affiliates, and violating the Bank Secrecy Act, the International Emergency Economic Powers Act and the Trading with the Enemy Act); Press Release, DOJ, Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Offered Rate and Agrees to Pay $160 Million Penalty (June 27, 2012) (announcing fine for manipulation of LIBOR); Mark A. Stein, *Five Days; And Wall St. Was Filled With Settlements and Lamentations*, N.Y. TIMES, June 18, 2005 (where Bristol-Myers paid approximately $300 million to settle investigations by the Justice Department into its accounting practices); Press Release, DOJ, Monsanto Company Charged with Bribing Indonesian Government Official: Prosecution Deferred for Three Years

(Jan. 6, 2005) (where Monsanto was fined $1 million); Press Release, DOJ, America Online Charged with Aiding and Abetting Securities Fraud; Prosecution Deferred for Two Years (Dec. 15, 2004) (where Time Warner was fined $510 million); Press Release, DOJ, InVision Technologies, Inc. Enters Into Agreement with the United States (Dec. 6, 2004) (pursuant to which $800,000 in penalties was paid to the United States); *SEC v. GE InVision, Inc.*, SEC Litigation Release No. 19078 (Feb. 14, 2005) (requiring the company also to disgorge $589,000 in profits, plus $28,700 in prejudgment interest, and to pay a $500,000 civil penalty); Press Release, DOJ, American International Group Inc. Enters Into Agreements with the United States (Nov. 30, 2004) (where AIG was fined $80 million in penalties); Press Release, DOJ, Former Computer Associates Executive Indicted on Securities Fraud, Obstruction Charges (Sept. 22, 2004) (where $225 million was awarded to injured shareholders); Press Release, DOJ, Canadian Imperial Bank of Commerce Agrees to Cooperate with Enron Investigation, Exit Structured Finance Business, Implement Reforms, with Oversight By Monitor (Dec. 22, 2003) (where Canadian Imperial Bank was fined $80 million); Press Release, DOJ, Three Top Former Merrill Lynch Executives Charged with Conspiracy, Obstruction of Justice, Perjury in Enron Investigation (Sept. 17, 2003) (pursuant to which Merrill Lynch had to employ specific reforms and retain an independent auditor to monitor compliance); Press Release, DOJ, PNC ICLC Corp. Enters Into Deferred Prosecution Agreement with the United States (June 2, 2003) (where PNC ICLC agreed to pay $90 million to a restitution fund and $25 million in penalties to the United States); Press Release, DOJ, Banco Popular De Puerto Rico Enters Into Deferred Prosecution Agreement with the United States (Jan. 16, 2003) (where Banco Popular was fined $21.6 million).

616 Memorandum from Paul J. McNulty, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Dec. 12, 2006).

617 Memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Jan. 20, 2003).

618 *See* Memorandum from Mark R. Filip, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Aug. 28, 2008).

619 *See, e.g.*, *United States v. Barford*, SEC Litigation Release No. 19240 (May 26, 2005). Former Charter Communications executives were ordered to serve prison terms and pay substantial fines after pleading guilty to conspiracy to commit wire fraud. The executives had knowingly participated in a scheme to defraud Charter's stockholders by causing Charter to materially inflate the number of subscribers that it reported to the public in press releases and filings with the SEC.

620 *See* 18 U.S.C. § 1341.

621 *See* 18 U.S.C. § 1343. The statutes are given a similar construction and are subject to the same substantive analysis. *See Carpenter v. United States*, 484 U.S. 19, 25 n.6 (1987).

622 *See, e.g.*, *Kehr Packages, Inc. v. Fidelcor, Inc.*, 926 F.2d 1406 (3d Cir.), *cert. denied*, 501 U.S. 1222 (1991).

623 *See, e.g.*, *United States v. Kelley*, 929 F.2d 582 (10th Cir.), *cert. denied*, 502 U.S. 926 (1991).

624 *See, e.g.*, *United States v. Nelson*, 988 F.2d 798 (8th Cir.), *cert. denied*, 510 U.S. 914 (1993); *United States v. Wallach*, 935 F.2d 445 (2d Cir. 1991); *United States v. Melton*, 689 F.2d 679 (7th Cir. 1982).

625 *See McNally v. United States*, 483 U.S. 350 (1987). However, no private right of action has been implied under either statute. *See*, *e.g.*, Ryan v. Ohio Edison Co., 611 F.2d 1170, 1178–79 (6th Cir. 1979); *Bell v. Health-Mor, Inc.*, 549 F.2d 342, 346 (5th Cir. 1977); *Napper v. Anderson, Henley, Shields, Bradford & Pritchard*, 500 F.2d 634, 636 (5th Cir. 1974), *cert. denied*, 423 U.S. 837 (1975); *Oppenheim v. Sterling*, 368 F.2d 516, 518–19 (10th Cir. 1966), *cert. denied*, 386 U.S. 1011 (1967).

626 18 U.S.C. § 1346.

627 *Carpenter v. United States*, 484 U.S. 19, 26 (1987).

628 *Skilling v. United States*, 130 S. Ct. 2896 (2010).

629 *Skilling v. United States*, 130 S. Ct. 2896, 2934 (2010).

630 *See United States v. Tallant*, 547 F.2d 1291, 1299 (5th Cir. 1977), *cert. denied*, 434 U.S. 889 (1977).

631 *See Williams v. United States*, 979 F.2d 844 (1st Cir. 1992); *United States v. Gay*, 967 F.2d 322, 326 (9th Cir.), *cert. denied*, 506 U.S. 929 (1992); *United States v. Brien*, 617 F.2d 299, 312 (1st Cir.), *cert. denied*, 446 U.S. 919 (1980); *see also United States v. Mackay*, 491 F.2d 616, 623 (10th Cir. 1973), *cert. denied*, 416 U.S. 972 and *cert. denied*, 419 U.S. 1047 (1974).

632 *See, e.g.*, *South Atlantic Ltd. Partnership of Tennessee, L.P. v. Riese*, 284 F.3d 518, 531 (4th Cir. 2002) ("Good faith is a complete defense to mail fraud."); *United States v. Dunn*, 961 F.2d 648, 650 (7th Cir. 1992); *United States v. Alkins*, 925 F.2d 541, 549–50 (2d Cir. 1991) ("Good faith is a complete defense to a mail fraud charge. If an individual believes that the information set forth in a mailing is true, it follows that he cannot have the requisite intent to defraud. The government must prove lack of good faith beyond a reasonable doubt." (citation omitted)); *United States v. Dupre*, 339 F. Supp. 2d 534, 539–40 (S.D.N.Y. 2004) ("Under the wire fraud statute, even false representations or statements or omissions of material facts do not amount to a fraud unless done with fraudulent intent. However misleading or deceptive a plan may be, it is not fraudulent if it was devised or carried out in good faith." (citations omitted)).

633 *See* 18 U.S.C. § 3571.

634 This imprisonment term was increased from five to 20 years by the Sarbanes-Oxley Act. *See* § 11.07[3][f].

635 *See* § 807 of the Sarbanes-Oxley Act.

636 18 U.S.C. § 1961(1) and (5).

637 18 U.S.C. § 1001.

638 *See* 18 U.S.C. § 1956.

639 *See* 31 U.S.C. § 5324(a)(3).

640 *See, e.g.*, § 32 of the Exchange Act (up to $25,000,000 for corporate offenders per § 1106 of the Sarbanes-Oxley Act).

641 *See* 18 U.S.C. § 3571.

642 For example, in the 1980s prosecution of E.F. Hutton & Co. on charges of "check kiting" arising from its aggressive cash management techniques, Hutton's use of the mails and wires was prosecuted as 2,000 separate violations of the federal mail and wire fraud statutes. *See Mix v. E.F. Hutton & Co.*, Civ. A. Nos. 85-3109, 85-3110, 1986 WL 25425, at *6 (D.D.C. Sept. 29, 1986). Consequently, had the current penalty statute been effective at that time the sentencing court would have been authorized to fine Hutton more than $1 billion.

643 U.S. Sentencing Commission, GUIDELINES MANUAL, § 8 (Nov. 2015).

644 *See United States v. Booker*, 543 U.S. 220 (2005) (directing courts to consult federal sentencing guidelines but specifically ruling that the guidelines advise but do not bind the courts).

645 U.S. Sentencing Commission, GUIDELINES MANUAL, § 8C2.5 (Nov. 2015); *see also* Memorandum from Mark R. Filip, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Aug. 28, 2008) (updating prior memos on the principles of federal prosecution of business organizations).

646 U.S. Sentencing Commission, GUIDELINES MANUAL, § 8B2.1 (Nov. 2015).

U.S. Regulation of the International Securities and Derivatives Markets, § 11.10, SPECIAL LITIGATION ISSUES REGARDING FOREIGN DEFENDANTS AND OVERSEAS TRANSACTIONS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 11.10 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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This section briefly surveys some of the special litigation issues that arise whenever a plaintiff seeks to apply the U.S. securities laws to foreign defendants and overseas transactions. [647] First, the court must determine whether it has the authority to exercise its adjudicative powers over the foreign defendants. That authority, known as "personal jurisdiction," is discussed in § 11.10[1]. If a court concludes that it has personal jurisdiction over the foreign defendants, it may nevertheless decline to hear the case based on the doctrine of *forum non conveniens*, which is discussed in § 11.10[2]. Second, the court must decide whether the plaintiff's claims entitle it to relief under the relevant statute, and this conclusion is discussed in § 11.10[3]. [648] Finally, § 11.10[4] discusses an aspect of U.S. litigation that often comes as an unpleasant surprise to foreign defendants: discovery, the process by which litigants may obtain a wide range of information from each other and from nonparty witnesses.

[1] Personal Jurisdiction

As noted, personal jurisdiction refers to the authority of a court to exercise its adjudicative powers over a defendant. A U.S. court may exercise personal jurisdiction over a foreign defendant only if authorized to do so by a statute or rule and only if such exercise satisfies the Due Process Clause of the U.S. Constitution.

Statutes authorizing the exercise of personal jurisdiction over foreign defendants are known as "long-arm statutes." Every state in the United States has enacted some form of long-arm statute or rule of court. Many state long-arm statutes confer personal jurisdiction to the full extent permitted by the Due Process Clause; others are more restrictive. On the federal level, the Securities Act and the Exchange Act both contain long-arm provisions that extend personal jurisdiction to the full extent permitted by the Due Process Clause. [649]

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Generally speaking, the Due Process Clause permits a U.S. court to exercise personal jurisdiction over a foreign defendant who possesses "minimum contacts" with the forum where the court is located "such that the maintenance of the suit does not offend ‘notions of fair play and substantial justice.’" [650] The analysis under the Due Process Clause distinguishes between two types of personal jurisdiction: "general" jurisdiction and "specific" jurisdiction.

[a] General Jurisdiction

"General" jurisdiction permits a court to adjudicate any claim against the defendant, including claims based on activities entirely unrelated to the forum. For example, if a state court in New York has general jurisdiction over XYZ Corporation, then it may adjudicate a claim against XYZ based on the corporation's activities elsewhere, even activities occurring outside the United States.

The Due Process Clause permits the exercise of general jurisdiction over foreign defendants whose affiliations with the state where the court is located are so "continuous and systematic as to render [them] essentially at home in the forum State." [651] For an individual, the paradigm forum for the exercise of general jurisdiction is the individual's domicile. For a corporation, it is the place of incorporation and principal place of business. [652]

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Although the Supreme Court has not foreclosed the possibility that a corporation's operations in a forum other than its place of incorporation or principal place of business may support the exercise of general jurisdiction, it has stressed that it would only find general jurisdiction in that circumstance in an "exceptional case" and that merely distributing goods to the forum, maintaining offices and other facilities in the forum, or having sizeable sales in the forum is insufficient. This general jurisdiction analysis further requires an appraisal of a corporation's activities in their entirety, "nationwide and worldwide," because "[a] corporation that operates in many places can scarcely be deemed at home in all of them." [653]

The Due Process Clause also permits the exercise of general jurisdiction over a foreign defendant who is personally served with process in the forum where the court is located, even if the defendant's presence in that forum is transitory. This method of obtaining general jurisdiction over a foreign defendant is often called "tag service." Perhaps the most extreme application of tag service occurred in a case where the defendant was served with a complaint while he or she was a passenger in an aircraft in flight through the airspace of the forum state. [654] Although tag service has been the subject of substantial criticism, most courts continue to recognize it as an effective way of obtaining general jurisdiction over a foreign defendant. [655]

[b] Specific Jurisdiction

"Specific" jurisdiction permits only the adjudication of claims "arising out of" or "relating to" the defendant's activities in the forum. For example, a defendant whose only contact with the forum is selling product X might be subject to the personal jurisdiction of the forum's courts with respect to claims arising out of those sales. But the defendant would not be subject to the personal jurisdiction of the forum's courts with respect to claims based on its activities outside the forum, such as the sale of product Y.

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Specific jurisdiction may be exercised when: (i) the defendant has "purposefully availed" itself of the benefits and protections of the forum's law such that it should reasonably anticipate being subject to judicial proceedings there, and (ii) the exercise of personal jurisdiction over the defendant would be "reasonable." [656] Application of this two-pronged test is neither predictable nor precise; whether a court will exercise specific jurisdiction over a particular foreign defendant will depend upon all the facts and circumstances of the case. Nevertheless, because of the unique burdens faced by foreign defendants litigating in the United States, the Supreme Court has cautioned that "great care and reserve" should be exercised in asserting personal jurisdiction over foreigners. [657] In addition, the Supreme Court has recently cautioned against using facts that permit the exercise of specific jurisdiction over a foreign corporation to exercise general jurisdiction over such corporation. [658]

[2] *Forum Non Conveniens*

Almost every litigation involving foreign parties or overseas transactions will to some degree pose the issue of *forum non conveniens*. [659] The doctrine of *forum non conveniens* permits a U.S. court to dismiss an action if the balance of conveniences weighs heavily in favor of an alternative forum. [660]

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There is ordinarily a strong presumption in favor of a plaintiff's choice of forum. However, that presumption applies with less force when the plaintiff is a foreigner, rather than a citizen or resident of the United States. When an alternative forum has jurisdiction to hear the case, and when trial in the chosen U.S. forum would be unduly burdensome to the defendant or its foreign aspects would add substantially to the court's own administrative and legal problems, the court may, in its discretion, dismiss the case. To guide the court's discretion, the Supreme Court has developed a list of private interest factors affecting the convenience of the litigants and a list of public interest factors affecting the convenience of the forum. The private and public interest factors must clearly point toward trial in the alternative forum before the plaintiff's choice of forum will be disturbed.

The factors pertaining to the private interests of the litigants include:

- the relative ease of access to sources of proof;
- the availability of a compulsory process for attendance of unwilling, and the cost of obtaining attendance of willing, witnesses;
- the possibility of a view of the premises, if a view would be appropriate to the action; and
- all other practical problems that affect whether trial of a case will be easy, expeditious and inexpensive.

