Annual Review of Federal Regulation of Securities

By Subcommittee on Annual Review, Committee on Federal Regulation of Securities, ABA Section of Business Law*

Contents

Introduction........................................................................................................... 737

Regulatory Developments 2011............................................................................ 739
Dodd-Frank Act Related Rulemakings.............................................................. 739
  A. Dodd-Frank Act Securitization-Related Final Rules Overview ............ 739
     1. Disclosure of Repurchase Requests Required by Section 943 of the Dodd-Frank Act ................................................................. 740
        a. Rule 15Ga-1 Under the Securities Act ........................................... 740
        b. Item 1104 of Regulation AB ....................................................... 740
        c. Item 1121 of Regulation AB ....................................................... 740
     2. NRSRO Reports on Representations, Warranties, and Enforcement Mechanisms Available in ABS Required by Section 943 of the Dodd-Frank Act ................................................................. 740
        a. Rule 17g-7 Under the Exchange Act ............................................ 740
     3. Issuer Review of Assets Underlying ABS Required by Section 945 of the Dodd-Frank Act ................................................................. 740
        a. Rule 193 Under the Securities Act ................................................ 740

* Anna T. Pinedo, Chair, is a member of the New York bar and a partner in the Capital Markets Group at Morrison & Foerster LLP in New York; Seth Chertok is a member of the California, Illinois, and Missouri bars and an associate in the Corporate Group at Morrison & Foerster LLP; Jeremy Deese is a member of the North Carolina bar and an associate at Hunton & Williams LLP; William O. Fisher is a member of the California bar, an assistant professor at the University of Richmond School of Law, and a former partner of Pillsbury Winthrop LLP in San Francisco; Robert J. Hahn is a member of the New York and North Carolina bars and a partner in the Structured Finance Group at Hunton & Williams LLP; Jonathan H. Kim is a member of the North Carolina bar and an associate in the Structured Finance and Securitization Group at Hunton & Williams LLP; Katrina M. Llanes is a member of the New York and North Carolina bars and a partner in the Structured Finance Group at Hunton & Williams LLP; Andrew Lloyd is a member of the New York bar and an associate in the Corporate Department at Willkie Farr & Gallagher LLP; David Lynn is a member of the District of Columbia and Maryland bars and a partner in the Corporate Group of Morrison & Foerster LLP; Nikita Mehta is a member of the New Jersey bar and an associate in the Securities Department of Stark & Stark; Leah Shams-Molkara is a member of the New York and an associate in the Corporate and Financial Department at Willkie Farr & Gallagher LLP; Gerd Thomsen is a member of the New York bar and Of Counsel in the Capital Markets Group of Morrison & Foerster LLP; and Edward Welch is a member of the New York bar and an associate in the Capital Markets Group of Morrison & Foerster LLP.
b. Item 1111 of Regulation AB .......................................................... 741

4. Thresholds for Suspension of Duty to File Periodic Reports
   Under Section 15(d) of the Exchange Act Permitted
   by Section 943(a) of the Dodd-Frank Act ................................. 741
   a. Amendments to Rules 12h-3, 12h-6, and
      15d-22 and Form 15 ............................................................ 741

B. Rules Regarding Disclosure of Repurchase Requests
   Required by Section 943 of the Dodd-Frank Act ....................... 741
   1. Rule 15Ga-1 .............................................................................. 741
   2. Related Amendments to Regulation AB ................................. 744
      a. Item 1104 ............................................................................. 744
      b. Item 1121 ............................................................................. 745

C. Rule Regarding NRSRO Reports on Representations,
   Warranties, and Enforcement Mechanisms Available in ABS ....... 745

D. Rules Regarding Required Issuer Review of
   Assets Underlying ABS............................................................... 746
   1. Rule 193 .................................................................................... 746
   2. Amendments to Item 1111 ........................................................ 747

E. Rules Relating to Thresholds for Suspension of Duty
   to File Reports Under Section 15(d) of the Exchange Act ........... 748
   1. Rule 15d-22 .............................................................................. 749
   2. Related Rules and Form ............................................................. 750

F. Executive Compensation and Governance ...................................... 750
   1. Shareholder Director Nominations ............................................ 750
      a. Litigation Challenging the Commission’s
         Proxy Access Rule ................................................................. 751
      b. The Commission’s Response to the D.C. Circuit’s Decision... 751
      c. “Private Ordering” of Proxy Access...................................... 752
   2. Shareholder Approval of Executive Compensation .................... 752
      a. Say-on-Pay Votes ................................................................. 753
      b. Say-on-Frequency Votes ....................................................... 754
      c. Say-on-Golden-Parachute Votes .......................................... 755

G. Removal of References to Ratings in Form S-3 and Form F-3 ....... 757
   1. Forms S-3 and F-3 ................................................................ 757
   2. Investment Grade Rating Criterion Replaced with
      Alternative Criteria .................................................................... 758
   3. $1 Billion of Non-Convertible Securities or $750 Million of
      Non-Convertible Securities Outstanding .................................... 758
   4. Subsidiaries of WKSIs ............................................................... 759
   5. Grandfathering of Other Currently Eligible Issuers .................... 760
   6. Impact of Amendments ............................................................. 760

H. Whistleblower Protection ............................................................... 760
   1. Anti-Retaliation Measures ........................................................ 761
   2. Rule 21F-3 Payment Award ....................................................... 761
3. Definitions ................................................................. 762
   a. Voluntary ................................................................. 762
   b. Original Information ............................................... 763
   c. Independent Knowledge and Independent Analysis ........ 764
   d. Original Source ..................................................... 766
   e. Action ................................................................. 768
   f. Additional Definitions .......................................... 768
4. Amount of Award—Rule 21F-5 and Rule 21F-6 .................. 768
5. Confidentiality ......................................................... 769
6. Eligibility ................................................................. 770
7. Procedures for Submitting Original Information .................. 771
8. Procedure for Making a Claim Based on a Successful Commission Action ......................................... 771
9. Treatment of Whistleblowers Who Engage in Misconduct .... 774
10. Staff Communication with Whistleblowers ......................... 774
I. Security-Based Swaps and the Re-Adoption of the Beneficial Ownership and Reporting Requirements .......... 774
   1. Beneficial Ownership Determinations Under Section 13  ......................................................... 775
      a. Rule 13d-3(a)—Conferring Voting or Investment Power ..................................................... 775
      b. Rule 13d-3(b)—Evading Reporting Requirements ....................................................................... 776
      c. Rule 13d-3(d)(1)—Granting Right to Acquire Equity Security ..................................................... 776
   2. Beneficial Ownership Determinations Under Section 16 .............................................................. 776
      a. Rule 16a-1(a)(1)—Persons Subject to Section 16 Disclosures .................................................. 777
      b. Rule 16a-1(a)(2)—Reporting Obligations and Short-Swing Profit Recovery ............................... 777
   3. Beneficial Ownership Acquired Independently from a Security-Based Swap ........................................ 778
J. Rules Regarding Net Worth Standard for Accredited Investors as Required by Section 413(a) of the Dodd-Frank Act ................................................................. 778
   1. Rules 215 and 501 ..................................................... 778
   2. New Net Worth Standard ........................................... 779
      a. Treatment of Mortgage Debt ........................................ 780
      b. Increases in Mortgage Debt in the Sixty Days Before Sale of Securities ........................................ 780
      c. Grandfathering Provisions ......................................... 781
   3. Ongoing Review and Mandatory Study ........................................ 781
K. Rules Regarding Mine Safety Disclosure as Required by Section 1503 of the Dodd-Frank Act .................. 781
1. Section 1503(a)—Periodic Reporting Disclosure .......................... 782
   a. Disclosure Requirements ...................................................... 782
   b. Time Periods Covered ......................................................... 783
2. Section 1503(b)—Current Reporting Disclosure ...................... 783

Rulemaking Unrelated to the Dodd-Frank Act .................................... 783

A. Extension of Compliance Date for Brokers or Dealers with
   Market Access to Implement Risk Management Controls
   and Supervisory Procedures .................................................. 783
   1. Rule 15c3-5 ............................................................................. 784
      a. Financial Risk Management Controls and Supervisory
         Procedures ............................................................................. 784
      b. Regulatory Risk Management Controls and
         Supervisory Procedures ....................................................... 785
      c. Other Requirements ............................................................ 786
   2. Extension of Compliance Date ................................................. 787
      a. Fixed-Income Securities ...................................................... 787
      b. Equity Securities ................................................................. 787

B. Large Trader Reporting Requirements ...................................... 788
   1. Large Trader Status ............................................................. 788
      a. Persons Who Exercise Investment Discretion ...................... 788
      b. Control ................................................................................ 789
      c. NMS Security ................................................................. 789
      d. Identifying Activity Level .................................................... 789
   2. Voluntary Registration .......................................................... 789
   3. Duties of a Large Trader ......................................................... 790
   4. Self-Identification to Broker-Dealers .................................... 790
   5. Form 13H ............................................................................... 791
   6. Confidentiality ....................................................................... 791
   7. Broker-Dealers: Recordkeeping, Reporting, and Monitoring ................................................................. 791
      a. Recordkeeping Requirements .............................................. 791
      b. Reporting Requirements ...................................................... 791
      c. Monitoring Requirements .................................................... 792
      d. Temporary Extension .......................................................... 792
   8. ATSs ........................................................................................ 792
   9. Foreign Entities ....................................................................... 793
10. Implementation and Compliance Dates ................................... 793
11. Exemptive Authority ............................................................... 793

Accounting Developments 2011 .......................................................... 795
   Effective Dates Regarding Disclosures of Credit Quality of Financing Receivables ................................................. 795
   Effective Control and Repurchase Agreements .................................................. 797
   Fair Value and Disclosure—Synchronization of
   U.S. GAAP and IFRS ............................................................................. 798
INTRODUCTION

This Annual Review (“Review”) was prepared by the Subcommittee on Annual Review of the Committee on Federal Regulation of Securities of the ABA Section of Business Law. The Review covers significant developments in federal securities law and regulation during 2011. The Review is divided into three sections: regulatory actions, accounting statements, and caselaw developments.

The Review is written from the perspective of practitioners in the fields of corporate and securities law. This results in an emphasis on significant developments under the federal securities laws relating to companies, shareholders, and their respective counsel. Our discussion is limited to those developments that are of greatest interest to a wide range of practitioners.

Given the significance of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”),¹ the regulatory section of this year’s Review is organized into two parts, one focused on the final rules (proposed rules and studies are not discussed) adopted by the U.S. Securities and Exchange Commission (“Commission”) pursuant to the Dodd-Frank Act, and the second focused on the activities undertaken during 2011 by the Commission unrelated to the Dodd-Frank Act. A significant portion of the Commission’s resources during 2011 were devoted to rulemaking required by the Dodd-Frank Act. Generally, the Review does not discuss proposed regulations or rules that are narrowly focused. For example, the Review does not address OTC derivatives related rulemakings, nor does it address hedge fund and other private fund related rulemakings. Additionally, cases are chosen for both their legal concepts as well as factual background. While the Subcommittee tries to avoid making editorial comments regarding regulations, rules, or cases, we have attempted to provide a practical analysis of the impact of the developments in the law and regulations on the day-to-day practice of securities lawyers.

DODD-FRANK ACT RELATED RULEMAKINGS

A. DODD-FRANK ACT SECURITIZATION-RELATED FINAL RULES OVERVIEW

The Dodd-Frank Act required, among other things, the U.S. Securities and Exchange Commission ("SEC" or "the Commission") to adopt a number of rules regarding securitizations. Securitization is a financing technique used by issuers to obtain funding for certain assets, such as mortgages, auto loans, auto leases, equipment loans, equipment leases, credit card receivables, and similar debt and debt-like assets, by issuing securities (referred to as "asset-backed securities" or "ABS") that make periodic payments to their holders from payments received on the related assets. In 2011, the Commission issued a number of final rules under

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1. Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act created a definition of “asset-backed securities” (“Exchange Act-ABS”) by adding section 3(a)(77) to the Exchange Act, which states as follows:

   The term “asset-backed security”—
   (A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including—
      (i) a collateralized mortgage obligation;
      (ii) a collateralized debt obligation;
      (iii) a collateralized bond obligation;
      (iv) a collateralized debt obligation of asset-backed securities;
      (v) a collateralized debt obligation of collateralized debt obligations; and
      (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and
   (B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.


2. The securitization reforms are set forth in Subtitle D of Title IX: Improvements to the Asset-Backed Securitization Process. See Dodd-Frank Act, supra note 1, § 1(b), 124 Stat. at 1381–82 (“Table of Contents”).
the Securities Act of 1933, as amended (the “Securities Act”) and the Securities Exchange Act of 1934, as amended (the “Exchange Act”) required by the Dodd-Frank Act as follows:

1. Disclosure of Repurchase Requests Required by Section 943 of the Dodd-Frank Act

   a. **Rule 15Ga-1 Under the Securities Act**, requiring securitizers to disclose certain information in a specified format regarding fulfilled and unfulfilled repurchase requests, including the filing of reports containing such information for a three-year lookback period on new Form ABS-15G;

   b. **Item 1104 of Regulation AB**, requiring disclosures in prospectuses for ABS to include the certain information required to be disclosed by Rule 15Ga-1; and

   c. **Item 1121 of Regulation AB**, requiring the inclusion of specific ABS containing certain information in a specified format regarding fulfilled and unfulfilled repurchase requests on Form 10-D.

2. NRSRO Reports on Representations, Warranties, and Enforcement Mechanisms Available in ABS Required by Section 943 of the Dodd-Frank Act

   a. **Rule 17g-7 Under the Exchange Act**, requiring nationally recognized statistical rating organizations (“NRSROs”) to include with any report accompanying a credit rating for an ABS both (i) a description of the representations, warranties, and enforcement mechanisms available to investors in that ABS; and (ii) a description of how those representations, warranties, and enforcement mechanisms available to investors differ from those found in other, similar ABS.

3. Issuer Review of Assets Underlying ABS Required by Section 945 of the Dodd-Frank Act

   a. **Rule 193 Under the Securities Act**, requiring issuers of ABS to conduct a review of the assets underlying such ABS and that such review be undertaken at a specified minimum standard of review; and

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5. See infra Part I.B.2.a.


8. See infra Part I.C.


10. See infra Part I.D.1.
b. **Item 1111 of Regulation AB**, requiring issuers of ABS to disclose in the prospectus for an ABS the nature of the review undertaken by the issuer of the assets underlying such ABS and the findings and conclusions of such review. ¹¹

4. Thresholds for Suspension of Duty to File Periodic Reports Under Section 15(d) of the Exchange Act Permitted by Section 943(a) of the Dodd-Frank Act ¹²

   a. **Amendments to Rules 12h-3, 12h-6, and 15d-22 and Form 15**, setting certain thresholds for the suspension or termination of the duty of issuers of ABS to file reports under section 15(d) of the Exchange Act. ¹³

Each of these rules is summarized below.

**B. RULES REGARDING DISCLOSURE OF REPURCHASE REQUESTS REQUIRED BY SECTION 943 OF THE DODD-FRANK ACT**

Section 943 of the Dodd-Frank Act requires the Commission to adopt regulations requiring (a) NRSROs to include in any report accompanying a credit rating of any ABS a description of the representations, warranties, and enforcement mechanisms available to investors and how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities; and (b) securitizers to “disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer, so that investors may identify asset originators with clear underwriting deficiencies.” ¹⁴ As required by section 943 of the Dodd-Frank Act, the Commission adopted Rule 15Ga-1 and Rule 17g-7 and issued modifications to the disclosure and reporting requirements under Items 1104 and 1121 of Regulation AB.

1. **Rule 15Ga-1**

   Rule 15Ga-1 is applicable to both public and private securities offerings. ¹⁵ Rule 15Ga-1 applies only to those Exchange Act-ABS (A) with underlying transaction agreements ("Underlying Agreements") that include a covenant to repurchase or replace individual pool assets for which it is discovered that a breach of a representation or warranty made in the Underlying Agreements with respect to such individual asset(s) occurred ("Repurchase Covenants"), (B) against which demands for repurchase or replacement have been made, and (C) which are held by non-affiliates of the securitizer during the reporting period (each ABS meeting the foregoing criteria, an "Affected ABS"). ¹⁶

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¹¹. See infra Part I.D.2.
¹³. See infra Part I.E.
Rule 15Ga-1 took effect on March 28, 2011, but initial filings thereunder were not required until February 14, 2012. 17 Securitizers18 (other than municipal entity securitizers19) that issued ABS at any time during the three years ended on December 31, 2011 (the “Lookback Period”) pursuant to Underlying Agreements containing Repurchase Covenants had to file a completed Form ABS-15G with the Commission by February 14, 2012 (the “Initial Disclosure Form”), regardless of whether any repurchase requests were made with respect to such Exchange Act-ABS.20 If demand was made against the Affected ABS of a securitizer prior to the start of the Lookback Period, and any activity relating to such demand was pursued during the Lookback Period, such securitizer’s Initial Disclosure Form had to report all such activity.21 Municipal securitizers that issued ABS—the Underlying Agreements for which contained Repurchase Covenants—at any time during the three years ended on December 31, 2014, must file a completed Form ABS-15G with the Commission by February 14, 2015, again, regardless of whether any repurchase requests were made with respect to such ABS.22

After filing the Initial Disclosure Form, Rule 15Ga-1 requires any securitizer of Affected ABS issued during the Lookback Period to continue to file completed Forms ABS-15G relating to such Affected ABS within forty-five days of the end of each calendar quarter beginning with the calendar quarter ended March 31, 2012.23 Securitizers that sponsored or issued Affected ABS prior to the start of the Lookback Period, but for which no initial filing is required because no activity relating to any demand took place during the Lookback Period, had to file a completed Form ABS-15G within forty-five days of the end of the calendar quarter ended March 31, 2012.24

Because Rule 15Ga-1 requires the “securitizer” to make the filing of Form ABS-15G and the definition of “securitizer” includes “(A) an issuer of an [Exchange Act-ABS]; or (B) a person who organizes and initiates an [Exchange Act-ABS] transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer,”25 in cases where the sponsor and a depositor of an Exchange Act-ABS transaction are affiliated entities, Rule 15Ga-1 deems one such securitizer’s filed Form ABS-15G to act as the consolidated filing for all affiliated securitizers for that specific ABS transaction.26

18. “Securitizer” is defined in section 15G(a)(3) of the Exchange Act to mean “(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.” 15 U.S.C. § 78o-11(a)(3) (Supp. IV 2010).
21. Id. (Instruction to paragraph (c)(1)).
24. See id.
The disclosure required by Rule 15Ga-1 must be in tabular format and contain information relating to each Affected ABS during the subject calendar quarter as follows:

(i) asset class;
(ii) name of issuing entity;
(iii) indication of whether such Affected ABS were registered under the Securities Act and, if so, the CIK number of the issuing entity;
(iv) originator of underlying assets;
(v) underlying asset information as of the time of securitization;
(vi) underlying asset information for those assets subject to a demand;
(vii) underlying asset information for those assets that were repurchased or replaced;
(viii) underlying asset information for those assets for which repurchase or replacement was pending due to the expiration of a cure period;
(ix) underlying asset information for those assets subject to disputed demands for repurchase or replacement;
(x) underlying asset information for those assets subject to withdrawn demands for repurchase or replacement;
(xi) underlying asset information for those assets subject to rejected demands for repurchase or replacement; and
(xii) aggregations of certain underlying asset information compiled by asset class, issuing entity, and all issuing entities. 27

The securitizer may expound on any information required to be disclosed in the Form ABS-15G table to make the reported data more comprehensible, and the Commission encourages the use of explanatory footnotes and narrative disclosures to do so. 28

Rule 15Ga-1 permits a securitizer to omit certain information indicated in the immediately preceding paragraph if such information is unknown and would not be available to the securitizer without the incurrence of unreasonable effort or expense. 29 If a securitizer does omit any required information because it is unknown and to produce it would involve an unreasonable effort or expense, such securitizer must both produce all of the information that it does know or possess and include a statement in the Form ABS-15G disclosure demonstrating that any unknown information is not known and cannot be obtained without unreasonable effort or expense. 30

28. Id. § 240.15Ga-1(a)(1) (Instruction 2 to paragraph (a)(1)).
29. 17 C.F.R. § 240.15Ga-1(a)(2) (2011). Note that the rule allows any securitizer who requested, but was unable to obtain information on, Affected ABS demands occurring prior to July 22, 2010, to include in its Form ABS-15G a footnote stating as much. See id. The footnote must also include a statement that the disclosures made on such Form ABS-15G do not contain information regarding investor demands occurring prior to July 22, 2010. See id.
30. Id.
A securitizer is permitted to suspend its obligation to file Form ABS-15G for a particular Exchange Act-ABS transaction if no demand for, or activity relating to a prior demand for, repurchase or replacement of pool assets ("Repurchase Activity") has occurred in the subject calendar quarter, and the last filed Form ABS-15G required by Rule 15Ga-1 indicated that there was no Repurchase Activity in the calendar quarter applicable thereto. This suspension continues automatically until the earlier to occur of (i) the next calendar quarter in which Repurchase Activity occurs, and (ii) the forty-fifth day after the end of any calendar year, which date represents the deadline for filing a Form ABS-15G confirming that no demand activity occurred in the prior calendar year.

2. Related Amendments to Regulation AB

In its rules implementing section 943 of the Dodd-Frank Act, the Commission also modified certain disclosure and reporting requirements under Regulation AB.

a. Item 1104

The Commission added subsection (e) to Item 1104 of Regulation AB requiring disclosure of Rule 15Ga-1 information for registered issuances of ABS. Specifically, Item 1104(e) requires each issuer to disclose information relating to the assets securitized by the related sponsor that were subject to repurchase or replacement pursuant to Repurchase Covenants included in the Underlying Agreements of any ABS transactions to which such sponsor was a party, which information may be limited to the prior one, two, or three years, depending upon when the prospectus related to such issuer’s ABS is filed with the Commission. Issuers must include such information in prospectuses for those ABS issuances (i) that qualify as ABS under the Regulation AB definition of the term, (ii) that are offered in the registered market, and (iii) for which the Underlying Agreements contain Repurchase Covenants. Rule 15Ga-1 disclosures made pursuant to Item 1104(e) must include (i) the sponsor’s CIK number and a reference to the most recent Form ABS-15G filed by such sponsor, and (ii) all pertinent information for all prospectuses for registered ABS filed pursuant to Rule 424 of the Securities Act (x) prior to February 14, 2013, from the immediately preceding year, (y) on

34. The term “asset-backed issuer” is defined in Regulation AB to mean “an issuer whose reporting obligation results from either the registration of an offering of asset-backed securities under the Securities Act, or the registration of a class of asset-backed securities under Section 12 of the Exchange Act.” 17 C.F.R. § 229.1101(b) (2011).
35. The term “sponsor” is defined in Regulation AB to mean “the person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.” 17 C.F.R. § 229.1101(l) (2011).
or after February 14, 2013, but prior to February 14, 2014, from the immediately preceding two-year period, and (z) on or after February 14, 2014, for the immediately preceding three-year period. The Form ABS-15G data presented in affected prospectuses cannot be more than 135 days old.

b. Item 1121

In addition to requiring the disclosure of Rule 15Ga-1 information in prospectuses for registered ABS under Item 1104(e) of Regulation AB, the Commission also adopted a corresponding requirement that such information be disclosed in the ongoing reporting regime for registered ABS. New subsection (c) of Item 1121 requires that securitizers disclose Rule 15Ga-1 information regarding the repurchase or replacement of assets pursuant to Repurchase Covenants that would be required to be disclosed under Rule 15Ga-1 on the Form 10-D report submitted for the asset pool. Each such disclosure must also include the securitizer’s CIK number and a reference to the most recent Form ABS-15G filed by such securitizer.

C. RULE REGARDING NRSRO REPORTS ON REPRESENTATIONS, WARRANTIES, AND ENFORCEMENT MECHANISMS AVAILABLE IN ABS

To implement section 943(a) of the Dodd-Frank Act, the Commission adopted Rule 17g-7, which requires NRSROs to disclose in any report accompanying a credit rating with respect to any ABS (i) the representations, warranties, and enforcement mechanisms available to investors that are included in the Underlying Agreements for such ABS; and (ii) a description of how such representations, warranties, and mechanisms differ from those found in the Underlying Agreements for issuances of similar securities. Rule 17g-7 employs the same, broader definition of ABS used in Rule 15Ga-1 and discussed in greater detail above.

In the official note to Rule 17g-7, the Commission makes clear that it intends for all reports relating to expected or preliminary credit ratings issued by an NRSRO prior to the issuance of its final, definitive credit rating for an ABS to be subject to the rule. The Commission stated its intention that Rule 17g-7 applies to both solicited and unsolicited credit ratings as well as to credit ratings delivered to foreign issuers of ABS.

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44. The Commission has declined to limit the effect of this rule to ABS issued in the United States. See Disclosure Required by Section 943 of the Dodd-Frank Act, supra note 3, 76 Fed. Reg. at 4504.
45. 17 C.F.R. § 240.17g-7 (2011).
46. See id.
D. RULES REGARDING REQUIRED ISSUER REVIEW OF ASSETS UNDERLYING ABS

Section 945 of the Dodd-Frank Act amends section 7 of the Securities Act by adding a new subsection (d) that requires the Commission to issue rules requiring issuers of registered ABS to perform due diligence review of the underlying assets and to disclose the nature of such review. To implement section 945 of the Dodd-Frank Act, the Commission adopted Rule 193 under the Securities Act ("Rule 193"), requiring issuers of ABS to review the underlying assets of all registered ABS offerings. The Commission also adopted certain amendments to Item 1111 of Regulation AB, requiring disclosure of the nature of the issuer’s review, including conclusions and findings of the review. Rule 193 and the amendments to Item 1111 became effective on March 28, 2011, and all ABS issuers must comply with the requirements for any registered ABS offerings made after December 31, 2011.

1. Rule 193

Rule 193 requires issuers of registered ABS offerings to perform a due diligence review of the underlying assets. Rule 193 also sets forth a minimum standard for review stating that, "[a]t a minimum, such review must be designed and effected to provide reasonable assurance that the disclosure regarding the pool assets in the form of prospectus filed pursuant to §230.424 of this chapter is accurate in all material respects." The Commission intended this standard to be flexible, and the type of review will vary depending on the type of assets and circumstances. For example, where the pool consists of a large group of assets, it may be appropriate to review a sample, but where the pool consists of a small group of assets, then it may be appropriate to review all of the assets in the pool.

The issuer may conduct the due diligence review itself or it may engage a third party to review the assets. The issuer may rely on the third party’s findings if (i) the review is of the type that meets the rule’s minimum review standard, (ii) the

49. 15 U.S.C. § 77g(d) (Supp. IV 2010).
50. Issuer Review Final Release, supra note 9, 76 Fed. Reg. at 4232 (noting that, for purposes of Rule 193, the “issuer” is the depositor or sponsor of the securitization).
54. Rule 193 applies only to ABS offerings that are registered under the Securities Act, not to unregistered ABS offerings. See 17 C.F.R. § 230.193.
56. Id. at 4244.
57. Id. at 4234.
58. Id.
59. Id. at 4235. Where only a sample of assets is reviewed, the issuer will need to disclose the size of the sample and criteria used to select the assets sampled. See id.
issuer names the third party in its registration statement, and (iii) the third party agrees to be named as an expert under Rule 436 of the Securities Act and section 7 of the Securities Act. If the issuer attributes the third party’s findings to itself, then the third party does not need to be named as an expert.

2. Amendments to Item 1111

In addition to Rule 193, the Commission adopted certain amendments to Item 1111 of Regulation AB. The purpose of the amendments is to expand the prospectus disclosures required by Item 1111 to give investors a better understanding of the type of review that was undertaken.

The Commission added new Item 1111(a)(7), requiring disclosure in the issuer’s prospectus of the nature of the review performed pursuant to Rule 193 and disclosure of the findings and conclusions of the review. When describing the “nature of the review,” the issuer is required to explain the scope of such review. If a sample pool was reviewed, the description would include the size of the sample pool and the criteria used to select the sample. The issuer would also disclose whether any third party conducted the review. The issuer is also required to disclose the “findings and conclusions” of the review. The “findings and conclusions” include such things as the criteria against which the assets were measured and why certain assets were excluded from the pool.

The Commission also added new Item 1111(a)(8), requiring disclosure in the issuer’s prospectus of the composition of the pool of assets that deviates from the sample pool or underwriting standards (“Exception Assets”). Item 1111(a)(8) requires the issuer to disclose in the issuer’s prospectus the identity of any third party reviewer of the Exception Assets, the criteria used to determine which assets were Exception Assets, the number of Exception Assets, the characteristics of the Exception Assets, and how they deviate from the rest of the pool and the entity that determined that the Exception Assets should be included in the pool.

The Commission believes that these disclosures will provide more transparency and accountability.

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63. Issuer Review Final Release, supra note 9, 76 Fed. Reg. at 4238 (setting forth the Commission’s belief that expanded disclosures will enable investors to evaluate the transaction).
64. 17 C.F.R. § 229.1111(a)(7).
65. Issuer Review Final Release, supra note 9, 76 Fed. Reg. at 4238 (setting forth the Commission’s belief that expanded disclosures will enable investors to evaluate the transaction).
66. Id. at 4238.
67. Id.
68. Id.
69. Id.
70. Id.
72. Issuer Review Final Release, supra note 9, 76 Fed. Reg. at 4238 (setting forth the Commission’s belief that such disclosures will facilitate informed decision-making by investors).
E. RULES RELATING TO THRESHOLDS FOR SUSPENSION OF DUTY TO FILE REPORTS UNDER SECTION 15(d) OF THE EXCHANGE ACT

Section 942(a) of the Dodd-Frank Act amended section 15(d) of the Exchange Act by eliminating the applicability of the automatic suspension provision to an issuer of ABS.\(^73\) Prior to the enactment of the Dodd-Frank Act, section 15(d) of the Exchange Act permitted the automatic suspension of any issuer’s obligation to file ongoing periodic reports with respect to any fiscal year (other than the fiscal year during which the related registration statement became effective pursuant to the Securities Act) if, at the beginning of such fiscal year, the securities related to such registration statement were held of record by less than 300 persons.\(^74\) Section 942(a) of the Dodd-Frank Act added a new subsection (2) to section 15(d) of the Exchange Act, which permitted the Commission to promulgate rules or regulations that would “provide for the suspension or termination of the duty to file” with respect to any class of ABS in a manner that the Commission determined was “necessary or appropriate in the public interest or for the protection of investors.”\(^75\)

Because it was not clear whether section 942(a) of the Dodd-Frank Act would require that all existing ABS transactions that had suspended Exchange Act reporting prior to the enactment of the Dodd-Frank Act would have to resume such reporting, on January 6, 2011, the Commission released a “no-action” letter to the American Securitization Forum (the “No-Action Letter”) in which the Commission confirmed that it would not pursue an enforcement action against an issuer of ABS that continued to determine its reporting obligations for outstanding transactions according to the terms of section 15(d) of the Exchange Act prior to its amendment by section 942(a) of the Dodd-Frank Act.\(^76\) The No-Action Letter is applicable to an issuer of ABS subject to the following conditions:

(i) the issuer’s reporting obligation was suspended by operation of the automatic suspension provision set forth in section 15(d) of the Exchange Act immediately prior to the enactment of the Dodd-Frank Act;

(ii) the issuer continues to make information regarding the ABS and the related assets available to security holders (directly or indirectly through the related trustee) in accordance with the terms of the related transaction agreements; and

(iii) the issuer retains the information reported pursuant to item (ii) above for a period of not less than five years after the related ABS are no longer outstanding and provides such information to the Commission upon request.\(^77\)

\(^73\) Dodd-Frank Act § 942(a), 15 U.S.C. § 78o(d) (Supp. IV 2010).
\(^75\) Dodd-Frank Act § 942(a), 15 U.S.C. § 78o(d)(2).
\(^77\) Id.
The Commission released its final rule (the “Final Rule”) implementing section 942(a) of the Dodd-Frank Act on August 17, 2011, which became effective on September 22, 2011. The Final Rule sets forth certain requirements for the suspension of reporting obligations of an issuer of ABS under section 15(d) of the Exchange Act and amends Exchange Act Rules 12h-3, 12h-6, and 15d-22 accordingly.