The list of public interest factors includes:

- the administrative difficulties flowing from court congestion;
- the local interest in having localized controversies decided at home;
- the interest in having the trial of a diversity case in a forum that is at home with the law that must govern the action;
- the avoidance of unnecessary problems in conflict of laws, or in the application of foreign law; and
- the unfairness of burdening citizens in an unrelated forum with jury duty.

The doctrine of *forum non conveniens* is a flexible one. There are no hard and fast rules that require dismissal; each case turns on its facts. Nevertheless, a plaintiff may not defeat a motion to dismiss on the ground of *forum non conveniens* merely by showing that the substantive law that would be applied in the alternate forum is less favorable to the plaintiff than that of the present forum. The possibility of a change in substantive law is ordinarily not given substantial

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weight in the *forum non conveniens* inquiry. [661] By the same token, the possibility of a change in law favorable to the defendant is not considered. If the defendant is able to overcome the presumption in favor of the plaintiff by showing that trial in the chosen forum would be unnecessarily burdensome, dismissal is appropriate—regardless of the fact that the defendant may also have been motivated by a desire to obtain a more favorable forum.

[3] Extraterritorial Reach of the Securities Laws

Claims under the Securities Act and the Exchange Act generally fall within the federal question jurisdiction of the federal courts. However, because both statutes are silent as to their extraterritorial application, whenever a plaintiff brings an Exchange Act or Securities Act claim based on an overseas transaction, the court must ascertain whether the relevant statute reaches the challenged conduct.

In *Morrison v. National Australia Bank* [662] ("*Morrison*"), the Supreme Court rejected the longstanding and widely applied "conduct" and "effects" test for determining the extraterritorial reach of the federal securities laws, and instead held that § 10(b) of the Exchange Act gives rise to liability only for securities transactions on a U.S. exchange or otherwise occurring in the United States. This new test—a "transactional" test—does not turn on whether the alleged fraud produced substantial "effects" in the United States or whether the alleged fraud was "conduct[ed]" in the United States, but rather whether the purchase and sale "transactions" took place in the United States. The rule of *Morrison* is more categorical than the earlier standards and means that companies that sell securities outside the United States will have significant protection from U.S. securities law class action litigation. [663] For purposes of actions brought by

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the SEC, however, the Dodd-Frank Act effectively revives the prior "conduct and effects" test. [664]

The *Morrison* decision did not indicate—and lower courts will need to consider—what constitutes a purchase or sale of a non-listed security "in the United States." Transactions may be negotiated in the United States but paid from or delivered outside the United States, for example, and the Court's decision does not provide guidance for such circumstances. In *Absolute Activist Value Master Fund Limited v. Ficeto*, the Second Circuit held that a transaction in a security not listed on a U.S. exchange takes place in the United States where "irrevocable liability was incurred or title was transferred within the United States." [665] According to the *Absolute Activist* court, relevant considerations in determining whether irrevocable liability was incurred or title was transferred within the United States include "facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money," rather than the identity of the parties, the type of security at issue, or whether each defendant engaged in conduct within the United States. On remand, the district court determined that the transactions at issue took place within the United States because the parties delivered the signed purchased agreement in the United States, the closing took place in the United States, and the trades were settled through a clearinghouse located in the United States. [666]

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The Second Circuit applied its *Absolute Activist* decision in *United States v. Vilar*. [667] In *Vilar*, the Second Circuit concluded that the transactions at issue qualified as "domestic" transactions because certain of the victims "entered into and renewed" their purchase agreements in the United States. In particular, the Second Circuit supported its conclusion by pointing to evidence that: (1) the parties met in the United States to discuss the securities; (2) the victims committed to the investments while in the United States; (3) the defendants sent a letter to the victims in the United States confirming the investments; (4) the victims were in the United States when they reinvested their money in the securities; and/or (5) the victims were in the United States when they received and signed commitment forms, and sent money to the defendants to open their accounts. In reaching this conclusion, however, the Second Circuit rejected the government's arguments that the relevant transactions were "domestic" merely because the securities were "marketed and sold to customers based in the United States" or the "investors were directed to wire funds to a New York bank, and the custodian of the fund was a New York securities firm." The court likewise rejected the defendants' arguments that the transactions were not "domestic" because the securities transactions at issue were "deliberately and carefully structured to occur outside the United States." According to the court, "[t]he parties' intention to engage in foreign transactions is entirely irrelevant" under *Morrison*.

More recently, the Second Circuit considered the scope of its *Absolute Activist* decision in the context of claims under the civil liability provisions of the Commodity Exchange Act in *Loginovskaya v. Batrachenko*. [668] In *Loginovskaya*, the Second Circuit affirmed the dismissal of the plaintiff's claims for failure to plead a domestic transaction. With respect to *Absolute Activist*'s title-transfer prong, the court held that the plaintiff could not rely on the allegedly domestic transfer of title to the assets underlying her investments because she did not directly hold title to those assets and instead only owned an interest in those assets through shares in an investment account, which were not transferred within the United States. With respect to the irrevocable-liability prong of *Absolute Activist*, the Second Circuit rejected as insufficient the plaintiff's allegation that she was required to wire transfer her funds to a bank account in the United States, concluding that those transfers "were actions needed to carry out the transactions, and not the transactions themselves—which were previously entered into when the contracts were executed in Russia." [669]

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The Second Circuit further considered the application of *Morrison* to swap transactions in *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*. [670] The case involved U.S. and foreign hedge funds that had entered into security-based swap agreements in the United States that referenced the share price of Volkswagen ("VW"), the German automaker. Their complaints alleged that Porsche, another German company, concealed its intention to acquire VW, and that plaintiffs relied on Porsche's statements when entering the swap agreements. Attempting to invoke § 10(b), plaintiffs alleged that they entered into the swap agreements in the United States with U.S.-based counterparties, and that the agreements contained New York choice-of-law provisions and forum selection clauses. They did not, however, allege that Porsche was a party to the swap agreements, that its deceptive conduct occurred primarily in the United States, or that the referenced VW shares were traded on a U.S. exchange. Because the swaps were not traded on any exchange, the Circuit had to decide whether entering into the swaps constituted "domestic transactions in other securities."

The Second Circuit construed *Morrison* as precluding the application of § 10(b) to the swap agreements at issue. The Circuit first rejected the argument that the *situs* of transactions was determinative of whether the claim was extraterritorial under *Morrison* because applying that principle to the swap agreements at issue "would subject to U.S. securities laws conduct that occurred in a foreign country, concerning securities in a foreign company, traded entirely on foreign exchanges, in the absence of any congressional provision addressing the incompatibility of U.S. and foreign law nearly certain to arise"—a result *Morrison* "plainly did not contemplate and … does not … permit." The Circuit next concluded that whether a swap transaction effected in the United States fell within *Morrison's* scope depended on the facts and circumstances and could not be decided based on any bright line rule. Thus, while a domestic transaction is a necessary element of a § 10(b) claim, it is not sufficient on its own to bring a particular claim within the confines of § 10(b). Rather, the Circuit held that whether conduct—some of which took place abroad—would be sufficient to invoke § 10(b) where there was a securities transaction in the United States

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depended on whether the Plaintiffs' claims were so "predominantly foreign as to be impermissibly extraterritorial." The Circuit held that, on the facts pleaded, the Plaintiffs did not plead a transaction that was sufficiently domestic to satisfy § 10(b). [671] The procedural history of the *Parkcentral* case also demonstrates the extent to which *Morrison* may direct securities litigation away from the federal courts. After the district court's decision in *Parkcentral*, certain plaintiffs refiled their common law fraud and unjust enrichment claims in New York state court, where the Appellate Division granted the defendants' motion to dismiss on the ground of *forum non conveniens*. [672] Those plaintiffs subsequently pursued their claims in Germany.

In a decision arising out of the Volkswagen diesel emissions scandal, however, a district court distinguished *Parkcentral* and held that the plaintiffs adequately alleged that their transactions in Volkswagen's sponsored Level 1 ADRs were subject to the federal securities laws as "domestic transactions in other securities." [672.1] The court concluded that the transactions at issue were not "predominantly foreign" under *Parkcentral*, reasoning that the ADRs were "not independent from Volkswagen's foreign securities or from Volkswagen itself" since "Volkswagen sponsored the ADRs and thus was directly involved in the domestic offering of the ADRs." The court also rejected the defendants' argument that the level of the ADRs—Level 1, as opposed to Level 2 or 3—warranted a conclusion that the transactions were "predominantly foreign"

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because, "[r]egardless of the level of the ADRs, Volkswagen took affirmative steps to make its securities available to investors here in the United States," including entering into deposit agreements governed by New York law with a bank in New York, submitting registration statements with the SEC, and complying with SEC rules that required it to provide on its website English-translated versions of market disclosure documents provided in its home country.

In another more recent case, *Cascade Fund, LLP v. Absolute Capital Management Holdings Ltd.*, a lower court dismissed under *Morrison* the § 10(b) claims of U.S. investors in funds organized under the laws of the Cayman Islands. Plaintiffs argued that because the money to invest in the funds was wired to the fund managers *via* an account in New York, the transactions had taken place within the United States. The district court disagreed, noting that because the subscription agreements that the plaintiffs entered into to invest in the funds were sent to the fund manager in the Cayman Islands and were subject to final approval (or rejection) in that jurisdiction (in other words the "transaction was not completed" until the fund manager accepted an application in the Cayman Islands), the transaction at issue occurred outside the United States. [673]

Relying on reasoning similar to that of the *Cascade Fund* court, another lower court recently dismissed the SEC's § 10(b) claims against Fabrice Tourre, a U.S.-based Goldman Sachs employee, in connection with Goldman's creation and sale to U.S. and foreign investors of a synthetic collateralized debt obligation ("CDO") whose performance was tied to the performance of certain RMBSs. [674] The SEC alleged that Tourre marketed the CDO at issue out of his New York office, to investors in the United States and abroad. Tourre moved to dismiss the SEC's § 10(b) claims under *Morrison*, arguing that the SEC did not allege sufficient facts to establish that the "sale or purchase" of the security at issue had occurred in the United States. The district court agreed, noting that the SEC's allegations with respect to marketing conduct that occurred in the United States "is precisely that … just conduct," and that the Supreme Court in *Morrison* had soundly rejected any reliance on "conduct" within the United States to confer jurisdiction over § 10(b) claims. [675] Instead, the court reasoned, the question after *Morrison* for non-listed securities was where the "sale or purchase" was made, a question that in turn depends on where and when someone "incurred an *irrevocable* liability" to either take or deliver a security. [676] Because the SEC had not alleged that an

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irrevocable liability to sell the securities had arisen in the United States (and, indeed, Tourre had suggested that irrevocable liability arose when a trade confirmation for the security issued, which had occurred abroad with respect to both U.S. and foreign purchasers), the court dismissed the § 10(b) claims. [677]

[4] Discovery

[a] Overview of U.S. Discovery

Pretrial discovery in the United States often strikes foreign defendants as unusual and burdensome. First, unlike in most other countries, discovery in the United States is conducted by the litigants, rather than by the trial court. Plaintiffs' lawyers can be quite persistent in seeking information from foreign defendants. Second, the scope of discovery is much wider in the United States than in most other countries. U.S. litigants are entitled to obtain not only admissible evidence, but also any information that appears "relevant to any party's claim or defense and proportional to the needs of the case." [678] In addition to obtaining information from each other, parties can take discovery from nonparty witnesses.

There are various methods for conducting discovery in the United States. The most frequently used are oral depositions, subpoenas or demands for the production of documents and written interrogatories. Other methods include depositions on written questions, physical and mental examinations and requests for admissions. Parties are generally free to employ any combination of these discovery devices.

U.S. discovery is typically conducted with little judicial supervision. Parties are free to make discovery requests without prior court approval, and, in most cases, compliance with such requests is achieved through private negotiations among the parties and nonparty witnesses. If negotiations break down, the parties and witnesses can bring their discovery disputes to the court for resolution.

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Once a court has ordered a party or nonparty to provide discovery, failure to do so is a ground for sanctions. With respect to the litigants, courts have a wide array of sanctions at their disposal, including:

- finding particular facts against the disobedient party;
- precluding use of evidence by that party;
- dismissing that party's claims or defenses;
- ordering the recalcitrant party (or that party's lawyer) to pay the other side's attorney's fees; and

- treating the party's noncompliance as a contempt of court, punishable by a fine or, in truly egregious cases, imprisonment.

A nonparty who disobeys a discovery order of the court risks a finding of contempt of court, with its attendant severe penalties.

U.S. pre-trial discovery can be a long and expensive process. In a complicated securities case, discovery can easily take a year or more, require the production of hundreds of thousands of documents and entail the taking of scores of depositions. In recognition of the magnitude of these burdens and the fact that many securities cases ultimately are dismissed as a matter of law, in 1995, Congress passed legislation mandating the suspension of discovery in any private suit under the Exchange Act or Securities Act between the time a defendant moves for dismissal and the resolution of the motion by the court, barring a showing of "undue prejudice" by the plaintiff. [679] While this amendment provides welcome protection against some of the more egregious abuses of the previous discovery rules, such as the filing by plaintiffs of voluminous discovery demands at the outset of even frivolous suits to pressure defendants into settling for "nuisance value," the discovery process in securities cases that survive a motion to dismiss is likely to be time-consuming and expensive. [680]

[b] Extraterritorial Application of U.S. Discovery

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Under certain circumstances, parties to a U.S. lawsuit may obtain information from persons and entities located abroad simply by using the standard mechanisms of U.S. discovery.

For example, U.S. law entitles parties to obtain relevant documents within the custody or control of adverse parties. Accordingly, foreign defendants can be compelled to produce all relevant documents over which they have control, regardless of whether such documents are located abroad. Moreover, U.S. parent corporations generally must produce documents from their foreign subsidiaries, because parents generally are deemed to control their subsidiaries. The formalities of corporate organization, however, are not dispositive. On occasion, U.S. subsidiaries have been ordered to produce documents from their foreign parents because the facts established that, as a practical matter, the subsidiaries and parents shared control of the documents. Each case involving the "control" of corporate documents located abroad rests on its own particular facts. [681]

A foreign nonparty witness can also be compelled to produce documents located abroad, provided that the witness: (i) is properly served with a subpoena, (ii) is subject to the personal jurisdiction of the U.S. court, and (iii) has control of the documents. Even where these prerequisites are met, however, courts sometimes refrain from ordering production, presumably because they recognize the unfairness of forcing foreign companies to spend time and money producing documents located abroad in lawsuits in which the companies have no stake. [682]

Rules governing the oral depositions of foreign witnesses generally draw a distinction between party and nonparty witnesses. If the proposed witness is a party, then the court can compel a deposition of the witness. When the party is a corporation, the court's power to compel a deposition generally extends to the corporation's officers, directors and managing agents. The court has broad discretion to select a convenient place for the deposition; whether it will order a foreign witness to travel to the United States depends on the circumstances. As a general matter, courts require foreign plaintiffs to attend depositions in the United States; on the other hand, courts have sometimes excused foreign defendants from traveling to the United States where such travel would be

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unreasonable under the particular circumstances of the case. A foreign nonparty witness, by contrast, generally cannot be compelled to travel to the United States; however, some courts have ordered nonparty foreign companies over whom they have personal jurisdiction to make their overseas employees available for depositions by telephone.