1. Rule 15d-22

The Final Rule amended Rule 15d-22(a) to clarify, for ABS, when reports must be filed and when reporting suspension dates should be determined with respect to a takedown of a shelf offering. As amended, Rule 15d-22(a) provides that the reporting requirements with respect to a class of ABS sold through a shelf offering will begin upon the first “takedown of securities under the registration statement.” The amended rule also states that the “starting and suspension dates for any reporting obligation” with respect to any such class of ABS should be “determined separately for each takedown of securities under the registration statement.” The Commission notes that the changes to Rule 15d-22(a) were made to “retain the approach relating to separate takedowns” in effect prior to the enactment of the Dodd-Frank Act.

The amendments to Rule 15d-22(b) implement the new reporting suspension criteria for issuers of ABS. An issuer’s obligation to file annual and other reports with respect to any class of ABS under section 15(d) of the Exchange Act is suspended with respect to any semi-annual fiscal period if, at the beginning of such period (other than a period during the fiscal year in which the related registration statement became effective or, for shelf offerings, the related takedown occurred), “there are no asset-backed securities of such class that were sold in a registered transaction held by non-affiliates of the depositor” and a Form 15 certification has been filed. In addition, the amended rule also permits the suspension of an issuer’s reporting obligations “[w]hen there are no [ABS] of such class that were sold in a registered transaction still outstanding” upon the filing of a Form 15 certification and “if the issuer has filed all reports required . . . for the . . . most recent three fiscal years.” If such Form 15 certification is withdrawn by the issuer or denied by the Commission, the issuer must file all reports that would have otherwise been required to be filed had such certification not been filed within sixty days of such withdrawal or denial.

In addition to the foregoing, the Commission included two notes clarifying certain aspects of the amended rule. The first note makes clear that, in determining

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79. Id. at 52555 (to be codified at 17 C.F.R. § 240.15d-22(a)).
80. Id. (to be codified at 17 C.F.R. § 240.15d-22(a)(2)).
81. Id. at 52552.
82. Id. at 52556 (to be codified at 17 C.F.R. § 240.15d-22(b)(1)).
83. Id. (to be codified at 17 C.F.R. § 240.15d-22(b)(2)).
84. Id. (to be codified at 17 C.F.R. § 240.15d-22(b)(2)).
85. Id.
whether an ABS is being held by a non-affiliate of the depositor, it is sufficient if the beneficial holder of such security is the depositor or an affiliate of the depositor.86 This note contemplates the situation where an ABS is in an indirect holding system and the securities are considered to be held by the separate beneficial owners. The second note is an anti-avoidance provision that prohibits the suspension of reporting requirements if “the issuer and its affiliates acquire and resell securities as part of a plan or scheme to evade the reporting obligations of Section 15(d).”87

2. Related Rules and Form

The Commission amended Rule 12h-3(b)(1) to exclude ABS from the classes of securities eligible for suspension,88 and to conform the exclusion with amendments to section 15(d) of the Exchange Act.89 In addition, a new note to Rule 12h-3 directs issuers of ABS to Rule 15d-22 for the requirements regarding the suspension of reporting.90

Similarly, Rule 12h-6 now includes a note directing issuers of ABS to Rule 15d-22 for the requirements regarding the suspension of reporting.91

Form 15 was amended to include a new checkbox referring to Rule 15d-22(b).92

F. EXECUTIVE COMPENSATION AND GOVERNANCE

1. Shareholder Director Nominations

Section 971 of the Dodd-Frank Act authorized the Commission to promulgate “proxy access” rules that would permit specified shareholders to include director nominees in a company’s proxy materials.93 The Dodd-Frank Act did not prescribe specific standards for these rules, and the Commission had in fact proposed proxy access rules prior to enactment of the Dodd-Frank Act.94 The Commission issued final rules facilitating shareholder director nominations on August 25, 2010, and such rules were scheduled to become effective on November 15, 2010.95 However, the effectiveness of those rules was stayed due to litigation challenging the rules.

The Commission adopted both a mandatory proxy access rule (Rule 14a-11) and also amended Rule 14a-8 to permit shareholder proposals that would
establish additional, more flexible proxy access procedures. Under Rule 14a-11 as adopted by the Commission, qualifying shareholders or groups holding at least 3 percent of the voting power of a company’s securities, who had held their shares for at least three years, would have had the right to include director nominees in proxy materials upon meeting certain other requirements.96 An amendment to Rule 14a-8 that ultimately did become effective provides that companies may not exclude from their proxy materials under the “director elections” basis those shareholder proposals that seek to establish proxy access procedures.97

a. Litigation Challenging the Commission’s Proxy Access Rule

On September 29, 2010, the Business Roundtable and United States Chamber of Commerce filed a petition with the United States Court of Appeals for the District of Columbia Circuit (the “D.C. Circuit”) seeking judicial review of the proxy access rules.98 On the same day, they filed a motion with the Commission seeking a stay of the effective date of the rules.99 On October 4, 2010, the Commission granted the request for a stay of Rule 14a-11 and associated rules pending resolution of the petition for review by the D.C. Circuit.100

On July 22, 2011, the D.C. Circuit vacated Rule 14a-11.101 The D.C. Circuit held that the Commission was “arbitrary and capricious” in promulgating Rule 14a-11 because it failed to address adequately the economic effects of the rule.102 The D.C. Circuit expressed significant concerns about the conclusions that the Commission reached and the agency’s consideration of comments during the course of the rulemaking.103

b. The Commission’s Response to the D.C. Circuit’s Decision

Following the D.C. Circuit’s ruling, the Commission issued a statement that it would not seek rehearing or Supreme Court review, but that its staff would continue to study the viability of a proxy access rule.104 The statement also indicated that the amendment to Rule 14a-8 referenced above would go into effect when the D.C. Circuit’s mandate was finalized.105 As a result, the amendments to Rule 14a-8

102. Id. at 1148–49, 1156.
103. Id. at 1149–54. The D.C. Circuit did not address the petitioner’s First Amendment challenge to the rule. Id. at 1156.
105. Id.
(along with other rules adopted in connection with Rule 14a-11) became effective on September 20, 2011, following the Commission’s publication of a notice announcing the effective date of the rule changes.\textsuperscript{106}

c. “Private Ordering” of Proxy Access

The amendments to Rule 14a-8 permit the type of “private ordering” for proxy access through the shareholder proposal process that many commenters had supported in the course of the proxy access rulemaking. Under Rule 14a-8(i)(8), as amended, a company may no longer exclude under this basis for exclusion a shareholder proposal that would amend or request that the company consider amending governing documents to facilitate director nominations by shareholders or disclosures related to nominations made by shareholders, as long as such proposal does not conflict with Rule 14a-11 and is not otherwise excludable under some other procedural or substantive basis in Rule 14a-8.\textsuperscript{107} The Commission also codified some of the Commission staff’s historical interpretations of Rule 14a-8(i)(8) that permitted exclusion of a shareholder proposal that would (1) seek to disqualify a nominee standing for election; (2) remove a director from office before the expiration of his or her term; (3) question the competence, business judgment, or character of a nominee or director; (4) nominate a specific individual for election to the board of directors, other than through an applicable Commission provision, an applicable state law provision, or an issuer’s governing documents; or (5) otherwise affect the outcome of the upcoming election of directors.\textsuperscript{108}

2. Shareholder Approval of Executive Compensation

While the Dodd-Frank Act focuses principally on changes to the financial regulatory system, several provisions of the Act address the governance of, as well as compensation and disclosure by, public companies. These include, among other provisions, a requirement that public companies solicit an advisory vote on executive compensation (the “Say-on-Pay” vote), an advisory vote on the frequency of holding an advisory vote on executive compensation (the “Say-on-Frequency” vote), and, in the event of a merger or other similar extraordinary transaction, a vote on certain golden parachute compensation that is triggered by the transaction (a “Say-on-Golden-Parachute” vote).\textsuperscript{109}

In January 2011, the Commission adopted rules implementing the Say-on-Pay, Say-on-Frequency, and Say-on-Golden-Parachute requirements.\textsuperscript{110} Section 951

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\textsuperscript{107} Proxy Access Amendments, \textit{supra} note 95, 76 Fed. Reg. at 56782 (to be codified at 17 C.F.R. § 240.14a-8(i)(8)).
\textsuperscript{108} \textit{Id.} (to be codified at 17 C.F.R. § 240.14a-8(i)(8)).
\end{flushleft}
of the Dodd-Frank Act requires that, for shareholder meetings occurring on or after January 21, 2011, all public companies (except those companies exempted from the requirement by the Commission) include a resolution in their proxy statements asking shareholders to approve, in a nonbinding, advisory vote, the compensation of their executive officers, as required to be disclosed in the proxy statement pursuant to Item 402 of Regulation S-K. 111 A Say-on-Frequency vote is required at least once every six years in the form of a separate resolution asking stockholders to cast a nonbinding vote on whether the Say-on-Pay vote takes place every one, two, or three years. 112

a. Say-on-Pay Votes

Rule 14a-21(a) provides that, if a solicitation is made by an issuer relating to a meeting of shareholders at which directors will be elected and for which the Commission’s rules require executive compensation disclosure pursuant to Item 402 of Regulation S-K, then the issuer must conduct a Say-on-Pay vote, and a Say-on-Pay vote must occur thereafter no later than at the annual or other meeting of shareholders held in the third calendar year after the immediately preceding Say-on-Pay vote. 113 The Say-on-Pay vote relates to the executive compensation disclosure required to be included in the proxy statement pursuant to Item 402 of Regulation S-K, which generally includes the Compensation Discussion and Analysis (the “CD&A”), the compensation tables, and the narrative disclosure on executive compensation, all with respect to the issuer’s “named executive officers” as that term is defined in Item 402 of Regulation S-K. 114

Rule 14a-21(a) does not require that issuers use a specific form of resolution. However, the Instruction to Rule 14a-21(a) provides the following non-exclusive example that would satisfy the requirements of the rule: “RESOLVED, that the compensation paid to the company’s named executive officers, as disclosed pursuant

111. Dodd-Frank Act § 951, 15 U.S.C. § 78n-1(a). Companies that qualify as “smaller reporting companies” as of January 21, 2011, including newly public companies that qualify as “smaller reporting companies” after that date, are not subject to the Say-on-Pay or Say-on-Frequency requirements or the Commission’s related rules until the first meeting of shareholders at which directors will be elected, and for which executive compensation disclosure is required, occurring on or after January 21, 2013. Say-on-Pay Adopting Release, supra note 110, 76 Fed. Reg. at 6010. This temporary exemption does not apply to the Say-on-Golden-Parachute vote requirement. See id.


113. Say-on-Pay Adopting Release, supra note 110, 76 Fed. Reg. at 6045–46 (to be codified at 17 C.F.R. § 240.14a-21(a)).

114. See 17 C.F.R. § 229.402 (2011). Instruction 1 to Rule 14a-21 provides that the Say-on-Pay vote covers neither director compensation disclosed pursuant to paragraphs (k) and (r) of Item 402 of Regulation S-K nor any disclosure pursuant to Item 402(s) of Regulation S-K about the company’s compensation policies and practices as they relate to risk management and risk-taking incentives. Say-on-Pay Adopting Release, supra note 110, 76 Fed. Reg. at 6046 (to be codified at 17 C.F.R. § 240.14a-21 (Instruction 1)). However, if risk considerations are a material aspect of the company’s compensation policies or decisions for named executive officers, then the Instruction indicates that the company must discuss these considerations as part of the CD&A, and such disclosure will then be subject to the Say-on-Pay vote. See id. (to be codified at 17 C.F.R. § 240.14a-21 (Instruction 1)).
to Item 402 of Regulation S-K, including the Compensation Discussion and Analysis, compensation tables and narrative discussion, is hereby APPROVED.”

b. Say-on-Frequency Votes

Rule 14a-21(b) provides that, if a solicitation is made by a company relating to a meeting of shareholders at which directors will be elected, and for which the Commission’s rules require executive compensation disclosure pursuant to Item 402 of Regulation S-K, then that issuer must conduct a Say-on-Frequency vote for its first annual or other meeting of shareholders occurring on or after January 21, 2011, and requires that such Say-on-Frequency vote occur thereafter no later than the annual or other meeting of shareholders held in the sixth calendar year after the immediately preceding Say-on-Frequency vote.

Under Rule 14a-21(b), the required Say-on-Frequency resolution must ask shareholders to indicate whether future Say-on-Pay votes should occur every one, two, or three years. As a result, shareholders are given four choices on the proxy card: whether the Say-on-Pay vote will take place every one, two, or three years, or to abstain from voting on the resolution.

The Commission also adopted changes to certain forms and rules of the Exchange Act relating to Say-on-Pay and Say-on-Frequency.

115. See id. at 6045 (to be codified at 17 C.F.R. § 240.14a-21(a) (Instruction)). While the Commission has provided this non-exclusive example of a form of resolution, the Commission states in the Say-on-Pay Adopting Release that companies “should retain the flexibility to craft the resolution language.” See id. at 6014. The Commission staff has indicated that it is permissible for the Say-on-Pay vote to omit the words—“pursuant to Item 402 of Regulation S-K”—and to replace those words with a plain English equivalent, such as “pursuant to the compensation disclosure rules of the Securities and Exchange Commission, including the compensation discussion and analysis, the compensation tables and any related material disclosed in this proxy statement.” Exchange Act Rules Compliance and Disclosure Interpretations Question 169.05, U.S. SEC. & EXCH. COMM’N (Feb. 11, 2011), http://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm.

116. Say-on-Pay Adopting Release, supra note 110, 76 Fed. Reg. at 6045–46 (to be codified at 17 C.F.R. § 240.14a-21(b)).

117. See id. (codified at 17 C.F.R. § 240.14a-21(b)).

118. Despite providing a safe harbor as guidance to meeting the Say-on-Pay vote requirement in Rule 14a-21(a), the Commission failed to provide a non-exclusive example of a Say-on-Frequency resolution. The Commission’s staff, however, noted that the Say-on-Frequency vote need not be set forth as a resolution, and that it is permissible for the Say-on-Frequency vote to include the words “every year, every other year, every three years, or abstain” in lieu of “every 1, 2, or 3 years, or abstain.” Exchange Act Rules Compliance and Disclosure Interpretations Questions 169.04 & 169.06, U.S. SEC. & EXCH. COMM’N (Feb. 11, 2011), http://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm.

119. The Commission amended Rule 14a-6(a) to add the advisory votes on executive compensation to the list of items that will not trigger the requirement to file a preliminary proxy statement. Say-on-Pay Adopting Release, supra note 110, 76 Fed. Reg. at 6045 (to be codified at 17 C.F.R. § 240.14a-6(a)(7)). Item 24 to Schedule 14A was adopted which requires disclosure in the proxy statement when a company is providing the Say-on-Pay, Say-on-Frequency, or the Say-on-Golden Parachute vote. Id. at 6046 (to be codified at 17 C.F.R. § 240.14a-101 (Item 24)). Item 402(b)(1) of Regulation S-K was amended to require that a company address in its CD&A whether and how it considered the most recent advisory vote on executive compensation. Id. at 6043 (to be codified at 17 C.F.R. § 229.402(b)(1)(vii)). Item 5.07 of Form 8-K was amended to require an issuer to disclose its decision as to how frequently it will conduct Say-on-Pay votes following each Say-on-Frequency vote. Id. at 6046–47. Rule 14a-8(0)(10) now permits the exclusion of a shareholder proposal as “substantially implemented” if the proposal would provide for a Say-on-Pay vote, seek Say-on-Pay votes, or relate to the frequency of Say-on-Pay votes. Id. at 6045 (to be codified at 17 C.F.R. § 240.14a-8(0)(10)).
c. Say-on-Golden-Parachute Votes

Rule 14a-21(c) provides that if a solicitation is made by the company for a meeting of shareholders at which the shareholders are asked to approve an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all of the assets of the issuer, then the company must provide a separate shareholder advisory vote to approve any agreements or understandings and compensation disclosed pursuant to Item 402(t) of Regulation S-K. However, if such agreements or understandings have been subject to a shareholder advisory vote under Rule 14a-21(a) (the Say-on-Pay vote), then a separate shareholder vote is not required. Consistent with Exchange Act section 14A(b), any agreements or understandings between an acquiring company and the named executive officers of the issuer, where the issuer is not the acquiring company, are not required to be subject to the separate shareholder advisory vote. The Commission did not adopt any specific form of the Say-on-Golden-Parachute resolution and has clarified the advisory nature of the Say-on-Golden-Parachute vote.

Golden parachute compensation must be disclosed in a table along with accompanying footnotes and narrative disclosure. The table requires quantification with respect to any type of compensation, whether present, deferred, or contingent, that is based on or relates to an acquisition, merger, consolidation, sale, or other disposition of all or substantially all of the assets, including (i) cash severance payments, (ii) the value of equity awards that are accelerated or cashed out, (iii) pension and nonqualified deferred compensation enhancements, (iv) perquisites and other personal benefits, (v) tax reimbursements, (vi) in the “Other” column, any additional compensation that is not included in any other column, and (vii) separate footnote identification for amounts attributable to “single-trigger” and “double-trigger” arrangements.

Item 402(t) of Regulation S-K also requires a description of any material conditions or obligations applicable to the receipt of payment, including, but not limited to, non-compete, non-solicitation, non-disparagement, or confidentiality agreements, their duration, and provisions regarding waiver or breach. Moreover, disclosure of the specific circumstances that would trigger payment, whether the payments would be lump sum, or annual, and their duration, and by whom the payments would be provided, and other material factors regarding each agreement is also required by Item 402(t). Separate disclosure or quantification with respect to compensation disclosed in the Pension Benefits Table and Nonqualified Deferred Compensation Table (unless such benefits are enhanced in connection

120. Id. at 6047 (to be codified at 17 C.F.R. § 240.14a-21(c)).
121. Id. (to be codified at 17 C.F.R. § 240.14a-21(c)).
122. Id. (to be codified at 17 C.F.R. § 240.14a-21(c)).
123. Additional forms, schedules, and disclosure requirements have been amended in order to address golden parachute compensation, such as Schedule 14A, Schedule 14C, Forms S-4 and F-4, Schedule 14D-9, Schedule 13E-3, and Item 1011 of Regulation M-A. See id. at 6042–46.
124. See id. at 6043–44 (to be codified at 17 C.F.R. § 229.402(t)).
125. See id. (to be codified at 17 C.F.R. § 229.402(t)).
126. See id. at 6044 (to be codified at 17 C.F.R. § 229.402(t)(3)(iii)).
127. See id. (to be codified at 17 C.F.R. § 229.402(t)(3)(i), (ii)).
with the transaction), previously vested equity awards, and compensation from bona fide post-transaction employment agreements entered into in connection with the merger or acquisition is not required.\textsuperscript{128}

The Golden Parachute disclosure is generally required for arrangements (1) between the acquiring company and its named executive officers and the named executive officers of the target, and (2) between the target company and its named executive officers and the named executive officers of the acquiring company.\textsuperscript{129} Note, however, that in all cases the disclosure is limited to arrangements that will be triggered by the actual transaction.\textsuperscript{130}

With respect to the Say-on-Golden-Parachute vote, if the target company is soliciting proxies to approve the transaction, under Rule 14a-21(c), the target company must conduct a separate shareholder advisory vote on the following: (i) golden parachute arrangements between the target company and its own named executive officers, and (ii) golden parachute arrangements between the target company and the named executive officers of the acquiring company.\textsuperscript{131} In those situations, the target company will not need to seek a vote on golden parachute arrangements between the acquiring company and the named executive officers of the target company.\textsuperscript{132}

If the acquiring company is soliciting proxies to approve the transaction, Rule 14a-21(c) requires that the acquiring company conduct a separate shareholder advisory vote on the following: (i) golden parachute arrangements between the acquiring company and its own named executive officers, and (ii) golden parachute arrangements between the acquiring company and the named executive officers of the target company.\textsuperscript{133} Note that a separate vote is required only if shareholders are being asked to approve the transaction. If the acquiring company is seeking a vote for other purposes, for example if it will be issuing 20 percent of its outstanding shares and needs a vote because of exchange listing requirements, a separate vote is not required from the acquiring company.\textsuperscript{134}

\begin{itemize}
  \item \textsuperscript{128} See id. at 6027.
  \item \textsuperscript{129} See id. at 6043 (to be codified at 17 C.F.R. § 229.402(i)(1)).
  \item \textsuperscript{130} See id. at 6046 (to be codified at 17 C.F.R. § 240.14a-21(c)).
  \item Rule 14a-21(c) provides: “Consistent with section 14A(b) of the Exchange Act . . . , any agreements or understandings between an acquiring company and the named executive officers of the registrant, where the registrant is not the acquiring company, are not required to be subject to the separate shareholder advisory vote under this paragraph.” See id. at 6046 (to be codified at 17 C.F.R. § 240.14a-21(c)).
  \item \textsuperscript{133} See id. at 6046 (to be codified at 17 C.F.R. § 240.14a-21(c)).
  \item \textsuperscript{134} The Say-on-Pay Adopting Release specifies:
  
  However, issuers are not required to provide a separate shareholder advisory vote in proxy statements for meetings at which shareholders are asked to approve other proposals, such as an increase in authorized shares or a reverse stock split, which may be necessary for the issuer to effectuate a transaction. A vote under Rule 14a-21(c) is required only if the shareholders are voting to approve the transaction and the transaction and golden parachute arrangements come within those covered by Section 14A(b).
  
  Id. at 6030.
\end{itemize}
The implementation of Say-on-Pay votes was one of the most widely anticipated corporate governance developments in the United States over the past five years. Advocates for Say-on-Pay hope that the advisory votes on executive compensation will increase managerial accountability and shareholder engagement.

G. REMOVAL OF REFERENCES TO RATINGS IN FORM S-3 AND FORM F-3


1. Forms S-3 and F-3

Forms S-3 and F-3 are the short forms that eligible issuers can use to register securities offerings under the Securities Act.\footnote{139. See id. at 46604. Neither the text of Form S-3 nor the text of Form F-3 appears in the Code of Federal Regulations. Id. at 46618–19.} These forms allow eligible issuers to register primary offerings on a shelf registration statement and, once the registration statement is effective, offer securities in various tranches or “takedowns” without any further Commission action.\footnote{140. See id. at 46604 (referencing 17 C.F.R. § 230.415).} To be eligible to use Form S-3 or Form F-3, an issuer must meet both (a) the eligibility requirements and (b) at least one of the form’s transaction requirements. One such transaction requirement permits registrants to register primary offerings of non-convertible securities, if they are rated investment grade by at least one NRSRO.\footnote{141. See id. at 46604 & nn.22 & 23.} For issuers that do not have a public float to meet the required threshold, this has provided an alternate means of becoming eligible to register offerings on Form S-3 or Form F-3.\footnote{142. Issuers who satisfy the $75 million public float requirement will remain eligible for registration on Forms S-3 and F-3 and are largely unaffected by the new rules.} The new rules replace the investment grade rating requirement with four alternate standards, as discussed below.
2. **Investment Grade Rating Criterion Replaced with Alternative Criteria**

Under the changes to Forms S-3 and F-3 adopted by the Commission, the investment grade rating transaction criteria will be replaced with the following four alternative criteria. Issuers will need to satisfy only one of the four criteria to use either Form S-3 or Form F-3 for offerings of non-convertible securities other than common equity.\(^{143}\) They are

a. The issuer has issued (as of a date within sixty days prior to the filing of the registration statement) at least $1 billion in non-convertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the Securities Act, over the prior three years; or

b. The issuer has outstanding (as of a date within sixty days prior to the filing of the registration statement) at least $750 million of non-convertible securities, other than common equity, issued in primary offerings for cash, not exchange, registered under the Securities Act; or

c. The issuer is a wholly owned subsidiary of a Well-Known Seasoned Issuer (“WKSI”), as defined in Rule 405 under the Securities Act; or

d. The issuer is a majority-owned operating partnership of a real estate investment trust (“REIT”) that qualifies as a WKSI.\(^{144}\)

In addition, the Commission has permitted an issuer that has a reasonable belief that it would have been qualified to use Form S-3 or Form F-3 under the investment grade rating criteria to continue to use these forms for a period of three years from the effective date of the amendments.\(^{145}\)

3. **$1 Billion of Non-Convertible Securities or $750 Million of Non-Convertible Securities Outstanding**

In addition to the $1 billion threshold of non-convertible securities, other than common equity, issued over three years, an issuer that has at least $750 million of non-convertible securities outstanding, other than common equity, issued in primary offerings for cash, not exchange, registered under the Securities Act, will be eligible to use either Form S-3 or Form F-3, if the issuer meets the other requirements of the form.\(^{146}\) The thresholds would be calculated consistent with the standards used to determine WKSI status.\(^{147}\) In determining compliance with both the $1 billion issued and the $750 million outstanding thresholds:

a. Issuers can aggregate the amount of non-convertible securities, other than common equity, issued in registered primary offerings that were issued within the previous three years (measured as of a date within sixty days prior

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143. See id. at 46606.
144. See id.
145. See id. at 46604.
146. Id. at 46607.
147. Id.
to the filing of the registration statement) or, for the non-convertible securities (other than common equity) outstanding threshold, that are outstanding as of a date within sixty days prior to the filing of the registration statement;

b. Issuers can include only such non-convertible securities, other than common equity, that were issued in registered primary offerings for cash and not registered exchange offers; and

c. Parent company issuers only can include in their calculation the principal amount of their full and unconditional guarantees, within the meaning of Rule 3-10 of Regulation S-X, of non-convertible securities, other than common equity, of their majority-owned subsidiaries issued in registered primary offerings for cash over the prior three years or, for the non-convertible securities (other than common equity) outstanding threshold, that are outstanding as of a date within sixty days prior to the filing of the registration statement.\(^{148}\)

In calculating the $1 billion or the $750 million threshold, as applicable, issuers generally may include the principal amount of any debt and the greater of liquidation preference or par value of any non-convertible preferred stock that was issued in primary registered offerings for cash.\(^{149}\) Insurance company issuers, when registering offerings of insurance contracts, may include in their calculation the amount of insurance contracts, including variable insurance contracts, issued in offerings registered under the Securities Act over the prior three years or, for the non-convertible securities (other than common equity) outstanding threshold, that are outstanding as of a date within sixty days prior to the filing of the registration statement.\(^{150}\) An insurance company may include the purchase payments or premium payments for insurance contracts issued in registered offerings over the prior three years.\(^{151}\) For the non-convertible securities threshold, the contract value (as of the measurement date) of any outstanding insurance contracts issued in registered offerings may be included.\(^{152}\)

Securities issued in unregistered offerings, registered exchange offers, or Regulation S offerings cannot be included in calculating the $1 billion or $750 million calculations.\(^{153}\)

4. Subsidiaries of WKSIs

The new rules permit issuers that are wholly owned subsidiaries of WKSIs to use Forms S-3 and F-3 for offerings of non-convertible securities other than common equity. Majority-owned or partially owned subsidiaries are not permitted under the new eligibility criteria to use either Form S-3 or Form F-3.\(^{154}\)

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148. Id.
149. Id. at 46608.
150. Id. at 46607–08.
151. Id. at 46608.
152. Id.
153. Id.
154. Id.
Although the new criteria for subsidiaries of WKSIIs generally are limited to wholly owned subsidiaries, there is a limited exception for certain operating partnerships of REITs. A majority-owned operating partnership subsidiary of a REIT is permitted to register offerings of non-convertible securities, other than common equity, on Form S-3 or Form F-3, so long as the REIT parent is a WKSI.\textsuperscript{155}

5. Grandfathering of Other Currently Eligible Issuers

To ease transition to the new rules, the Commission has permitted issuers that reasonably believe they would have qualified to use either Form S-3 or Form F-3 under the investment grade rating criteria to continue to use those forms for a period of three years from the effective date of the amendments.\textsuperscript{156} The issuer must have a reasonable belief that it would have been eligible to use the form and disclose that belief and the basis for it in the registration statement.\textsuperscript{157} Factors that indicate a reasonable belief of eligibility include, but are not limited to, the following:

\begin{enumerate}
\item An investment grade issuer credit rating;
\item A previous investment grade credit rating on a security issued in an offering similar to the type the issuer seeks to register that has not been downgraded or put on a watch list since its issuance; or
\item A previous assignment of a preliminary investment grade rating;\textsuperscript{158}
\end{enumerate}

6. Impact of Amendments

The Commission estimates that most issuers that were previously eligible to use either Form S-3 or Form F-3 will remain eligible to use those forms.\textsuperscript{159} Because the Commission believes that Congress did not intend to alter substantially the companies eligible to use those forms, it designed its rules to achieve that end.\textsuperscript{160} According to the Commission release, several issuers in the insurance industry will become newly eligible to use Form S-3 or Form F-3.\textsuperscript{161}

Particularly once the grandfathering period has ended, issuers that do not satisfy the $75 million public float requirement of Form S-3 or Form F-3 will need to review their prior and outstanding issuances of registered securities every three years to determine whether they satisfy the new eligibility requirements for short-form registration.

H. Whistleblower Protection

Section 922 of the Dodd-Frank Act added a new section 21F to the Exchange Act entitled “Securities Whistleblower Incentives and Protection.”\textsuperscript{162} The whistle-

\begin{itemize}
\item[155.] \textit{id.}
\item[156.] \textit{id.} at 46608–09.
\item[157.] \textit{id.} at 46609.
\item[158.] \textit{id.}
\item[159.] \textit{id.}
\item[160.] \textit{id.} at 46609–10.
\item[161.] \textit{id.} at 46607.
blower rules promulgated under the Dodd-Frank Act became effective August 12, 2011.\textsuperscript{163}

Rule 21F-2 defines “whistleblower”:

You are a whistleblower if, alone or jointly with others, you provide the Commission with information . . . and the information relates to a possible violation of the Federal securities laws (including any rules or regulations thereunder) that has occurred, is ongoing, or is about to occur.\textsuperscript{164}

The rules are specific that only individuals qualify for the award, and companies and entities are ineligible for any whistleblower award.\textsuperscript{165} To be eligible for an award, the whistleblower must submit original information to the Commission in accordance with the related rules.\textsuperscript{166}

1. Anti-Retaliation Measures

A whistleblower will be afforded anti-retaliation protection even if the whistleblower fails to satisfy the procedures or conditions necessary for an award.\textsuperscript{167} To be eligible for anti-retaliation protection, the whistleblower must (a) report information in accordance with the Commission rules and (b) possess a reasonable belief that the information relates to a possible securities law violation.\textsuperscript{168} The Commission explained that the “reasonable belief” standard requires “that the employee hold a subjectively genuine belief that the information demonstrates a possible violation, and that this belief is one that a similarly situated employee might reasonably possess.”\textsuperscript{169}

2. Rule 21F-3 Payment Award

The Commission will pay an award to an individual that (a) voluntarily provides the Commission, (b) with original information, (c) that leads to the successful enforcement by the Commission of a federal court or administrative action, (d) in which the Commission obtains monetary sanctions totaling more than $1,000,000.\textsuperscript{170}

The Commission will also pay a monetary award based upon amounts collected in “related actions,” whether judicial or administrative, brought by the United States Attorney General, a regulatory agency, a self-regulatory organization, or a state attorney general in a criminal case.\textsuperscript{171} However, the whistleblower will only

\begin{footnotesize}
\begin{enumerate}
\item 164. Id. at 34363 (to be codified at 17 C.F.R. § 240.21F-2(a)(1)).
\item 165. Id. (to be codified at 17 C.F.R. § 240.21F-2(a)(1)).
\item 166. Id. (to be codified at 17 C.F.R. § 240.21F-2(a)(2)).
\item 167. Id. (to be codified at 17 C.F.R. § 240.21F-2(b)(1)(iii)).
\item 168. Id. (to be codified at 17 C.F.R. § 240.21F-2(b)(1)).
\item 169. Id. at 34304 (citing Livingston v. Wyeth, Inc., 520 F.3d 344, 352 (4th Cir. 2008); Clover v. Total Sys. Servs., Inc., 176 F.3d 1346, 1351 (11th Cir. 1999)).
\item 170. Id. at 34363 (to be codified at 17 C.F.R. § 240.21F-3(a)).
\item 171. Id. at 34363–64 (to be codified at 17 C.F.R. § 240.21F-3(b)(1)).
\end{enumerate}
\end{footnotesize}
receive a payment award for a related action if the same original information voluntarily provided to the Commission led to another successful action, and that information led the Commission to a successful action with sanctions exceeding $1,000,000.172 The Commission will not pay an award for a related action to a whistleblower who has already received payment from the United States Commodity Futures Trading Commission.173 Neither will the Commission pay an award to a whistleblower for a related action if the Commission cannot substantiate that the related action draws from the same original information provided to the Commission.174

3. Definitions

a. Voluntary

A whistleblower “voluntarily” provides information if she submits the information before a request, inquiry, or demand that relates to the subject matter of the submission is directed to her or her representative by specified authorities.175 The rule precludes a whistleblower from making a “voluntary” submission if the whistleblower was previously requested to provide information (i) by the Commission; (ii) in connection with an investigation, inspection, or examination by the Public Company Accounting Oversight Board (“PCAOB”) or any self-regulatory organization; or (iii) in connection with an investigation by Congress or any other authority of the federal government or a state attorney general or securities regulatory authority.176 The Commission clarified that a submission will not be considered voluntary even if a response is not compelled by subpoena.177 The Commission chose not to include foreign authorities in the list of Rule 21F-4(a) authorities, as information exchange between the Commission and foreign authorities is uncertain.178

The whistleblower rules prevent individuals from making “voluntary” submissions to the Commission following information requests by the above specified authorities.179 However, only requests that are directed to the individual or her representative will preclude the individual from making a “voluntary” submission to the Commission at a later point.180 Likewise, submissions will not be deemed “voluntary” if the submission responds, or provides closely related information, to a request.181 Those under continuing legal duties to provide information to the Commission will be disqualified under these rules.182 The Commission will not

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172. Id. at 34364 (to be codified at 17 C.F.R. § 240.21F-3(b)(2)).
173. Id. (to be codified at 17 C.F.R. § 240.21F-3(b)(3)).
174. Id. (to be codified at 17 C.F.R. § 240.21F-3(b)(2)(ii)).
175. Id. (to be codified at 17 C.F.R. § 240.21F-4(a)(1)).
176. Id. (to be codified at 17 C.F.R. § 240.21F-4(a)(1)).
177. Id. (to be codified at 17 C.F.R. § 240.21F-4(a)(2)).
178. Id. at 34308 n.74.
179. Id. at 34308 (to be codified at 17 C.F.R. § 240.21F-4(a)(1)).
180. Id. at 34309.
181. Id. at 34364 (to be codified at 17 C.F.R. § 240.21F-4(a)(1)).
182. Id. (to be codified at 17 C.F.R. § 240.21F-4(a)(3)).
treat as “voluntary” one’s submission if made pursuant to a contractual obligation to the Commission or one of the other specified regulatory bodies,183 but general contractual obligations to disclose will not prohibit the treatment of one’s submission as “voluntary.” Otherwise, employers could require such disclosure of employees by contract and prevent any employee’s eligibility as a whistleblower.184 While submissions will still be considered “voluntary” if submitted to the Commission after an internal investigation, the Commission may diminish rewards for those whistleblowers who choose not to utilize their employer’s internal compliance program in addressing possible violations of law.185

b. Original Information

Rule 21F-4(b) defines “original information” as information (1) derived from the whistleblower’s “independent knowledge” or “independent analysis,” (2) not already known to the Commission from any other source; (3) not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation; or from the news media, unless the whistleblower was the source of the information, and (4) provided to the Commission for the first time after July 21, 2010 (the date of enactment of the Dodd-Frank Act).186

The last requirement makes clear that individuals eligible for the whistleblower reward are only those who provide “original information” to the Commission for the first time after the enactment of the Dodd-Frank Act.187

The definition of “original information” requires that the whistleblower provide “independent knowledge” or “independent analysis,” both of which are defined terms.188 “Independent knowledge” means “factual information in [one’s] possession that is not derived from publicly available sources. [One] may gain ‘independent knowledge’ from [one’s] experiences, communications and observations in [one’s] business or social interactions.”189 The definition of “independent knowledge” does not require direct first-hand knowledge.190

The Commission defined “independent analysis” to mean “[one’s] own analysis, whether done alone or in combination with others. Analysis means [one’s] examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public.”191

The definition of “original information” contains three general exclusions from the definitions of “independent knowledge” and “independent analysis,” which the Commission describes as “(1) [o]n behalf of a third party operating in a

183. Id. (to be codified at 17 C.F.R. § 240.21F-4(a)(3)).
184. Id. at 34309.
185. Id. at 34308.
186. Id. at 34364 (to be codified at 17 C.F.R. § 240.21F-4(b)(1)).
187. See id.
188. Id. (to be codified at 17 C.F.R. § 240.21F-4(b)(2), (3)).
189. Id. (to be codified at 17 C.F.R. § 240.21F-4(b)(2)).
190. Id. at 34312.
191. Id. (to be codified at 17 C.F.R. § 240.21F-4(b)(3)).
sensitive legal, compliance, or governance role . . . ; or (2) in the performance of an engagement required by the Federal securities laws . . . ; or (3) by illegal means.”

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c. Independent Knowledge and Independent Analysis

Rule 21F-4(b)(4)(i) excludes from the definitions of “independent knowledge” and “independent analysis” information that is obtained through communication subject to the attorney-client privilege.\[193\] Relatedly, Rule 21F-4(b)(4)(ii) excludes from the “independent knowledge” and “independent analysis” definitions information obtained through legal representation.\[194\] Consequently, attorneys will not be granted an award for any privileged information submitted to the Commission. The aforementioned exclusions apply to non-attorneys as well, such that one who submits to the Commission any information obtained through a confidential attorney-client communication would not be eligible for an award.\[195\] However, if one submits to the Commission any communication that is specifically exempted from the attorney-client privilege, such as communication subject to the crime-fraud exemption, then the person would remain eligible for an award, whether that person was an attorney or non-attorney.\[196\]

Rules 21F-4(b)(4)(iii) and (iv) exclude from the definitions of “independent knowledge” and “independent analysis” any information obtained by certain company personnel charged with compliance-related responsibilities.\[197\] Officers, directors, trustees, or partners of an entity are excluded from the definitions if (1) the person learned of alleged misconduct as a result of being informed by another person, or (2) the person learned of the alleged misconduct through the company’s process for identifying, reporting, and correcting potential non-compliance with the law.\[198\] An officer or another designated person is not precluded from obtaining an award for a whistleblower submission in all circumstances; for example, the rules do not preclude an officer from becoming eligible for a whistleblower award if the officer discovers information indicating that other members of senior management are engaged in a securities law violation.\[199\] An employee or another charged with internal audit or compliance responsibilities for a company and who obtains information due to such a position would not be submitting that information based upon that person’s “independent knowledge” or “independent analysis.”\[200\] Finally, an employee or affiliated person retained to conduct an inquiry or investigation into possible violations and who obtains

\[192\] Id. at 34313.
\[193\] Id. at 34364 (to be codified at 17 C.F.R. § 240.21F-4(b)(4)(i)).
\[194\] Id. (to be codified at 17 C.F.R. § 240.21F-4(b)(4)(ii)).
\[195\] Id. at 34315.
\[196\] Id.
\[197\] Id. at 34364 (to be codified at 17 C.F.R. § 240.21F-4(b)(4)(iii), (iv)).
\[198\] Id. (to be codified at 17 C.F.R. § 240.21F-4(b)(4)(iii)(A)). For the definition of “officer,” see 17 C.F.R. § 240.3b-2 (2011).
\[200\] Id. at 34364 (to be codified at 17 C.F.R. § 240.21F-4(b)(4)(iii)(B)).
information because of such a position would not be submitting that information based upon that person’s “independent knowledge” or “independent analysis.”

Rule 21F-4(b)(4)(iii)(D) excludes from the definitions of “independent knowledge” and “independent analysis” information learned by an employee of, or person associated with, a public accounting firm through an audit or engagement required by the federal securities laws if the information concerns the client or the client’s directors, officers, or employees. The rule does not limit an individual from making a submission alleging that the public accounting firm violated the federal securities laws or professional standards.

While Rule 21F-4(b)(4)(iii) generally excludes certain categories of individuals from eligibility for a whistleblower award, the rules set forth several “exceptions to the exceptions” that generally restore one’s eligibility for a whistleblower award. The first restorative example applies when one has “a reasonable basis to believe that disclosure of the information to the Commission is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors.” The whistleblower will generally need to demonstrate that responsible management was aware of an imminent violation and failed to take steps to prevent it. The second example applies when the whistleblower has a reasonable basis to believe that the entity is engaging in conduct that would impede an investigation of the misconduct. The third example permits a whistleblower to submit information to the Commission if more than 120 days have passed since either (1) the person passed the information on to the person’s supervisor or the company’s audit committee, chief legal officer, chief compliance office (or the equivalents); or (2) the person learned the information under circumstances in which the person’s supervisor and/or the company’s audit committee, chief legal officer, chief compliance officer (or the equivalents) were already aware of the information.

Under Rule 21F-4(b)(4)(iv), a whistleblower’s information will be excluded from the definitions of “independent knowledge” and “independent analysis” if the information was obtained in a manner that is determined by a United States court to violate applicable federal or state criminal law. The Commission determined not to extend the exclusion to information obtained in violation of domestic civil or foreign law, or judicial or administrative protective orders.

Under Rule 21F-4(b)(4)(vi), the Commission will not consider information to be derived from one’s “independent knowledge” or “independent analysis” if one “obtained the information from a person who is subject to this section, unless
the information is not excluded from that person’s use pursuant to this section, or [one is] providing the Commission with information about possible violations involving that person.” Therefore, if a senior officer, after receiving a report concerning possible securities violations, gave the information to her assistant, the assistant would not be able to seek a whistleblower award based on that information as long as the senior officer was barred from doing so.

d. Original Source

Rule 21F-4(b)(5) describes how the Commission would determine the “original source” of information. An individual (“Person B”) will be considered the “original source” if the information provided to the Commission satisfies the definition of “original information,” and the source that provided information to the Commission or other relevant authority (“Person A”) actually received the information from Person B. Information must be voluntarily provided by the source to one of the previously specified authorities. One who claims to be the “original source” must establish such status to the satisfaction of the Commission. The Commission may verify the source of information by working with relevant authorities or another entity, such as the source’s employer. Person A’s qualification as the “original source” will not exclude Person B from obtaining an award, to the extent that Person B’s submission was derived from “independent knowledge.” However, if the Commission has already begun an investigation based on Person B’s information, Person A may have to satisfy the additional requirement that his or her information “significantly contributed” to the success of the action under Rule 21F-4(c)(2).

Rule 21F-4(b)(6) specifies that one who is not an original source and who submits information about a matter already known to the Commission may nonetheless be an “original source” for any information derived from one’s “independent knowledge” or “independent analysis” that “materially adds to the information that the Commission already possesses.”

Rule 21F-4(b)(7) provides a lookback period for the date of disclosure for information provided to one of the listed authorities prior to its disclosure to the Commission. If a person provides information to certain listed authorities other than the Commission and/or an entity’s internal whistleblower compliance mechanism, and within 120 days submits the same information to the Commission,

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210. Id. at 34365 (to be codified at 17 C.F.R. § 240.21F-4(b)(vi)).
211. Id. at 34321.
212. Id. at 34365 (to be codified at 17 C.F.R. § 240.21F-4(b)(5)).
213. Id. (to be codified at 17 C.F.R. § 240.21F-4(b)(5)).
214. Id. (to be codified at 17 C.F.R. § 240.21F-4(b)(5)).
215. Id. (to be codified at 17 C.F.R. § 240.21F-4(b)(5)).
216. Id. (to be codified at 17 C.F.R. § 240.21F-4(b)(5)).
217. Id. at 34321.
218. Id. at 34321–22.
219. Id. at 34365 (to be codified at 17 C.F.R. § 240.21F-4(b)(6)).
220. Id. (to be codified at 17 C.F.R. § 240.21F-4(b)(7)).
the Commission will consider the date of disclosure as the date information was originally provided to the authority other than the Commission. The rule places the burden of establishing a date of submission on the whistleblower, though the Commission may verify the submission date. The lookback rule for date of original submission is particularly useful to a party who has submitted information to the Commission that resulted in the investigation, where another party submitted information to one of the listed authorities other than the Commission. The lookback rule permits the treatment of the second party to disclose to the Commission as the “original source.”

To be eligible for a whistleblower award, one must voluntarily provide the Commission with original “information that leads to successful enforcement.” Under Rule 21F-4(c)(1), information will have led to a successful enforcement if the whistleblower provided (1) original information that was (2) sufficiently specific, credible, and timely, and caused (3) the staff to commence an examination, commence an investigation, reopen an investigation, or inquire about different conduct as part of a current examination or investigation, and (4) the Commission brought a successful judicial or administrative action based in whole or in part on the information.

The Commission does not envision a mechanical application of this standard, but rather will examine the identifications of persons, times, places, entities and/or conduct that correspond to those alleged by the Commission in a judicial or administrative action. When a whistleblower provides information concerning conduct that is already under investigation or examination, the whistleblower’s information must have “significantly contributed” to a successful action. In applying the “significantly contributed” to standard, the Commission will review whether the information contributed to a successful action utilizing less time or resources, or provided additional claims against the same persons or entities, or claims against additional persons or entities. Rule 21F-4(c)(3) provides additional incentives to report through internal compliance programs. The individual may receive full credit for the information provided by the employer if an individual provided information through an entity’s internal whistleblower, legal, or compliance program, and that entity later provided the individual’s information to the Commission that led to a successful enforcement action and satisfied Rule 21F-4(c)(1) or (2), or that entity later provided results of an audit or investigation that was initiated by the individual’s information. The individual must submit the information to the Commission within 120 days of providing the same information to the

221. Id. (to be codified at 17 C.F.R. § 240.21F-4(b)(7)).
222. Id. (to be codified at 17 C.F.R. § 240.21F-4(b)(7)).
223. Id. at 34322.
224. Id. at 34322–23.
225. Id. at 34365 (to be codified at 17 C.F.R. § 240.21F-4(c)).
226. Id. (to be codified at 17 C.F.R. § 240.21F-4(c)(1)).
227. Id. at 34324.
228. Id. at 34365 (to be codified at 17 C.F.R. § 240.21F-4(c)(2)).
229. Id. at 34325.
230. Id. at 34365 (to be codified at 17 C.F.R. § 240.21F-4(c)(3)).
231. Id. (to be codified at 17 C.F.R. § 240.21F-4(c)(3)).
company.\textsuperscript{232} If the entity does not have an established internal procedure for reporting violations of law, the Commission will consider an employee who reports a possible violation to the entity’s legal counsel, senior management, or director or trustee to satisfy the requirements of this section.\textsuperscript{233} Reporting to a supervisor will only qualify under this section if the company’s internal compliance procedures require or permit reporting to a supervisor.\textsuperscript{234}

e. Action

Rule 21F-4(d) defines “action” generally to mean “a single captioned judicial or administrative proceeding brought by the Commission.”\textsuperscript{235} The rule also identifies two exceptions to the general definition. First, the Commission will consider an “action” to be two or more administrative or judicial proceedings if the proceedings arise out of the same nucleus of operative facts.\textsuperscript{236} Second, the Commission will treat as part of the same action any subsequent Commission proceeding that individually results in a monetary sanction of $1,000,000 or less and arises out of the same nucleus of operative facts.\textsuperscript{237}

f. Additional Definitions

“Appropriate regulatory agency” is defined as “the Commission, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and any other agencies that may be defined as appropriate regulatory agencies under Section 3(a)(34) of the Exchange Act.”\textsuperscript{238} The Commission defined “appropriate regulatory agency” not to include the PCAOB.\textsuperscript{239} However, the PCAOB is separately set forth as an authority with which the Commission may share whistleblower information.\textsuperscript{240} The related definition of “appropriate regulatory authority” is simply defined as “an appropriate regulatory agency other than the Commission.”\textsuperscript{241}

“Monetary sanctions,” “appropriate regulatory agency,” and “self-regulatory organization” are each defined consistently with the Exchange Act.\textsuperscript{242}

4. Amount of Award—Rule 21F-5 and Rule 21F-6

The Commission has absolute discretion in determining the amount of the award to a whistleblower.\textsuperscript{243} The total award the Commission will provide,

\begin{itemize}
\item \textsuperscript{232} Id. (to be codified at 17 C.F.R. § 240.21F-4(c)(3)).
\item \textsuperscript{233} Id. at 34325.
\item \textsuperscript{234} Id.
\item \textsuperscript{235} Id. at 34365 (to be codified at 17 C.F.R. § 240.21F-4(d)).
\item \textsuperscript{236} Id. (to be codified at 17 C.F.R. § 240.21F-4(d)(1)).
\item \textsuperscript{237} Id. (to be codified at 17 C.F.R. § 240.21F-4(d)(2)).
\item \textsuperscript{238} Id. at 34365–66 (to be codified at 17 C.F.R. § 240.21F-4(f)).
\item \textsuperscript{239} Id. at 34328.
\item \textsuperscript{240} Id. at 34367 (to be codified at 17 C.F.R. § 240.21F-7(a)(2)).
\item \textsuperscript{241} Id. at 34366 (to be codified at 17 C.F.R. § 240.21F-4(g)).
\item \textsuperscript{242} Id. at 34328–29 (to be codified at 17 C.F.R. § 240.21F-4(e), (f), (h)).
\item \textsuperscript{243} Id. at 34366 (to be codified at 17 C.F.R. § 240.21F-5(a)).
\end{itemize}
whether only one or several whistleblowers provide information in connection with the same or related actions, will be at least 10 percent, but not more than 30 percent, of the monetary sanctions that the Commission and other authorities are able to collect.\textsuperscript{244}

The criteria for determining the amount of the award are set forth in Rule 21F-6.\textsuperscript{245} The following are relevant factors to increase a whistleblower’s percentage of reward: (a) significance of the information provided by the whistleblower, (b) assistance provided by the whistleblower, (c) law enforcement interest in making a whistleblower award, and (d) participation by the whistleblower in internal compliance systems.\textsuperscript{246} A whistleblower need not meet all of the factors in order to receive the full amount of award permitted under the rule.

In contrast, the following criteria may decrease a whistleblower’s award percentage: (a) culpability of the whistleblower, (b) unreasonable reporting delay by the whistleblower, and (c) interference with internal compliance and reporting systems by the whistleblower.\textsuperscript{247}

5. Confidentiality

Rule 21F-7 tracks the Dodd-Frank Act regarding the protection of the identity of any whistleblower.\textsuperscript{248} The Commission generally is prohibited from disclosing information that could “reasonably be expected to reveal the identity of the whistleblower.”\textsuperscript{249} Information may be disclosed as required by (a) a federal court or administrative action that the Commission files or (b) another public action filed by an authority to which the Commission provided the information.\textsuperscript{250} Information may also be disclosed (a) as the Commission determines is necessary to accomplish the purposes of the Exchange Act; and (b) to protect investors, to the U.S. Department of Justice, an appropriate regulatory authority, a self-regulatory organization, a state attorney general in connection with a criminal investigation, any appropriate state regulatory authority, the PCAOB, or foreign securities and law enforcement authorities.\textsuperscript{251} Finally, information may be disclosed in accordance with the Privacy Act of 1974.\textsuperscript{252}

In addition, the Commission set forth guidelines through which a whistleblower can provide information anonymously.\textsuperscript{253} The whistleblower must be represented by an attorney whose name and contact information is provided to the

\textsuperscript{244}. Id. (to be codified at 17 C.F.R. § 240.21F-5(b), (c)).

\textsuperscript{245}. Id. (to be codified at 17 C.F.R. § 240.21F-6).

\textsuperscript{246}. Id. (to be codified at 17 C.F.R. § 240.21F-6(a)(1)–(4)).

\textsuperscript{247}. Id. at 34366–67 (to be codified at 17 C.F.R. § 240.21F-6(b)(1)–(3)).

\textsuperscript{248}. Id. at 34367 (to be codified at 17 C.F.R. § 240.21F-7(a) (referencing 15 U.S.C. § 78u-6(h)(2), which was created by section 922 of the Dodd-Frank Act)).

\textsuperscript{249}. Id. (to be codified at 17 C.F.R. § 240.21F-7(a)).

\textsuperscript{250}. Id. (to be codified at 17 C.F.R. § 240.21F-7(a)(1)).

\textsuperscript{251}. Id. (to be codified at 17 C.F.R. § 240.21F-7(a)(2)). Each of the specified regulators—other than foreign securities law enforcement authorities—is subject to the confidentiality requirements set forth in the Exchange Act. Id. (to be codified at 17 C.F.R. § 240.21F-7(a)(2)).

\textsuperscript{252}. Id. (to be codified at 17 C.F.R. § 240.21F-7(a)(3)).

\textsuperscript{253}. Id. (to be codified at 17 C.F.R. § 240.21F-7(b)).
Commission, and the submission must comply with Rule 21F-9. The identity of the anonymous person must be provided to the Commission, and is subject to verification, before the Commission will pay an award.

6. Eligibility

Rule 21F-8 sets forth the procedural requirements that a whistleblower must satisfy to be eligible for a whistleblower award. In general, the whistleblower must be available to provide an explanation of information, provide additional information, and provide testimony. The whistleblower may also be required to enter into a confidentiality agreement as to any non-public information the Commission provides to the whistleblower. The confidentiality agreement would not limit the whistleblower’s use of information that the whistleblower already knows or learns from other sources.

Rule 21F-8 sets forth additional criteria that could render one ineligible to receive a whistleblower award. A person is ineligible for whistleblower status if he or she is convicted of a criminal violation that is related to the Commission action or a related action for which the whistleblower would have received an award. One is ineligible for whistleblower status if—in the submission to, or other dealings with, the Commission or other authority—he or she (a) knowingly and willfully makes any false, fictitious, or fraudulent statement or representation; or (b) uses any false writing or document knowing that it contains any false, fictitious, or fraudulent statement or entry with intent to mislead or hinder the Commission or another authority. The eligibility exclusion does not apply to false information provided in the course of an internal investigation.

The rule further excludes one from whistleblower status if he or she obtained original information through an audit of the entity’s financial statements, and if the submission would be contrary to the requirements of section 10A of the Exchange Act. One is similarly ineligible as a whistleblower if his or her source was subject to the auditor’s exclusion, unless the auditor would have been permitted to use that information, or the person is providing the Commission with information about possible violations that involve that auditor.

Rule 21F-8 renders some individuals ineligible for a whistleblower award based on their employer. One is ineligible for whistleblower status if he or she is, or

254. Id. (to be codified at 17 C.F.R. § 240.21F-7(b)(1), (2)).
255. Id. (to be codified at 17 C.F.R. § 240.21F-7(b)(3)).
256. Id. (to be codified at 17 C.F.R. § 240.21F-8).
257. Id. (to be codified at 17 C.F.R. § 240.21F-8(b)(1)–(3)).
258. Id. (to be codified at 17 C.F.R. § 240.21F-8(b)(4)).
259. Id. at 34334.
260. Id. at 34367–68 (to be codified at 17 C.F.R. § 240.21F-8(c)).
261. Id. at 34368 (to be codified at 17 C.F.R. § 240.21F-8(c)(3)).
262. Id. (to be codified at 17 C.F.R. § 240.21F-8(c)(7)).
263. Id. at 34335.
264. Id. at 34368 (to be codified at 17 C.F.R. § 240.21F-8(c)(4)).
265. Id. (to be codified at 17 C.F.R. § 240.21F-8(c)(6)).
was at the time of providing original information to the Commission, a member, officer, or employee of (a) the Commission, the U.S. Department of Justice, an appropriate regulatory agency, a self-regulatory organization, the PCAOB, or any law enforcement organization; or (b) a foreign government or foreign regulatory authority. Moreover, certain family members and persons who reside with an employee of the Commission are ineligible for whistleblower status.

7. Procedures for Submitting Original Information

A person must make a submission to the Commission online or by mail or fax to the Commission Office of the Whistleblower using Form TCR. Other than anonymous submissions, the submission must be made under penalty of perjury that, to the best of the whistleblower’s knowledge and belief, the information is true and correct.

For an anonymous submission, the whistleblower still must complete a Form TCR, signed under penalty of perjury, and provide that form to his or her attorney. When the whistleblower’s attorney makes a submission on behalf of the whistleblower, the attorney must certify that he or she (a) has verified the whistleblower’s identity; (b) has reviewed the Form TCR for accuracy and completeness, and that the information contained therein is true, correct, and complete, to the best of the attorney’s knowledge, information, and belief; (c) has obtained the whistleblower’s non-waivable consent to provide the Commission with an original Form TCR in the event the Commission believes the whistleblower may have knowingly provided false information; and (d) consents to be legally obligated to provide the original Form TCR within seven days of the Commission’s request.