Under certain circumstances, U.S. depositions can be conducted abroad. Generally, the deponent must agree to the deposition, and the deposition must be permissible under local law. U.S. law expressly provides for taking depositions in foreign countries and sets forth detailed procedures for conducting such discovery. [683]

[c] Blocking Statutes

A number of foreign countries have enacted so-called "blocking statutes," which prohibit the production of evidence located within the blocking country's territory. Although the scope of foreign blocking statutes varies widely from country to country, most carry criminal penalties. Some blocking statutes, such as the Swiss bank secrecy law, have existed for many decades and were designed to serve long-standing government policies. Other statutes were specifically intended to respond to efforts by U.S. litigants to take U.S.-style discovery abroad. Some of these statutes, such as that in France, flatly prohibit compliance with foreign discovery orders. Litigants seeking evidence located in France must go through official government channels. Other blocking statutes, such as those in the United Kingdom, Australia and Canada, authorize certain government agencies to prohibit compliance with any foreign discovery order that would infringe on the country's sovereignty or security. Finally, many foreign blocking statutes only prohibit disclosures relating to particular industries. For example, the Bahamas, the Cayman Islands, Bermuda, Liechtenstein and Panama all have blocking statutes that apply to the banking industry.

Blocking statutes are not the only way that foreign countries have expressed their interest in the nondisclosure of information located within their territory. [684] Some countries that do not have blocking statutes nevertheless

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recognize a right of confidentiality in the customer account records of financial institutions. In Belgium and the Netherlands, for example, that right is derived from the standard contract between a financial institution and its customer. In Hong Kong and Germany, by contrast, the right stems from judicial decisions holding that customers whose records are disclosed can recover civil damages from their financial institutions.

U.S. courts sometimes order foreign litigants and nonparty witnesses to produce information notwithstanding the fact that such production would violate a foreign country's blocking statute. Litigants and nonparty witnesses facing such discovery orders obviously find themselves in a difficult position: if they comply with the U.S. court order, they risk criminal prosecution for violating the blocking statute; on the other hand, if they comply with the blocking statute, they risk being sanctioned by the U.S. court. This dilemma can arise in the course of both civil and criminal proceedings. [685]

Courts generally balance several factors in deciding whether to issue discovery orders that conflict with a foreign blocking statute and whether to impose sanctions for noncompliance with such orders. These factors include:

- the vital national interests of the United States and the foreign country;
- the extent and the nature of the hardship that inconsistent enforcement actions would impose on the party from whom discovery is sought;
- the nationality of the person from whom discovery is sought; and

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- the importance of the evidence. [686]

In addition, in deciding whether to impose sanctions, most courts place substantial emphasis on whether the person from whom discovery is sought has acted in bad faith. Acts of bad faith include secreting documents in a jurisdiction where they cannot be produced legally, colluding with a foreign government to obtain passage of a blocking statute or failing to seek a waiver of the blocking statute from the foreign country.

In order to minimize the risk of sanctions, the party from whom discovery is sought should respond in a way that makes its good faith unquestionable. Acts of good faith include promptly making as much disclosure as applicable law permits, attempting to obtain a waiver of the blocking statute and seeking alternative means by which to provide the information at issue. [687]

Finally, U.S. courts have the authority, at least in criminal cases, to issue so-called "consent directives." A consent directive is a court order directing a person to consent to the production of his or her documents by a records custodian, often a financial institution, located overseas. Consent directives are designed to take advantage of foreign blocking statutes that permit the production of records if the owner of such records consents to the production. [688]

[d] Letters Rogatory

If the person or entity possessing relevant information is not subject to the personal jurisdiction or subpoena power of the U.S. courts, then those courts cannot order discovery directly and must instead seek the assistance of foreign courts in obtaining the information. The traditional method of obtaining such assistance is by letter rogatory—a formal request by the court of one nation to the courts of another for assistance in performing a judicial act. In the discovery context, a U.S. letter rogatory typically will ask a foreign court to compel an individual or entity in the foreign jurisdiction to provide testimony or documents to the foreign court, so that the foreign court can then forward the evidence to the U.S. court. Letters rogatory may be used in both civil and criminal cases. [689]

As a practical matter, letters rogatory are inefficient and cumbersome. First, foreign courts are under no obligation to execute letters rogatory. As a result, foreign courts sometimes refuse to execute letters rogatory in cases

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involving claims based on U.S. laws that conflict with the foreign jurisdiction's policy. Second, each nation has its own required form for letters rogatory. This often results in a lengthy series of rejections and resubmissions as the requesting party attempts to comply with the required form. Third, even when foreign courts execute U.S. letters rogatory, they often refuse to provide the full extent of the discovery sought. Foreign courts generally execute letters rogatory in accordance with their own procedures. Thus, oral testimony may be taken without an oath and without a transcript. In addition, foreign courts generally do not execute the wide-ranging document requests that are common in the United States. Fourth, the processing of letters rogatory is notoriously slow. The letters must be sent to the foreign court through diplomatic channels, which usually involves sending the letters to the U.S. State Department, which in turn will send them to the foreign affairs ministry, which then will send them to the foreign court. The information is sent back *via* the same route. Completing discovery *via* letters rogatory can easily take more than one year.

[e] The Hague Convention

In an effort to improve upon the letters rogatory mechanism in civil cases, the United States and nearly 20 other countries have become parties to the Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters (the "Convention"). [690] Parties to the Convention are required to designate a "Central Authority." When a court in one member state seeks access to evidence located in another member state, it sends a "letter of request" to the Central Authority in the second state. Unlike letters rogatory, the receiving Central Authority is generally required by the Convention to execute foreign letters of request. In addition, the Convention provides that such letters should be executed expeditiously. The receiving Central Authority forwards the letters to the appropriate local court for execution and the evidence obtained thereunder is then returned to the requesting court. [691] The Convention applies to evidence sought from third parties as well as from the litigants themselves.

The general obligation of parties to execute letters of request is subject to several important exceptions. One such exception, pursuant to Article 23 of the Convention, permits parties to declare that they will not execute letters of request seeking pretrial discovery of documents. All the parties to the Convention except the United

States, Israel and Czech Republic have issued such declarations, most

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likely because they feared "fishing expeditions" by U.S. lawyers into the files of local companies.

The Convention does not provide exclusive or mandatory procedures for obtaining evidence located abroad; it establishes optional procedures for obtaining such evidence. Thus, the Convention does not deprive a U.S. court of the power to employ traditional methods of U.S. discovery with respect to a litigant or nonparty over whom the court has personal jurisdiction. Whether a court will employ the Convention, rather than traditional U.S. discovery methods, depends upon a particularized analysis of the facts of the case, the sovereign interests of the countries involved and the likelihood that use of the Convention will prove effective. [692] On the other hand, when discovery is sought from a nonparty that is not subject to U.S. personal jurisdiction, traditional U.S. discovery is not available, and the Hague Convention (or letters rogatory) must be used. [693]

[f] Mutual Legal Assistance Treaties, Executive Agreements and Memoranda of Understanding

The United States has entered into various agreements with foreign countries in order to facilitate the government's own ability to gather evidence abroad. Many of these agreements are specifically designed to pierce the blocking statutes of foreign countries.

First, the United States has entered into Mutual Legal Assistance Treaties ("MLATs") with a number of foreign countries. [694] MLATs generally apply only

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to criminal matters. Unlike the Hague Convention, each MLAT is a separately negotiated treaty, defining the countries' obligations to provide assistance, the scope of such assistance and the contents required in all requests for assistance. MLATs generally require that all requests be made by and sent to the Central or Competent Authority designated by each country. The U.S. Attorney General has been designated as the competent authority to make and receive such requests in the United States. Countries entering into MLATs generally reserve the right to deny a request if execution would prejudice their sovereignty, security or other essential public interest. In addition, most MLATs contain a dual criminality requirement: the offense under investigation must be punishable under the criminal laws of both countries. Some MLATs entitle a country to refuse a request for assistance if the offense in question is political or military in nature; other MLATs list specific offenses for which assistance will not be given.

Second, the U.S. government has also entered into "executive agreements" with certain countries in order to facilitate international criminal investigations in particular areas, such as drug trafficking and money laundering. [695] Executive agreements have also been negotiated on an *ad hoc* basis with respect to specific cases.

Finally, the SEC has entered into a variety of agreements, including multilateral and bilateral Memoranda of Understanding ("MOUs") and *ad hoc* arrangements, with a number of foreign governments to facilitate the SEC's ability to obtain information, such as account information from non-U.S. financial institutions, in securities law enforcement matters. [696] MOUs arose from the difficulty the SEC experienced in obtaining evidence through ordinary diplomatic channels or by means of international law enforcement, which posed a real obstacle to prosecuting transnational securities violations. [697] The increasing globalization of corporations, capital markets and securities transactions has necessitated the internationalization of enforcement. Without cooperative information-sharing agreements, it would be much easier for violators to escape prosecution by operating outside the enforcing jurisdiction. MOUs, which provide for mutual

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assistance and agreement between countries for the orderly exchange of information in pending investigations, are arguably the most effective of the above-listed tools for gathering international evidence and have facilitated increased international cooperation. [698] Prior to 2002, the SEC relied primarily on bilateral MOUs with foreign regulators, setting forth detailed guidelines for the sharing, use and confidentiality of information. The SEC has entered into such MOUs with 20 other securities regulators. [699] Although these bilateral MOUs formerly represented the SEC's primary means of securing international cooperation, since 2002 the SEC and other regulatory agencies have pursued a multilateral approach. Thirty-six securities regulators have signed the International Organization of Securities Commissions' (IOSCO's) Multilateral Memorandum of Understanding, which generally provides for information sharing similar to that established by the bilateral MOUs. [700] In addition, the SEC has negotiated *ad hoc* arrangements with foreign jurisdictions or regulators to cooperate in specific enforcement matters.

Footnotes

647 For purposes of this section, the term "foreign defendants" refers to (i) individuals who are neither citizens nor residents of the United States and (ii) companies that are neither incorporated nor have their principal places of business in the United States. The term "overseas transactions" refers to securities transactions that occur principally outside the United States.

648 Until recently, this analysis, which considers whether a plaintiff presents a claim for relief under U.S. law, was considered by courts to be an inquiry into subject matter jurisdiction.

649 *See* § 22 of the Securities Act; § 27 of the Exchange Act; *Bersch v. Drexel Firestone*, *Inc.*, 519 F.2d 974, 998 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975); *Leasco Data Processing Equipment Corp. v. Maxwell*, 468 F.2d 1326, 1339–40 (2d Cir. 1972).

650 *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945) (quoting *Milliken v. Meyer*, 311 U.S. 457, 463 (1940)). In a state court proceeding, the personal jurisdiction issue turns on whether the foreign defendant has sufficient "minimum contacts" with the individual state. In a federal court proceeding under the Securities Act or the Exchange Act, personal jurisdiction generally turns on whether the foreign defendant has sufficient "minimum contacts" with the United States, rather than with any one particular state. *See, e.g.*, *Securities Investor Protection Corp. v. Vigman*, 764 F.2d 1309, 1315–16 (9th Cir. 1985).

651 *Daimler AG v. Bauman*, 134 S. Ct. 746, 754 (2014).

652 Certain regulated entities, such as registered nonresident investment advisers and broker-dealers, must appoint the SEC as their agent in the United States for receipt of service of process. *See* Rule 15b1-5 under the Exchange Act and Rule 0-2 under the Advisers Act. The courts are divided as to whether a corporation that appoints an agent for service of process solely because it is required to do so by law thereby subjects itself to the general jurisdiction of the U.S. courts. *Compare Sternberg v. O'Neil*, 550 A.2d 1105 (Del. 1988) (upholding Delaware law requiring all foreign corporations doing business there to appoint agents to receive process in any action, thereby subjecting corporations to general jurisdiction), *with Ratliff v. Cooper Laboratories, Inc.*, 444 F.2d 745, 748 (4th Cir.), *cert. denied*, 404 U.S. 948 (1971) (Due Process Clause does not permit general jurisdiction based only on company's registration to do business and appointment of agent to receive service of process). *See generally Reynolds & Reynolds Holdings, Inc. v. Data Supplies, Inc.*, 301 F. Supp. 2d 545, 550–51 (E.D. Va. 2004) (collecting cases and holding that complying with registration statutes that require appointing an agent for service does not amount to consent to general personal jurisdiction).

653 *Daimler AG v. Bauman*, 134 S. Ct. 746, 762 n.20 (2014).

654 *See Grace v. MacArthur*, 170 F. Supp. 442 (E.D. Ark. 1959).

655 *See, e.g.*, *Burnham v. Superior Court of California*, 495 U.S. 604 (1990); *Amusement Equipment, Inc. v. Mordelt*, 779 F.2d 264 (5th Cir. 1985). The courts are divided, however, as to whether tag service on a corporate officer is sufficient to obtain general personal jurisdiction over the corporation. *Compare Aluminal Industries, Inc. v. Newtown Commercial Associates*, 89 F.R.D. 326 (S.D.N.Y. 1980) (tag service on managing partner established personal jurisdiction over out-of-state limited partnership), *with Scholz Research Development, Inc. v. Kurzke*, 720 F. Supp. 710 (N.D. Ill. 1989) (Due Process Clause does not

permit jurisdiction over company based on tag service on corporate officer).

656 *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 297 (1980).

657 *Asahi Metal Industries Co. v. Superior Court of California*, 480 U.S. 102, 115 (1987) (quoting *United States v. First National City Bank*, 379 U.S. 378, 404 (1965) (Harlan, J., dissenting)); *see also SEC v. Unifund SAL*, 910 F.2d 1028, 1033 (2d Cir. 1990); *SEC v. Euro Security Fund*, Fed. Sec. L. Rep. (CCH) ¶90,433 (S.D.N.Y Feb. 17, 1999).

658 *See Goodyear Dunlop Tires Operations v. Brown*, 131 S. Ct. 2846 (2011). In *Goodyear*, the plaintiff sued a foreign corporation for the negligent design of tires that the plaintiff alleged had caused an accident abroad, and sought to establish jurisdiction over the foreign corporation based on the fact that some of its tires had been distributed in the United States. The Supreme Court rejected the exercise of general jurisdiction over the foreign corporation based on these facts, noting that "ties serving to bolster the exercise of specific jurisdiction do not warrant a determination that, based on those ties, the forum has general jurisdiction over a defendant." *Goodyear Dunlop Tires Operations v. Brown*, 131 S. Ct. 2846, 2855 (2011).