8. Procedure for Making a Claim Based on a Successful Commission Action

Rule 21F-10 sets forth the procedure for claiming money based on a successful action by the Commission. Whenever a Commission action results in monetary sanctions totaling more than $1,000,000, the Office of the Whistleblower will publish a “Notice of Covered Action” on the Commission’s website. The Commission additionally plans to provide actual notice to the whistleblowers with whom the staff has worked closely. A claimant must file a Form WB-APP within ninety days from the date the Notice of Covered Action is published to make a claim, or such claim will be barred. Anonymous whistleblowers must disclose their identity in order

266. Id. at 34367–68 (to be codified at 17 C.F.R. § 240.21F-8(c)(1), (2)).
267. Id. at 34368 (to be codified at 17 C.F.R. § 240.21F-8(c)(5)).
268. Id. (to be codified at 17 C.F.R. § 240.21F-9(a)).
269. Id. (to be codified at 17 C.F.R. § 240.21F-9(b)).
270. Id. (to be codified at 17 C.F.R. § 240.21F-9(c)).
271. Id. (to be codified at 17 C.F.R. § 240.21F-9(c)(1)–(4)).
272. Id. (to be codified at 17 C.F.R. § 240.21F-10).
273. Id. (to be codified at 17 C.F.R. § 240.21F-10(a)).
274. Id. at 34343.
275. Id. at 34368 (to be codified at 17 C.F.R. § 240.21F-10(a), (b)).
to claim an award.\textsuperscript{276} The Commission may request further information from the whistleblower before determining the award amount.\textsuperscript{277} The Commission will make a Preliminary Determination setting forth a preliminary assessment as to whether an award should be granted, and if so, the proposed award percentage amount.\textsuperscript{278}

Rule 21F-11 sets forth the procedures for making a claim based on a successful related action.\textsuperscript{279} Claimants must submit a signed and completed Form WB-APP.\textsuperscript{280} If a final order imposing monetary sanctions has been entered in a related action at the time the whistleblower submits a claim for an award in connection with a Commission action, the whistleblower must submit a claim for an award in that related action on the same Form WB-APP used for the Commission action.\textsuperscript{281} If a final order imposing monetary sanctions in a related action has not been entered at the time the whistleblower submits a claim for an award in connection with a Commission action, the whistleblower must submit a claim on Form WB-APP within ninety days of the issuance of a final order imposing sanctions in the related action.\textsuperscript{282} Similar to Rule 21F-10, the Commission may request further information from the whistleblower in order to determine the award amount.\textsuperscript{283}

Both Rules 21F-10 and 21F-11 set forth the process by which a whistleblower may contest the denial of an award or the amount of an award.\textsuperscript{284} The individual seeking a whistleblower award may, within thirty days of the date of the Preliminary Determination, request (a) to review the materials that set forth the basis of the Preliminary Determination, or (b) a meeting with the Office of the Whistleblower (but no such meeting is required, and the office, in its sole discretion, may decline the request).\textsuperscript{285} The person seeking to contest an award must submit a written response and supporting materials to the Office of the Whistleblower within sixty days of the date of the Preliminary Determination or the date the Commission made information available to the whistleblower.\textsuperscript{286} The Preliminary Determination will become a Final Order of the Commission if no party contests the award.\textsuperscript{287} If a whistleblower contests the award, the Claims Review Staff will consider the issues presented and provide a Proposed Final Determination.\textsuperscript{288} The Office of the

\textsuperscript{276} Id. (to be codified at 17 C.F.R. § 240.21F-10(c)).
\textsuperscript{277} Id. at 34369 (to be codified at 17 C.F.R. § 240.21F-10(d)).
\textsuperscript{278} Id. (to be codified at 17 C.F.R. § 240.21F-11(b)).
\textsuperscript{279} Id. (to be codified at 17 C.F.R. § 240.21F-11(b)(1)).
\textsuperscript{280} Id. (to be codified at 17 C.F.R. § 240.21F-11(b)(2)).
\textsuperscript{281} Id. (to be codified at 17 C.F.R. § 240.21F-11(c)).
\textsuperscript{282} Id. (to be codified at 17 C.F.R. § 240.21F-11(e)).
\textsuperscript{283} Id. at 34369–70 (to be codified at 17 C.F.R. § 240.21F-10(e)); id. at 34369–70 (to be codified at 17 C.F.R. § 240.21F-11(e)).
\textsuperscript{284} Id. at 34369 (to be codified at 17 C.F.R. § 240.21F-10(e)(1)(i)–(ii)); id. at 34370 (to be codified at 17 C.F.R. § 240.21F-11(e)(1)(i)–(ii)).
\textsuperscript{285} Id. at 34369 (to be codified at 17 C.F.R. § 240.21F-10(e)(2)); id. at 34370 (to be codified at 17 C.F.R. § 240.21F-11(e)(2)).
\textsuperscript{286} Id. at 34369 (to be codified at 17 C.F.R. § 240.21F-10(f)); id. at 34370 (to be codified at 17 C.F.R. § 240.21F-11(f)).
\textsuperscript{287} Id. at 34369 (to be codified at 17 C.F.R. § 240.21F-10(g)); id. at 34370 (to be codified at 17 C.F.R. § 240.21F-11(g)). The Claims Review Staff will be designated by the Director of the Division of Enforcement. Id. at 34369.
Whistleblower will notify the Commission of the Proposed Final Determination, which will become a Final Order thirty days thereafter, unless a Commissioner requests to review the Proposed Final Determination during that thirty-day period.  

Rule 21F-12 specifies the materials that the Commission and Claims Review Staff may rely upon in making an award determination. These materials include (a) publicly available information, including filings with a court; (b) the whistleblower’s Form TCR and Form WB-APP, including any attachments; (c) sworn declarations from the Commission staff; and (d) any other documents the Commission receives or obtains that the entity has authorized the Commission to share with the whistleblower. The whistleblower is not entitled to obtain from the Commission any materials other than those just described, which materials may be redacted. The claimant cannot, for example, obtain “pre-decisional or internal deliberative process materials that are prepared exclusively to assist the Commission in deciding the claim.”

After a Final Order is issued pursuant to Rule 21F-10 or Rule 21F-11, a party may appeal (a) whether an award is made and (b) the persons to whom an award is made. The aggrieved person may appeal the order in either the United States Court of Appeals for the District of Columbia Circuit, or the circuit where the aggrieved person resides or has a principal place of business. However, no person may appeal the amount of the award where the Commission makes an award of not less than 10 percent and not more than 30 percent of the monetary sanctions collected in the Commission or related action. The record on appeal shall consist of the materials listed in Rule 21F-12(a), the Preliminary Determination, and the Final Order. As with Rule 21F-12(a), the record on appeal shall not include any pre-decisional or internal deliberative process materials, including drafts, that are prepared exclusively to assist the Commission in deciding the claim.

Awards to whistleblowers will be paid out of a Commission Investor Protection Fund (“Fund”). A whistleblower will not receive an award until the later of (a) monetary sanctions actually collected or (b) the conclusion of the whistleblower appeals process arising from the Notice of Covered Action or a related action. If the amounts available in the Fund are insufficient to pay the entire whistleblower award, the balance of payment distribution among multiple whistleblowers will be paid as follows: (a) where payments owed arise from the same Notice of Covered Action.
Action, on a pro rata basis to each whistleblower; and (b) for payments owed arising from separate Notices of Covered Action, on a priority basis determined by the date the Commission collects monetary sanctions, unless recovered on the same date, in which case whistleblowers will be paid on a pro rata basis.  

9. Treatment of Whistleblowers Who Engage in Misconduct

A whistleblower may receive an award even if the whistleblower engaged in culpable conduct. Any monetary sanctions that the whistleblower has to pay, or any liability of the entity based substantially on the actions of the whistleblower, will not count toward the $1,000,000 threshold to be satisfied prior to the payment of an award. A whistleblower does not automatically receive amnesty if she provides information to the Commission regarding securities violations. The Commission may bring an action against the whistleblower who participated in misconduct.

10. Staff Communication with Whistleblowers

No person can take any action to impede another individual from communicating directly with the Commission. If an individual comes forward with information regarding a possible securities violation, and that individual is a director, officer, member, or employee of an entity with counsel, the Commission may speak directly with the individual who reports a possible securities violation without seeking consent of an entity’s counsel.

I. Security-Based Swaps and the Re-Adoption of the Beneficial Ownership and Reporting Requirements

On June 8, 2011, the Commission readopted, without change, certain provisions of its existing Exchange Act Rules 13d-3 and 16a-1. These rules were originally proposed for re-adoption in the wake of the Dodd-Frank Act’s creation of section 13(o). This newly created section 13(o) authorized the Commission

301. Id. (to be codified at 17 C.F.R. § 240.21F-14(d)).
302. Id. (to be codified at 17 C.F.R. § 240.21F-16).
303. Id. (to be codified at 17 C.F.R. § 240.21F-16).
304. Id. (to be codified at 17 C.F.R. § 240.21F-15).
305. Id. (to be codified at 17 C.F.R. § 240.21F-15).
306. Id. (to be codified at 17 C.F.R. §§ 240.21F-17(a)).
307. Id. (to be codified at 17 C.F.R. §§ 240.21F-17(b)).
309. Beneficial Ownership Reporting Requirements and Security-Based Swaps, 76 Fed. Reg. 15874 (proposed Mar. 17, 2011) (to be codified at 17 C.F.R. pt. 240); see also Dodd-Frank Act § 766, 15 U.S.C. § 78m(o) (Supp. IV 2010) (stating that, for purposes of Section 13 and 16 of the Exchange Act, “a person shall be deemed to acquire beneficial ownership of an equity security based on the purchase or sale of a security-based swap, only to the extent that the Commission, by rule, determines . . . that the purchase or sale of the security-based swap . . . provides incidents of ownership comparable to direct ownership of the equity security, and that it is necessary to achieve the purpose of this section [13] that the purchase or sale of the security-based swaps . . . be deemed the acquisition of beneficial ownership of the equity security” (emphasis added)).
to enact a rule attributing beneficial ownership to a person who purchases or sells a security-based swap, only if it determined that such person has incidents of ownership in the underlying security akin to direct ownership. By readopting, without change, certain provisions of Rules 13d-3 and 16a-1, the Commission ensured that the existing beneficial ownership determinations would continue to apply to persons who use security-based swaps in certain situations. Absent such re-adoptions, section 13(o) may have rendered the beneficial ownership regulations inapplicable to a person who uses a security-based swap.

1. Beneficial Ownership Determinations Under Section 13

Sections 13(d) and 13(g) of the Exchange Act require a person who becomes a beneficial owner of more than 5 percent of certain equity securities to disclose information relating to ownership. As originally adopted and applied, Rule 13d-3 provided the criteria for determining whether a person would be deemed a “beneficial owner” of a security. By readopting Rule 13d-3(a), Rule 13d-3(b), and Rule 13d-3(d)(1), the Commission ensured that these determinations would continue to apply in the same manner as they had before section 13(o) became effective to persons who purchase or sell security-based swaps.

a. Rule 13d-3(a)—Conferring Voting or Investment Power

Under Rule 13d-3(a), a person is deemed a beneficial owner when a contract or other arrangement confers to that person the voting or investment power of the underlying security. As a result of its re-adoption, Rule 13d-3(a) will continue to deem a person the beneficial owner of an equity security if voting or investment power in the underlying security is conferred by (1) a security-based swap or (2) an arrangement or other understanding based on the use of a security-based swap.

310. See Dodd-Frank Act § 766, 15 U.S.C. § 78m(o) (requiring the Commission to consult with prudential regulators and the Secretary of the Treasury before promulgating a rule that would deem a person to have acquired beneficial ownership of an equity based on the purchase or sale of a security-based swap).
312. Id. at 34580.
313. See 15 U.S.C. § 78m(d)(1) (2006 & Supp. IV 2010) (applying to any equity security (a) of a class that is registered pursuant to section 78f of the Exchange Act, (b) issued by a closed-end investment company registered under the Investment Company Act of 1940, (c) issued by a Native Corporation pursuant to 43 U.S.C. § 1629c(d)(6), or (d) described in Rule 13d-1(i)); 15 U.S.C. § 78m(g) (2006 & Supp. IV 2010) (same).
314. See 15 U.S.C. § 78m(d) (2006 & Supp. IV 2010) (requiring a person to file Schedule 13D with the Commission within ten days after acquiring beneficial ownership of more than 5 percent of a class of certain equity securities); 15 U.S.C. § 78m(g) (enabling certain persons to file a short form Schedule 13G with the Commission after acquiring beneficial ownership of more than 5 percent of a class of certain equity securities).
316. Id. at 34584.
318. Readopted Rules, supra note 308, 76 Fed. Reg. at 34584 (to be recodified at 17 C.F.R. § 240.13d-3(a)).
b. Rule 13d-3(b)—Evading Reporting Requirements

A person is deemed a beneficial owner under Rule 13d-3(b) when that person creates or uses a device to divest a beneficial ownership—or to prevent the vesting of a beneficial ownership—to evade the beneficial ownership reporting requirements.\(^\text{319}\) By virtue of its re-adoption, Rule 13d-3(b) will continue to deem a person the beneficial owner of a security when that person uses a security-based swap to evade the reporting requirements associated with beneficial ownership, and that person will continue to be subject to the beneficial ownership disclosure requirements.\(^\text{320}\)

c. Rule 13d-3(d)(1)—Granting Right to Acquire Equity Security

Under Rule 13d-3(d)(1), a person is deemed the beneficial owner of a security when that person has the right to acquire a beneficial ownership of that security (a) within sixty days or (b) for the purpose of changing or influencing control of the issuer.\(^\text{321}\) After its re-adoption, Rule 13d-3(d)(1) will continue to deem such a person the beneficial owner of a security if the right to acquire that security originates from the use of a security-based swap or an understanding in connection with a security-based swap.\(^\text{322}\)

2. Beneficial Ownership Determinations Under Section 16

Section 16(a) of the Exchange Act requires every person who is the beneficial owner of more than 10 percent of any class of registered equity security (“holder”) or who is a director or officer (“management”) of the issuer of such security (collectively “insiders”) to file certain information disclosing their beneficial ownership—or any changes in their ownership—of the issuer’s securities.\(^\text{323}\) To prevent these insiders from misusing non-public information, section 16(b) provides the issuer with a private right of action to recover any profits received by an insider from the purchase and sale—or sale and purchase—of the issuer’s equity securities within any period of less than six months.\(^\text{324}\)

As used in section 16, the term “beneficial owner” has two distinct meanings: (1) one meaning for determining who is subject to the section 16 disclosures and (2) another meaning for determining what securities are subject to disclosure and short-swing profit disgorgement.\(^\text{325}\)

\(^{319}\) 17 C.F.R. § 240.13d-3(b) (2011); Readopted Rules, \textit{supra} note 308, 76 Fed. Reg. at 34585.

\(^{320}\) Readopted Rules, \textit{supra} note 308, 76 Fed. Reg. at 34585 (to be recodified at 17 C.F.R. § 240.13d-3(b)).


\(^{322}\) Readopted Rules, \textit{supra} note 308, 76 Fed. Reg. at 34582, 34585–86 (to be recodified at 17 C.F.R. § 240.13d-3(d)(1)).

\(^{323}\) 15 U.S.C. § 78p(a) (2006 & Supp. IV 2010); Readopted Rules, \textit{supra} note 308, 76 Fed. Reg. at 34582. These reporting requirements are intended to reach persons Congress presumes to have access to information that can be used to influence or control the issuer. \textit{Id}.


a. Rule 16a-1(a)(1)—Persons Subject to Section 16 Disclosures

In determining whether a person is subject to the reporting requirements of section 16 as a holder, Rule 16a-1(a)(1) uses the regulatory regime established by Rule 13d-3.\textsuperscript{326} In other words, a person who is deemed a beneficial owner under Rule 13d-3 will also be deemed a beneficial owner under section 16 for purposes of determining whether that person is a beneficial owner of more than 10 percent of any class of equity securities.\textsuperscript{327} By partially readopting Rule 16a-1(a)(1), the Commission ensured that the beneficial ownership determinations of Rule 13d-3, as readopted, will apply to a person who purchases or sells a security-based swap—in determining whether that person is subject to section 16 reporting requirements.\textsuperscript{328}

Rule 16a-1(a)(1) also excludes certain persons and institutions from being considered a beneficial owner when those persons hold securities for their clients in a fiduciary capacity in the ordinary course of their business.\textsuperscript{329} However, because the Commission did not readopt this provision, Rule 16a-1(a)(1), as readopted, will not affect the rule’s exclusion of these persons from being subject to section 16 as a beneficial owner.\textsuperscript{331}

b. Rule 16a-1(a)(2)—Reporting Obligations and Short-Swing Profit Recovery

Once it is determined that a person is subject to section 16 reporting requirements—by virtue of being a holder or management—Rule 16a-1(a)(2) provides a different meaning of “beneficial owner” for determining the securities and transactions to be disclosed and the transactions to be subject to short-swing profit disgorgement.\textsuperscript{332}

Under Rule 16a-1(a)(2), a person is a beneficial owner if that person has or shares a direct or indirect pecuniary interest\textsuperscript{333} in the underlying security through a contract, arrangement, or other understanding.\textsuperscript{334} The Commission partially\textsuperscript{335}

\textsuperscript{326} 17 C.F.R. § 240.16a-1(a)(1); Readopted Rules, supra note 308, 76 Fed. Reg. at 34582–83.

\textsuperscript{327} Id.

\textsuperscript{328} Id. at 34586 (to be recodified at 17 C.F.R. § 240.16a-1(a)(1)).

\textsuperscript{329} See 17 C.F.R. § 240.16a-1(a)(1).

\textsuperscript{330} See Readopted Rules, supra note 308, 76 Fed. Reg. at 34586 n.61 (stating that the relevant portion of Rule 16a-1(a)(1) that the Commission is readopting is “(a) The term beneficial owner shall have the following applications: (1) Solely for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered pursuant to Section 12 of the Act, the term ‘beneficial owner’ shall mean any person who is deemed a beneficial owner pursuant to section 13(d) of the Act and the rules thereunder . . . .”).

\textsuperscript{331} Id. at 34586 (to be recodified at 17 C.F.R. § 240.16a-1(a)(1)).

\textsuperscript{332} Id.

\textsuperscript{333} As used in Rule 16a-1(a)(2), the term “pecuniary interest” means “the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities.” See 17 C.F.R. § 240.16a-1(a)(2)(i).

\textsuperscript{334} 17 C.F.R. § 240.16a-1(a)(2).

\textsuperscript{335} See Readopted Rules, supra note 308, 76 Fed. Reg. at 34586 n.63 (stating that the relevant portion of Rule 16a-1(a)(2) being readopted is “(2) Other than for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered under Section 12 of the Act, the term beneficial owner shall mean any person who, directly or indirectly,
readopted Rule 16a-1(a)(2) to ensure that security-based swap holdings and transactions will continue to be disclosed under section 16(a), and that security-based swaps will not be used to engage in short-swing trading in an attempt to escape the disgorgement provisions of section 16(b). 336

3. Beneficial Ownership Acquired Independently from a Security-Based Swap

Finally, neither the newly created section 13(o) nor the Readopted Rules will disrupt the regulatory regime governing beneficial ownership determinations of a person who acquires ownership of an equity security through means other than a security-based swap. 337

J. Rules Regarding Net Worth Standard for Accredited Investors as Required by Section 413(a) of the Dodd-Frank Act

In section 413(a) of the Dodd-Frank Act, Congress required the Commission to “adjust any net worth standard for an accredited investor as set forth in the rules of the Commission.” 338 On December 21, 2011, the Commission amended the accredited investor standards in its rules under the Securities Act to implement section 413(a) of the Dodd-Frank Act. 339

1. Rules 215 and 501

Rules 215 340 and 501(a)(5) 341 under the Securities Act set forth the accredited investor standards. 342 Section 413(a) of the Dodd-Frank Act required the Commission to adjust the net worth standard for any natural person to “more than through any contract, arrangement, understanding, relationship or otherwise, has or shares a direct or indirect pecuniary interest in the equity securities, subject to the following: (i) The term pecuniary interest in any class of equity securities shall mean the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities.”). By readopting only subpart (i), and not also subpart (ii), the SEC confirmed that an insider’s holdings and transactions in security-based swaps have “incidents of ownership comparable to direct ownership of the underlying equity security within the meaning of Section 13(o).” Id. at 34586.

336. Id. (to be recodified at 17 C.F.R. § 240.16a-1(a)(2)).
337. See id. at 34580.
338. Dodd-Frank Act § 413(a), 15 U.S.C. § 77b note (Supp. IV 2010). The Dodd-Frank Act was enacted on July 21, 2010, and its terms generally became effective the next day. See Dodd-Frank Act § 4, 12 U.S.C. § 5301 note (Supp. IV 2010) (“Except as otherwise specifically provided, . . . this Act . . . shall take effect 1 day after the date of enactment . . . .”).
Before the adoption of section 413(a), the standard under Rules 215 and 501(a)(5) required a minimum net worth of more than $1,000,000, but permitted an individual investor and his or her spouse to include the net equity value of their primary residence in calculating whether they qualified for accredited investor status.344

In amending Rules 215 and 501(a)(5) to conform to the new standard under the Dodd-Frank Act, the Commission adopted identical language in the two rules,345 defining individual accredited investor status to require net worth in excess of $1,000,000, provided that “[t]he person’s primary residence shall not be included as an asset.”346 The final rules also specifically address the treatment of incremental debt secured by the primary residence that is incurred in the sixty days before the sale of securities to the individual in the exempt offering and certain new grandfathering provisions, as described below.

2. New Net Worth Standard

As amended, Rule 215 of Regulation D and, save for the numbering of the subparagraphs, Rule 501 address the individual net worth standard in the accredited investor definition as follows:

(e) Any natural person whose individual net worth, or joint net worth with that person’s spouse, exceeds $1,000,000.

(1) Except as provided in paragraph (e)(2) of this section, for purposes of calculating net worth under this paragraph (e)

(i) The person’s primary residence shall not be included as an asset;

(ii) Indebtedness that is secured by the person’s primary residence, up to the estimated fair market value of the primary residence at the time of the

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343. Dodd-Frank Act § 413(a), 15 U.S.C. § 77b note (Supp. IV 2010) (“The Commission shall adjust any net worth standard for an accredited investor, as set forth in the rules of the Commission under the Securities Act of 1933, so that the individual net worth of any natural person, or joint net worth with the spouse of that person, at the time of purchase, is more than $1,000,000 (as such amount is adjusted periodically by rule of the Commission), excluding the value of the primary residence of such natural person, except that during the 4-year period that begins on the date of enactment of this Act, any net worth standard shall be $1,000,000, excluding the value of the primary residence of such natural person.”).


346. Id. at 81805 (to be codified at 17 C.F.R. § 230.215(e)(1)(i)); id. at 81806 (to be codified at 17 C.F.R. § 230.501(a)(5)(i)(A)). The accredited investor definition in the Net Worth Standard Adopting Release is consistent with the approach taken in the proposing release with respect to the basic treatment of the primary residence and indebtedness secured by the primary residence. See Net Worth Standard Proposing Release, supra note 339, 76 Fed. Reg. at 5316.
sale of securities, shall not be included as a liability (except that if the amount of such indebtedness outstanding at the time of the sale of securities exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess shall be included as a liability); and

(iii) Indebtedness that is secured by the person’s primary residence in excess of the estimated fair market value of the primary residence at the time of the sale of securities shall be included as a liability. 347

a. Treatment of Mortgage Debt

In calculating net worth, “[i]ndebtedness that is secured by the person’s primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability.” 348 Thus, net worth is calculated by excluding positive equity an investor may have in his or her primary residence. 349 The Commission believed this approach to be the most appropriate way to conform its rules to section 413(a), stating that it “reduces the net worth measure by the net amount that the primary residence contributed to net worth before enactment of Section 413(a), which we believe is what is commonly meant by ‘the value of a person’s primary residence.’” 350 The final rules also provide that any excess of indebtedness secured by the primary residence over the estimated fair market value of the residence is considered a liability for purposes of determining accredited investor status on the basis of net worth, whether the lender can seek repayment from other assets in default. 351 In the Commission’s view, the full amount of the debt incurred by the investor is the most appropriate value to use in determining accredited investor status. 352

b. Increases in Mortgage Debt in the Sixty Days Before Sale of Securities

The Commission specifically addressed the treatment of incremental debt secured by the primary residence incurred in the sixty days before the sale of securities, to address concerns that investors might artificially inflate their net worth by incurring incremental indebtedness secured by their primary residence. 353 Under the final rules any increase in the amount of debt secured by a primary residence in the sixty

348. Id. at 81805 (to be codified at 17 C.F.R. § 230.215(e)(1)(ii)); id. at 81806 (to be codified at 17 C.F.R. §§ 230.501(a)(5)(i)(A)–(B)).
349. Id. at 81796.
350. Id.
351. See id. at 81797.
352. Id. (explaining that the full amount of such debt “is the basis on which interest accrues under the mortgage and the amount that third parties would look to in assessing creditworthiness”).
353. Id. at 81805 (to be codified at 17 C.F.R. §§ 230.215(e)(1)(ii)); id. at 81806 (to be codified at 17 C.F.R. §§ 230.501(a)(5)(i)(B)). Such provisions prevent the conversion of home equity—which is excluded from the net worth calculation—into cash or other assets that would be included in the net worth calculation. See id. at 81797.
days before the sale of securities to an individual generally will be included as a liability, even if the estimated value of the primary residence exceeds the aggregate amount of debt secured by the residence. If any such incremental debt is incurred, net worth will be reduced by the amount of the incremental debt.


The Commission adopted limited grandfathering provisions. Accordingly, the new net worth standard is not applicable to any calculations of net worth made in connection with the purchase of securities in accordance with a right to purchase such securities in an exempt offering, so long as (i) the right was held by the person on July 20, 2010; (ii) the person qualified as an accredited investor on the basis of net worth at the time the person acquired the right; and (iii) the person held securities of the same issuer, other than the right, on July 20, 2010.

3. Ongoing Review and Mandatory Study

Section 413(b) of the Dodd-Frank Act provides that four years after enactment, and every four years thereafter, the Commission must review the “accredited investor” definition as applied to natural persons, including adjustment of the threshold, although it may not be lowered below $1 million. Section 415 of the Dodd-Frank Act requires the Comptroller General of the United States to conduct a “Study and Report on Accredited Investors” examining “the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds.” The study is due three years after the enactment of the Dodd-Frank Act and is expected to be taken into account by the Commission in future rulemakings in this area.

K. Rules Regarding Mine Safety Disclosure as Required by Section 1503 of the Dodd-Frank Act

On December 21, 2011, the Commission adopted amendments to its rules and forms to implement section 1503 of the Dodd-Frank Act. Section 1503(a) requires issuers that are mandated to file reports with the Commission pursuant to section 13(a) or 15(d) of the Exchange Act, and that are operators, or that have a subsidiary that is an operator, of a coal or other mine in the United States to disclose in their periodic reports filed with the Commission information regarding specified health and

354. Id. at 81805 (to be codified at 17 C.F.R. § 230.215(e)(1)(ii)); id. at 81806 (to be codified at 17 C.F.R. § 230.501(a)(5)(i)(B)).
355. Id. at 81797–98.
356. Id. at 81806 (to be codified at 17 C.F.R. § 230.215(e)(2)); id. (to be codified at 17 C.F.R. § 230.501(a)(5)(ii)).
358. Dodd-Frank Act, supra note 1, § 415, 124 Stat. at 1578.
safety violations, orders and citations, related assessments and legal actions, and min-
ing-related fatalities. Section 1503(b) mandates the filing of a Form 8-K disclosing
the receipt of certain shutdown orders and notices of patterns or potential patterns
of violations from the Mine Safety and Health Administration (the “MSHA”). The
disclosure requirements set forth in section 1503 of the Dodd-Frank Act went into
effect on August 20, 2010, and issuers have been providing disclosure in their peri-
odic and current reports filed with the Commission since the effective date of section
1503. In section 1503, Congress authorized, but did not require, the Commission
to “issue such rules or regulations as are necessary or appropriate for the protection
of investors and to carry out the purposes of [section 1503].”

1. Section 1503(a)—Periodic Reporting Disclosure

The final rules largely adopt the rules as proposed and follow the statutory
provisions closely. The rules add Item 104 to Regulation S-K, Item 4 to Part II
of Form 10-Q, and Item 4 to Part I of Form 10-K to implement the disclosure
requirements, and amend Item 601 of Regulation S-K to add a new exhibit re-
quirement to Form 10-K and Form 10-Q.

a. Disclosure Requirements

The final rules require issuers that have matters to report to include brief dis-
closure in the body of the periodic report stating that they have matters (i.e., mine
safety violations or other regulatory matters) to report in accordance with section
1503(a), and that the required information is included in an exhibit to the re-
port. The exhibit would include the detailed disclosure about specific violations
and regulatory matters as required under section 1503(a). The Commission
reiterated that, to the extent that mine safety matters raise concerns that should
be addressed in other parts of a periodic report, such as risk factors, the business
description, legal proceedings, or the MD&A, that disclosure would still be re-
quired. The final rules do not specify any particular presentation requirements

shall take effect thirty days after enactment).
2010, the Commission proposed amendments to its rules and forms relating to mine safety disclosure.
pts. 229, 239 & 249) [hereinafter Mine Safety Disclosure].
366. Mine Safety Disclosure Adopting Release, supra note 360, 76 Fed. Reg. at 81782 (to be codi-
fied at 17 C.F.R. § 229.104).
367. Id. at 81785 (noting that the text of Form 10-Q does not appear in the Code of Federal Regula-
tions).
368. Id. (noting that the text of Form 10-K does not appear in the Code of Federal Regulations).
369. Id. at 81783 (to be codified at 17 C.F.R. § 229.601).
370. See id. at 81766.
371. Id.
372. Id. at 81766–67.
for the new disclosure, but the Commission encouraged issuers to use tabular presentations whenever possible if it would facilitate investor understanding.\textsuperscript{373} The disclosure will be considered “filed,” not “furnished.”\textsuperscript{374}

\textit{b. Time Periods Covered}

The disclosure requirements are applicable to annual reports on Form 10-K, Form 20-F, and Form 40-F and, for issuers other than foreign private issuers, quarterly reports on Form 10-Q.\textsuperscript{375} The final rules require each Form 10-Q to include the required disclosure for the quarter covered by the report.\textsuperscript{376} For each of Forms 20-F and 40-F, the disclosure is required for the issuer’s fiscal year.\textsuperscript{377} Similarly, in a change from the proposal, the final rules require each Form 10-K to include disclosure of the information for the fiscal year only, not for the fourth quarter individually plus the fiscal year cumulatively.\textsuperscript{378}

2. \textit{Section 1503(b)—Current Reporting Disclosure}

In light of the newly added Item 1.04 to Form 8-K, issuers that are operators, or have a subsidiary that is an operator, of a mine in the United States now must report on Form 8-K the receipt of certain notices from the MSHA, including imminent danger orders and written notices of a pattern (or the potential to have a pattern) of violations of mandatory health or safety standards that could significantly and substantially contribute to the cause and effect of coal or other mine health or safety hazards.\textsuperscript{379} Item 1.04 of Form 8-K requires disclosure of the date of receipt of the order or notice, the category of order or notice, and the name and location of the mine involved.\textsuperscript{380} Failure to file timely the Form 8-K for an Item 1.04 triggering event will not result in the loss of Form S-3 eligibility.\textsuperscript{381}

\textbf{Rulemaking Unrelated to the Dodd-Frank Act}

\textbf{A. Extension of Compliance Date for Brokers or Dealers with Market Access to Implement Risk Management Controls and Supervisory Procedures}

In an attempt to ensure that broker-dealers with market access for trading securities—on an exchange or an alternative trading system—appropriately control

\begin{itemize}
\item \textsuperscript{373} See id. at 81767.
\item \textsuperscript{374} See id. The Commission believes that this approach is consistent with the statutory language of section 1503—which provides that an issuer must “include [the required disclosure] in each periodic report filed with the Commission.” Id.
\item \textsuperscript{375} Id. at 81783–85.
\item \textsuperscript{376} Id. at 81785.
\item \textsuperscript{377} Id. at 81783–84.
\item \textsuperscript{378} See id. at 81785. \textit{Compare with Mine Safety Disclosure, supra note 365, 75 Fed. Reg. at 80377 (proposing that “each Form 10-K would include disclosure covering both the fourth quarter of the issuer’s fiscal year, and cumulative information for the entire fiscal year”).}
\item \textsuperscript{379} Mine Safety Disclosure Adopting Release, supra note 360, 76 Fed. Reg. at 81785. These orders and notices are still required to be disclosed in issuers’ periodic reports as discussed above.
\item \textsuperscript{380} Id.
\item \textsuperscript{381} Id. at 81783 (amending General Instruction I.A.3(b) of Form S-3).
\end{itemize}
the risks associated with market access, the Commission adopted Exchange Act Rule 15c3-5. This rule originally required a broker-dealer to implement a system of risk management controls and supervisory procedures by July 14, 2011. However, after several broker-dealers experienced difficulties in implementing the required controls and procedures that were not widespread, the Commission extended the compliance date for certain requirements of this newly created rule until November 30, 2011.