659 For an example of the application of *forum non conveniens* to a securities fraud action, *see Otor, S.A. v. Credit Lyonnais, S.A.*, No. 04-CV-6978 (RO), 2006 WL 2613775 (S.D.N.Y. Sept. 11, 2006) or *Alfadda v. Fenn*, 159 F.3d 41 (2d Cir. 1998).

660 *See generally Piper Aircraft Co. v. Reynolds*, 454 U.S. 235 (1981); *Gulf Oil Corp. v. Gilbert*, 330 U.S. 501 (1947).

661 Only if the remedy provided by the alternative forum is so clearly inadequate or unsatisfactory that it is no remedy at all may the unfavorable change in law be given substantial weight. In that situation, the court may conclude that dismissal would not be in the interests of justice. *See, e.g.*, *In re Lernout & Hauspie Securities Litigation*, 208 F. Supp. 2d 74, 81 (D. Mass 2002) (holding that the lack of a fraud-on-the-market theory, when combined with the lack of a class action mechanism, "creates virtually insurmountable concerns regarding the adequacy of the foreign forum").

662 *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010).

663 After *Morrison*, the plaintiffs in *Cornwell v. Credit Suisse Group*, 729 F. Supp. 2d 620 (S.D.N.Y. 2010), attempted to revive the defunct "conduct and effects test" and limit *Morrison* to its facts, arguing that the transactional test it announced was limited to so-called "foreign-cubed" claims (*i.e.*, claims by a non-U.S. purchaser of securities of a non-U.S. entity on a non-U.S. exchange). Judge Marrero squarely rejected these arguments and held that *Morrison* also bars claims by U.S. plaintiffs who purchase securities on a non-U.S. exchange, regardless of whether the purchase was initiated in the United States or whether the plaintiff was enticed to purchase through acts committed in the United States. *See also In re Alstom SA Securities Litigation*, 741 F. Supp. 2d 469 (S.D.N.Y. 2010) (reaching same holding as *Cornwell*).

Also after *Morrison*, at least one set of plaintiffs argued that § 10(b) applies to purchases of securities on a foreign exchange if such security is also cross-listed on a U.S. exchange, relying on the Supreme Court's statement in *Morrison* that "Section 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security *listed* on an American stock exchange." *Morrison v. National Australia Bank*, 130 S. Ct. 2869, 2888 (2010) (emphasis added). This argument has failed. *See, e.g.*, *City of Pontiac Policemen's & Firemen's Retirement Systems v. UBS AG*, 752 F.3d 173, 181 (2d Cir. 2014) (holding that "*Morrison* does not support the application of § 10(b) of the Exchange Act to claims by a foreign purchaser of foreign-issued shares on a foreign exchange simply because those shares are also listed on a domestic exchange").

At least one court has extended *Morrison* to bar claims based on purchases of ADRs on the U.S. over-the-counter market (as opposed to on a U.S. exchange), noting that trading in ADRs in such a context is a "predominantly foreign securities transaction." *In re Societe Generale Securities Litigation*, No. 08-CV-2495 (RMB), 2010 WL 3910286, at *4 (S.D.N.Y. Sept. 29, 2010) (citation omitted).

664 *See* § 929P(b) of the Dodd-Frank Act. For a discussion of applications of the "conduct and effects" test, *see, e.g.*, *Morrison v. National Australia Bank Ltd.*, 547 F.3d 167 (2d Cir. 2008) *aff'd on other grounds*, 130 S. Ct. 2869 (2010); *SEC v. Berger*, 322 F.3d 187 (2d Cir. 2003); *IIT v. Vencap, Ltd.*, 519 F.2d 1001 (2d Cir.

1975); *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975). *See also* Edward Greene & Arpan Patel, *Consequences of Morrison v. NAB, securities litigation and beyond*, CAP. MKTS. L.J. (2016) 11 (2): 145–190.

665 *Absolute Activist Value Master Fund Limited v. Ficeto*, 677 F.3d 60 (2d Cir. 2012).

666 *Absolute Activist Value Master Fund, Limited v. Ficeto*, No. 09 Civ. 8862 (GBD), 2013 WL 1286170 (S.D.N.Y. Mar. 28, 2013).

667 *United States v. Vilar*, 729 F.3d 62 (2d Cir. 2013). In addition to interpreting the contours of "domestic" transactions under *Morrison*, the *Vilar* decision is also notable because the *Vilar* court held, in an issue of first impression, that *Morrison's* transactional approach applies to criminal actions under § 10(b) of the Exchange Act.

668 *Loginovskaya v. Batrachenko*, 764 F.3d 266 (2d Cir. 2014).

669 Building on this decision, a district court has held that the settlement of an unlisted security through The Depository Trust Company ("DTC"), by itself, does not establish a domestic transaction for the purposes of the federal securities laws. *See In re Petrobras Securities Litigation*, 150 F. Supp. 3d 337 (S.D.N.Y. 2015). The *Petrobras* court concluded that, "even assuming that DTC's bookkeeping affects a change in beneficial ownership in New York," "[t]he mechanics of DTC settlement are actions needed to carry out transactions," which were rejected as insufficient by *Loginovskaya*, but "involve neither the substantive indicia of a contractual commitment necessary to satisfy *Absolute Activist*'s first prong nor the formal weight of a transfer of title necessary for its second." In light of the parties' contention "that most securities transactions settle through the DTC or similar depository institutions," the court further observed that "the entire thrust of *Morrison* and its progeny would be rendered nugatory if all DTC-settled transactions necessarily fell under the reach of the federal securities laws."

670 *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*, 763 F.3d 198 (2d Cir. 2014).

671 In *Stoyas v. Toshiba Corporation*, No. CV 15-04194 DDP (JCx), 2016 WL 3563084, at *10 (C.D. Cal. May 20, 2016), a district court likewise held that transactions in unsponsored ADRs, including "securities transactions that occurred domestically [in that] they were both sold and purchased in the United States," "do not fall under the second [domestic-transaction] prong of *Morrison*" where the defendants are not "involved in those transactions in any way." In reaching this decision, the court reasoned that "nowhere in *Morrison* did the Court state that U.S. securities laws could be applied to a foreign company that only listed its securities on foreign exchanges but whose stocks are purchased by an American depositary bank on a foreign exchange and then resold as a different kind of security (an ADR) in the United States." *Stoyas v. Toshiba Corporation*, No. CV 15-04194 DDP (JCx), 2016 WL 3563084, at *10 (C.D. Cal. May 20, 2016). The court further observed that applying the federal securities laws in such a circumstance would be "inconsistent with the spirit and law of *Morrison*" since it "would create essentially limitless reach of § 10(b) claims because even if the foreign defendant attempted to keep its securities from being sold in the United States, the independent actions of depositary banks selling on OTC markets could create liability." *Stoyas v. Toshiba Corporation*, No. CV 15-04194 DDP (JCx), 2016 WL 3563084, at *10 (C.D. Cal. May 20, 2016). The court instead held that *Morrison* requires a plaintiff to establish that the defendant performed some "affirmative act in connection with securities sales in the United States" for the federal securities laws to apply against that defendant. *Stoyas v. Toshiba Corporation*, No. CV 15-04194 DDP (JCx), 2016 WL 3563084, at *11 (C.D. Cal. May 20, 2016).

672 *See Viking Global Equities, LP v. Porsche Automobile Holdings SE*, 101 A.D.3d 640 (1st Dep't 2012).

672.1 *In re Volkswagen "Clean Diesel" Marketing, Sales Practices, & Products Liability Litigation*, 3:15-md-02672-CRB, 2017 WL 66281 (N.D. Cal. Jan. 4, 2017). For a discussion of ADR sponsorship and the different levels of ADRs, *see* § 3.04 [1][b].

673 *Cascade Fund, LLP v. Absolute Capital Management Holdings Ltd.*, Fed. Sec. L. Rep. ¶96,269 (D. Colo. Mar. 31, 2011).

674 *SEC v. Goldman Sachs & Co.*, No. 10-CV-3229 (BSJ), 2011 WL 2305988 (S.D.N.Y. June 10, 2011). Goldman settled the matter with the SEC without admitting or denying liability.

675 *SEC v. Goldman Sachs & Co.*, No. 10-CV-3229 (BSJ), 2011 WL 2305988, *8–9 (S.D.N.Y. June 10, 2011).

676 *SEC v. Goldman Sachs & Co.*, No. 10-CV-3229 (BSJ), 2011 WL 2305988 (S.D.N.Y. June 10, 2011) (citing *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Company*, 753 F. Supp. 2d 166, 177 (S.D.N.Y. 2010) (emphasis added).

677 The case is also notable because the district court held that *Morrison* also applies to claims under the Securities Act, given the Supreme Court's statement in *Morrison* that "the Exchange Act and the Securities Act share the same focus on domestic transactions." *SEC v. Goldman Sachs & Co.*, No. 10-CV-3229 (BSJ), 2011 WL 2305988, *14 (S.D.N.Y. June 10, 2011) (citing *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869, 2885 (2010)) (internal quotation marks omitted). However, it refused to dismiss the SEC's § 17(a) claims against Tourre because that section "applies not only to the ‘sale’ but also to the ‘ *offer*… of any securities or any security-based swap agreement,'" and because the SEC had sufficiently alleged that Goldman's offer to sell securities to the foreign investors had originated within the United States. *See SEC v. Goldman Sachs & Co.*, No. 10-CV-3229 (BSJ), 2011 WL 2305988, *15 (S.D.N.Y. June 10, 2011) (citing 15 U.S.C. § 17(a)).

678 Fed. R. Civ. P. 26(b)(1). *See generally* Fed. R. Civ. P. 26 for the presumptive limitations on discovery in federal courts.

679 § 21D(b)(3)(B) of the Exchange Act and § 27(b)(1) of the Securities Act. This provision acts to suspend even the preliminary disclosure normally required in federal courts, such as the informal exchange of names and addresses of parties likely to have discoverable information and copies or descriptions of documents relevant to disputed facts. *See Medhekar v. U.S. District Court*, 99 F.3d 325, 328 (9th Cir. 1996) (*per curiam*) (noting that the Litigation Reform Act requires plaintiffs to "stand or fall based on [their] actual knowledge" rather than permitting "fishing expeditions" after filing aimed at revealing possible sources of liability).

680 After enactment of the Litigation Reform Act, there was a migration of securities claims to state courts, where, in some instances, discovery was permitted to proceed even pending resolution of motions to dismiss. Plaintiffs increasingly began to file parallel actions in federal and state courts, in the hope that the discovery obtained in the state court proceedings would enable them to better prosecute their federal court claims. In order to stop plaintiffs from using such tactics to circumvent the Litigation Reform Act's discovery stay provisions, Congress enacted § 101 of SLUSA, which enables federal courts to stay discovery in private state court actions when it is "necessary in aid of [the court's] jurisdiction, or to protect or effectuate its judgments." Courts have been willing to exercise their authority under this provision. *See, e.g.*, *In re Cardinal Health, Inc.*, 365 F. Supp. 2d 866, 877 (S.D. Ohio 2005); *In re Crompton Corp.*, Fed. Sec. L. Rep. CCH ¶93,330 (D. Conn. July 22, 2005).

681 *See, e.g.*, *In re Marc Rich & Co., A.G.*, 707 F.2d 663 (2d Cir.), *cert. denied*, 463 U.S. 1215 (1983); *United States v. First National City Bank*, 396 F.2d 897 (2d Cir. 1968); *Westinghouse Electric Corp. v. Rio Algom, Ltd. (In re Uranium Antitrust Litigation)*, 480 F. Supp. 1138 (N.D. Ill. 1979).

682 *See, e.g.*, *Minpeco, S.A. v. ContiCommodity Service, Inc.*, 116 F.R.D. 517 (S.D.N.Y. 1987); *Laker Airways, Ltd. v. Pan American World Airways Ltd.*, 607 F. Supp. 324 (S.D.N.Y. 1985).

683 The procedures for taking a deposition in a foreign country pursuant to the Federal Rules of Civil Procedure are set forth in Fed. R. Civ. P. 28(b).

684 The European Commission objected, for example, to the Sarbanes-Oxley Act's requirements that foreign accounting firms register with the Public Company Accounting Oversight Board (the "PCAOB") and therefore produce upon request all audit papers to the PCAOB and the SEC, on the grounds that this requirement generally duplicates existing local requirements and conflicts with European confidentiality statutes. *See* Carrie Johnson, *Accounting Panel, SEC Backs Registry for Foreign Auditors*, WASHINGTON POST, Apr. 1, 2003 (stating the SEC's rejection of the European Commission's suggestions to allow foreign auditors one year to register and warning British accountants that disclaimers of liability they used on European audit opinions were unacceptable for U.S. reports); Alan Obsorn, *EU Urges U.S. to Reconsider Rules*, ACCOUNTANCY AGE, June 12, 2003 (urging the United States not to apply the PCAOB process to

foreign auditors); Letter from the European Commission to Mr. Jonathan G. Katz, Secretary, SEC (Dec. 20, 2002) (same). The PCAOB does not require such firms to disclose information if such disclosure would violate foreign law. SEC Release No. 34-47990 (June 5, 2003). Recently, however, an SEC administrative law judge entered an initial decision censuring the Chinese affiliates of several accounting firms for refusing to provide audit work papers relating to U.S. issuers, and denying those affiliates the privilege of practicing or appearing before the SEC for a period of six months, notwithstanding the companies' argument that they were prevented from providing those materials by Chinese national security laws. *See In the Matter of BDO China Dahua CPA Co. Ltd., et al.*, SEC Initial Decision Release No. 553 (Jan. 22, 2014). Those affiliates subsequently agreed to pay $500,000 each to settle the dispute and also agreed to follow procedures designed to ensure that the SEC is able to obtain audit documents from them in the future. *See* Michael Rapoport, *SEC, Big Four Accounting Firms in China Settle Dispute*, WALL ST. J., Feb. 6, 2015.

685 *See, e.g.*, *Société Nationale Industrielle Aérospatiale v. U.S. District Court*, 482 U.S. 522 (1987); *Société Internationale Pour Participations Industrielles et Commerciales, S.A. v. Rogers*, 357 U.S. 197 (1958); *First American Corp. v. Price Waterhouse LLP*, 154 F.3d 16, 22 (2d Cir. 1998); *In re Sealed Case*, 825 F.2d 494 (D.C. Cir.), *cert. denied*, 484 U.S. 963 (1987); *CFTC v. Nahas*, 738 F.2d 487 (D.C. Cir. 1984); *United States v. First National City Bank*, 396 F.2d 897 (2d Cir. 1968); *Compagnie Francaise D'Assurance Pour Le Commerce Extérieur v. Phillips Petroleum Co.*, 105 F.R.D. 16, 31 (S.D.N.Y. 1984).

686 *See, e.g.*, *First American Corp. v. Price Waterhouse LLP*, 154 F.3d 16, 22 (2d Cir. 1998); *SEC v. Euro Security Fund*, No. 98-CV-7347 (DLC), 1999 WL 182598 (S.D.N.Y. Apr. 1, 1999).