1. Rule 15c3-5

Under Rule 15c3-5, a broker-dealer is required to establish, document, and maintain a set of risk management controls and supervisory procedures reasonably designed to manage financial and regulatory and other risks associated with market access. While Rule 15c3-5(c) provides a list of the types of controls and procedures that are required to be implemented by a broker-dealer, this list is not comprehensive—but merely designed to serve as a starting point. In fact, instead of requiring a broker-dealer to implement a specific set of controls and procedures, this rule permits the implementation of controls and procedures that are reasonably designed to manage the unique risks a broker-dealer faces as a result of market access.

a. Financial Risk Management Controls and Supervisory Procedures

Under Rule 15c3-5(c)(1), a broker-dealer must implement certain controls and procedures that limit the financial exposure a broker-dealer faces as a result of market access. These controls and procedures—at a minimum—must be reasonably designed to prevent the entry of orders that (i) exceed appropriate pre-set credit or capital thresholds or (ii) appear to be erroneous.

(i) Pre-Set Credit or Capital Thresholds

A broker-dealer’s controls must be reasonably designed to prevent a customer from entering an order that exceeds the pre-set credit or capital thresholds.

382. Risk Management Controls for Brokers or Dealers with Market Access, 75 Fed. Reg. 69792 (Nov. 15, 2011) (to be codified at 17 C.F.R. pt. 240) [hereinafter Market Access Rule]. This Rule regulates broker-dealers (1) “with access to trading securities directly on an exchange or alternative trading system, including those providing sponsored or direct market access to customers or other persons,” and (2) that are “operators of an ATS that provide access to trading securities directly on their ATS to a person other than a broker or dealer.” Id. at 69792.

383. Id.


385. Market Access Rule, supra note 382, 75 Fed. Reg. at 69825 (to be codified at 17 C.F.R. § 240.15c3-5(b)).

386. Id. (to be codified at 17 C.F.R. § 240.15c3-5(c) (“The . . . controls and . . . procedures required by paragraph (b) . . . shall include . . . ” (emphasis added))).

387. Id. (to be codified at 17 C.F.R. § 240.15c3-5(b) (“. . . shall establish . . . controls and . . . procedures reasonably designed to manage the . . . risks of this business activity”)).

388. Id. (to be codified at 17 C.F.R. § 240.15c3-5(c)(1)).

389. Id. (to be codified at 17 C.F.R. § 240.15c3-5(c)(1), (ii)). Under this Rule 15c3-5(c)(1), non-complying orders should be blocked on a pre-trade basis—as opposed to a post-trade review. Id. at 69795.

390. Id. at 69825 (to be codified at 17 C.F.R. § 240.15c3-5(c)(1)(i)). Beyond setting an aggregate threshold for a customer, a broker-dealer may also be required to set sub-limits for each exchange or ATS to which it provides the customer with access. Id. at 69800.
A customer’s threshold should be set by the broker-dealer after considering the customer’s pertinent information—including its business, financial condition, and trading patterns—391—and should also be tailored by sector, security, or any other condition, if appropriate. 392 This pertinent information must be continuously monitored by the broker-dealer to ensure that the established threshold remains appropriate—and that adjustments are made as necessary. 393

(ii) Erroneous Orders

A broker-dealer’s controls must also be reasonably designed to prevent the entry of erroneous orders. 394 In particular, these controls must be designed to detect and prevent duplicative orders and orders that exceed certain price or size parameters. 395 In setting the appropriate parameters for these controls, the broker-dealer should consider and focus on its customer’s trading patterns and history. 396 These parameters must be regularly monitored—and adjusted as necessary—to ensure that they are effective in preventing the entry of erroneous orders. 397

b. Regulatory Risk Management Controls and Supervisory Procedures

Under Rule 15c3-5(c)(2), a broker-dealer’s risk management controls and supervisory procedures must be reasonably designed to ensure compliance with all regulatory requirements. 398 Despite the rule’s apparently broad language, the Commission seeks to ensure compliance with all regulatory requirements that are applicable in connection with market access. 399 In fact, Rule 15c3-5(c)(2) does not impose any new substantive regulatory requirements, 400 but rather merely requires a broker-dealer to implement controls and procedures to ensure compliance with its existing regulatory obligations in at least four respects.

(i) Pre-Trade Regulatory Compliance

First, a broker-dealer must implement controls that are reasonably designed to prevent the entry of an order that does not comply with all pre-trade regulatory

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391. Id. at 69802.
392. Id. at 69825 (to be codified at 17 C.F.R. § 240.15c3-5(c)(1)(i)).
393. Id. at 69802.
394. Id. at 69825 (to be codified at 17 C.F.R. § 240.15c3-5(c)(1)(ii)).
395. Id. (to be codified at 17 C.F.R. § 240.15c3-5(c)(1)(iii)). These controls must be designed to detect and prevent orders regardless of whether the erroneous order results from a computer malfunction or a human error. Id. at 69802.
396. Id. at 69801.
397. Id. at 69802.
398. Id. at 69826 (to be codified at 17 C.F.R. § 240.15c3-5(c)(2)).
399. Id. at 69802; id. at 69803 n.93 (stating that “[r]egulatory requirements not connected with a broker-dealer’s having or providing access to trading securities on an exchange or ATS, as a result of being a member or subscriber thereof, are not included within the scope of [Rule 15c3-5]”); id. at 69825 (to be codified at 17 C.F.R. § 240.15c3-5(a)(2) (defining “regulatory requirements” as “all federal securities laws, rules and regulations, and rules of self-regulatory organizations, that are applicable in connection with market access”)).
400. Id. at 69803 (“The Commission . . . does not intend to substantively expand upon [existing regulatory requirements].”).
requirements.\textsuperscript{401} If an order fails to meet the applicable regulatory requirements—which include exchange trading rules, trading halts, odd-lot orders, and Commission rules under Regulations SHO and NMS—the controls must prohibit the order from being sent to the securities market.\textsuperscript{402}

\textbf{(ii) Pre-Trade Trading Restrictions}

Second, a broker-dealer must implement controls that are reasonably designed to prevent a person from ordering securities that they are restricted from trading.\textsuperscript{403} In particular, these restrictions must prevent a broker-dealer from trading certain securities—either for its own account or on behalf of a customer—that it is not qualified to trade, and must prevent a customer from trading securities that the customer is prohibited from trading.\textsuperscript{404}

\textbf{(iii) Restrictive Access to Trading Systems and Technology}

Third, a broker-dealer must implement controls and procedures that restrict a person—who has not been preapproved or authorized by the broker-dealer—from accessing trading systems or using technology that provide market access.\textsuperscript{405} To ensure that only trained personnel have access to these systems, the broker-dealer’s controls must at least provide an effective process for (a) screening and approving persons to use such systems, (b) securely maintaining such systems, and (c) requiring identify verification before granting access to such systems.\textsuperscript{406}

\textbf{(iv) Post-Trade Surveillance Execution Reports}

Finally, a broker-dealer must implement controls and procedures to ensure that its personnel instantly receive post-trade execution reports resulting from market access.\textsuperscript{407} While these post-trade execution reports will provide a broker-dealer with important information about particular trades, this provision does not require that the information be reviewed immediately for manipulation, fraud, or other violations.\textsuperscript{408}

c. Other Requirements

In addition to requiring the implementation of financial and regulatory risk management controls and procedures, Rule 15c3-5 requires ongoing maintenance of such controls and procedures.\textsuperscript{409} In particular, the broker-dealer must

\textsuperscript{401} Id. at 69826 (to be codified at 17 C.F.R. § 240.15c3-5(c)(2)(i)).
\textsuperscript{402} Id. at 69804.
\textsuperscript{403} Id. at 69826 (to be codified at 17 C.F.R. § 240.15c3-5(c)(2)(ii)).
\textsuperscript{404} Id. at 69804.
\textsuperscript{405} Id. at 69826 (to be codified at 17 C.F.R. § 240.15c3-5(c)(2)(iii)).
\textsuperscript{406} Id. at 69804.
\textsuperscript{407} Id. at 69826 (to be codified at 17 C.F.R. § 240.15c3-5(c)(2)(iv)).
\textsuperscript{408} Id. at 69804. Although post-trade surveillances need not be reviewed for manipulation, fraud, and other violations immediately, the surveillances should be reviewed in a timely manner as warranted by surrounding facts and circumstances. Id.
\textsuperscript{409} See id. at 69826 (to be codified at 17 C.F.R. § 240.15c3-5(d), (e), (f)).
have direct and exclusive control over its controls and procedures—except in certain instances.\textsuperscript{410} The broker-dealer must also implement a system for reviewing the effectiveness of—and for making necessary adjustments to—its controls and procedures.\textsuperscript{411} Finally, to ensure that (1) a broker-dealer implements controls and procedures in compliance with Rule 15c3-5 and (2) the controls and procedures are regularly reviewed, the broker-dealer’s highest ranking officer must annually certify such facts.\textsuperscript{412}

2. Extension of Compliance Date

While working to develop and implement adequate controls and procedures before the original July 14, 2011, compliance date, several broker-dealers requested that the Commission extend the compliance dates for certain provisions of Rule 15c3-5—where the required controls and procedures were not prevalent in their respective markets.\textsuperscript{413} The Commission acknowledged the hardship that compliance would place on broker-dealers in these instances, and provided a limited extension—until November 30, 2011—for complying with certain requirements.\textsuperscript{414} Specifically, the Commission extended the date on which a broker-dealer must comply with (1) the requirements of Rule 15c3-5 for all fixed-income securities and (2) the requirements of Rule 15c3-5(c)(1)(i) for all securities.\textsuperscript{415}

\textit{a. Fixed-Income Securities}

For a broker-dealer that accesses or provides access to an exchange or Alternative Trading System (“ATS”) for trading fixed-income securities, the broker-dealer had until November 30, 2011, to comply with Rule 15c3-5.\textsuperscript{416}

\textit{b. Equity Securities}

All broker-dealers that access or provide access to an exchange or ATS for trading equity securities had until November 30, 2011, to develop and implement controls reasonably designed to prevent the entry of orders that exceed pre-set credit or capital thresholds.\textsuperscript{417} However, these broker-dealers were still required to comply with the remainder of Rule 15c3-5 by the original July 14, 2011, compliance date.\textsuperscript{418}

\textsuperscript{410} Id. (to be codified at 17 C.F.R. § 240.15c3-5(d)). Under Rule 15c3-5(e)(1), a broker-dealer is required to review its activity related to its market access to assure that its controls and procedures are effective, at least annually. Id. (to be codified at 17 C.F.R. § 240.15c3-5(e)(1)).

\textsuperscript{411} Id. (to be codified at 17 C.F.R. § 240.15c3-5(e)).

\textsuperscript{412} Id. (to be codified at 17 C.F.R. § 240.15c3-5(e)(2)).


\textsuperscript{414} Id. at 38294.

\textsuperscript{415} Id.

\textsuperscript{416} Id.

\textsuperscript{417} Id.

\textsuperscript{418} Id.
B. LARGE TRADER REPORTING REQUIREMENTS

Section 13(h) of the Exchange Act authorizes the Commission to establish a large trader reporting system under such rules and regulations as the Commission may prescribe. In 2011, the Commission adopted new Rule 13h-1 and Form 13H under section 13(h) of the Exchange Act. The large trader reporting requirements have two primary components: (1) registration of large traders with the Commission; and (2) recordkeeping, reporting, and monitoring duties imposed on registered broker-dealers that service large trader customers. The following paragraphs summarize principal aspects of Rule 13h-1.

1. Large Trader Status

Rule 13h-1(a)(1) defines a “large trader” as any person that: (i) directly or indirectly, including through other persons controlled by such person, exercises investment discretion over one or more accounts and effects transactions for the purchase or sale of any NMS security for or on behalf of such accounts, by or through one or more registered broker-dealers, in an aggregate amount equal to or greater than the identifying activity level; or (ii) voluntarily registers as a large trader by filing electronically with the Commission Form 13H.

Rule 13h-1(c) sets forth rules of aggregation for the determination of whether one is a large trader.

To the extent that an entity employs a natural person that individually, or collectively with others, meets the definition of a “large trader,” then, for purposes of Rule 13h-1, the entity that controls that person or those persons would be a large trader. The Commission noted that, to determine whether a parent company is a large trader, the trading activity of all entities controlled by the parent company must be aggregated.

a. Persons Who Exercise Investment Discretion

Rule 13h-1(a)(4) provides that the term “investment discretion” has “the same meaning as in Section 3(a)(35) of the Exchange Act.” Rule 13h-1(a)(4) further specifies that a “person’s employees who exercise investment discretion within the scope of their employment are deemed to do so on behalf of such person.”

421. Id. at 46960–61.
422. Id. at 47002 (to be codified at 17 C.F.R. § 240.13h-1(a)(1)).
423. Id. at 47003 (to be codified at 17 C.F.R. § 240.13h-1(c)).
424. See id. at 47002 (to be codified at 17 C.F.R. § 240.13h-1(a)(3)).
425. See id. at 46966.
426. Id. at 47002 (to be codified at 17 C.F.R. § 240.13h-1(a)(4)).
427. Id. (to be codified at 17 C.F.R. § 240.13h-1(a)(4)). The Commission does not believe that a blanket exclusion for transactions effected on behalf of defined contribution plans is warranted because such trades are effected through the exercise of investment discretion, and thus fall within the
b. Control

Rule 13h-1(a)(3) defines the term “control” to mean “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of securities, by contract, or otherwise.” For purposes of this rule only, any person that directly or indirectly has the right to vote or direct the vote of 25% or more of a class of voting securities of an entity or has the power to sell or direct the sale of 25% or more of a class of voting securities of such entity, or in the case of a partnership, has the right to receive, upon dissolution, or has contributed, 25% or more of the capital, is presumed to control that entity.

c. NMS Security

The Commission defined an “NMS security” to mean “any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.”

d. Identifying Activity Level

Rule 13h-1(a)(7) defines the term “identifying activity level” as “aggregate transactions in NMS securities that are equal to or greater than: (i) during a calendar day, either two million shares or shares with a fair market value of $20 million; or (ii) during a calendar month, either twenty million shares or shares with a fair market value of $200 million.”

Rule 13h-1(a)(6) defines the term “transaction” to mean “all transactions in NMS securities, excluding the purchase or sale of such securities pursuant to exercises or assignments of option contracts,” and except for certain specifically enumerated transactions. Those specifically enumerated transactions are excluded because they are not effected with an intent that is commonly associated with the arm’s-length trading of securities in the secondary market and therefore do not fall within the types of transactions that are characterized by the exercise of investment discretion.

2. Voluntary Registration

The Commission adopted (1) a definition of large trader that includes those persons who voluntarily register as large traders; and (2) Form 13H that allows a market participant to register voluntarily as a large trader, and if it does so, it must
so specify and disclose the date on which it made the filing. Any such person that elects to file voluntarily will be treated as a large trader for purposes of the rule, and will be subject to all of the obligations of a large trader under the rule, notwithstanding the fact that the person had not effected the requisite level of transactions at the time it registered as a large trader.

3. Duties of a Large Trader

Pursuant to Rule 13h-1, a large trader must self-identify by filing Form 13H with the Commission. In complex organizations, more than one related entity can qualify as a large trader. In addition, a large trader must disclose its LTID to the registered broker-dealers effecting transactions on its behalf and identify for them each account to which it applies.

In addition to initial filings, large traders are subject to annual filings and amended filings when information becomes stale.

Rule 13h-1(b)(3)(iii) provides:

A large trader that has not effected aggregate transactions at any time during the previous full calendar year in an amount equal to or greater than the identifying activity level shall become inactive upon filing a Form 13H . . . and thereafter shall not be required to file Form 13H or disclose its large trader status unless and until its transactions again are equal to or greater than the identifying activity level. A large trader that has ceased operations may elect to become inactive by filing an amended Form 13H to indicate its terminated status.

Under Rule 13h-1(b)(3)(iii), a person, under certain narrow circumstances, may permanently end its large trader status by submitting a “Termination Filing.”

Under Rule 13h-1(b)(4), upon request, a large trader must promptly provide additional descriptive or clarifying information that would allow the Commission to identify further the large trader and all accounts through which the large trader effects transactions.

4. Self-Identification to Broker-Dealers

Rule 13h-1(b)(2) requires a large trader to disclose to the registered broker-dealers effecting transactions on its behalf its LTID and each account to which it applies.

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434. Id. at 47002, 47004.
435. Id. at 47002 (to be codified at 17 C.F.R. § 240.13h-1(a)(1)).
436. Id. (to be codified at 17 C.F.R. § 240.13h-1(b)(1)).
437. Id. at 46969.
438. Id. at 47003 (to be codified at 17 C.F.R. § 240.13h-1(b)(2)).
439. Id. at 47002 (to be codified at 17 C.F.R. § 240.13h-1(b)(1)(ii) (“Within 45 days after the end of each full calendar year”)); id. (to be codified at 17 C.F.R. § 240.13h-1(b)(1)(ii)) (“Promptly following the end of a calendar quarter in the event that any of the information contained in a Form 13H filing becomes inaccurate for any reason”).
440. Id. at 47003 (to be codified at 17 C.F.R. § 240.13h-1(b)(3)(iii)).
441. Id. at 46971.
442. Id. at 47003 (to be codified at 17 C.F.R. § 240.13h-1(b)(4)).
443. Id. (to be codified at 17 C.F.R. § 240.13h-1(b)(2)).
5. Form 13H

Form 13H is designed to collect basic identifying information about large traders that will allow the Commission to understand the character and operations of the large trader.\textsuperscript{444}

6. Confidentiality

The Commission shall not be compelled to disclose information collected from large traders and registered broker-dealers under a large trader reporting system, subject to limited exceptions.\textsuperscript{445}

7. Broker-Dealers: Recordkeeping, Reporting, and Monitoring

a. Recordkeeping Requirements

Under Rule 13h-1(d)(1), registered broker-dealers must maintain specified records for all transactions effected directly or indirectly by or through (i) an account such broker-dealer carries for a large trader or an Unidentified Large Trader; or (ii) if the broker-dealer is a large trader, any proprietary or other account over which such broker-dealer exercises investment discretion.\textsuperscript{446} In addition, where a non-broker-dealer carries an account for a large trader or an Unidentified Large Trader, the broker-dealer effecting transactions directly or indirectly for such large trader or Unidentified Large Trader must maintain records of the information required under paragraphs (d)(2) and (d)(3) for such transactions.\textsuperscript{447}

b. Reporting Requirements

Under Rule 13h-1(e), upon the request of the Commission, every registered broker-dealer who is itself a large trader or carries an account for a large trader or an Unidentified Large Trader shall electronically report to the Commission all information required under paragraphs (d)(2) and (d)(3) for all transactions effected directly or indirectly by or through accounts carried by such broker-dealer for large traders and Unidentified Large Traders, equal to or greater than the reporting activity level.\textsuperscript{448} Additionally, where a non-broker-dealer carries an account for a large trader or an Unidentified Large Trader, the broker-dealer effecting such transactions directly or indirectly for a large trader shall electronically report such information.\textsuperscript{449}

\textsuperscript{444} See id. at 46960.
\textsuperscript{446} Large Trader Reporting, supra note 420, 76 Fed. Reg. at 47003 (to be codified at 17 C.F.R. § 240.13h-1(d)(1)); id. at 47002 (to be codified at 17 C.F.R. § 240.13h-1(a)(9) (defining “Unidentified Large Trader” as a person who has not complied with the identification requirements of the rule, but who a registered broker-dealer knows or has reason to know is a large trader)).
\textsuperscript{447} Id. at 47003 (to be codified at 17 C.F.R. § 240.13h-1(d)(1)).
\textsuperscript{448} Id. at 47003–04 (to be codified at 17 C.F.R. § 240.13h-1(e)).
\textsuperscript{449} Id. at 47004 (to be codified at 17 C.F.R. § 240.13h-1(e)).
Rule 13h-1(a)(8) defines the reporting activity level as:

(i) each transaction in NMS securities, effected in a single account during a calendar day, that is equal to or greater than 100 shares; (ii) any other transaction in NMS securities for fewer than 100 shares, effected in a single account during a calendar day, that a registered broker-dealer may deem appropriate; or (iii) such other amount that may be established by order of the Commission from time to time. 450


c. Monitoring Requirements

Rule 13h-1 requires that a registered broker-dealer treat as an Unidentified Large Trader (for purposes of the recordkeeping and reporting provisions in paragraphs (d) and (e) of the rule) any person that the broker-dealer “knows or has reason to know” is a large trader where such person has not complied with the identification requirement applicable to large traders in paragraphs (b)(1) and (b)(2) (i.e., identified itself as a large trader to the broker-dealer and disclosed the accounts to which its LTID applies). 451


d. Temporary Extension

In April 2012, the Commission issued and order 452 that exempts registered broker-dealers from the Rule 13h-1 recordkeeping and reporting requirement until May 1, 2013. A clearing broker-dealer for a large trader where such large trader either (1) is a U.S.-registered broker-dealer or (2) trades through a sponsored access arrangement is temporarily exempted from compliance with the recordkeeping and reporting requirement until November 30, 2012. The order also exempts all registered broker-dealers from the monitoring requirement for unidentified large traders until May 1, 2013.

8. ATSs

The Commission noted that

the monitoring requirements are only applicable to registered broker-dealers that are large traders, carry accounts for large traders or Unidentified Large Traders, or effect transactions on behalf of large trader customers whose accounts are carried by non-broker-dealers. If an ATS is not operating in those capacities, then it is not subject to the monitoring requirements. 453

450. Id. at 47002 (to be codified at 17 C.F.R. § 240.13h-1(a)(8)).
451. Id. at 47002 (to be codified at 17 C.F.R. § 240.13h-1(a)(9) (defining “Unidentified Large Trader”); id. at 47003–04 (to be codified at 17 C.F.R. § 240.13h-1(e) (imposing obligations regarding Unidentified Large Traders)).
9. Foreign Entities

The rule requires a foreign entity that is a large trader to comply with the identification requirements of paragraph (b) of the rule.\footnote{Id.} With respect to the recordkeeping and reporting requirements, however, the Commission noted that paragraphs (d) and (e) of the rule, concerning recordkeeping and reporting, respectively, explicitly apply only to U.S.-registered broker-dealers.\footnote{Id. at 46980−81.}

In the event, which the Commission believes to be unlikely, that the laws of a large trader’s foreign jurisdiction preclude or prohibit the large trader from waiving such restrictions or otherwise voluntarily filing Form 13H with the Commission, then such foreign large traders or representatives of foreign large traders may request an exemption from the Commission pursuant to section 36 of the Exchange Act and paragraph (g) of the rule.\footnote{Id. at 46981.} A registered broker-dealer, however, would remain subject to the recordkeeping, reporting, and monitoring provisions of the rule with respect to any Unidentified Large Traders independent of whether any such entity had received an exemption from the requirements to file Form 13H with the Commission.\footnote{Id. at 46981 n.222.}

10. Implementation and Compliance Dates

December 1, 2011, was the date by which large traders were required to self-identify to the Commission.\footnote{Id. at 46960.} April 30, 2012, was the date by which broker-dealers were required to maintain records, report, and monitor larger trader activity.\footnote{Id.}

11. Exemptive Authority

Section 13(h)(6) of the Exchange Act authorizes the Commission “by rule, regulation, or order, consistent with the purposes of this chapter, [to] exempt any person or class of persons or any transaction or class of transactions, either conditionally or upon specified terms and conditions or for stated periods, from the operation of [section 13(h)], and the rules and regulations thereunder.”\footnote{15 U.S.C. § 78m(h)(6) (2006).} Rule 13h-1(g) implements this authority, providing that “[u]pon written application or upon its own motion, the Commission may by order exempt, upon specified terms and conditions or for stated periods, any person or class of persons or any transaction or class of transactions from the provisions of this section to the extent that such exemption is consistent with the purposes of the [Exchange Act].”\footnote{Large Trader Reporting, supra note 420, 76 Fed. Reg. at 47004 (to be codified at 17 C.F.R. § 240.13h-1(g)).}
As part of its April 2012 exemptive order, the Commission relied on its exemptive authority to provide a permanent exemption from the definition of “transaction” for certain capital markets transactions. These capital markets transactions will not be counted in the large trader identifying activity level calculation. The transactions that are excluded are certain transactions that are part of an offering of securities by or on behalf of an issuer, or by an underwriter on the issuer’s behalf, or by a selling stockholder who is a natural person.

462. See supra note 452.
Accounting Developments 2011

Effective Dates Regarding Disclosures of Credit Quality of Financing Receivables

In January 2011, the Financial Accounting Standards Board (the “FASB”) issued Accounting Standards Update (“ASU”) No. 2011-01, which deferred the effective date of the guidance provided in ASU No. 2010-20. ASU No. 2010-20 required reporting entities to provide additional disclosures regarding (i) their portfolios of financing receivables, (ii) how those portfolios are evaluated with respect to credit loss allowances, (iii) changes in credit loss allowances, and (iv) reasons for any changes in credit loss allowances. Prior to the issuance of ASU No. 2011-01, the amendments contained in ASU No. 2010-20 that required disclosures at the end of a reporting period were to become effective for interim and annual reporting periods ending on or after December 15, 2010, while ASU No. 2010-20's disclosure requirements concerning activity occurring during a reporting period were to become effective for interim and annual reporting periods beginning on or after December 15, 2010. For non-public entities, the amendments in ASU No. 2010-20 were to become effective for annual reporting periods ending on or after December 15, 2011.

The FASB stated that “[the new disclosure requirements] imposed by ASU No. 2010-20 regarding troubled debt restructurings in one reporting period followed by a change in what constitutes a troubled debt restructuring shortly thereafter would be burdensome for preparers and may not provide financial statement users with useful information.” Commenters

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3. Id. at 1–2. According to the FASB, and as indicated in ASU No. 2010-20, these disclosures should be provided on a disaggregated basis, for which two levels exist: (i) “portfolio segment” and (ii) “class” of financing receivable. Id. at 5–6.
4. ASU No. 2011-01, supra note 1, at 1.
5. Id.
6. Id.
asked the [FASB] to defer the effective date of the disclosure requirements for public entities about troubled debt restructurings in [ASU No. 2010-20] to be concurrent with the effective date of the guidance for determining what constitutes a troubled debt restructuring, as presented in [the FASB’s] proposed [ASU], Receivables (Topic 310): Clarifications to Accounting for Troubled Debt Restructurings by Creditors. 7

Accordingly, the FASB determined that, as provided in ASU No. 2011-01, the “effective date of the new disclosures about troubled debt restructurings for public entities and the guidance for determining what constitutes a troubled debt restructuring” would be delayed subject to the completion of its review. 8 In ASU No. 2011-01, the FASB anticipated that guidance to be effective for interim and annual periods ending after June 15, 2011.

Subsequently, in April 2011, the FASB issued ASU No. 2011-02, 9 which provided guidance from the FASB on what in fact constitutes a troubled debt restructuring. 10 Indicating that in order to reach a determination that a restructuring is a troubled debt restructuring, creditors must “separately conclude that . . . the restructuring constitutes a concession . . . [and] the debtor is experiencing financial difficulties[,]” the FASB issued clarifying guidance on how creditors may evaluate both whether they have granted a concession and whether the debtor is experiencing financial difficulties. 11

As regards a concession, the FASB, as evidenced through its guidance in ASU No. 2011-02, indicated that both increases and decreases in the interest rate for the restructured debt may evidence that the creditor has granted a concession. 12 Additionally, as regards whether a debtor is experiencing financial difficulties, the FASB stated that “financial difficulties” may exist in situations where the debtor “is not currently in payment default,” and that creditors should look to whether it is probable that the debtor would, without modification of the terms of the debt, enter into such a payment default in the “foreseeable future.” 13

For public entities, the amendments contained in ASU No. 2011-03 “are effective for the first interim or annual period beginning on or after June 15, 2011,”

8. ASU No. 2011-01, supra note 1, at 1.
10. Id.
11. Id. at 1–2.
12. Id. The FASB noted that below-market rate restructuring—evidence of a concession—would be considered to have taken place where a creditor provides a debtor with access to restructured debt, the terms of which would have been unavailable to the debtor at a market rate. Id. at 1. Also, the FASB indicated that “a temporary or permanent increase in [the interest rate] does not preclude the restructuring from being considered a concession because the [new interest rate] . . . could still be below the market interest rate for new debt with similar characteristics.” Id. at 1–2.
13. Id.
with retrospective application to the “beginning of the annual period of adoption.”\footnote{Id. at 2–3.} Non-public entities must comply with the amendments contained in ASU No. 2011-03 for annual periods (including interim periods therein) beginning on or after December 15, 2012.\footnote{Id. at 3.} Both public and non-public entities may elect early adoption of the amendments contained in ASU No. 2011-03.\footnote{Id.}

**Effective Control and Repurchase Agreements**

In April 2011, the FASB issued ASU No. 2011-03,\footnote{Fin. Accounting Standards Bd., Accounting Standards Update No. 2011-03, Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements (Apr. 2011) [hereinafter ASU No. 2011-03], available at http://www.fasb.org/cs/ContentServer?site=FASB&c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176158507347.} which focuses on the accounting for repurchase agreements—those that “both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity.”\footnote{Id. at 1.} As the FASB explained, in certain circumstances entities may recognize a sale “upon the transfer of financial assets subject to repurchase agreements.”\footnote{Id.} However, such a determination is based on particular factors, one of which, whether the entity has maintained effective control over the transferred assets, was addressed by the FASB in ASU No. 2011-03.\footnote{Id. at 2.} Notably, in ASU No. 2011-03, the FASB removed one criterion of “effective control”—that “requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee.”\footnote{Id. at 2.}

Additionally, in ASU No. 2011-03, the FASB concluded that the guidance regarding collateral maintenance implementation\footnote{That is the requirement that, in order for a transferor to conclude it is able to repurchase or redeem financial assets on “substantially the agreed terms, even in the event of default by the transferee,” the transferor must “at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement financial assets from others.” Id. at 7.} would also be removed from an entity’s assessment of the existence of “effective control.”\footnote{Id. at 2.} The FASB explained that ASU No. 2011-03 does not change the guidance with respect to the other criteria used to determine effective control with respect to repurchase agreements; these criteria include whether “the financial assets to be repurchased or redeemed are the same or substantially the same as those transferred,” whether the agreement “is to repurchase or redeem them before maturity, at a fixed or determinable price,” and whether the agreement “is entered into contemporaneously with, or in contemplation of, the transfer.”\footnote{Id. at 2.} Where an entity determines these criteria are
satisfied, it “has maintained effective control over the financial assets transferred [and] must account for the transaction as a secured borrowing.”