687 *See, e.g.*, *In re Sealed Case*, 825 F.2d 494 (D.C. Cir.), *cert. denied*, 484 U.S. 963 (1987).

688 *See Doe v. United States*, 487 U.S. 201 (1988); *United States v. Davis*, 767 F.2d 1025 (2d Cir. 1985).

689 *See* 28 U.S.C. § 1781 ("transmittal of letter rogatory or request").

690 The Hague Convention was opened for signature on March 18, 1970 and signed by the United States on October 7, 1972. It is reprinted in 28 U.S.C. § 1781.

691 The Convention also permits specified alternative procedures for taking evidence that go beyond the basic Central Authority mechanism. These alternative procedures generally involve the taking of evidence by consuls or court-appointed commissioners.

692 *See Société Nationale Industrielle Aérospatiale v. U.S. District Court*, 482 U.S. 522 (1987).

693 The regime under which discovery is sought can have important implications not only for the procedures by which the discovery is obtained, but the scope of discoverable material. Because different discovery protocols involve different bodies of substantive law, material that is discoverable under one regime (*i.e.*, under the Federal Rules) may not be discoverable under another regime (*i.e.*, Hague Convention or letters rogatory). This tension is particularly acute in disputes over discovery of potentially privileged materials. *See, e.g.*, *Tulip Computers International B.V. v. Dell Computer Corp.*, 254 F. Supp. 2d 469, 475 (D. Del. 2003); *Renfield Corp. v. E. Remy Martin & Co., S.A.*, 98 F.R.D. 442 (D. Del. 1982).

694 MLATs are currently in force between the United States and Anguilla (United Kingdom), Antigua & Barbuda, Argentina, Australia, Austria, Bahamas, Barbados, Belgium, Belize, Brazil, British Virgin Islands (United Kingdom), Canada, Cayman Islands (United Kingdom), Cyprus, Czech Republic, Dominica, Egypt, Estonia, France, Greece, Grenada, Hong Kong, Hungary, Israel, Italy, Jamaica, Korea (South), Latvia, Liechtenstein, Lithuania, Luxembourg, Mexico, Montserrat (United Kingdom), Morocco, the Netherlands, Panama, Philippines, Poland, Romania, the Russian Federation, St. Kitts & Nevis, St. Lucia, St. Vincent and the Grenadines, Spain, South Africa, Switzerland, Thailand, Trinidad & Tobago, Turkey, Turks & Caicos Islands (United Kingdom), the United Kingdom and Uruguay. U.S. Department of State Index of MLATS and Other Agreements Currently in Force. The United States has also entered into Mutual Legal Assistance Agreements by executive agreement with countries such as the People's Republic of China and Nigeria.

695 For example, the United States has entered into Financial Information Exchange Agreements ("FIEAs"), which facilitate the exchange of information relating to currency transfers, with Colombia, Ecuador, Mexico, Panama, Paraguay, Peru and Venezuela. The U.S. Department of Treasury's Financial Crimes

Enforcement Network ("FinCEN") has entered into separate Memoranda of Understanding with similar units in 18 other countries. *See* Bureau for International Narcotics and Law Enforcement Affairs, International Narcotics Control Strategy Report 2006: Treaties and Agreements.

696 *See, e.g.*, *In re Dominick & Dominick Inc.*, SEC Release No. 34-29243 (May 29, 1991); *SEC v. Katz*, SEC Litigation Release No. 11185 (Aug. 7, 1986); *see also* § 14.03[3][i] for a further discussion of MOUs.

697 By way of example, the absence of dual criminality in the MLAT with Switzerland led the SEC to negotiate its first MOU with Switzerland, which dealt with cooperation in insider trading cases. *See* Memorandum of Understanding with the Government of Switzerland, Release No. 2, 1982 SEC LEXIS 2631 (Aug. 31, 1982).

698 *See generally* The SEC Speaks in 2001, INTERNATIONAL AFFAIRS, at 977, 994–5 (Practising Law Institute 2001); John K. Carroll & Herbert S. Washer, *Globalization Comes to Law Enforcement*, N.Y.L.J., July 10, 2000. The SEC has entered into MOUs (or comparable agreements in treaty form) with Argentina, Australia, Brazil, Canada, Chile, China, Costa Rica, Egypt, the European Community, France, Germany, Hong Kong, Hungary, India, Indonesia, IADB/UNECLAC, Israel, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Russia, Singapore, South Africa, Spain, Sweden, Switzerland and the United Kingdom.

699 *See* SEC Index of Cooperative Arrangements with Foreign Regulators, http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml (last updated July 22, 2010).

700 *See* IOSCO List of Signatories to the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information.

U.S. Regulation of the International Securities and Derivatives Markets, § 11.11, SPECIAL LITIGATION ISSUES RELATING TO DERIVATIVES

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 11.11 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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This section briefly surveys certain issues that have arisen in suits concerning transactions in derivative instruments. For purposes of this section, "derivatives" or "derivative instruments" are instruments of the type described in U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 2. As discussed in U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 2, whether or not a particular derivative instrument is characterized by a court as, for example, a "security" or a "commodity future" or an "option contract," will determine the law to be applied to a dispute involving the derivative instrument, [701] and, perhaps, the court (*e.g.*, federal or state) where the litigation will proceed.

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When a party faces losses on a derivatives transaction, the result may be a lawsuit (usually against the counterparty—often a dealer) aimed at recovering the losses. In a situation where the party transacted on margin, a drop in value in the derivative may result in a margin call, which if unmet leads to the liquidation of the instrument or account. In such a situation, the dealer may bring suit to recover any deficiencies. Regardless of the posture of the litigation, issues that recur in these litigations, and that are surveyed in this section, include: first, enforceability; second, the relevance of a counterparty's sophistication and contractual disclaimers as defenses to a fraud, breach of duty or other tort claim; third, the scope of duties imposed by law on counterparties to derivatives transactions; fourth, the valuation of derivatives; and fifth, the treatment afforded derivatives in bankruptcy proceedings.

[1] Enforceability

[a] Local Law Considerations

In a cross-border dispute the parties may disagree over the threshold question of what law applies to the contract or conduct at issue. Differences in the laws of the relevant jurisdictions may have outcome-determinative effects. The ISDA Master Agreement allows the parties to set forth their choice of law in the Schedule to the Agreement, and as a general matter, sophisticated parties usually include choice of law provisions in agreements to which they are party. Such provisions, depending on their drafting, may not definitively resolve all of the choice of law questions that arise in a lawsuit. For example, in *Finance One Public Company Limited v. Lehman Brothers Special Financing, Inc.*, [702] the Schedule to the ISDA Master Agreement signed by the parties specified New York law as governing "[t]his agreement." The Second Circuit held, however, that this choice of law clause did not reach the extracontractual setoff rights at issue in the dispute. [703] The court applied New York's choice of law analysis and held that Thai law was applicable because Thailand had the most significant contacts with the dispute, as well as a strong governmental interest in ensuring the stability of its economy following the late-90s financial crisis in Southeast Asia. [704] Under Thai

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law, the defendant was entitled to the setoff rights it had exercised without any equitable reduction in the setoff amount. [705]

Even where the scope of the contractual choice of law clause is not disputed, a party may invoke the law of a relevant jurisdiction to argue that the derivative instrument is unenforceable under local law. In *Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, [706] Lehman entities entered into foreign exchange swaps and forwards with a Chinese conglomerate that produced over $50 million in losses. When Lehman sued the defendants on various contractual theories, the defendants asserted as an affirmative defense that the agreements at issue were not enforceable because they were entered into without the relevant license required by Chinese law. [707] Even though the governing ISDA Master Agreement chose New York law, the court found the place of performance of the contracts to have been China, and explained that a "contract that is illegal in its place of performance is unenforceable in New York if the parties entered into the contract with a view to violate the laws of that other jurisdiction." [708] The court ruled that it was an issue of fact for trial whether the parties entered into the agreement with a view to violate Chinese law, and so denied summary judgment. [709]

The enforceability of jury trial waivers, which are typically included in ISDA Master Agreements, may be affected by the choice of forum in which to litigate. The California Supreme Court held in *Grafton Partners, L.P. v. Superior Court* that jury trial waivers are unenforceable in that jurisdiction. [710] However, arbitration clauses were held to be enforceable because they had been specifically authorized by the legislature. [711] A pre-litigation contractual agreement to the appointment of a judicial referee is also specifically authorized in California. [712] Parties facing any possibility of litigation in California should consider including such clauses in their agreements, as many adverse judgments and unfavorable settlements of derivatives disputes have resulted from jury verdicts or the threat of adverse jury verdicts.

[b] Transactional Authority

A party to a litigation may argue that a derivative is unenforceable either because it was *ultra vires* or otherwise entered into by an individual or entity lacking the authority to engage in the transaction. [713] So long as the challenged party had actual, implied or apparent authority to engage in the transaction, a challenge to enforceability based on lack of authority generally should fail. [714] An important exception to this doctrine exists in the case of certain entities created by statute, such as municipalities. For these entities, apparent authority is an insufficient basis on which to enforce contractual obligations where the entity lacks actual authority. [715] A party's actual authority to engage in certain types of transactions is by and large a legal question governed by relevant law, regulation or the party's constituent instruments. For example, in derivatives litigation involving Orange County, counsel for Orange County argued that its treasurer

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had acted *ultra vires* when he entered into reverse repurchase agreements in connection with billions of dollars in collateralized mortgage obligations ("CMOs") and CMO derivatives. This position was based on a California constitutional provision limiting a county's ability to create excess indebtedness or liability. The argument was rejected, however, based on California precedent holding that the debt limit is measured at the outset of a transaction and not in the period following the transaction. [716] Since each of the investments had been potentially profitable at the outset, they were not *ultra vires* assumptions of excessive debt. [717]

On the other hand, arguments that a party possessed apparent authority to enter into a transaction will involve an examination of the facts and circumstances of the particular case to determine whether, for example, the third party relied on some act or statement of the principal, cloaking the agent with the authority to take the action now challenged. [718]

[c] Possibility of Reclassification of a Derivatives Transaction

Occasionally issues arise between parties over the proper characterization of derivatives transactions. [719] A party to a litigation may seek to avoid an obligation by arguing that a derivatives transaction, or the combined effect of several derivatives transactions, actually constitutes an alternative transaction type (*e.g.*, a loan). [720] In *Mahonia Ltd. v. JP Morgan Chase Bank*, [721] defendant WestLB AG ("WestLB") sought to avoid a claim on a letter of credit it issued to Mahonia Ltd. ("Mahonia"), a special purpose vehicle established to participate in a series of energy derivative transactions with JP Morgan Chase Bank ("Chase") and an Enron subsidiary ("ENAC"). The economic effect of these derivative transactions was that $350 million was paid by Chase to Mahonia and

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by Mahonia to ENAC in September 2001, and ENAC was obliged, approximately six months later, to pay approximately $356 million to Chase. [722] WestLB argued that the figure of $356 million was calculated specifically by reference to rates of interest that would accrue on a $350 million loan over the relevant period. As a result, WestLB argued, related derivatives transactions constituted a loan of $350 million with an effective annual interest rate of 3.44%. WestLB maintained that these transactions should thus have been accounted for as a loan and that the composite transaction and its nature as a loan should have been disclosed prior to WestLB's issuance of the letter of credit. [723] The court rejected WestLB's attempt to recharacterize the derivatives transactions as a loan, finding that "other individual characteristics" of the derivatives transactions, including the existence of price and performance risks, supported Enron's accounting of them as "price risk management activities." [724]

[2] The Requirement of Reasonable or Justified Reliance

Whether brought under federal or state law, a fraud claim requires the plaintiff to establish "reasonable" or "justified" reliance on the alleged misrepresentation or omission. Claims of reliance on misstatements or omissions that might be deemed reasonable for an ordinary investor may not be reasonable where the investor is sophisticated. In this context, institutional investors and individuals with high net worth or investment experience are considered "sophisticated" in light of their knowledge, experience and ability to conduct due diligence of the risks inherent in investment. [725]

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In *Société Nationale d'Exploitation Industrielle des Tabacs et Allumettes v. Salomon Brothers International Ltd.*, the court found unpersuasive plaintiff's contention that it had relied on defendants' materially incomplete disclosure, because plaintiff was itself a sophisticated institutional investor and the governing contract contained a disclaimer of representations of value. [726] Indeed a buyer's sophistication may result in a transaction being exempted from particular regulations altogether, such as exemptions from the CEA for certain transactions with individuals whose assets exceed $10 million. The NASD Conduct Rules currently note that certain securities broker due diligence requirements do not apply to customers with assets greater than $50 million. [727]

Not only are the parties who transact in derivatives generally "sophisticated," but relevant documentation, *e.g.*, the ISDA Master Agreement and confirmations, contains representations specifically attesting to the parties' sophistication and general non-reliance on statements (written or oral) outside the documents. The parties also represent that they are not relying on communications by their counterparty as investment advice or recommendations to transact. [728] A party entering into a properly drafted agreement is therefore limited in its ability to claim fraud based on alleged misstatements outside the documents, when those statements are inconsistent with express contractual provisions, because such reliance would be unreasonable as a matter of law. [729]

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Even without explicit disclaimers, courts typically reject claims that a party reasonably relied on statements in marketing materials, or other "sales talk," that is contradicted by the relevant prospectus or offering document. [730]

A contractual disclaimer, however, is generally enforceable only if it "tracks the substance of the alleged misrepresentation." [731] In other words, the disclaimer must cover the alleged misrepresentation or omission. In *Caiola v. Citibank, N.A.*, the court held that the disclaimers in the ISDA Agreement and the confirmations governing the specific trades at issue did not cover alleged assurances made to the plaintiff since the disclaimers stated only in general terms that neither party would rely "on any advice, statements or recommendations (whether written or oral) of the other party." [732] According to the court, the disclaimer did not preclude plaintiff from claiming that it was misled by Citibank's alleged assurance that the parties' existing relationship would remain unchanged and that Citibank would continue to act as a hedging counterparty following Citibank's merger with the Travelers Group. [733]

[3] Primary/Secondary Liability Theories

[a] Limitation on Duties

In typical derivatives transactions, executed on a principal basis by arm's-length counterparties or on an agency basis for a nondiscretionary account, there is no general fiduciary duty that exists between the parties. [734] A fiduciary duty

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arises only where the customer has delegated discretionary trading authority to the broker, or if it is otherwise provided for in the governing agreements. [735] In nondiscretionary trading accounts, where the customer retains full responsibility for trading decisions, the parties ordinarily agree and understand that the broker has narrowly defined duties that begin and end with each transaction. [736] Any special duty owed by the broker to the client in a nondiscretionary trading account can arise only if "special circumstances" transform the broker-client relationship. Such "special circumstances" include a client with impaired faculties, a closer than arm's-length relationship between the client and broker or a client who is so lacking in sophistication that *de facto* control is deemed to rest in the broker. [737] Superior knowledge on the part of the dealer, standing alone, will generally be insufficient to create the "special circumstances" necessary for the court to impose fiduciary obligations. As the court explained in *Procter & Gamble v. Bankers Trust*, [738] the fact that Bankers Trust had "superior knowledge in the swaps transactions" did not convert the parties' "business relationship to one in which fiduciary duties are imposed."