The FASB advised that the amendments contained in ASU No. 2011-03 should result in convergence between United States generally accepted accounting principles (“U.S. GAAP”) and International Financial Reporting Standards (“IFRS”) because IFRS do not require the consideration of the criterion removed by ASU No. 2011-03. ASU No. 2011-03 is effective for both interim and annual financial periods ending after December 15, 2011, and it should be applied on a prospective basis to any transaction or modification of an existing transaction that occurs on or after such date.

**Fair Value and Disclosure—Synchronization of U.S. GAAP and IFRS**

In May 2011, the FASB issued ASU No. 2011-04, which contained numerous amendments to the FASB Accounting Standards Codification designed to “result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRS.”

In issuing ASU No. 2011-04, the FASB explained that the amendments contained therein do not “establish valuation standards or affect valuation practices outside of financial reporting” and do not “require additional fair value measurements.”

Certain amendments contained in ASU No. 2011-04 are designed to “clarify [the FASB’s] intent about the application of existing fair value measurement and disclosure requirements.” For example, ASU No. 2011-04 clarified the FASB’s interpretation of the highest and best use concept regarding fair value measurement (it should not be applied to measuring the fair value of nonfinancial assets, liabilities, or financial assets) and the measurement of the fair value of an instrument classified in shareholders’ equity, “such as equity interests issued as consideration in a business combination” (the FASB provided “explicit instructions for measuring the fair value of such instruments”). The FASB also clarified that reporting entities “should disclose quantitative information about the unobserv-
able inputs used in a fair value measurement that is categorized within Level 3 of the fair value hierarchy.”

Other amendments addressed in ASU No. 2011-04 are designed to synchronize with IFRS the requirements under U.S. GAAP regarding measurement of fair value of financial assets and liabilities exposed to both market risks (e.g., interest rate and currency risks) and credit risk (e.g., counterparty risk), as well as clarify the use of premiums and discounts in a fair value measurement.

The amendments contained in ASU No. 2011-04, which the FASB indicated should be applied prospectively, will become effective for both interim and annual periods (for public entities) and annual periods (for non-public entities) beginning on or after December 15, 2011.

PRESENTATION OF COMPREHENSIVE INCOME

In June 2011, the FASB issued ASU No. 2011-05, which amended how entities may present components of comprehensive income in their financial statements. Prior to the issuance of ASU No. 2011-05, Subtopic 210-10 allowed entities three alternatives from which to choose in reporting components of other comprehensive income: (i) “below the components of net income in a statement of comprehensive income” (ii) “in a separate statement of comprehensive income [beginning] with total net income”; and (iii) “in a statement of changes in stockholders’ equity.” Pursuant to the FASB’s issuance of ASU No. 2011-05, entities now no longer have the option to present other comprehensive income, and its components, as part of a statement of changes in stockholders’ equity.

Of note, the FASB made clear in ASU No. 2011-05 that the update did not address what items should, and should not, be reported in other comprehensive income, nor does the update “affect how earnings per share is calculated or presented.”

The FASB indicated that the amendments contained in ASU No. 2011-05 should receive retrospective application and, for public entities, would be effective for both fiscal years, and interim periods therein, after December 15, 2011. Non-public entities would not be required to comply with the amendments in

33. Id. at 3.
34. Id. at 4–5.
35. Id. at 6.
37. Id. at 1.
38. Id. at 43.
39. Id.
40. Id.
41. Id. at 2.
42. Id. at 2, 44.
ASU No. 2011-05 until fiscal years ending after December 15, 2012, and for inter- 
term periods therein.43

ASU No. 2011-05 also requires entities to “present items that are reclassified 
from other comprehensive income to net income alongside their respective com-
ponents of net income and other comprehensive income,” and that such reclas-
sification adjustments should be presented on both the financial statement that 
presents net income and that which presents the components of other com-
prehensive income.44 In so doing, the FASB indicated that this presentation would 
provide users of financial statements with “important information about the com-
position of a current period’s net income (profit and loss) and other comprehen-
sive income,”45 and help alert users to “certain items of net income [that] may 
have already been included in a prior period’s comprehensive income.”46

In December 2011, however, the FASB issued ASU No. 2011-12,47 which de-
ferred the effective date for ASU No. 2011-05’s amendments pertaining to the 
reclassification discussed above.48 In so doing, the FASB noted that it had received 
concerns regarding the difficulty of preparing these reclassification adjustments 
and the potential for “add[ing] unnecessary complexity to financial statements.”49 
ASU No. 2011-12’s amendments are effective for non-public entities for fiscal 
years ending after December 15, 2012 (and interim and annual periods thereaf-
fter), while public entities must comply with the amendments set forth in ASU No. 
2011-12 for fiscal years, and interim periods within such years, beginning after 
December 15, 2012.50

TESTING GOODWILL FOR IMPAIRMENT

In September 2011, the FASB issued ASU No. 2011-08,51 which provides both 
public and private entities with an option to apply a qualitative test regarding 
the impairment of goodwill. Previously, the guidance under Topic 350 imposed 
a quantitative two-step test in order to test goodwill for impairment.52 The guid-
ance issued by the FASB in ASU No. 2011-08 allows an entity to perform, prior to 
carrying out the qualitative goodwill impairment test, a qualitative assessment of

43. Id. at 3.
44. Id. at 45.
45. Id. at 46.
46. Id.
47. Fin. Accounting Standards Bd., Accounting Standards Update No. 2011-12, Comprehensive 
Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclas-
sifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Up-
48. Id.
49. Id. at 1.
50. Id. at 3.
51. Fin. Accounting Standards Bd., Accounting Standards Update No. 2011-08, Intangibles—
FASB%2FDocument_C%2FDocumentPage&cid=1176158924168.
52. Id. at 1.
whether events or circumstances indicate that, more likely than not, the fair value of a reporting unit is less than its carrying amount. The FASB indicated that this qualitative assessment must take into account the “totality of the circumstances” and, in the revisions to Topic 350 provided by ASU No. 2011-08, gave examples of events and circumstances that may be indicative of a reporting unit whose fair value is less than its carrying value.

Certain of these examples provided by the FASB cover issues related to macroeconomic conditions, industry and market considerations, cost factors, overall financial performance, and accounting events affecting a reporting unit. Additionally, the FASB indicated that “sustained decrease in share price” may be a relevant factor in an entity’s performance of the qualitative assessment covered by ASU No. 2011-08, although the entity must consider both the absolute and relative terms of such decrease. ASU No. 2011-08 also provides, as an example of a qualitative factor, events occurring on an entity-specific level, such as management and strategy changes, the effects of litigation, or potential bankruptcy filings.

As a result of the amendments contained in ASU No. 2011-08, a test for goodwill impairment may now consist of an initial single-step qualitative test followed by, in the event such test leads an entity to conclude an impairment of goodwill has more likely than not occurred, the previously required two-step qualitative test, consisting of (i) an initial step “calculat[ing] the fair value of the reporting unit and comparing it with its carrying amount, including goodwill,” and, if such fair value is less than the reporting unit’s carrying amount, (ii) a second step “calculat[ing] and compar[ing] the implied fair value of [the reporting unit’s goodwill] with [the] carrying amount of that goodwill.” However, as the FASB made clear in ASU No. 2011-08, an entity is not required to conduct the initial qualitative test, and may proceed directly to the previously required two-step quantitative test.

In ASU No. 2011-08, the FASB further noted that the amendments contained therein differ from the guidance provided in IAS 36, Impairment of Assets, which imposes a single-step quantitative test at the level of a “cash-generating unit or group of [such] units” for determining impairment of goodwill. The FASB has indicated that the amendments contained in ASU No. 2011-08 will be effective for annual and interim tests for the impairment of goodwill performed for fiscal years beginning on or after December 15, 2011.

53. Id.
54. Id.
55. Id. at 6.
56. Id.
57. Id.
58. Id.
59. Id. at 13. ASU No. 2011-08 also contains, in its markup of Topic 350 evidencing the amendments thereto, a helpful flow chart that lays out the available testing regime.
60. Id. at 2.
61. Id.
62. Id. at 3.
**EFFECT ON PRACTICE**

The accounting standards updates issued by the FASB in the previous year highlight the challenges faced by the various constituencies involved in the preparation and disclosure of financial statements—the regulators, such as the FASB and the International Accounting Standards Board (which oversees the IFRS) that guide their preparation, their end users, and the entities themselves that prepare them. As in previous years, the FASB’s updates in 2011 aim to reduce discrepancies or inconsistencies in accounting practice as utilized by reporting entities and make those entities’ issued financial statements and related disclosures easier for users to digest. Attorneys who work with clients in preparing these disclosures should remain abreast of these and other updates issued by the FASB and alert their clients to important changes in accepted accounting practice.

Particularly, clients should be made aware that the FASB has altered or provided metrics for certain determinations by reporting entities, such as conclusions with respect to troubled debt restructurings and effective control for repurchase agreements. Additionally, attorneys should take note of the FASB’s acknowledgement that a qualitative assessment may now be an initial test in a reporting entity’s analysis of potential goodwill impairment, and that such an assessment may require the review of litigation and/or potential or actual bankruptcy filings affecting the entity.

Finally, clients preparing financial statements should be made aware that, as in recent years, the FASB has also taken steps to increase the amount of financial information that companies are required to disclose for both interim and annual periods.
Caselaw Developments 2011

OVERVIEW

U.S. Supreme Court defines the “makers” of statements liable for violating Rule 10b-5, addresses the relationship between statistical significance and materiality in the life sciences context, and limits what a court need find in order to certify a Rule 23(b)(3) class in a Rule 10b-5 securities case. In 2011, the U.S. Supreme Court limited the “makers” of statements who can be liable under Rule 10b-5 to individuals and entities controlling the statements’ content and communication. The Court ruled that statistical significance is not necessary in order that side effects from drugs and medical devices be material. And the Court held that a plaintiff need not demonstrate loss causation in order to obtain certification of a Rule 23(b)(3) class in a Rule 10b-5 private lawsuit.

The courts of appeals produced a welter of opinions last year, striking down a controversial Securities and Exchange Commission (“SEC” or “Commission”) rule that provided shareholder access to issuers’ proxy statements and proxy cards for the purpose of soliciting votes for shareholder-nominated director candidates. Those courts addressed matters ranging from disclosure of one-time accounting benefits from new contracts, to whether an issuer that makes a voluntary disclosure of an event thereby creates an obligation to disclose similar events in the future, to the degree to which closing provisions in deal documents for international transactions affect the application of Rule 10b-5 to the purchases and sales of the securities involved.

SEC rulemaking. The D.C. Circuit vacated the proxy access rule that the SEC promulgated on the ground that the Commission’s consideration of costs and benefits was arbitrary and capricious.

Materiality and falsity. The Second Circuit ruled that a company’s bankruptcy planning was not material in light of the extensive information already public that demonstrated the company’s financial distress, held that loan loss reserves

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1. The caselaw developments section covers opinions decided from December 1, 2010, through the end of November 2011. Where this portion of the annual review expresses opinions, those opinions are those of the author of the caselaw developments, William O. Fisher, and not necessarily the opinions of other authors contributing to the annual review or of members of the subcommittee producing the review or of the American Bar Association.
2. See infra notes 75–101 and accompanying text.
3. See infra notes 103–33 and accompanying text.
4. See infra notes 135–50 and accompanying text.
5. See infra notes 151–63 and accompanying text.
6. See infra notes 170–73 and accompanying text.
are not false for securities law purposes unless the issuer publishing the reserve figures does not believe the reserve is adequate, and found that market timing arrangements with one mutual fund shareholder were material to the other fund shareholders. The Ninth Circuit reaffirmed its position that a fact can be material even though it does not affect the price of the issuer’s stock and, in the same case, ruled that postings on an internet message board can be material.

**Duty to disclose.** The First Circuit ruled that a medical device company had no duty to disclose the views of its reimbursement professionals, which were critical of the company’s recommendation that doctors use particular codes to obtain reimbursement for use of the company’s device, because the company repeatedly warned of potential and actual difficulties that doctors encountered in obtaining reimbursement, and the outcome of reimbursement decisions respecting the device remained largely unclear during the period of the alleged fraud. The Eighth Circuit held that, where a company disclosed problems at a manufacturing plant without a securities law obligation to do so, the company did not thereby create an obligation to disclose problems at its plants in the future. The Ninth Circuit found a duty to disclose—sufficient for securities law purposes—in a contractual disclosure obligation.

**Disclosure under Item 303.** Two decisions by the Second Circuit addressed Item 303(a)(3)(ii) of Regulation S-K—requiring disclosure of “any known trends or uncertainties that have had or . . . will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.” In the first opinion, the court held that an issuer must disclose the material impact, on the issuer, of even publicly known trends and held that an impact on a key segment of an issuer’s operations may be material even if the impact will not significantly affect the issuer’s overall financial figures. In the second opinion, the court held that a plaintiff cannot sue for violation of that segment-focused disclosure obligation where the plaintiff has deconstructed the issuer’s business into artificial segments to find one that was particularly affected by the omitted information.

**SEC enforcement actions.** Courts of appeals rendered decisions in SEC enforcement actions that addressed substantive securities law obligations, remedies, and statute of limitations questions. The Second Circuit found materially false a statement that a mutual fund limited market timing trades where the fund’s adviser had arranged for a fund shareholder to make such trades. The Second Circuit also held that a broker facilitating late trading in mutual funds breached an implied

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7. See infra notes 174–83 and accompanying text.
8. See infra notes 290–98 and accompanying text.
9. See infra notes 184–94 and accompanying text.
10. See infra notes 198–215 and accompanying text.
11. See infra notes 216–23 and accompanying text.
13. See infra notes 224–76 and accompanying text.
14. See infra notes 230–57 and accompanying text.
15. See infra notes 258–73 and accompanying text.
16. See infra notes 290–98 and accompanying text.
representation that the orders the broker submitted before funds computed their net asset values were final orders when, in fact, those orders were merely placeholders that the broker’s customer was free to change after the funds’ computations were made. The Ninth Circuit held that a company can make a material misrepresentation by including (without special explanation) numbers in published financials from new contracts or changes in existing contracts that produce a one-time financial effect and, in the same decision, ruled that disagreement among the accountants inside a company as to whether to include numbers within published financials may be evidence that including those numbers misleads investors.

In a case in which the SEC stumbled badly at trial, the Eighth Circuit found a description of option pricing literally correct, even though the option grants included exercise prices equal to the issuer’s stock price on dates that preceded the dates on which the company decided to make the grants, and ruled that an outside director defendant did not have any of the mental states required for liability in part because he relied on accountants and lawyers.

The Ninth Circuit held the SEC must prove that an officer had knowledge that he or she was signing a false management representation letter to an auditor in order to prove a Rule 13b2-2 violation by that letter. The D.C. Circuit held that a defendant could not rely on a Pink Sheet quotation to prove a pre-fraud amount paid for shares in order to reduce the amount of a disgorgement where the volume producing the quotation was far below the number of shares the defendant owned.

Several circuits reaffirmed the general rule that defendants cannot—in a disgorgement calculation—deduct business expenses from gross fraud proceeds. The Second Circuit held that the five-year statute of limitations governing government actions for civil penalties does not begin to run until the government either actually discovers the wrongdoing for which the penalty is imposed or should have discovered that wrongdoing in the exercise of due diligence.

The D.C. Circuit held that that five-year statute does not apply either to claims for disgorgement or to SEC administrative proceedings for cease-and-desist orders. The Second Circuit found that relief defendants did not have a legitimate claim to proceeds from a fraud where those defendants obtained the proceeds through a distribution prohibited by the applicable state limited partnership law, and the Ninth Circuit held that the bankruptcy law provision prohibiting discharge of debts for violation of the securities laws does not prohibit discharge of a disgorgement obligation incurred by a relief defendant in an SEC enforcement action.

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17. See infra notes 299–308 and accompanying text.
18. See infra notes 309–23 and accompanying text.
19. See infra notes 324–51 and accompanying text.
20. See infra note 498 and accompanying text.
21. See infra notes 352–60 and accompanying text.
22. See infra notes 361–67 and accompanying text.
23. See infra notes 368–73 and accompanying text.
24. See infra notes 374–76 and accompanying text.
25. See infra notes 377–82 and accompanying text.
26. See infra notes 383–86 and accompanying text.
distribution order by a receiver, even as to investors who had attempted to invoke a contractual right to full redemption. And the D.C. Circuit held that the venue for SEC actions cannot be expanded to permit an action in any district in which a coconspirator committed a violation.

Insider trading. The Ninth Circuit reaffirmed that the issuer is an insider for Rule 10b-5 insider trading liability, but held that a plaintiff failed to allege the issuer’s scienter where the undisclosed facts were the sales in a secondary offering by founder/officers and those sales hurt the issuer. The Second Circuit cleaned up uncertainty by holding that a tipper violation requires that the tipper understand the tippee will use the conveyed information for trading. Providing a judicial endorsement to a long-standing SEC interpretation, the Ninth Circuit found that an executive does not “purchase” a security—for purposes of Exchange Act section 16—when an option vests.

Criminal cases. The Ninth Circuit found no error in the exclusion of expert testimony on the definition of a “reasonable investor” for purposes of defining materiality and seemed to approve the admission of testimony from a novice investor to prove materiality. The Ninth Circuit reversed a chief financial officer’s (“CFO”) conviction—for a criminal violation of Rule 13b2-2 by signing management representation letters to an auditor—on the ground that the government failed to prove that the CFO knew the letters were wrong. The Ninth Circuit rejected a challenge to a sentence as substantively unreasonable in part because the length of imprisonment fell below the U.S. Sentencing Guidelines (“Guidelines”) range, and the Eleventh Circuit held that a trial court’s use of a version of the Guidelines in effect at the time of sentencing does not violate the Ex Post Facto Clause of the U.S. Constitution—even if the version of the Guidelines in effect at the time of the crime would have recommended a shorter range of imprisonment—unless the use of the harsher Guidelines creates a substantial risk of a longer prison term. The Eighth Circuit interpreted the provision in section 32(a) of the Exchange Act, providing that a defendant cannot be sentenced to imprisonment for violation of an SEC “rule or regulation” if he or she proves no knowledge of such rule or regulation, to apply in cases where the government prosecutes for violation of a statute: section 10(b) of that act.

Private Securities Litigation Reform Act of 1995 (“PSLRA”) pleading. Courts of appeals applied the special statutory standard for pleading scienter in private Rule 10b-5 actions in factual settings important to counselors as well as litigators. The First Circuit affirmed a district court ruling that a plaintiff failed to plead the

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27. See infra notes 387–404 and accompanying text.
28. See infra notes 405–08 and accompanying text.
29. See infra notes 412–21 and accompanying text.
30. See infra notes 422–39 and accompanying text.
31. See infra notes 440–62 and accompanying text.
32. See infra notes 468–75 and accompanying text.
33. See infra notes 476–99 and accompanying text.
34. See infra notes 500–02 and accompanying text.
35. See infra notes 503–21 and accompanying text.
36. See infra notes 522–37 and accompanying text.
scienter of defendants who failed to disclose a change in Japanese regulations that affected an issuer’s sales in that country, basing the affirmance significantly on the plaintiff’s failure to allege that the defendants believed that the regulatory change would cause a material decline in the issuer’s worldwide revenue. 37 The Sixth Circuit reversed dismissal of a case charging defendants with fraud through optimistic statements about an issuer’s profitability and growth where the alleged facts, considered holistically, painted such a bleak picture of the issuer’s financial condition and prospects that the court of appeals found it hard to believe the top officers did not know the company was failing. 38 The Eleventh Circuit affirmed dismissal of a case in which the plaintiffs claimed that the defendants fraudulently characterized a debt obligation as “non-recourse,” but the plaintiffs did not allege the officers at the issuer (i) were ever told this legal conclusion was false or (ii) believed that their characterization was false. 39 The Ninth Circuit reversed a district court’s dismissal of a case based on the defendants’ failure to make a contractually required disclosure, in part on the basis that the failure to make the disclosure itself suggested the defendants acted with scienter. 40 In a case involving e-business, the Eleventh Circuit affirmed dismissal of a complaint alleging that the defendants committed fraud by failing to disclose that two businesses on whose websites the issuer placed ads for the issuer’s customers were employing “click fraud” to increase the apparent number of viewers redirected from those two websites to the websites of the issuer’s customers; the complaint failed to allege facts to show that the defendants knew about the click fraud at the critical times. 41 And the Third Circuit affirmed dismissal of a case in which the plaintiffs alleged fraud by the defendants who explained a shipping company’s financial success without revealing that the issuer’s operating subsidiary was engaged in a price-fixing conspiracy—that holding based on the complaint’s failure to connect knowledge of the price fixing with the individuals who made the challenged statements. 42

Rule 10b-5 statute of limitations. The statute of limitations for private Rule 10b-5 actions contains two parts, requiring plaintiffs to file (i) within two years of the date on which they discover the facts constituting the violation or should have discovered those facts through due diligence and (ii) within five years of the violation. The Seventh Circuit held that the five-year portion of the statute is an absolute bar and that the commencement of the five-year period does not await injury but begins when the defendant makes the false or misleading statement. 43

Class certification. In line with the Supreme Court’s decision that a district court need not find loss causation in order to certify a Rule 23(b)(3) class, the Ninth

37. See infra notes 551–68 and accompanying text.
38. See infra notes 569–79 and accompanying text.
39. See infra notes 580–90 and accompanying text.
40. See infra notes 591–620 and accompanying text.
41. See infra notes 621–33 and accompanying text.
42. See infra notes 634–40 and accompanying text.
43. See infra notes 641–60 and accompanying text.
Circuit held that a Rule 10b-5 plaintiff need not prove the materiality of the misstatements in order to obtain such certification.\footnote{See infra notes 661–74 and accompanying text.}

Reliance. Two appellate opinions addressed the reliance element of private Rule 10b-5 claims, both outside the class action context. The Second Circuit affirmed dismissal of a case brought by a sophisticated investor alleging false statements about the liquidity of auction rate securities because those statements conflicted with express written warnings, including warnings posted online.\footnote{See infra notes 680–98 and accompanying text.} The Eleventh Circuit held that sellers could not invoke the presumption that they relied on the omission of a fact where the undisputed evidence demonstrated that the sellers would have sold even if they had known the fact.\footnote{See infra notes 699–721 and accompanying text.}

Loss causation. Four opinions significantly discussed the loss causation element of a Rule 10b-5 claim. The Fourth Circuit held that plaintiffs must plead loss causation with a degree of specificity at least close to that demanded by Rule 9(b) and affirmed a district court ruling that the plaintiffs had not—in a case alleging the failure to disclose negotiations to lower the price of a leveraged buyout (“LBO”) or to terminate the deal—adequately pled that information about the fraud leaked into the market (i) through news that three regulatory bodies met without approving the transaction and (ii) by the company’s failure to issue a press release after a fourth regulator approved the deal.\footnote{See infra notes 727–44 and accompanying text.} The Second Circuit held a plaintiff alleging that a disclosure created the loss necessary for a Rule 10b-5 claim thereby identifies the date of that disclosure as the date commencing the one-year portion of the statute of limitations for the plaintiff’s section 11 claim.\footnote{See infra notes 745–50 and accompanying text.} The Eleventh Circuit held that statements repeating a fraud can cause recoverable loss.\footnote{See infra notes 751–72 and accompanying text.} The Ninth Circuit held that a plaintiff adequately alleged loss causation, in a case involving founder/executives’ failure to reveal stock sales, by pleading that the plaintiff’s shares became worthless when the issuer disclosed those sales.\footnote{See infra note 617.}

Auditor liability under Rule 10b-5. Because auditors play a unique monitoring role for investors and because, arguably, auditors are uniquely vulnerable to open market Rule 10b-5 actions with potentially huge damages, this review separately summarizes decisions in auditor cases. The Tenth Circuit affirmed dismissal of a Rule 10b-5 claim against an auditor based on the auditor’s alleged misinterpretation of an accounting rule,\footnote{See infra notes 777–86 and accompanying text.} but the Ninth Circuit reversed dismissal of a claim against an auditor based on its alleged failure to follow up on suspicious facts.\footnote{See infra notes 787–803 and accompanying text.} The D.C. Circuit affirmed dismissal of a case against an auditor—based on financial statements’ failure to disclose that the issuer was conducting a Ponzi scheme—with the court holding the auditor’s opinion constituted an affirmative
statement and, therefore, the presumption that plaintiff relied on a material omission did not apply. 53

Section 11. The Second Circuit held that rating agencies were not subject to Securities Act section 11 liability as “underwriters,” even though the agencies consulted with investment banks as the banks structured the mortgage-related securities registered for sale. 54 The First Circuit held that a plaintiff can waive the right to pursue a section 11 claim in state court by failing to move for remand until after losing a motion to dismiss and, in the same case, also held that named plaintiffs could not bring class claims based on securities that they did not buy. 55 The court went on to rule that allegations of misstatements in registration statements must provide some specificity—with allegations in that mortgage-backed securities case sufficient to the extent they charged that a particular mortgage originator did not adhere to lending guidelines, but insufficient to the extent they generally charged (without reference to any originator) that appraisals backing mortgages were not conducted according to professional standards. 56 That First Circuit opinion also found the complaint failed to plead that credit ratings in registration statements were false because the complaint contained no allegations that the rating agencies did not honestly believe the securities merited the ratings the agencies assigned. 57

Securities law violation as a defense to contract liability. The Seventh Circuit held that defendants could defend against contract claims on the ground the contracts violated Regulations G and U, even though the defendants could not bring an affirmative action based on violations of those regulations. 58

Securities Litigation Uniform Standards Act (“SLUSA”). The Sixth Circuit held that the carve-out for cases based on purchases by an issuer from its shareholders did not apply to remove from SLUSA preclusion a case brought by mutual fund shareholders claiming that they had failed to exercise their redemption rights due to defendants’ failure to disclose risks. 59 In the same case, the appellate court held that, if SLUSA precludes a case, a district court can dismiss that case when the court considers the plaintiff’s motion to remand. 60 The Sixth Circuit and the Seventh Circuit—although both affirming dismissal of cases filed in state court—differed on the importance that alleged misrepresentations or omissions must play in a complaint in order to trigger SLUSA scrutiny, with the Sixth Circuit holding that any such allegation triggers scrutiny 61 and the Seventh Circuit leaning toward the view that inessential allegations of misrepresentations or omissions do not implicate SLUSA. 62

53. See infra notes 804–17 and accompanying text.
54. See infra notes 821–42 and accompanying text.
55. See infra notes 843–57 and accompanying text.
56. See infra notes 858–67 and accompanying text.
57. See infra notes 868–82 and accompanying text.
58. See infra notes 883–99 and accompanying text.
59. See infra notes 908–18 and accompanying text.
60. See infra notes 908–21 and accompanying text, particularly at notes 919–21.
61. See infra notes 908–27 and accompanying text, particularly at notes 922–27.
62. See infra notes 928–38 and accompanying text.
Additional cases. Courts of appeals authored other interesting securities opinions, addressing share sterilization as a remedy in private actions under Exchange Act section 13(d), application of the attorney-client privilege to documents generated in internal investigations, the prohibition against using securities violations as predicates for civil Racketeer Influenced and Corrupt Organizations Act (“RICO”) claims, the Financial Industry Regulatory Authority’s (“FINRA”) right to sue for recovery of unpaid penalties that it levies, self-regulatory organization (“SRO”) immunity, whether particular investments were “investment contracts” (including those in limited partnerships, in a limited liability company (“LLC”), and in condominiums to be organized into short-term rental units), and the effect of closing provisions on the application of Rule 10b-5 in international securities transactions.

U.S. Supreme Court

The year 2011 produced three Supreme Court cases of great interest to securities lawyers. The Court held that a person or entity “makes” a statement for purposes of Rule 10b-5(b) only if the person or entity has the “ultimate authority” over the statement’s content and communication. Addressing a matter of particular concern to the drug and medical device industry, the Court held that information about adverse side effects can be “material” for federal securities law purposes even before the reported instances of such side effects have reached statistical significance. Resolving a dispute between circuits and effectively limiting efforts to litigate the merits on motions to certify classes in private Rule 10b-5 actions, the Court held that a plaintiff need not establish loss causation in order to certify a Rule 23(b)(3) class in such cases.

“Maker” of statement under Rule 10b-5(b) is “the person or entity with ultimate authority” over the statement’s content and communication. Rule 10b-5(b) makes it “unlawful for any person, directly or indirectly, . . . [t]o make any untrue statement of a material fact . . . in connection with the purchase or sale of a security.” In Janus Capital Group, Inc. v. First Derivative Traders, the Court considered whether Janus Capital Management LLC (“JCM”), the advisor to mutual funds organized in a

63. See infra notes 948–57 and accompanying text.
64. See infra notes 958–62 and accompanying text.
65. See infra notes 963–68 and accompanying text.
66. See infra notes 969–75 and accompanying text.
67. See infra notes 976–79 and accompanying text.
68. See infra notes 980–86 and accompanying text.
69. See infra notes 987–95 and accompanying text.
70. See infra notes 996–1021 and accompanying text.
71. See infra notes 1022–28 and accompanying text.
72. See infra notes 75–101 and accompanying text.
73. See infra notes 103–33 and accompanying text.
74. See infra notes 134–50 and accompanying text.
75. 17 C.F.R. § 240.10b-5(b) (2011).
76. 131 S. Ct. 2296 (2011).
Massachusetts business trust named Janus Investment Fund, made” statements in the funds’ prospectuses representing (falsely as the plaintiffs claimed) that the funds were unfriendly to and took steps to discourage “market timing” trades in fund shares. Reversing the Fourth Circuit, the Court held that JCM had not “made” those statements within the meaning of Rule 10b-5 because (i) JCM and the Janus Investment Fund were legally independent of one another; (ii) only the Fund had “the statutory obligation to file the prospectuses” (with the complaint including “no allegation that JCM in fact filed [those] prospectuses”); so that (iii) only the Fund “made” the statements under the “rule” that “the maker of a statement is the entity with authority over the content of the statement and whether and how to communicate it.”

The Court reasoned its way to the “rule” that “the maker of a statement [for purposes of Rule 10b-5(b)] is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it,” by a dictionary analysis of the word “make,” finding that “to make” a statement is “the approximate equivalent of ‘to state.’” The Court then concluded that stating, or

77. Id. at 2299.
78. Id. at 2300. The alleged misstatements led to the lawsuit by a complicated path. The plaintiffs had not purchased shares in the mutual funds whose prospectuses misled but had instead purchased stock in Janus Capital Group, Inc. (“JCG”), which was the parent of JCM and was also the company that had “created the Janus family of mutual funds” organized in the Janus Investment Fund. Id. at 2299. The JCG investors claimed that they had bought JCG stock before the New York Attorney General (“NYAG”) exposed the falsehoods in the Janus fund prospectuses and that the value of the JCG stock declined after the NYAG filed his complaint disclosing the falsity because (i) the value of JCG stock depended on financial performance of its subsidiary, JCM; (ii) JCM’s management fees from the funds depended on the amounts invested in the funds; and (iii) investors withdrew their money from Janus funds after the NYAG’s allegations. Id. at 2300. While this theory raises a question of whether the statements in the Janus fund prospectuses were made “in connection with” trading in JCG stock, the Court did not address that issue.
79. Id. at 2299. Aside from their formal “legal independence,” the Court also observed that while “all of the officers of Janus Investment Fund were also officers of JCM, . . . only one member of Janus Investment Fund’s board of trustees was associated with JCM” and that this degree of independence of the funds from the advisor exceeded that required by federal law. Id. at 2299–300.
80. Id. at 2304–05.
81. Id. at 2304.
82. Id. at 2303. The Court further held that JCM did not “make” the statements in the prospectuses by “provid[ing] access to Janus Investment Fund’s prospectuses on [JCM’s] Web site,” as “[m]erely hosting a document on a Web site does not indicate that the hosting entity adopts the document as its own statement or exercises control over its content.” Id. at 2305 n.12.
83. Id. at 2302.
84. Id. The Court reasoned:

One “makes” a statement by stating it. When “make” is paired with a noun expressing the action of a verb, the resulting phrase is “approximately equivalent in sense” to that verb. 6 Oxford English Dictionary 66 (def. 59) (1933) (hereinafter OED); accord[] Webster’s New International Dictionary 1485 (def. 43) (2d ed. 1934) (“Make followed by a noun with the indefinite article is often nearly equivalent to the verb intransitive corresponding to that noun[,]”). For instance, “to make a proclamation” is the approximate equivalent of “to proclaim,” and “to make a promise” approximates “to promise.” See 6 OED 66 (def. 59). The phrase at issue in Rule 10b-5, “[t]o make any . . . statement,” is thus the approximate equivalent of “to state.”

Id.
making, a statement requires “control” over what is said and how it is disseminated. The Court specifically rejected the notion that “[o]ne who prepares or publishes a statement on behalf of another” “makes” that statement, and specifically rejected the government’s amicus position that “‘make’ should be defined as ‘create,’” so that a defendant could be said to “make” a false statement for Rule 10b-5 purposes by “‘provid[ing] . . . false or misleading information that another person then puts into the statement.’” Thus, neither the “‘well-recognized and uniquely close relationship between a mutual fund and its investment adviser’” nor the allegation that “JCM was significantly involved in preparing the prospectuses” proved sufficient to plead that JCM “made” the statements in those selling documents. But the Court did allow that a person or entity could “make” a statement “indirectly” through words spoken or written by another if the statement was “attributed” to that person or entity.

Significance and analysis. Before Janus, the courts of appeals formulated a wide variety of rules to determine whether a defendant was primarily liable for a false statement and therefore an appropriate defendant in a private Rule 10b-5

85. Id.
86. Id. In doing so, the Court analogized to a “speechwriter,” who does not “make” the statements in a speech—those statements only being made by “the person who delivers [the speech]” and who thereby controls its content. Id.
87. Id. at 2303–04.
88. Id. at 2304 (quoting First Derivative brief).
89. Id. at 2305.
90. Id. The Court relied again in this analysis on the fact that “the corporate formalities were observed here. JCM and Janus Investment Fund remain legally separate entities, and Janus Investment Fund’s board of trustees was more independent than the statute requires.” Id. at 2304.
91. Id. at 2306 (Breyer, J., dissenting).
92. Id. at 2305 n.11 (majority opinion). The Court said that, “[i]n the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed.” Id. at 2302. Later, and tying this thought to the “directly or indirectly” language in Rule 10b-5, the majority wrote:

First Derivative suggests that “indirectly” in Rule 10b-5 may broaden the meaning of “make.” We disagree. The phrase “directly or indirectly” is set off by itself in Rule 10b-5 and modifies not just “to make,” but also “to employ” and “to engage.” We think the phrase merely clarifies that as long as a statement is made, it does not matter whether the statement was communicated directly or indirectly to the recipient. . . .

In this case, we need not define precisely what it means to communicate a “made” statement indirectly because none of the statements in the prospectuses were attributed, explicitly or implicitly, to JCM. Without attribution, there is no indication that Janus Investment Fund was quoting or otherwise repeating a statement originally “made” by JCM. More may be required to find that a person or entity made a statement indirectly, but attribution is necessary.

Id. at 2305 n.11 (citations omitted) (emphasis added).
action based upon that statement. The distinctions between the rules particularly impacted secondary actors, such as attorneys who draft SEC filings and selling documents, including prospectuses and offering memoranda. The Ninth Circuit took an expansive view that anyone who played a significant role in the writing of a statement, or substantially participated in its preparation, was primarily liable for the statement in a private Rule 10b-5 action. The Second Circuit took a much more restrictive view, holding that a secondary actor could be primarily liable only if the statement was attributed to that actor at the time the statement was disseminated. Janus decisively moves the law toward the Second Circuit view and away from the Ninth Circuit’s position. This is good news particularly for attorneys who draft offering documents, at least with respect to private Rule 10b-5 actions based on portions of those documents not attributed to the attorneys.

92. See In re Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 628–29 & n.3 (9th Cir. 1994) (accountants could be primarily liable under Rule 10b-5 on two letters from the company to the SEC when one of the letters stated it “was prepared after extensive review and discussions with” the accountants and the plaintiffs presented evidence that the accountants “played a significant role in drafting and editing” the other letter; the plaintiffs alleged that the letters falsely stated that the issuer did not have preliminary financial data for a particular quarter and misleadingly described OEM contracts); Howard v. Everex Sys., Inc., 228 F.3d 1057, 1061 n.5 (9th Cir. 2000) (characterizing the Software Toolworks standard in this way: “substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor’s actual making of the statements”).

93. See Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998) (auditor not liable for unaudited annual financial results in issuer’s press release distributed before publication of audited figures: “a secondary actor cannot incur primary liability under the [Securities Exchange] Act for a statement not attributed to that actor at the time of its dissemination”); Pac. Inv. Mgmt. Co. v. Mayer Brown LLP, 603 F.3d 144, 158 (2d Cir. 2010), cert. denied, 131 S. Ct. 3021 (2011) (relying on Wright and affirming dismissal of action against an outside law firm and an individual law partner based on misstatements in offering documents for REFCO, Inc.; reasoning that “[n]o statements in the Offering Memorandum, the Registration Statement, or the IPO Registration Statement are attributed to [the partner], and he is not even mentioned by name in any of those documents” and that “neither document attributes any particular statements to Mayer Brown”).

94. While a plaintiff might argue that an attorney, by knowingly drafting a statement into an offering document “employ[s] a device, scheme, or artifice to defraud” and is so liable under Rule 10b-5(a), or “engage[s] in [an] act, practice, or course of business which operates or would operate as a fraud or deceit on any person” and so is liable under Rule 10b-5(c), it seems unlikely that such theories would prevail in light of the Court’s pronouncement in Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 161 (2008), that those theories fail when the defendant’s actions do not make the statement “necessary or inevitable,” as drafting would not where the client retains the ultimate control over the content of the offering document. Indeed, the majority quoted, in Janus, the “necessary or inevitable” language from Stoneridge as supporting the Janus decision. Janus, 131 S. Ct. at 2303. A few months before the Court decided Janus, the Third Circuit reached that very conclusion. In re DVI, Inc. Sec. Litig., 639 F.3d 623 (3d Cir. 2011). Finding in the class certification context that plaintiffs could not invoke the fraud-on-the-market presumption to certify a Rule 23(b)(3) class against a law firm that allegedly advised the defendant company on a deceptive way to avoid reporting a material weakness in internal control over financial reporting, id. at 642–49, the court concluded that the attorneys could not be held liable on a Rule 10b-5(a) or (c) theory for the company’s allegedly false statement about internal controls because the attorneys were no more closely connected with the false statement here than the vendors who entered into the transactions that Charter Communications misreported in Stoneridge. Id. at 647. Moreover, no alleged act by [the law firm] made it necessary for DVI to file the misleading 10-Q. Even assuming [the law firm] developed the workaround to avoid disclosure of DVI’s material weaknesses,
Applying *Janus* to a company that produces an offering document, however, presents difficulties. Two circuits hold that *company* scienter requires the scienter of persons within the company “who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like).” 95 If as a result of *Janus* the focus for corporate scienter analysis—like the focus for “making the statement” analysis—shifts to those with formal authority for issuance, then corporations might frequently avoid private Rule 10b-5 liability altogether. In most cases, the board of directors will have the ultimate authority for filing a registration statement or issuing a prospectus or an offering memorandum. Certainly, corporate attorneys could ensure that such formal authority is located in the board, and only the board. Yet, in the great majority of cases, the documents will be prepared by non-board members of management, by attorneys, by accountants, and by others. If *Janus* moves the focus of scienter analysis, as well as the focus of analysis for who “makes” a statement, to the board, then the *company* may escape liability because the board does not know of the deliberate falsehood even though those who prepare the documents do; on the other hand, the individuals who fraudulently prepare the documents may escape liability because they do not “make” the false statements that the documents contain. 96

*Janus* also poses a puzzle for Rule 10b-5 enforcement actions brought by the SEC. While the *Janus* majority repeatedly pointed out that the case before it was a private one 97 and while it approached the case from the general perspective

and DVI would have issued a truthful 10-Q if the law firm did not present this alternative, it was still DVI, not [the law firm], that filed it.

*Id.* at 647 (emphasis added).

95. See Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 366 (5th Cir. 2004); accord Makor Issues & Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702, 708 (7th Cir. 2008).

96. The *Janus* dissent presented this conundrum:

The possibility of guilty management and innocent board is the 13th stroke of the new rule’s clock. What is to happen when guilty management writes a prospectus (for the board) containing materially false statements and fools both board and public into believing they are true? Apparently under the majority’s rule, in such circumstances no one could be found to have “made” a materially false statement—even though under the common law the managers would likely have been guilty or liable (in analogous circumstances) for doing so as principals (and not as aids and abettors).

*Janus*, 131 S. Ct. at 2310 (Breyer, J., dissenting) (citations omitted).

At least when an officer within the company drafts the false statement, the courts might avoid this issue by drawing a distinction between *Janus*, where the defendant under consideration was a separate legal entity from the issuer, and the officer/board case, where both the officer and the board are within the same legal entity. *See*, e.g., *In re Merck & Co., Inc. Sec., Derivative & ERISA Litig., MDL No. 1658 (SRC), Civil Action Nos. 05-1151 (SRC), 05-2367 (SRC)*, 2011 WL 3444199, at *24–25 (D.N.J. Aug. 8, 2011).

97. *Janus*, 131 S. Ct. at 2301 (“We granted certiorari to address whether JCM can be held liable in a private action under Rule 10b-5 for false statements included in Janus Investment Fund’s prospectuses.”); *id.* at 2302–03 (relying on Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994) and *Stoneridge*, 552 U.S. 148 because those cases, like *Janus*, involved “private” Rule 10b-5 actions).
that it should narrowly construe the private right of action under Rule 10b-5 because the private claim is judicially implied, the majority’s analysis focuses on the word “make,” a word that is in Rule 10b-5(b) and therefore applies whether the action based upon that rule subsection is brought by a private plaintiff or by the SEC. Thus, Janus invites courts to end the tortured difference between the definition of primary liability in private actions and the definition of primary liability in public SEC enforcement actions. If Janus accomplishes this result and thereby restricts the meaning of “making” a statement in SEC actions as in private actions, however, the opinion should do little damage to SEC enforcement efforts because the SEC’s ability to sue those who aid and abet a primary violation—an ability that private plaintiffs do not enjoy—may render the new restriction effectively meaningless in most cases.

Statistical significance is not determinative when considering whether adverse effects produced by drugs are “material.” In 1998, the Second Circuit held statements by a drug manufacturer that sales of a drug had increased did not become “materially misleading” due to deaths associated with the drug’s use “until [the manufacturer] had information that [the drug] had caused a statistically significant number of . . . deaths and therefore [the manufacturer] had reason to believe that the commercial viability of [the drug] was threatened.” In 2000, the Second Circuit, in a later appeal during the same case, held that, “[b]ecause there was no statistical link between [the drug] and any adverse side effect before [the end of the class period defining the temporal limits of the alleged fraud],” the complaint failed to allege scienter. The Supreme Court reached the opposite conclusion on each of those points in 2011, when it affirmed a Ninth Circuit decision in Matrixx Initiatives, Inc. v. Siracusano.

Matrixx produced an over-the-counter cold remedy called Zicam, which used zinc gluconate and accounted for about 70 percent of Matrixx’s revenue. In September 2003, Matrixx learned that two doctors at the University of Colorado intended to present to the American Rhinologic Society their findings that Zicam caused anosmia, loss of smell. With that information in hand, and after two plaintiffs filed product liability lawsuits against Matrixx alleging that Zicam

98. Id. at 2302, 2303 (“Our holding . . . accords with the narrow scope that we must give the implied private right of action.”).
99. The definitions have diverged because primary liability in the private setting depends on whether the plaintiff could have relied on the defendant, whereas reliance is not an element in an SEC enforcement action. See, e.g., SEC v. Tambone, 597 F.3d 436, 447 n.9 (1st Cir. 2010).
102. The one caveat is that if Janus prevented the SEC from identifying any primary violator in a particular fact setting—see supra notes 95–96 and accompanying text—there would be no primary violation to aid and abet.
105. 131 S. Ct. 1309, 1309 (2010).
106. Id. at 1314.
107. Id. at 1315.
damaged their olfactory abilities, Matrixx (i) “stated that Zicam was ‘poised for growth in the upcoming cough and cold season’ and that the company had ‘very strong momentum,’” (ii) “expressed its expectation that revenues would ‘be up in excess of 50% and that earnings per share for the full year [would] be in the 25 to 30 cent range,’” and (iii) “raised its revenue guidance, predicting an increase in revenues of 80 percent and earnings per share in the 33-to-38-cent range.”

While Matrixx warned generally in its Form 10-Q that products liability claims could hurt the company even if not valid, the company did not disclose the lawsuits claiming loss of smell from Zicam use. After a news report that the U.S. Food and Drug Administration (“FDA”) was looking into reports that Zicam caused smell loss and a third lawsuit making that allegation, Matrixx issued a press release stating that two clinical studies of zinc gluconate had produced no “reports of anosmia related to the use of this compound.”

The company apparently repeated that statement after an additional news report highlighting the findings of the two doctors from the University of Colorado and noting that now four lawsuits were pending against Matrixx alleging anosmia.

Investors who bought Matrixx stock while these events unfolded brought a Rule 10b-5 action against the company. Rejecting the company’s argument that it had not made any misleading statements by failing to disclose the reports of smell loss because “adverse event reports that do not reveal a statistically significant increased risk of adverse events from product use are not material information,” the Court rejected statistical significance as a “bright-line rule” for determining materiality in the pharmaceutical industry. The Court reasoned that “[a] lack of statistically significant data does not mean that medical experts have no reliable basis for inferring a causal link between a drug and adverse events.” To support this view, the Court noted that the FDA “does not limit the evidence it considers for purposes of assessing causation and taking regulatory action to statistically significant data” but instead “requires manufacturers of over-the-counter drugs to revise their labeling to include a warning as soon as there is reasonable evidence of an association of a serious hazard with a drug; a causal relationship need not have been proved.” And the SEC, in an amicus brief, stated that “medical researchers . . . consider multiple factors in assessing causation.” Since “medical professionals and regulators act on the basis of evidence of causation that is not

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108. Id. (some internal quotation marks omitted). Although “poised for growth” and “strong momentum” might well have constituted inactionable “puffery,” Matrixx did not present that argument to the Court in a timely way. Id. at 1315 n.2.
109. Id. at 1315.
110. Id. at 1316.
111. Id.
112. Id. at 1314.
113. Id. at 1318 (quoting Matrixx brief).
114. Id. at 1313–14.
115. Id. at 1319.
116. Id. at 1320 (quoting 21 C.F.R. § 201.80(e) (2006)).
117. Id. at 1319 (quoting SEC brief).
While the Court conceded that “the mere existence of reports of adverse events—which says nothing in and of itself about whether the drug is causing the adverse events—will not satisfy [the securities law materiality standard], . . . contextual inquiry may reveal in some cases that reasonable investors would have viewed reports of adverse events as material even though the reports did not provide statistically significant evidence of a causal link.” \(^{119}\) Here there was enough in the complaint to “‘raise a reasonable expectation that discovery will reveal evidence’ satisfying the materiality requirement,” \(^{120}\) because the securities law plaintiffs alleged that (i) “three medical professionals and researchers” reported that more than 10 patients . . . had lost their sense of smell after using Zicam,” (ii) “nine plaintiffs commenced four product liability lawsuits against Matrixx alleging a causal link between Zicam use and anosmia,” and (iii) two doctors presented to a professional medical organization “their findings about a causal link.” \(^{121}\) Since “[c]onsumers likely would have viewed the risk associated with Zicam (possible loss of smell) as substantially outweighing the benefit of using the product (alleviating cold symptoms), particularly in light of the existence of many alternative products on the market,” and since “Zicam Cold Remedy allegedly accounted for 70 percent of Matrixx’s sales,” the complaint contained enough “facts suggesting a significant risk to the commercial viability of Matrixx’s leading product” to render the facts material. \(^{122}\)

The Court then quickly disposed of the additional argument that the complaint failed to allege sufficient facts to raise a strong inference of scienter, \(^{123}\) an inference reached in a private Rule 10b-5 action only if a plaintiff alleges facts from which “‘a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw.’” \(^{124}\) Matrixx contended that “because respondents do not allege that [Matrixx] knew of statistically significant evidence of causation, there is no basis to consider the inference that it acted recklessly or knowingly to be at least as compelling as the alternative inferences.” \(^{125}\) Concluding that “Matrixx’s proposed bright-line rule requiring an allegation of statistical significance to establish a strong inference of scienter is just as flawed as its approach to materiality,” \(^{126}\) the Court found “[t]he inference that Matrixx acted recklessly (or intentionally, for that matter) is at least as compelling, if

\(^{118}\) Id. at 1321.

\(^{119}\) Id.

\(^{120}\) Id. at 1323 (quoting Bell Atl. Corp. v. Twombly, 550 U.S. 544, 556 (2007)).

\(^{121}\) Id. at 1322.

\(^{122}\) Id. at 1323.


\(^{124}\) Matrixx Initiatives, 131 S. Ct. at 1324 (quoting Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 324 (2007)).

\(^{125}\) Id.

\(^{126}\) Id.
not more compelling, than the inference that it simply thought the reports did not indicate anything meaningful about adverse reactions.”

The Court reached that conclusion on the basis that Matrixxx had (i) advised at least one doctor that the company had “hired a consultant to review the product”; (ii) “asked [that doctor] to participate in animal studies” to test for anosmia; (iii) successfully pressured the doctors presenting at the rhinologic society to avoid using the Zicam name; and (iv) “[m]ost significantly, . . . issued a press release that suggested that studies had confirmed that Zicam does not cause anosmia when, in fact, [Matrixxx itself] had not conducted any studies relating to anosmia and the scientific evidence at that time, according to the panel of scientists [that Matrixxx convened], was insufficient to determine whether Zicam did or did not cause anosmia.”

Significance and analysis. Matrixxx removes a clear test that drug and medical device manufacturers could use to determine the materiality of adverse side effects for securities law purposes. The decision accords with the Court’s earlier rejection of agreements in principle as the bright-line test to determine the materiality of merger discussions. But the Court throws out the statistical significance test in the drug/device context and substitutes a squishy test that is hard to apply and was satisfied here at the pleading stage by alleging, for a product used by tens or hundreds of thousands of consumers, (i) reports from three doctors on “more than ten patients” and (ii) four lawsuits by nine plaintiffs. Is any report of an adverse side effect “material” provided that it comes from a doctor, and the doctor advances the hypothesis or argument that the drug or device caused the side effect? If one is not enough, will two do? Apparently less than two dozen patients either suing or involved in reports from doctors suffice—at least for pleading materiality in a lawsuit and surviving a motion to dismiss and perhaps forcing a settlement.

127. Id.
128. Id. It is unclear from the opinion just when Matrixxx convened the panel. The opinion gives the date of the Form 8-K disclosing the panel as February 19, 2004, id. at 1316, while the class period defining the chronological end of the alleged fraud concluded on February 6, 2004, id. at 1314.
129. Id. at 1318 (discussing the Court’s rejection of such a bright-line rule (citing Basic Inc. v. Levinson, 485 U.S. 224, 236 (1988))).
130. The Court notes that the price of Matrixxx stock fell after the news story that the FDA was looking into reports that Zicam caused anosmia and “plummeted” after a Good Morning America segment featuring the findings of the two doctors at the University of Colorado. Id. at 1315–16. The price drop gives some objective credence to the materiality analysis, but the Court does not rely on the price decline.

The First Circuit has applied the Court’s Matrixxx opinion in affirming summary judgment for a medical device manufacturer. Miss. Pub. Employees’ Ret. Sys. v. Bos. Scientific Corp., 649 F.3d 5, 20–21, 30–31 (1st Cir. 2011). The plaintiffs claimed that Boston Scientific Corporation (“BSC”) made false and misleading statements about problems with a coronary stent that eventually led BSC to recall that product. Id. at 8–9. BSC’s Taxus stent—which the plaintiffs based their case—used the same catheter delivery system as BSC’s Express stent, but the Taxus stent included a polymer coating treated with a drug helpful in defeating complications from stent implant. Id. at 9. Doctors installed each stent by inserting the stent and a deflated balloon into an artery, inflating the balloon to clear the artery, deploying the stent, then deflating the balloon and removing the balloon and catheter. Id. The balloons included in both the Express and Taxus stents sometimes did not deflate after clearing the artery and deploying the stent (the “no-deflate” problem). Id. at 10, 14. Some doctors reported that the Taxus stent seemed to stick in arteries during deployment, a “sticky stent” tendency caused by the polymer coating. Id. at 15.
The Court suggests a drug company can avoid making the difficult materiality determination that Matrixx describes because Rule 10b-5 does not require a company to disclose even material information unless the failure to do so would render the company’s other disclosures misleading without adding information on

After receiving no-deflate reports in 2003 from physicians implanting Express stents, BSC studied the issue, made a number of changes in its Express manufacturing processes, and concluded that it need not recall any of the stents. Id. at 10–11. In October 2003, BSC also sought and received FDA permission to use a new design for the Express stent that addressed the no-deflate problem. Id. at 12. At the same time as BSC undertook these corrective actions, it also studied whether shifting the location of a laser bond during the manufacture of the Express and Taxus stents (BSC having begun to sell the Taxus stents in Europe in February 2003) would reduce no-deflates. Id. at 12–13. Work on validating that laser shift—which included an investigation into whether the shift would create new problems as well as defeat the no-deflate problem—began in September 2003, id. at 13, and continued into 2004, id. at 14. In April 2004, BSC sought, and on May 5 BSC received, FDA approval for the laser shift in the manufacture of both Express and Taxus stents. Id. at 14–16.

BSC started FDA-approved sale of the Taxus stent in the United States in March 2004. Id. at 14. In April 2004, the FDA contacted BSC about sticky stent problems in the insertion of the Taxus stents—a problem that European doctors had previously reported to BSC when BSC was selling Taxus in Europe but not in the United States, and a problem that subsided when European doctors gained experience with Taxus. Id. at 15.

On the evening of June 22, 2004, a BSC Product Inquiry Report (“PIR”) team advised of no-deflate issues in seven stents from one Taxus manufacturing lot—but found no such problems in other Taxus lots manufactured contemporaneously with the troubled lot—and, after BSC discovered similar problems with a second lot, the company recalled both lots on July 2. Id. at 17. The company subsequently discovered (i) that a new inspection protocol could identify stents with potential laser bonding problems that could lead to no-deflates and (ii) that “cone puffing”—a process used in the manufacture of Taxus but not Express—was an additional cause of no-deflates. Id. at 19. Using these discoveries, BSC recalled about 85,000 Taxus stents on July 16, 2004, id., ending the asserted fraud. In re Bos. Scientific Corp. Sec. Litig., 708 F. Supp. 2d 110, 114 (D. Mass. 2010) (class period ran from Nov. 20, 2003 to July 15, 2004).

The First Circuit found that scienter related to materiality. Miss. Pub. Employees’ Ret. Sys. v. Bos. Scientific Corp., 649 F.3d at 20 (citing Miss. Pub. Employees’ Ret. Sys. v. Bos. Scientific Corp., 523 F.3d 75, 87 (1st Cir. 2008)). Tying those two ideas together toward the end of the opinion, the court reasoned that “the key issue is not whether defendants were aware that [a corrective measure to eliminate no-deflates] was being contemplated, as plaintiff suggests, but rather whether they were aware or recklessly unaware that the no-deflate problem threatened Taxus’s viability and hence the price of BSC’s stock.” Id. at 28–29.

While the plaintiffs alleged that BSC and the individual defendants acted with scienter by failing to disclose the laser bond shift in November 2003—well before the shift became public through FDA approval on May 5, 2004—the court found that BSC had still been studying the wisdom of the shift in November 2003 and “[i]t would have been inappropriate for the company to disclose that it was considering a manufacturing change before it was satisfied that the change would not itself cause other problems, and no inference of scienter can be drawn from this non-disclosure.” Id. at 22–23. Moreover, by the end of November, “there had been only two no-deflate complaints for the tens of thousands of Express and Taxus devices manufactured at [one of two plants] after the introduction of the May 2003 [manufacturing] changes, and there had been only three no-deflates ever on Express devices manufactured at [the other plant].” Id. at 23. “[N]o inference of scienter can be drawn from defendants’ conclusion that the preventive [manufacturing changes] implemented in May [2003] had been effective in further reducing what was already, by industry standards, a very low rate of complications.” Id.

While the plaintiffs alleged that the defendants’ scienter was shown by their statements blaming no-deflates on physician technique, id. at 23–24, the court found that this argument confused BSC statements about no-deflates with the company’s statements about sticky stents, id. at 24, an issue that was related to physician unfamiliarity with the Taxus stent, id. While the plaintiffs alleged that BSC misled through a June 22, 2004, morning Dow Jones Newswire story quoting a BSC spokesperson as saying there would not be a recall, the critical information leading to the first recall did not arrive until the evening of June 22, when the PIR team reported finding more stents with problems, which then had to be evaluated through an internal BSC protocol anyway before any action (here the first recall on July 2) could occur. Id. at 26. While the plaintiffs charged that BSC acted with
side effects.\textsuperscript{131} But that analysis is cold comfort under the facts of the case. Virtually any positive statement about a drug or device that produces a large percentage of a company’s total revenue (here 70 percent) or any statement about company revenue or earnings, coupled with a statement that sales of one product provided the majority of the revenue, would arguably mislead unless the issuer added “material” information about adverse side effects associated with that product.\textsuperscript{132}

So what can a company do? Perhaps a company could post on its website all complaints or reports of adverse effects that the company receives about any drug or device that it manufactures, or at least about any drug or device that contributes a material percentage of revenues or profits. But then must the company also post its response to each complaint, else the failure to do so deprive investors of “material” information? If a company is investigating complaints of adverse side effects in order to determine the relationship of the complaints to the drug or device, must the company post its preliminary conclusions? Would all of this disclosure just dump insignificant information into the marketplace? Could companies avoid the issue by reporting each complaint to the FDA, with the FDA then posting the complaints on its website? It is hard to say. But the Court’s eagerness to expand the “no bright-line” analysis from merger and acquisition events to consumer complaints seems made without considering practicalities.\textsuperscript{133}

\textsuperscript{131} Matrixx Initiatives, 131 S. Ct. at 1321–22.

\textsuperscript{132} The Court held that the alleged omitted information constituted “material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.” Id. at 1323 (quoting 17 C.F.R. § 240.10b-5(b)). If the allegations were true, the company needed (1) to disclose “information indicating a significant risk to its leading revenue-generating product” in order not to mislead by projecting “that revenues were going to rise 50 and then 80 percent,” and (2) to disclose it had “evidence” of a biological link between Zicam’s key ingredient and anosmia, and [that the company] had not conducted any studies of its own to disprove that link” in order not to mislead by stating that reports of Zicam causing anosmia “were ‘completely unfounded and misleading’ and that ‘the safety and efficacy of zinc gluconate for the treatment of symptoms related to the common cold have been well established.’” Id.

\textsuperscript{133} See, e.g., Basic, 485 U.S. at 231 (noting the need to avoid setting too low a floor for materiality as a “minimal standard might bring an overabundance of information within its reach” and produce “an avalanche of trivial information” (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976)).
Plaintiff in a private Rule 10b-5 case need not prove loss causation in order to win certification of a class under Federal Rule of Civil Procedure 23(b)(3).\(^\text{134}\) In *Erica P. John Fund, Inc. v. Halliburton Co.*\(^\text{135}\), the Court confronted the extent to which a plaintiff need prove its substantive case in order to win a motion to certify a class in a private Rule 10b-5 lawsuit. The lead plaintiff sought certification under Federal Rule of Civil Procedure 23(b)(3) which requires, among other things, “that the questions of law or fact common to class members predominate over any questions affecting only individual members.”\(^\text{136}\) The elements of a private Rule 10b-5 claim include reliance.\(^\text{137}\) While an investor can prove reliance individually by showing that he or she was personally aware of a misrepresentation and bought a security based on that awareness,\(^\text{138}\) such individual proof “prevent[s] . . . plaintiffs ‘from proceeding with a [Rule 23(b)(3)] class action, since individual issues’ [then] ‘overwhelm[] the common ones.’”\(^\text{139}\) Plaintiffs can convert reliance from an individual issue into a common issue by “invok[ing] a rebuttable presumption of reliance based into . . . the ‘fraud-on-the-market’ theory” which posits that, in an efficient market, the market price reflects a misrepresentation and thereby transmits the misrepresentation to all buyers and sellers in the market who all then rely on the misrepresentation by buying or selling at the price the misrepresentation influenced.\(^\text{140}\) Converting reliance into a common issue in this way permits certification of a Rule 23(b)(3) class in an investor fraud case.