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In *De Kwiatkowski v. Bear, Stearns & Co.*, a wealthy investor sued his broker for, *inter alia*, negligence and breach of fiduciary duty relating to currency futures trading. [739] A jury awarded De Kwiatkowski $111.5 million in damages. In reversing the verdict, the Second Circuit ruled that no "special circumstances" existed warranting holding the broker liable as a fiduciary or in negligence even though the broker performed substantial advisory functions with respect to the size, placement and timing of complex transactions that made and lost hundreds of millions of dollars within a span of a few months. [740] The Second Circuit noted that while the circumstances of the broker-client relationship were unusual, there was nothing in the relationship to render the client investor dependent on the broker. Instead, the investor's sophistication (his wealth, expertise and huge appetite for risk) precluded him from arguing that he was dependent on his broker's advice. [741] *De Kwiatkowski* has been followed by other courts in dismissing, on a motion directed to the pleadings, a fiduciary duty claim against a broker where the client employed "sophisticated traders of its own who made the decisions regarding the nature and timing of trades." [742] A party may nevertheless plead "special circumstances," or raise an issue of fact concerning the existence of such circumstances, sufficient to survive a pleadings motion or a motion for summary judgment. [743]

[b] Aiding and Abetting Liability

Where a dealer has not had direct contact with a party seeking to bring suit on a derivatives transaction, a theory of secondary liability may be the basis for a claim. [744] Under New York law, the elements of an aiding and abetting fraud claim are: (i) existence of a fraud, (ii) defendant's knowledge of the fraud and

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(iii) that defendant provided substantial assistance to advance the fraud's commission. [745] The elements of an aiding and abetting breach of fiduciary duty claim are: (i) breach by a fiduciary of obligations to another, [746] (ii) that defendant knowingly induced or participated in the breach and (iii) damages. [747]

[i] *Knowledge*

To satisfy the knowledge requirement, New York law requires that an aider/abettor have "actual knowledge" of the underlying fraud or breach of fiduciary duty. [748] Plaintiffs cannot meet the knowledge requirement by arguing for application of the lesser standard of recklessness. [749] However, in order to state a claim the defendant's knowledge and intent need only be "averred generally," and a plaintiff can satisfy the *scienter* pleading requirement when "circumstances indicating conscious behavior by the defendant" or a clear opportunity and a motive to aid the wrong is identified. [750] Pursuit of ordinary economic goals is not enough to support a claim of a motive for aiding and abetting. [751]

While a stricter *scienter* standard may apply to an aider or abettor rather than to a primary perpetrator since the "‘*scienter* requirement scales upward when activity is more remote,’" the *scienter* requirement need not be more exacting where there are allegations that the primary and secondary actors worked closely together. [752] In the context of derivatives transactions—where dealers can play various roles in structuring, selling, valuing and lending with respect to any particular instrument—courts may be tempted to conclude that the dealer was not a distant actor in connection with the challenged transactions. [753] The court may therefore conclude that a plaintiff need not satisfy any heightened pleading requirement to plead *scienter* on the part of an alleged aider and abettor.

[ii] *Substantial Assistance and Participation*

Under New York law, the meanings of "substantial assistance" and "participation" are synonymous, [754] and exist where a defendant "‘affirmatively assists, helps conceal, or by virtue of failing to act when required to do so enables the fraud to proceed.’" [755] Inaction is "actionable participation only when the defendant owes a fiduciary duty directly to the plaintiff." [756] Substantial assistance can take many forms, but the closer the activities are to ordinary course trading, the less likely that a determination will be made that substantial assistance was provided. [757] Courts will consider in totality an alleged aider and abettor's conduct in deciding whether it "substantially assisted" the primary wrongdoers. [758]

There is no bright line rule for what is or is not substantial assistance, and so the practitioner must review available precedent for the most comparable fact patterns. "Substantial assistance" has been found in cases where a bank "insisted" that the wrongdoer continue the fraud; [759] where brokers allegedly provided false "performance marks" to a CMO fund manager for dissemination to investors; [760] and where brokers participated in the creation of a document that contained false statements, while others substantially assisted the fraud by reviewing and approving the document, devising the marketing and financial scheme for the fraud, and engaging in "atypical" financing transactions. [761] "Substantial assistance" has not been found where a clearing broker merely clears trades, even if the trades are for a primary broker who is acting in violation of the law; [762] for a failure to enforce margin requirements or for continuing to

execute trades despite margin violations; [763] and for executing trades in order to reduce "a loan of money under margin." [764]

[4] Valuation Issues

Litigation may also result following the termination of a trading relationship and the liquidation or settlement of open positions. The liquidating party may commence litigation to recover any shortfalls resulting from the liquidation; the liquidated party may challenge the propriety of the liquidation and claim damages.

The propriety of the liquidation will be analyzed according to the terms of the governing documentation. [765] The court will analyze whether the liquidating party adhered to any procedures required by the relevant contracts. [766] The valuation methodology set forth in the ISDA Master Agreement has evolved over successive versions of the Agreement, with the 2002 ISDA Master Agreement providing for a single measure of damages standard, "Close-out Amount." This standard replaces the "Market Quotation" and "Loss" methodologies contained in the 1992 ISDA Master Agreement, which were subject to criticism and arguably misapplied by courts. [767]

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Given that the law of all states implies in every contract a covenant of good faith and fair dealing, the court may also enquire whether the liquidating party acted in good faith in conducting the liquidation, including in exercising any discretion granted it under the relevant contract. [768] The 2002 ISDA Master Agreement specifically provides that the party determining the "Close-out Amount" for a terminated transaction "will act in good faith and use commercially reasonable procedures in order to produce a commercially reasonable result." The Agreement allows flexibility to the party making the valuation determination, listing nonexclusive sources of "relevant information" (*e.g.*, quotations and market data) and types of "commercially reasonable procedures" that may be utilized. [769]

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If a party is held to have breached the relevant agreement, damages must be determined. As in any other breach of contract situation, the damages are "determined by the loss sustained or the gains prevented at the time and place of breach." [770] As a practical matter, this standard means that the litigation of damages would involve a "battle of experts" concerning the value that should have been obtained in a proper liquidation of the derivative instrument in question. [771]

[5] Bankruptcy Issues

Upon the filing of a petition for relief under the Bankruptcy Code (the "Code"), the Code automatically stays proceedings against the debtor and prevents parties, without permission of the bankruptcy court, from acquiring or obtaining assets of the debtor. [772] The Code provides exceptions to the automatic stay for certain actions in connection with protected contracts. Thus, the Code does not stay:

- the exercise by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency of any contractual right … under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract,

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  forward contract or securities contract, or of any contractual right … to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such contracts, including any master agreement for such contracts; or [773]

- the exercise by a repo participant or financial participant of any contractual right … under any security agreement or arrangement or other credit enhancement forming a part of or related to any repurchase agreement, or of any contractual right … to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements. [774]

In addition, the Code excludes certain categories of contracts (*e.g.*, securities contracts, forward contracts, commodities contracts, repurchase agreements, swap agreements and certain margin and settlement payments) from the reach of a trustee's avoidance powers and so allows for transfers under such contracts without concern that the transfer can be set aside as a fraudulent transfer or preference. For transfers made prior to the bankruptcy petition, and except for fraudulent transfers as defined in Code § 548(a)(1) (transfers made within two years of the petition date with actual intent by the broker to hinder or defraud), [775] a trustee may not avoid: (i) margin or settlement payments made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant or securities clearing agency, [776] (ii) margin or settlement payments made by or to a repo participant or financial participant in

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connection with a repurchase agreement, [777] (iii) transfers by or to a swap participant or financial participant, under or in connection with any swap agreement, [778] or (iv) transfers made by or to a master netting agreement participant under or in connection with any master netting agreement or any individual contract covered by the master netting agreement. [779] Additionally, the Code

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generally protects contractual rights of liquidation in securities contracts, commodities contracts, forward contracts, repurchase agreements and swap agreements. [780]

The Code limits the reach of the bankruptcy trustee's avoidance powers as applying only against "the initial transferee" of the transfer sought to be avoided, "the entity for whose benefit such transfer was made," or "any immediate or mediate transferee of such initial transferee." [781] The Code does not define "initial transferee." The Seventh Circuit in *Bonded Financial Services Inc. v. European American Bank* held that a bank that received a check for the benefit of a customer's checking account was simply an intermediary and not an initial transferee because it had no "dominion over" the property at issue. [782] Recently, the Seventh Circuit characterized its approach to the initial transferee questions as "track[ing] the function of the bankruptcy trustee's avoiding powers: to recoup money from the real recipient of preferential transfers" and held that the trustee of a securitization vehicle did qualify as an initial transferee because a charge against the trustee would "draw from the corpus of the trust, not from [the trustee's] corporate assets." [783]

A party should be aware of a counterparty's status under the Bankruptcy Code; if a counterparty qualifies as a "stockbroker," it cannot be a debtor eligible for reorganization under Chapter 11 [784] and is instead subject to liquidation under the Securities Investor Protection Act ("SIPA") and Chapter 7 of the

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Code. [785] A stockbroker's "customers" have an important priority over other creditors under the Code, including most derivatives creditors. [786] In *In re Refco, Inc.*, the bankruptcy court found an off-shore unregulated financial intermediary, RCM, to be a stockbroker. [787] The court found that the Code's definition of broker-dealer, which includes the language "engaged in the business of effecting transactions in securities with the general public," [788] did not exclude a broker-dealer who traded with sophisticated parties. [789] Many of the derivatives creditors who had contracted with RCM had failed to appreciate that they were doing business with a stockbroker.

A decision in 2010 also cast doubt on the enforceability of provisions in swap agreements (or documents referenced in swap agreements) that purport to modify the priority of payments made from a derivative structure following an event of default caused by a bankruptcy filing by a counterparty (or an entity related to a counterparty). In *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd. (In re Lehman Brothers Holdings Inc.) ("Dante")*, [790] the court found that the *ipso facto* provisions of the Code [791] invalidated contractual clauses that subordinated the counterparty's priority payment as a result of the counterparty's or its parent entity's filing for bankruptcy. However, the *Dante* court itself recognized that its decision was "unprecedented" and potentially "controversial," and subsequent decisions have questioned its reasoning. [792]

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A more recent decision arising out of the Lehman Brothers bankruptcy held that, while the enforcement of payment priority provisions in swap agreements may violate the *ipso facto* provisions of the Code, such distributions are nonetheless protected by a safe harbor in § 560 of the Code, [793] provided that the contractual provisions are either explicitly part of a swap agreement or incorporated into a swap agreement. [794] The court explained that, under recent Second Circuit precedent, a "broad and literal interpretation" must be given to the Code's safe harbors, and § 560 protects the right to "liquidation," which includes enforcement of provisions that modify the priority of payments and distributions of proceeds following that modification. [795] In a related decision, the court held that the right to "liquidation" protected by the safe harbor in § 560 also extended to protect the methodology specified in a swap agreement for carrying out that liquidation (*i.e.*, the method for determining the amount due and payable to the parties). [796]

Footnotes

701 U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, §§ 2.02–2.07.

702 *Finance One Public Company Limited v. Lehman Brothers Special Financing, Inc.*, 414 F.3d 325, 332 (2d Cir. 2005).

703 *Finance One Public Company Limited v. Lehman Brothers Special Financing, Inc.*, 414 F.3d 325, 335 (2d Cir. 2005). The court did note that if the Master Agreement and Schedule had created the setoff right, the choice-of-law clause would reach the dispute and New York law would be applicable. *Finance One Public Company Limited v. Lehman Brothers Special Financing, Inc.*, 414 F.3d 325, 336 (2d Cir. 2005).

704 *See Finance One Public Company Limited v. Lehman Brothers Special Financing, Inc.*, 414 F.3d 325, 336–39 (2d Cir. 2005).

705 *See Finance One Public Company Limited v. Lehman Brothers Special Financing, Inc.*, 414 F.3d 325, 344–45 (2d Cir. 2005).

706 *See Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118 (S.D.N.Y. 2000).

707 *See Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118, 139 (S.D.N.Y. 2000). The defendants also argued that because the transactions were illegal under Chinese law, they were invalid under Article 8 of the International Monetary Fund's Articles of Agreement, which states: "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member." *See* Articles of Agreement of the International Monetary Fund, Dec. 27, 1945, 60 Stat. 1401, 2 U.N.T.S. 39, art. VIII, sec. 2(b). The court did not reach this argument, however, because China did not become subject to Article 8 until after the transactions at issue in the litigation. *See Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118, 143 (S.D.N.Y. 2000).

708 *See Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118, 138 (S.D.N.Y. 2000).

709 *See Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118, 143 (S.D.N.Y. 2000). The matter ultimately settled after 39 days of trial. At the time of settlement (June 12, 2002), the case was the oldest ongoing U.S. derivatives litigation, having commenced in 1994.

710 *See Grafton Partners, L.P. v. Superior Court*, 116 P.3d 479 (Cal. 2005). Pre-litigation jury trial waivers are also unenforceable in Georgia and North Carolina. *See Bank South, N.A. v. Howard*, 444 S.E.2d 799 (Ga. 1994); N.C. GEN. STAT. § 22B-10 (2006).

711 *Grafton Partners, L.P. v. Superior Court*, 116 P.3d 479 (Cal. 2005).

712 *Grafton Partners, L.P. v. Superior Court*, 116 P.3d 479 (Cal. 2005).

713 The English case *Hazell v. Hammersmith and Fulham LBC*, [1992] 2 A.C. 1, brought significant attention to the power of the *ultra vires* defense. There, the House of Lords (the highest court in England) held that a

London borough council acted outside the scope of its borrowing authority, as authorized under the Local Government Act of 1972, when it entered into various swap transactions; the House of Lords consequently voided the contracts.

714 *See Three Valleys Municipal Water District v. E.F. Hutton & Co. Inc.*, 116 F.3d 486 (9th Cir. 1997) (finding that the municipalities had delegated their investment authority to the person signing the contracts and holding that "a delegation of authority to bind a municipality to arbitration need not be express, but rather can be implied from a grant of authority to contract"); *Community College District No. 508 v. Westcap Government Securities*, No. 94 C 1920, 1994 WL 530849 (N.D. Ill. Sept. 29, 1994) (where community college district board had given its treasurer the authority to invest on its behalf, the executed investment agreements and their arbitration provisions were valid and enforceable).

715 *See* RESTATEMENT (THIRD) OF AGENCY § 2.03 cmt. g (2006).

716 *See In re County of Orange v. Fuji Securities, Inc.*, 31 F. Supp. 2d 768, 776–79 (C.D. Cal. 1998).

717 *See In re County of Orange v. Fuji Securities, Inc.*, 31 F. Supp. 2d 768, 785 (C.D. Cal. 1998). The court in *Orange County* implied that *quantum meruit* might exist as a basis for relief on the part of the County in light of the fact that the County's acts were not *ultra vires*.

718 *See Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118, 148 (S.D.N.Y. 2000) (alleged agent lacked actual and inherent authority because his acts were unauthorized and illegal, but a question of fact remained as to whether apparent authority could be established).

719 *See generally* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 2.

720 In addition to private litigation, there have been governmental actions surrounding the proper characterization of derivatives transactions. In a July 2003 civil action against J.P. Morgan Chase & Co. in the Southern District of Texas, for example, the SEC based its fraud argument on the theory that "[t]he structural complexity of [the derivatives] transactions had no business purpose aside from masking the fact that, in substance, they were loans." *SEC v. J.P. Morgan Chase & Co.*, SEC Litigation Release No. 18252 (July 28, 2003).

721 *Mahonia Ltd. v. JP Morgan Chase Bank*, [2004] EWHC 1938 (Comm).

722 *Mahonia Ltd. v. JP Morgan Chase Bank*, [2004] EWHC 1938 (Comm).

723 *Mahonia Ltd. v. JP Morgan Chase Bank*, [2004] EWHC 1938 (Comm). WestLB argued that Mahonia and Chase were party to a conspiracy with Enron to devise a scheme to enable Enron to illegally account for the "loan." Such accounting, WestLB argued, breached U.S. securities law and hence WestLB was entitled not to pay the demand on the letter of credit it issued. WestLB also argued that it was fraudulently induced to rely on the apparent financial strength of Enron and the apparent legality of the purpose behind the derivative transactions when issuing the letter of credit.

724 *See Mahonia Ltd. v. JP Morgan Chase Bank*, [2004] EWHC 1938 (Comm). Justice Cooke rejected WestLB's invitation to "collapse" into a single lending transaction what were in his view separate swap transactions between, respectively, Chase and Mahonia, Mahonia and ENAC, and ENAC and Chase. The court found the transactions to be "independent" of each other, noting the lack of "offsetting, netting or cross-default provisions between them." Justice Cooke noted that had he found the accounting to be illegal, he "would have accepted [WestLB's] contention that the [letter of credit] was directly tied to the illegal purpose since it was an important part of the scheme which was to give rise to the unlawful accounting."

725 *See Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 497 (S.D.N.Y. 2001). The *Primavera* court rejected the argument that institutional investors who lacked specific experience with CMOs were "unsophisticated" for purposes of a claim that they were defrauded in connection with investments in a CMO hedge fund.

726 *See Société Nationale d'Exploitation Industrielle des Tabacs et Allumettes v. Salomon Brothers International Ltd.*, 268 A.D.2d 373, 374 (App. Div. 2000); *see also Lazard Fréres & Co. v. Protective Life*

Insurance Co., 108 F.3d 1531, 1543 (2d Cir. 1997) ("As a substantial and sophisticated player in the bank debt market, [defendant] was under a further duty to protect itself from misrepresentation.").

727 *See De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1309 n.14 (2d Cir. 2002) (citing 7 U.S.C. §§ 1a(12), 2; NASD Conduct Rules, Rule 2310, NASD MANUAL). The NASD rule will be withdrawn upon the effectiveness of a successor FINRA rule, which provides that the exemption will not apply unless the broker-dealer has reason to believe that "the institutional customer is capable of evaluating investment risks independently." FINRA Rules, Rule 2111, FINRA MANUAL (effective July 9, 2012).

728 Language regarding investor nonreliance, investor sophistication and the nonfiduciary and nonadvisory role of the counterparty is commonly found in either the ISDA Master Agreement or accompanying Schedules. Such language usually varies little from the language provided in Part 4(m)(i) of the model ISDA Schedule to the 2002 Master Agreement. Parties can include additional representations in separately negotiated confirmations.

729 *See St. Matthew's Baptist Church v. Wachovia Bank National Association*, No. Civ. A. 04-4540 (FLW), 2005 WL 1199045, at *5–7 (D.N.J. May 18, 2005) (dismissing claims of fraudulent and negligent misrepresentation in connection with interest rate swap unwind fee given contractual language regarding requirement to pay such fee); *Republic National Bank v. Hales*, 75 F. Supp. 2d 300, 315 (S.D.N.Y. 1999), *aff'd sub nom*. *HSBC Bank USA v. Hales*, 4 F. App'x 15 (2d Cir. 2001) ("[R]easonable reliance is precluded when an express provision in a written contract contradicts a prior alleged oral representation in a meaningful fashion."); *see also Independent Order of Foresters v. Donaldson, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 940 (2d Cir. 1998) (finding no reasonable reliance in light of "warnings in the Offering Circulars and Prospectuses regarding the risks associated with the investments and the provisions in those documents disavowing any outside representations").

730 *See, e.g.*, *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1032 (2d Cir. 1993) ("An investor may not justifiably rely on a misrepresentation if, through minimal diligence, the investor should have discovered the truth.").

731 *Caiola v. Citibank, N.A.*, 295 F.3d 312, 330 (2d Cir. 2002); *Grumman Allied Industries, Inc., v. Rohr Industries, Inc.*, 748 F.2d 729, 735 (2d Cir. 1984).

732 *Caiola v. Citibank, N.A.*, 295 F.3d 312, 330 (2d Cir. 2002). The *Caiola* court relied on the rule cited in *Manufacturers Hanover Trust Co. v. Yanakas*, 7 F.3d 310, 316 (2d Cir. 1993), that a valid disclaimer provision "must contain explicit disclaimers of the particular representations that form the basis" of the fraud claim. *See also Hunt v. Alliance North American Government Income Trust, Inc.*, 159 F.3d 723, 728–29 (2d Cir. 1998) (a general disclaimer that a fund's hedging strategy might fail was insufficient to defeat a fraud claim based on an allegation that the fund had, in fact, no opportunity to hedge at all).

733 *Caiola v. Citibank, N.A.*, 295 F.3d 312, 319 (2d Cir. 2002).

734 Even where there is no fiduciary duty, applicable securities law requires that information disclosed not contain any material misstatement or omission. Parties to a contract also are bound by a duty to deal fairly and in good faith. *See Procter & Gamble v. Bankers Trust*, 925 F. Supp. 1270, 1289–91 (S.D. Ohio 1996) (even though no fiduciary duty existed between the parties, the defendant had a "duty to disclose material information to plaintiff before the parties entered into the swap transactions and in their performance, and also a duty to deal fairly and in good faith"). In *In re BT Securities Corp.*, SEC Release No. 33-7124 (Dec. 22, 1994), the SEC found that Bankers Trust violated § 17(a) of the Securities Act and §§ 10(b) and 13(a) of the Exchange Act, and Rules 10b-5, 13a-1 and 12b-20 thereunder, because BT Securities misrepresented the value of derivatives sold to the company, Gibson Greetings. The SEC found that Gibson lacked the expertise to value derivatives accurately and relied on the numbers provided by BT Securities to decide whether to purchase more derivatives and to prepare financial statements.

735 *See Independent Order of Foresters v. Donaldson, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 940–41 (2d Cir. 1998); *see also St. Matthew's Baptist Church v. Wachovia Bank National Association*, No. Civ. A. 04-4540 (FLW), 2005 WL 1199045, at *10 (D.N.J. May 18, 2005) (finding no fiduciary duty as a matter of law, relying, *inter alia*, on language in Schedule and swap documentation disclaiming the existence of a fiduciary

relationship); *Power & Telephone Supply Company, Inc. v. Suntrust Banks, Inc.*, No. 03-2217 MI/V, 2005 WL 1329538, at *5 (W.D. Tenn. May 10, 2005) (in dispute involving an interest rate swap, dismissing on summary judgment a fiduciary duty claim by a bank borrower since Tennessee law does not impose fiduciary duties on the bank-customer relationship and the borrower failed to produce "any evidence that Defendants entered into a written agreement with Plaintiff to act as a fiduciary"). While the plaintiff in *Power & Telephone Supply Company, Inc. v. Suntrust Banks, Inc.*, abandoned its breach of fiduciary duty claim on appeal, it challenged the dismissal of its negligence claim on the grounds that "it [had] asserted a claim for 'professional negligence' for which a duty to exercise reasonable care arises as a matter of law." *Power & Telephone Supply Company, Inc. v. Suntrust Banks, Inc.*, 447 F.3 923, 932 (6th Cir. 2006). The Sixth Circuit rejected this argument on the grounds that the plaintiff "ha[d] not demonstrated that defendants owed it a legal duty to advise it on the appropriateness of the swap transactions distinct from the agency and breach of fiduciary duty claims." *Power & Telephone Supply Company, Inc. v. Suntrust Banks, Inc.*, 447 F.3 923, 933 (6th Cir. 2006).

736 *See De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002). These duties include, for example, diligence and competence in executing the client's trade orders.

737 *See De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1306 (2d Cir. 2002).

738 *Procter & Gamble v. Bankers Trust*, 925 F. Supp. 1270, 1289 (S.D. Ohio 1996).

739 *See De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1295–96 (2d Cir. 2002).

740 *See De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1307–09 (2d Cir. 2002).

741 *See De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1309 (2d Cir. 2002).

742 *See, e.g.*, *Salomon Brothers International Ltd. v. Eagle Cayman International, L.P.*, No. 601872/01 (N.Y. Sup. Ct. Mar. 13, 2003).

743 *See Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118, 150–52 (S.D.N.Y. 2000) (finding questions of fact as to the "true nature" of the parties' "very strong relationship" were sufficient to deny defendant's motion for summary judgment).

744 Plaintiffs who wish to bring claims of aiding and abetting fraud must now rely on state law theories of liability, in light of *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), which found no private right of action to exist for aiding and abetting a violation of § 10(b) of the Exchange Act, and *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), which significantly limited the circumstances under which a secondary actor could be found liable for a violation of § 10(b) in a private cause of action. *See also* § 11.04[2][b][ii] for discussion of the different tests for determining when a secondary actor may be found to be primarily liable.

745 *See Wight v. BankAmerica Corp.*, 219 F.3d 79, 91 (2d Cir. 2000); *Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 470 (S.D.N.Y. 2001).

746 The New York Court of Appeals has held that the fiduciary duties owed by a limited partnership's attorney to that entity do not extend to the limited partners. *Eurycleia Partners L.P. v. Seward & Kissel, LLP*, 12 N.Y.3d 553, 561–62 (2009).

747 *See In re Sharp International Corp.*, 403 F.3d 43, 49–50 (2d Cir. 2005); *Kolbeck v. LIT America, Inc.*, 939 F. Supp. 240, 245 (S.D.N.Y. 1996), *aff'd*, 152 F.3d 918 (2d Cir. 1998).

748 *See Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 494 (S.D.N.Y. 2001).

749 *See Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 495 n.28 (S.D.N.Y. 2001).

750 *See Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 494–95 (S.D.N.Y. 2001).

751 *See Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 494–95 (S.D.N.Y. 2001).

752 *Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 508 (S.D.N.Y. 2001) (quoting *ABF Capital Management v. Askin Capital Management, L.P.*, 957 F. Supp. 1308, 1331 n.5 (S.D.N.Y. 1997)) (reciting allegations that brokers aided and abetted the purported fraud by hedge fund manager).

753 *See Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 508 (S.D.N.Y. 2001).

754 *Kolbeck v. LIT America, Inc.*, 939 F. Supp. 240, 247 (S.D.N.Y. 1996) (defining "participation" as "substantial assistance").

755 *Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 470 (S.D.N.Y. 2001) (quoting *Nigerian National Petroleum Corp. v. Citibank, N.A.*, No. 98-CV-4960 (MBM), 1999 WL 558141, at *8 (S.D.N.Y. July 30, 1999)).

756 *Kolbeck v. LIT America, Inc.*, 939 F. Supp. 240, 247 (S.D.N.Y. 1996).

757 *See Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 511 (S.D.N.Y. 2001) ("Executing transactions, even ordinary course transactions, can constitute substantial assistance under some circumstances, such as where there is an extraordinary motivation to aid in the fraud.").

758 *Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 511 (S.D.N.Y. 2001) ("Where there is evidence of various types of activities by an alleged aider and abetter going to [the substantial assistance] issue, the evidence should be considered together.").

759 *Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 471 (S.D.N.Y. 2001) (citing *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 803 (3d Cir. 1978)).

760 *ABF Capital Management v. Askin Capital Management, L.P.*, 957 F. Supp. 1308, 1329–30 (S.D.N.Y. 1997).

761 *In re Gas Reclamation, Inc. Securities Litigation*, 659 F. Supp. 493, 504 (S.D.N.Y. 1987).

762 *Greenberg v. Bear, Stearns & Co.*, 220 F.3d 22, 29 (2d Cir. 2000), *cert. denied*, 531 U.S. 1075 (2001).

763 *See Dillon v. Militano*, 731 F. Supp. 634, 637, 639 (S.D.N.Y. 1990); *Stander v. Financial Clearing & Services Corp.*, 730 F. Supp. 1282, 1286–87 (S.D.N.Y. 1990).

764 *Ross v. Bolton*, 639 F. Supp. 323, 327 (S.D.N.Y. 1986).

765 *See Drexel Burnham Lambert Products Corp. v. MCorp*, Civ. A. No. 88C-NO-80 (SCDP), 1989 WL 16981 (Del. Super. Ct. Feb. 23, 1989) (upholding on summary judgment Drexel's calculation of "Agreement Value damages" where contract made such calculation "conclusive in the absence of manifest error" and counterparty proffered no evidence of any error); *see also The First National Bank of Chicago v. Ackerley Communications, Inc.*, No. 94 Civ. 7539 (KTD), 2001 WL 15693 (S.D.N.Y. Jan. 8, 2001), *aff'd*, 28 F. App'x 61 (2d Cir. 2002) (applying the plain terms of the agreement in determining whether the plaintiff had properly exercised its option to extend the swap agreement).

766 In *Granite Partners, L.P. v. Bear, Stearns & Co., Inc.*, 17 F. Supp. 2d 275, 300–02 (S.D.N.Y. 1998), the court declined to apply Article 9's "commercial reasonableness" standard to a liquidation of instruments subject to repurchase agreements, holding that such agreements qualify as "purchase and sales" and not "secured loans" subject to UCC Article 9. If the agreements governing repurchase transactions are ambiguous as to whether the transactions are loans or purchases and sales, courts will look to extrinsic evidence. *See Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 543 (S.D.N.Y. 2001).

767 Given the frequency with which disputes involving derivatives settle prior to litigation, there is little case law applying the Market Quotation and Loss methodologies. Two such cases— *Peregrine Fixed Income Ltd (In Liquidation) v. Robinson Department Store Plc*, [2000] Lloyd's Rep. Bank. 304 (QBD (Comm Ct)), and *Enron Australia Finance Pty Ltd v. Integral Energy Australia*, [2002] NSWSC 753—were roundly criticized for failing to reflect market practice or the parties' intent as evidenced by the relevant agreements. In *Peregrine*, the court rejected as "commercially unreasonable" the Market Quotation calculation of the nondefaulting party, and instead required the parties' settlement amount to be calculated under the ISDA Loss methodology. The court reached this conclusion despite the fact that the nondefaulting party—which the court recognized as the best party to determine commercial reasonableness—had not judged the result under the Market Quotation methodology as commercially unreasonable. Many believe that *Peregrine* should be limited to its unique facts: Peregrine had performed its side of the bargain and had it not appointed provisional liquidators and triggered a default, the other party, in financial distress itself, would likely have defaulted and hence Peregrine would have been in the position of determining whether the result produced by the Market Quotation method was reasonable. In *Enron Australia Finance*, the court

noted that although it is commonly understood in the derivatives market that the defaulting party bears the cost of the bid/offer spread, the electricity market in Australia was so illiquid that the bid/offer spread was artificially wide and, accordingly, the Market Quotation, measure of damages produced a commercially unreasonable result. The court then imposed a measure of damages not contemplated by either party. *See also Peregrine Fixed Income Limited v. JP Morgan Chase Bank*, No. 05 Civ. 4351 (RMB) (THK), 2006 U.S. Dist. LEXIS 8766, at *4–8 (S.D.N.Y. Jan. 26, 2006) (denying defendant's motion to dismiss on the grounds that the ISDA Master Agreement was ambiguous as to the date when market quotations should be obtained); *High Risk Opportunities HUB Fund (In Liquidation) v. Credit Lyonnais*, M-2375, M-2463, 2006 N.Y. App. Div. LEXIS 7788 (June 6, 2005) (unpublished opinion) (good faith clause of the ISDA Master Agreement was violated when the defendant "interfered with the Market-makers' independence in valuing the [non-deliverable forward contracts] as of the termination date").

768 *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); *see also Granite Partners, L.P. v. Bear, Stearns & Co., Inc.*, 17 F. Supp. 2d 275, 305 (S.D.N.Y. 1998) (citing *Dalton v. Educational Testing Service*, 87 N.Y.2d 384, 389, 663 N.E.2d 289, 292, 639 N.Y.S.2d 977, 979 (1995)). A party, however, may not use the implied covenant to create additional, unbargained-for rights otherwise not present in the contract. *See JPMorgan Chase Bank, N.A. v. IDW Group, LLC*, No. 08-Civ-9116 (PGG), 2009 WL 321222, at *4 (S.D.N.Y. Feb. 9, 2009) ("An implied covenant of good faith and fair dealing, however, arises out of the known reasonable expectations of the other party which arise out of the agreement entered into. The covenant does not create duties which are not fairly inferable from the express terms of that contract." (citation omitted)); *Granite Partners, L.P. v. Bear, Stearns & Co., Inc.*, 17 F. Supp. 2d 275, 306 (S.D.N.Y. 1998).

769 The flexible approach to valuation reflected in the 2002 ISDA Master Agreement replaced the 1992 ISDA Master Agreement's "Market Quotation" definition, which required a terminating party to obtain five dealers' price quotes for closed-out transactions. The definition of Market Quotation was deemed unworkable during times of market dislocation or liquidity shocks, when market participants, struggling to maintain their own positions, are limited in their ability to value trades for others. *See* Counterparty Risk Management Policy Group, *Improving Counterparty Risk Management Practices* 42–43 (June 1999) (criticizing the definition of Market Quotation).

770 *Lucente v. IBM Corp.*, 310 F.3d 243, 262–63 (2d Cir. 2002). The court in *Lucente* specifically rejected the use in contract cases of the "highest intermediate value rule" (where damages are determined by identifying the highest intermediate value of a security between the commission of the alleged wrongful act and some reasonable time thereafter). *See also The First National Bank of Chicago v. Ackerley Communications, Inc.*, No. 94 Civ. 7539 (KTD), 2001 WL 15693 (S.D.N.Y. Jan. 8, 2001), *aff'd*, 28 F. App'x 61 (2d Cir. 2002) (dismissing plaintiff's damages claim because no evidence was proffered to establish lost profit or to demonstrate any attempt to mitigate damages).

771 *See Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 522–30 (S.D.N.Y. 2001) (reviewing admissibility of proposed expert testimony concerning CMO values and valuation procedures).

772 *See* 11 U.S.C. § 362. In 2005, the President signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), Pub. L. No. 109-8, 119 Stat. 23. Title IX of the Act clarifies the treatment of certain financial contracts upon the insolvency of a counterparty and in so doing makes amendments to the Bankruptcy Code, the Securities Investor Protection Act, the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation Improvement Act of 1991, and the Federal Credit Union Act. Most significant among these amendments is the expansion of the Code's definitions of "forward contract," "repurchase agreement," "swap agreement," "commodity contract" and "securities contract" to account for relevant market developments and the introduction of the phrase "or any other similar agreement" to allow for greater flexibility in the Act's application. Additionally, the counterparties that are eligible for financial contract protection are expanded to include "financial participants"—defined as entities engaged in a certain minimum gross dollar value of enumerated transactions. The Code also now provides for bilateral "cross-product" netting across financial contracts and clarifies the measurement of damages in the event of a debtor's rejection of a financial contract.

773 11 U.S.C. § 362(b)(6).

774 11 U.S.C. § 362(b)(7).

775 A trustee cannot avoid transfers where the transferees took "for value and in good faith." 11 U.S.C. § 548(c). "To establish a lack of 'good faith,' on the part of securities customers under § 548(c)… the trustee must show that the customer either actually knew of the broker's fraud or 'willfully blinded' himself to it." *Picard v. Avellino*, 469 B.R. 408, 412 (S.D.N.Y. 2012). "Willful blindness" is a "subjective standard"—the investor must "intentionally choose[] to blind himself to the 'red flags' that suggest a high probability of fraud." *Picard v. Katz*, 462 B.R. 447, 455 (S.D.N.Y. 2011), *abrogated on other grounds in Secs. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Secs. LLC*, 513 B.R. 437 (S.D.N.Y. 2014).

776 *See* 11 U.S.C. § 546(e). In *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329 (2d Cir. 2011), the Second Circuit recently held that § 546(e) prevented a bankruptcy trustee from avoiding payments made to retire the debtor's unsecured commercial paper prior to maturity. The court reasoned that the definition of "settlement payments" under § 741(8) of the Bankruptcy Code is broad, and that the phrase "commonly used in the securities industry" in that definition was meant to act as a catchall and not to impose any requirement that a transaction be a common occurrence. The court also noted that there was nothing in § 741(8) or anywhere else in the Bankruptcy Code to support imposing a requirement that a payment result in the acquisition of title to a security, as opposed to merely retiring debt, to be properly considered a "settlement payment." Extending this reasoning further, the Second Circuit held that "settlement payments" made by a broker pursuant to a contract to buy or sell securities cannot be avoided under § 546(e) even if the broker did not actually trade securities or the contract did not specify information about the securities to be traded. *See In re Bernard L. Madoff Inv. Secs. LLC*, 773 F.3d 411 (2d Cir. 2014). *See also In re QSI Holdings, Inc.*, 571 F.3d 545 (6th Cir. 2009) (§ 546(e) prevented bankruptcy trustee from avoiding payments made to corporate debtor's shareholders in connection with leveraged buyout of privately held securities); *In re Olympic Natural Gas Co.*, 294 F.3d 734 (5th Cir. 2002) (§ 546(e) prevented bankruptcy trustee from avoiding settlement payments by debtor to forward contract merchant); *Nagel v. ADM Investor Services, Inc.*, 217 F.3d 436, 441 (7th Cir. 2000) (contract is forward if eventual delivery of commodity is reasonably assured). But see *In re Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996) (§ 546(e) inapplicable when payments not "made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency" (quoting 11 U.S.C. § 546(e)); *Grafton Partners, L.P. v. Circle Trust F.B.O.*, 321 B.R. 527, 529 (B.A.P. 9th Cir. 2005) (holding that nonpublic transactions in illegally unregistered securities are not "commonly used in the securities trade" and therefore are avoidable preferences ineligible for protection under § 546(e)); *American Tissue, Inc. v. Donaldson, Lufkin & Jenrette*, 351 F. Supp. 2d 79 (S.D.N.Y. 2004) (denying defendant's motion to dismiss a fraudulent conveyance claim in part because it doubted whether the payments qualified as "transfer payments" under § 546(e) because their disruption did not threaten a market collapse). In the context of a Ponzi scheme, a trustee can avoid settlement payments, even those made before the two year petition date, when the trustee shows that the transferee had "actual knowledge" of the Ponzi scheme, meaning "actual knowledge of, and indeed participation in, every aspect of [the] scheme." *See, e.g.*, *Secs. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Secs. LLC*, 2013 WL 1609154 (S.D.N.Y. Apr. 15, 2013).

777 *See* 11 U.S.C. § 546(f); *In re Hamilton Taft & Co.*, 114 F.3d 991, 993 (9th Cir. 1997) (meaning of "settlement payment" includes initial transfer of securities to stockbroker under reverse repurchase agreement); *In re Bevill, Bresler, & Shulman Asset Management Corp.*, 878 F.2d 742, 752–53 (3d Cir. 1989) (meaning of "settlement payment" includes transfer of securities under repurchase agreement); *In re David*, 193 B.R. 935, 941 (Bankr. C.D. Cal. 1996) (payments applied principally to settle debts for securities purchases or margin calls are either "settlement payments" or "margin payments" even if they cannot be traced to specific settlements or margin calls).

778 *See* 11 U.S.C. § 546(g); *Secs. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Secs. LLC*, 505 B.R. 135 (S.D.N.Y. 2013) (holding that redemption payments transferred pursuant to a swap agreement could not be avoided, and giving a broad interpretation for transfers "in connection with" any swap agreement, as used in the Bankruptcy Code); *In re National Gas Distributors, LLC*, 556 F.3d 247, 250–59 (4th Cir. 2009) (holding that

gas supply contracts qualified as non-avoidable swap agreements as "commodity forward agreements," by giving a broad reading to the term "commodity forward agreements" as used in the Bankruptcy Code); *In re Interbulk, Ltd.*, 240 B.R. 195, 202 (Bankr. S.D.N.Y. 1999) (attachment of counterparty's assets to enforce the obligations owed under a swap agreement is not a transfer "under" that swap agreement and therefore not protected by § 546(g)). Unlike "settlement payments" pursuant to § 546(e), "the issue of knowledge is irrelevant to the application of section 546(g)." *Secs. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Secs. LLC*, 505 B.R. 135, 142 n.6 (S.D.N.Y. 2013).

779 *See* 11 U.S.C. § 546(j).

780 *See* 11 U.S.C. §§ 555, 556, 559, 560; *In re Enron Corp., Debtors*, 306 B.R. 465, 473 (Bankr. S.D.N.Y. 2004) (§ 560 protects rights triggered by *ipso facto* clauses in swap agreements but does not permit a nondefaulting counterparty to terminate a swap agreement because of some other reason); *In re Thrifty Oil Co.*, 322 F.3d 1039, 1048–54 (9th Cir. 2002) (affirming bankruptcy court holding that a claim for damages upon termination of an interest rate swap agreement was not a disallowable claim for unmatured interest); *In re Amcor Funding*, 117 B.R. 549, 551 (D. Ariz. 1990) (contractual rights protected under § 555 include only those based on the debtor's insolvency); *In re R.M. Cordova International, Inc.*, 77 B.R. 441, 448–49 (Bankr. D.N.J. 1987) (termination of contracts for purchase of coconut oil protected by § 556); *but see Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd. (In re Lehman Brothers Holdings Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010) (limiting § 560 to clauses that address "liquidation, termination or acceleration," but not "the alteration of rights as they exist," and holding that § 560 only applies to provisions contained in a swap agreement itself and not to provisions contained in agreements referenced by a swap agreement).

781 11 U.S.C. § 550(a).

782 *Bonded Financial Services Inc. v. European American Bank*, 838 F.3d 890, 893–94 (7th Cir. 1988).

783 *Paloain v. LaSalle Bank, N.A.*, 619 F.3d 688, 692 (7th Cir. 2010).

784 11 U.S.C. § 109(d).

785 Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1686 (codified as amended at 15 U.S.C. §§ 78aaa to 78lll) (liquidation of SEC-regulated stockbrokers); Subchapter III of Chapter 7, 11 U.S.C. §§ 741 to 753 (liquidation of unregulated stockbrokers).

786 11 U.S.C. § 752.

787 Transcript of Record at 271, *In re Refco, Inc.*, No. 05-60006 (Bankr. S.D.N.Y. Jan. 20, 2006).

788 11 U.S.C. § 101(53A)(B).

789 Transcript of Record at 273–74, *In re Refco, Inc.*, No. 05-60006 (Bankr. S.D.N.Y. Jan. 20, 2006).

790 *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd.* (*In re Lehman Brothers Holdings Inc.*), 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

791 *See* 11 U.S.C. §§ 365(e)(1) ("[A]n executory contract of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on the commencement of a case under this title."); 11 U.S.C. § 541(c)(1)(B) (providing that a debtor's interest in property "becomes property of the estate notwithstanding any provision in an agreement that is conditioned on the commencement of a case under this title and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.").

792 *See, e.g.*, *Lehman Brothers Special Financing Inc. v. BNY Mellon Corp.* (*In re Lehman Brothers Holdings Inc*.), Nos. 11 Civ. 2404(CM), 11 Civ. 2784(CM), 2011 WL 2651771, at *4 (S.D.N.Y. June 21, 2011), vacated on other grounds, 697 F.3d 74 (2d Cir. 2012) (noting that the *Dante* decision "has never been tested in a higher court").

793 11 U.S.C. § 560 ("The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title … shall not be stayed, avoided, or otherwise limited by

operation of any provision of this title or by order of a court … in any proceeding under this title.")

794 *Lehman Brothers Special Financing Inc. v. Bank of America National Association* (*In re Lehman Brothers Holdings Inc.*), No. 10-03547 (SCC), 2016 WL 3621180, at *17–21 (Bankr. S.D.N.Y. June 28, 2016).

795 *Lehman Brothers Special Financing Inc. v. Bank of America National Association* (*In re Lehman Brothers Holdings Inc.*), No. 10-03547 (SCC), 2016 WL 3621180, at *18, *20 (Bankr. S.D.N.Y. June 28, 2016) (quoting *Picard v. Ida Fishman Revocable Trust* (*In re Bernard L. Madoff Inv. Sec. LLC*, 773 F.3d 411, 419 (2d Cir. 2014)).

796 *Lehman Brothers Holdings Inc. v. Michigan State Housing Development Authority* (*In re Lehman Brothers Holdings Inc.*), 502 B.R. 383, 393–94 (Bankr. S.D.N.Y. 2013).