The district court in *Halliburton*, and the Fifth Circuit, refused to certify a private Rule 10b-5 plaintiff class because Fifth Circuit authority required a plaintiff prove loss causation—that the stock price declined when the truth about the asserted misrepresentations came out and the decline could not be attributed to other factors—in order to trigger the fraud-on-the-market presumption.\(^\text{141}\) The Supreme Court vacated the Fifth Circuit judgment,\(^\text{142}\) holding that the reliance element of a private Rule 10b-5 action is separate from the loss causation element\(^\text{143}\) and that an investor can employ the fraud-on-the-market presumption for reliance “so long as [a misrepresentation] was reflected in the market price at the time of his [or her] transaction.”\(^\text{144}\) The Court further held that “[t]he fact that a subsequent loss may have been caused by factors other than the revelation of [the] misrepresentation,” so that the investor could not establish loss causation,

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134. For an additional case on class certification—addressing whether a plaintiff must establish materiality in order to litigate a Rule 10b-5 claim on behalf of a class—see infra notes 661–74 and accompanying text.
136. FED. R. CIV. P. 23(b)(3).
137. *Halliburton*, 131 S. Ct. at 2184.
138. *Id.* at 2185.
139. *Id.* (quoting Basic Inc. v. Levinson, 485 U.S. 224, 242 (1988)).
140. *Id.*
141. *Id.* at 2183–84.
142. *Id.* at 2187.
143. *Id.* at 2186 (“Loss causation addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock.”).
144. *Id.*
“has nothing to do with whether [the] investor relied on the misrepresentation in the first place.” 145 All a plaintiff “must demonstrate” in order to invoke the fraud-on-the-market reliance presumption is “that the alleged misrepresentations were publicly known (else how would the market take them into account?), that the stock traded in an efficient market, and that the relevant transaction took place ‘between the time the misrepresentations were made and the time the truth was revealed.’” 146

Significance and analysis. Halliburton should limit what had become extensive merits litigation on class certification motions in private Rule 10b-5 actions, litigation which had enlarged in some cases to include dueling expert opinions on loss causation. 147 But the merits will still matter on class certification, and expert opinions may still be offered on certification motions, because the Court affirmed that a plaintiff employing the fraud-on-the-market reliance presumption must show that the relevant security traded in an efficient market during the period of the alleged fraud. 148 The Court made no statement simplifying that showing. 149 And the circumstance that the price of a stock does not decline when the truth comes out—though it cannot be used to argue loss causation on a class certification motion—may be still relevant to market efficiency. 150

145. Id.

146. Id. at 2185 (quoting Basic Inc. v. Levinson, 485 U.S. 224, 248 n.27 (1988)).


149. Plaintiffs often offer expert work to establish market efficiency. For example, in Schleicher v. Wend, the plaintiffs offered an expert witness report to show that the security there traded in an efficient market because “the price of . . . [the] stock [at issue there] changed rapidly, and in the expected direction, in response to new information.” 618 F.3d 679, 684 (7th Cir. 2010). Similarly, when deciding In re DVI, Inc. Securities Litigation, a few months before Halliburton, the Third Circuit affirmed an order certifying a class on the fraud-on-the-market theory where the plaintiffs presented an expert’s event study to show “that, of the 34 days during the class period when DVI’s common stock saw significant price changes, 20 of those days coincided with news releases,” together with “two studies . . . which found that on average ‘only about one-third of statistically significant changes in the stock price of publicly traded companies are actually associated with identifiable news or events.’” 639 F.3d 623, 635 (3d Cir. 2011) (quoting In re DVI, Inc. Sec. Litig., 249 F.R.D. 196, 212 (E.D. Pa. 2008)), cert. denied, 132 S. Ct. 350 (2011). Since the “cause-and-effect relationship between a company’s material disclosures and the security price is normally the most important factor in an efficiency analysis” and since the “correlation” between news and stock price movement at DVI “was at least twice as high” as for stocks on average, the trial court’s “factual findings that 60% and 65% correlations between news releases and price changes in DVI stock . . . weigh in favor of market efficiency were not clearly erroneous.” Id. at 634–35. The court further held that the circumstance that “some information took two days to affect the [stock] price” even though “most of the information was incorporated into the price within one day,” did “not undermine a finding of [market] efficiency.” Id. at 635.

150. See In re DVI, Inc., 639 F.3d at 638 (“Evidence [that] an allegedly corrective disclosure did not affect the market price undermines the fraud-on-the-market presumption of reliance” because “[a] demonstration the market did not assimilate information about the security into the market price—either when the alleged misrepresentation occurred, or when an alleged corrective disclosure occurred—may undercut the general claim of market efficiency or demonstrate market inefficiency relating to the securities in issue.”).
Courts of Appeals

SEC Rulemaking: Proxy access rule adopted without adequate analysis of benefits and costs

In 2010, the SEC adopted a proxy access rule, permitting shareholders—who have, for at least three years, owned a public company’s securities possessing a minimum of 3 percent of total voting power—to place a minority number of director candidates on the company’s proxy card and to include in the company’s proxy statement up to 500 words supporting the election of those candidates.  

In 2011, the D.C. Circuit vacated the rule in Business Roundtable v. SEC, on the ground that the SEC’s adoption of the rule was arbitrary and capricious under the Administrative Procedure Act. The court rested its holding on four grounds. First, the D.C. Circuit found that the Commission had not considered the costs and benefits of the new rule. The SEC “did nothing to estimate and quantify the costs it expected companies to incur” in opposing shareholder-nominated director candidates, “nor did [the SEC] claim estimating those costs was not possible.” Instead, the Commission simply predicted that companies might not oppose shareholder candidates at all, even though “the [SEC] . . . presented no evidence that such forbearance is ever seen in practice” and even though the American Bar Association commented to the Commission that a sitting board would have a fiduciary duty to oppose a candidate it did not deem appropriate. With respect to benefits, while the SEC “acknowledged the numerous studies submitted by commenters” concluding that the rule would not yield better board performance or increase shareholder value, the Commission “completely discounted those studies” and “relied exclusively and heavily upon two relatively unpersuasive studies, one concerning the effect of ‘hybrid boards’ (which include some dissident directors) and the other concerning the effect of proxy contests in general, upon shareholder value.” The court held that “[i]n view of the admittedly (and at best) ‘mixed’ empirical evidence, . . . the Commission has not sufficiently supported its conclusion that increasing the potential for election of directors nominated by shareholders” would yield “improved board and company performance and shareholder value.”

Second, the D.C. Circuit found that the SEC “failed to respond” to the concern of commenters who argued that “investors with a special interest, such as unions and state and local governments whose interests in jobs may well be greater than their interest in share value” would use proxy access to nominate director candidates who would “pursue [their] self-interested objectives rather than the goal of maximizing shareholder value.” Third, the court found that the SEC, which

153. Id. at 1150.
154. Id.
155. Id. at 1150–51.
156. Id. at 1151.
157. Id. at 1152.
had recognized that shareholders might use the new rule to nominate a minority number of director candidates instead of engaging in a traditional proxy fight, “arbitrarily ignored the effect of the final rule upon the total number of election contests,” thus leaving itself without the “crucial datum”—whether the rule would produce enough net new contests to provide a benefit. 158 Fourth, the SEC had included investment companies within the rule even though the reasoning behind one supposed benefit of doing so—greater protection of shareholder interests in the terms of advisory contracts—failed to consider that mutual fund shareholders already vote on advisory contracts 159 and the Commission “failed to deal with the concern” that the new rule might disrupt “the unitary and cluster board structures” of mutual funds “with the introduction of shareholder-nominated directors who sit on the board of a single fund, thereby requiring multiple, separate board meetings and making governance less efficient.” 160

Significance and analysis. The SEC’s efforts to permit shareholders to use the company proxy apparatus to put forward director candidates—first proposed but not adopted in 2003 161 and then adopted in an altered form in 2010, but here struck down for arbitrary and capricious analysis—have proved very controversial. 162 It is unclear whether the Commission will seek to create an analysis for a mandatory proxy access rule that will survive judicial scrutiny. Perhaps more important, the D.C. Circuit reminded the Commission in the Business Roundtable decision that the court had struck down a number of SEC rules in recent years for patently insufficient analysis. 163 The SEC has enjoyed a fine reputation as a very professional agency. Promulgating contentious rules on scanty records threatens to tarnish that reputation by creating the impression that the SEC is more interested in pursuing a political or ideological agenda than protecting investor rights.

Materiality and Falsity 164: Issuer’s bankruptcy planning was not a material fact where the market was informed of the company’s dire financial straits by SEC filings reporting large losses and the financial press reported that the company would go bankrupt if the losses continued; goodwill and loan loss provisions were opinions that were not false unless the defendants did not believe them; proof of materiality need not include a showing of market reaction in the Ninth Circuit; postings on internet message boards can be material

158. Id. at 1153. The court also found that the SEC’s estimates of the number of times shareholders would use the new rule varied, so that the Commission predicted a high number when analyzing benefits and a low number when analyzing costs. Id. at 1153–54.
159. Id. at 1154–55.
160. Id. at 1155.
162. Congress has implicitly endorsed shareholder access by providing that the Commission has the authority to promulgate a rule requiring it. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010).
164. For other decisions addressing materiality, see supra notes 103–33 and accompanying text; infra notes 290–98 and accompanying text, particularly at notes 297–98; and infra notes 551–68 and accompanying text. See also infra notes 224–75 and accompanying text.
A fact is material for securities law purposes if there is “a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information . . . available” and relevant to a decision to purchase or sell the security.\(^\text{165}\) To be actionable, a statement of material fact must be false or misleading.\(^\text{166}\) In 2011, the Second Circuit ruled that information about a company bankruptcy contingency planning was not material in light of disclosed losses and analyst predictions that the company would fail.\(^\text{167}\) The Second Circuit also held that goodwill numbers and loan loss reserves were opinions that were not false absent a showing that the company reporting the reserves did not believe them adequate.\(^\text{168}\) The Ninth Circuit held, again, that materiality does not depend on stock price movement, and in the same case held that internet message board postings can be material.\(^\text{169}\)

**Materiality of bankruptcy planning.** In affirming summary judgment for a chief executive officer (“CEO”), the Second Circuit held in *Beleson v. Schwartz*\(^\text{170}\) that the executive had not violated Rule 10b-5 by failing to disclose, among other things, his company’s contingency bankruptcy plans.\(^\text{171}\) The court held that the omitted information was not material because “the market was adequately informed of the dire nature of [the company’s] financial condition.”\(^\text{172}\) The court reached this conclusion because (i) the company’s SEC filings disclosed “large losses of approximately $66.2 million in 2000, $128.5 million in 2001, and $502.4 million in 2002, as well as a decline in cash reserves from $159.9 million in 2001 to $65.9 million in 2002”; (ii) public information showed that its debt/equity ratio was “almost twenty-to-one”; and (iii) “some analysts were predicting that ‘if results were to slide further, the company would be challenged to sustain its present capital structure,’ and ‘the heavily leveraged company will be unable to avoid another Chapter 11 bankruptcy filing.’”\(^\text{173}\)


\(^{166}\) See, e.g., 17 C.F.R. § 240.10b-5(b) (2011).

\(^{167}\) See infra notes 170–73 and accompanying text.

\(^{168}\) See infra notes 174–83 and accompanying text.

\(^{169}\) See infra notes 184–94 and accompanying text.

\(^{170}\) 419 F. App’x 38 (2d Cir. 2011).

\(^{171}\) Id. at 40; see also Beleson v. Schwartz, 599 F. Supp. 2d 519, 520–21 (S.D.N.Y. 2009) (identifying the defendant as the company’s CEO). The plaintiff “argue[d] that [the CEO] had a duty to disclose [the company’s] lack of viability and impending bankruptcy because his failure to disclose the satellite sale negotiations with Intelsat and the related contingency bankruptcy plans ‘rendered [the company’s] Class period public statements materially incomplete and, thus, misleading.’” Beleson, 419 F. App’x at 40.

\(^{172}\) Beleson, 419 F. App’x at 40.

\(^{173}\) Id. (citation omitted). With respect to the negotiations on the satellite deal and related bankruptcy contingency plans, the Second Circuit added that they “were not finalized until immediately before they were publicly announced.” Id. at 40–41.

While the court prefaced its fact-based analysis with the comment that the materiality of a contingent or speculative event is based on the probability of the event weighted by its anticipated magnitude in relation to the entire activity of the company at issue, id. at 40 (quoting Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 180 (2d Cir. 2001)), the opinion fails to follow through by relating the facts that it recites to that analytical construct. One way of doing so would see the probability of bankruptcy so high in light of the information already publicly available that, although bankruptcy would
The Business Lawyer; Vol. 67, May 2012

Falsity of goodwill and loan loss reserves. Turning from materiality to falsity, the Second Circuit in Fait v. Regions Financial Corp. affirmed dismissal of Securities Act section 11 and section 12(a)(2) claims that were based on allegedly false goodwill and loan loss reserve numbers. About nine months after the offering in which those numbers were used, Regions Financial reported a multi-billion dollar loss, driven by a multi-billion dollar impairment charge to goodwill and a 100 percent increase in its loan loss provision. The Second Circuit held that both goodwill constitute an event of great magnitude, the additional statements the CEO might have made about that possibility would not, in the minds of the sophisticated investors determining market price, have raised the probability of bankruptcy much above its already elevated level.

The other analytical notion that the opinion advances is that the materiality of any omitted information must be judged by asking whether its revelation would have “significantly altered the total mix of information” in the market. Id. (citation and internal quotation marks omitted). Here (the court may have reasoned), any further comments about possible bankruptcy by the CEO would not have altered that total mix in an appreciable way given the extensive and negative information about the issuer already available to the Street.

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174. 655 F.3d 105 (2d Cir. 2011).
177. The plaintiff purchased hybrid securities, with characteristics of both equity and debt, from a financing trust. Regions Fin. Corp., 655 F.3d at 107. The registration statement and prospectus for that offering incorporated SEC filings by Regions Financial Corporation, and it was those filings that contained the allegedly false numbers. Id.
178. Id.
179. Here is the court’s analysis of goodwill:

Under SFAS No. 141, goodwill is “an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.” J.A. 940 (Business Combinations, SFAS No. 141 ¶ 3) (Fin. Accounting Standards Bd. 2007). When an acquisition occurs, GAAP requires that any excess of the purchase price over the fair value of the assets acquired and the liabilities assumed be reported as goodwill or “excess purchase price.” GAAP also requires that goodwill be tested for impairment annually, or “more frequently if events or changes in circumstances indicate that the asset might be impaired.” J.A. 538 (Goodwill and Other Intangible Assets, SFAS No. 142 ¶ 17 (Fin. Accounting Standards Bd. 2001)).

After the AmSouth acquisition, Regions recorded goodwill of $6.2 billion in connection with the acquisition. Regions then tested for impairment at the end of 2007 and apparently found none. In fact, in its 2007 Form 10-K, Regions increased the amount of goodwill attributed to the AmSouth acquisition to approximately $6.6 billion.

[The plaintiff] contends that “[d]espite clear indications that impairment testing was necessary, Regions failed to conduct impairment tests in the first three quarters of [fiscal year] 2007 and failed to properly record impairment charges during th[at] period.” J.A. 1085 (Am. Compl. ¶ 155). Moreover, he alleges, when Regions did conduct impairment testing at the end of 2007, it should have concluded that goodwill was impaired due to “the deterioration of the banking sector” by that time. Id. (Am. Compl. ¶ 158). Thus, he asserts, “the incorporation of the Company’s 2007 Form 10-K in the 2008 Offering led to a materially false and misleading Registration Statement.” Id.

As Judge Kaplan correctly recognized, plaintiff’s allegations regarding goodwill do not involve misstatements or omissions of material fact, but rather a misstatement regarding Regions’ opinion. Estimates of goodwill depend on management’s determination of the “fair value” of the assets acquired and liabilities assumed, which are not matters of objective fact.

Id. at 110 (emphasis added).
and loan loss reserves\textsuperscript{180} were opinions, beliefs, or judgments and hence could only be false for securities law purposes if they were both objectively wrong and “disbelieved by the defendant[s] at the time” they were stated.\textsuperscript{181} While acknowledging that the numbers embodying those opinions, beliefs, or judgments can be “actionable,” the court found that the complaint did not plead them false because it failed to allege that Regions subjectively disbelieved the numbers when it used them.\textsuperscript{182} The court suggested that the case might have come out differently if either (i) Regions had guaranteed that the impairment charge or loan loss was correct or (ii) the plaintiff had alleged that Regions should have but did not use identified objective standards that would have produced lower figures.\textsuperscript{183}

\textsuperscript{180} Here is the court’s analysis of loan loss reserves:

[The plaintiff] alleges that GAAP required Regions to maintain adequate reserves for: (1) estimated credit losses for loans specifically identified as being impaired; (2) estimated credit losses for loans or groups of loans with specific characteristics that indicate probable losses; and (3) estimated credit losses inherent in the remainder of the portfolio based on current economic events and circumstances. According to SFAS No. 114, “[a] loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement.” J.A. 1089 (Am. Compl. ¶ 169 (quoting Accounting by Creditors for Impairment of a Loan, SFAS No. 114 ¶ 8 (Fin. Accounting Standards Bd. 1993))).

. . . [P]laintiff contends that “Regions’ loan loss reserves from the first quarter of 2007 through the first three quarters of 2008 were materially inadequate and did not reflect the high risk of loss inherent in its mortgage loan portfolio.” J.A. 1088 (Am. Compl. ¶ 168).

. . . As Judge Kaplan recognized, determining the adequacy of loan loss reserves is not a matter of objective fact. Instead, loan loss reserves reflect management’s opinion or judgment about what, if any, portion of amounts due on the loans ultimately might not be collectible. See J.A. 1025–26 (Am. Compl. ¶ 10 (“The provision for loan losses is used to maintain the allowance for loan losses at a level that, in management’s judgment, is adequate to cover losses inherent in the loan portfolio as of the balance sheet date.” (emphasis added) (quoting Regions 2007 Form 10-K))). Such a determination is inherently subjective, and like goodwill, estimates will vary depending on a variety of predictable and unpredictable circumstances.

\textit{Id.} at 112–13 (emphasis added).

\textsuperscript{181} Id. at 110 (citing Va. Bankshares v. Sandberg, 501 U.S. 1083, 1095–96 (1991)).

\textsuperscript{182} Id. at 112 (“Plaintiff relies mainly on allegations about adverse market conditions to support the contention that defendants should have reached different conclusions about the amount of and the need to test for goodwill. The complaint does not, however, plausibly allege that defendants did not believe the statements regarding goodwill at the time they made them.”); id. at 113 (“in order for the alleged statements regarding the adequacy of loan loss reserves to give rise to liability under sections 11 and 12, plaintiff must allege that defendant’s opinions were both false and not honestly believed when they were made. Because the complaint does not plausibly allege subjective falsity, it fails to state a claim.” (citation omitted)).

\textsuperscript{183} Far from presenting the goodwill as a guarantee, Regions’ 10-K stated: “‘Adverse changes in the economic environment, declining operations of the business unit, or other factors could result in a decline in implied fair value of excess purchase price.’” Id. at 110 n.3 (quoting joint appendix). The 10-K included similar language about loan loss reserves: “‘We believe that our allowance for credit losses is adequate. However, if our assumptions or judgments are wrong, our allowance for credit losses may not be sufficient to cover our actual credit losses. We may have to increase our allowance in the future . . . to adjust for changing conditions and assumptions, or as a result of any deterioration in the quality of our loan portfolio.’” Id. at 113 n.6 (quoting joint appendix).

In both cases, the Second Circuit emphasized that the plaintiff had failed to plead an objective standard that Regions should have used. Id. at 110 (“Plaintiff does not point to any objective standard such as market price that he claims Regions should have but failed to use in determining the value of [the impaired] assets.”); id. at 113 (“Plaintiff does not point to an objective standard for setting loan loss reserves.”).
Significance and analysis. Both Beleson and Regions Financial suggest strategies in the cases growing out of the credit crisis. Defendants may argue (à la Beleson) that—particularly after the crisis was underway and its contours became well known—any information that a defendant failed to provide would have added little to the total mix of information already available and already suggesting awful consequences for a defendant company. The more bad news the company put out before the alleged omission, the better that argument will be. On the plaintiffs’ side, Regions Financial counsels complainants—when pleading the falsity of numbers dependent on valuations of illiquid assets—to find objective standards that defendants either said they were using, or should have been using, but did not in fact employ. If a financial number must be computed by an objective standard then, arguably, it is not an opinion and, if the number is not an opinion, the rule that the number must be disbelieved in order to be false will not apply.

Materiality of internet postings. Affirming convictions on multiple counts of securities fraud and related crimes, the Ninth Circuit in United States v. Jenkins provided two noteworthy holdings on materiality in the context of determining that the government presented sufficient evidence to support the convictions in that case. First, the court rejected the defendants’ contention that the government failed to prove materiality because the government failed to prove that the misrepresentations affected the issuer’s stock price. The Ninth Circuit repeated the position it has taken in prior decisions that “[m]ateriality in securities fraud does not depend on demonstration of a market reaction to the misstatements” but only “on the significance the reasonable investor would place on the withheld or misrepresented information.” Second, the court rejected the argument “that posts on an internet message board [here Raging Bull], regardless of their content, can never be important to a reasonable investor.” The court did so in part because one of the defendants “closely monitored posts on Raging Bull and instructed employees to post positive comments and counteract negative ones.”

184. 633 F.3d 788 (9th Cir. 2011), cert. denied, 132 S. Ct. 257 (2011).
185. Id. at 796 (listing the convictions of two defendants on charges of conspiracy, securities fraud, wire fraud, tax evasion, and money laundering), 809 (affirming convictions), 801–03 (discussing sufficiency of the evidence, as to materiality, on the securities fraud counts).
186. Id. at 802. The defendants claimed that the issuer’s stock price increased “due to external market forces, namely, the dot-com bubble.” Id.
187. Id. (citing No. 84 Emp’t-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp., 320 F.3d 920, 934–35 (9th Cir. 2003)).
188. Id. (quoting Basic Inc. v. Levinson, 485 U.S. 224, 240 (1988)).
189. Jenkins, 633 F.3d at 802.
and in part because “one of [the issuer’s] board members and shareholders read Raging Bull to keep apprised of information about the company.”

Significance and analysis. While the Ninth Circuit and the Second\textsuperscript{191} do not require proof of stock price effect to demonstrate materiality, the Third Circuit holds that “when a stock is traded in an efficient market, the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm’s stock,” and hence that “if a company’s disclosure of information has no effect on stock prices, ‘it follows that the information disclosed . . . was immaterial as a matter of law.’”\textsuperscript{192} The Ninth and Second Circuit position may be more in tune with the view that the Supreme Court expressed in\textit{Matrixx} that courts should eschew bright-line tests in determining materiality.\textsuperscript{193}

The Ninth Circuit’s holding that postings on an internet bulletin board can be material recalls the Fourth Circuit’s 2009 holding that a trading tip provided by e-mail can be material.\textsuperscript{194} These decisions respond to investors’ increasing reliance on electronic media to make buy/sell decisions.

Duty to Disclose\textsuperscript{195}: A company that warned of possible insurance reimbursement problems for doctors using the medical device that the company produced had no duty to disclose the views of two of its directors of reimbursement, one of whom advised that use of reimbursement codes the company suggested doctors employ would constitute Medicare fraud and both of whom advised that the company should apply for a new device-specific code rather than advise physicians to use existing codes; a company that had been disclosing incidents that interrupted or reduced production at plant facilities did not, by that pattern, create a duty to disclose such incidents.

The First Circuit held last year that a medical device company had no duty to disclose the views of its reimbursement professionals as to physician use of existing codes to obtain payment for using the device that the company sold.\textsuperscript{196} The Eighth Circuit ruled that a company did not, by voluntarily disclosing certain information in a number of instances, thereby assume a duty to disclose similar information in the future.\textsuperscript{197}

Disclosure of internal dissent. Large companies frequently make decisions after considerable staff work. During that work, some employees (including expert employees) may reach a conclusion with which top management ultimately dis-

\textsuperscript{190} Id. at 803.
\textsuperscript{191} See supra note 187 and accompanying text; United States v. Bilzerian, 926 F.2d 1285, 1296–99 (2d Cir. 1991).
\textsuperscript{192} Oran v. Stafford, 226 F.3d 275, 282 (3d Cir. 2000) (quoting In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1425 (3d Cir. 1997)).
\textsuperscript{193} See supra note 114 and accompanying text.
\textsuperscript{194} SEC v. Pirate Investor LLC, 580 F.3d 233, 238, 241 (4th Cir. 2009), cert. denied, 130 S. Ct. 3506 (2010).
\textsuperscript{195} For another decision, summarized under a different heading, that also addresses the duty to disclose, see infra notes 591–620 and accompanying text. See also the decisions addressing Item 303 at infra notes 224–76 and accompanying text.
\textsuperscript{196} See infra notes 198–215 and accompanying text.
\textsuperscript{197} See infra notes 216–23 and accompanying text.
agrees. In *Hill v. Gozani*, the First Circuit considered whether, in such a case, the company must disclose the view of the dissenting employee in order to avoid misleading the public when disclosing the top management’s judgment. Neuro-Metrix, Inc. produced a battery-powered hand-held device (the “NC-Stat”) that, when placed on a human body, provided nerve conduction information—a device designed to replace the prevailing invasive, needle-based testing. Since physicians receive reimbursement from private and government insurance programs by entering codes on bills to show the tests that they performed and since no code existed for tests performed with the NC-Stat device, NeuroMetrix suggested to doctors that they use the codes for the needle-based technology.

Throughout and after the period of the alleged fraud, NeuroMetrix made generally optimistic comments about physician reimbursement through the use of existing codes, but included multiple and escalating warnings of possible reimbursement problems. The plaintiff claimed, among other things, that these

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198. 638 F.3d 40 (1st Cir. 2011).
199.  Id. at 46–47.
200.  Id. at 47.
201.  The class period ran from October 27, 2005, through March 6, 2007.  Id. at 46.
202.  In an October 27, 2005, press release, the company referred to “risks and uncertainties” that could affect the outcomes predicted by forward-looking statements and specifically referred to “risks associated with . . . reimbursement by third party payors to the Company’s customers for procedures performed using the NC-Stat System.”  Id. at 56 (emphasis omitted). In a 10-Q filed on November 10, 2005, NeuroMetrix reported that “[r]eimbursement from third-party payers is an important element of success for medical products companies and that the company ‘generally’ believe[d] that the nerve conduction studies performed by our customers with the NC-Stat System have been satisfactorily covered by third-party payers.”  Id. at 61. But NeuroMetrix cautioned that, (i) as use of NC-Stat increased, “we have experienced and are likely to continue to experience an increased focus from third-party payers regarding the reimbursement”; (ii) “[w]idespread adoption of the NC-Stat System by the medical community is unlikely to occur if physicians do not receive satisfactory reimbursement”; (iii) “reimbursement problems could lead to ‘future product sales [being] severely harmed’”; and (iv) “[f]uture regulatory action relating to Medicare/Medicaid reimbursement could change the re-imbursement landscape.”  Id. That report concluded: “We are unable to predict what changes will be made in the reimbursement methods used by private or governmental third-party payers.”  Id.

The company's 2005 annual report included this passage:

We believe that the nerve conduction measurements performed by the NC-Stat System meet the requirements stipulated in the code descriptions published by the AMA and that these [neurology] codes [CPT codes: 95900, 95903, and 95904] are currently used by physicians performing nerve conduction studies with the NC-Stat System. If the CPT codes that apply to the procedures performed using our products are changed, reimbursement for performances of these procedures may be adversely affected.

Id. at 61–62. The NeuroMetrix first quarter 2006 report repeated the company’s “[g]eneral[ ] . . . belie[f] that the nerve conduction studies performed by our customers with the NC-Stat System have been satisfactorily covered by third-party payers” but repeated, too, that increased use of the device would draw increased reimbursement scrutiny from “third-party payers and governmental agencies” and that “[w]idespread adoption” of the device was “unlikely” if doctors failed to “receive satisfactory reimbursement” for using it.  Id. at 63 (emphasis omitted).

In a conference call with analysts after the second quarter of 2006, the NeuroMetrix CEO characterized the “reimbursement situation” as “[b]asically . . . very positive” but acknowledged that “par for the course in the industry ‘there are from time to time reimbursement issues that come up that have to be addressed, many of them often are just the way customers code, the way they code their insurance claims.”  Id. at 63–64. In its report for that quarter, the company stated that use of its device “was reimbursed ‘satisfactorily,’ even though it was the subject of ‘increased focus’ from payers.”  Id. at 64. In a conference call after Q3 2006, the defendants said:
As reported by our customers, we believe the technology has been routinely reimbursed by over 600 payors, including all Medicare carriers and nearly all commercial and worker’s compensation payors throughout the nation. Several Medicare carriers have draft LCDs or local coverage determinations, which include[] select potential concerns for NeuroMetrix, which if implemented as a final policy could adversely impact the reimbursement for the NC-Stat. Id. at 65. They also noted a draft Cigna LCD that could adversely affect reimbursement. Id. On the other hand, the defendants said that “[t]he reimbursement landscape today remains straightforward for the vast majority of our customers,” the adverse LCDs related to “a relatively small portion of the country,” Medicare use constituted only about 30 percent of the device’s use, and many of the LCDs were still only in draft form. Id. at 65–66.

The company’s warnings in its Q3 2006 report were more extensive:

At any point in time, a number of third-party payers may take the position of not reimbursing our customers for their use of the NC-Stat System. Recently, two local Medicare carriers covering Florida, Texas and several additional states issued policies indicating that physicians using the NC-Stat System will not be reimbursed under the existing Current Procedural Terminology (“CPT”) codes for nerve conduction testing (95900, 95903 and 95904) but rather should submit for reimbursement under a separate miscellaneous neurological procedure code (95999). We do not know what success our customers will have in obtaining reimbursement under this code and what level of reimbursement they may receive. This decision could potentially adversely impact our future revenues. In addition, several additional local Medicare carriers have issued draft local coverage determinations, which if implemented as final policies, could adversely impact the reimbursement received by our customers and therefore potentially adversely impact our future revenues.

Id. at 66 (emphasis omitted). The report also included a risk factor that referred to “the possibility that providers would be unable to receive sufficient reimbursement and that, as a result, ‘our future product sales will be severely harmed.’” Id.

While the COO said after the 2006 fourth quarter that the company “believe[s] our customers should be able to perform medically appropriate NCS tests and appropriately bill them under standard NCS codes,” the company’s annual report for 2006 disclosed that

(1) five regional Medicare carriers covering a total of twenty states issued draft local coverage determinations that could adversely affect reimbursement, including several that would not reimburse for NC-Stat procedures under the neurology codes; (2) the AMA Editorial Panel formed a committee to examine coding practices for similar devices; and (3) local coverage determinations and “coding articles” addressed other issues, including the background and training of physicians performing the tests.

Id. at 67. The report for the first quarter of 2007 then cautioned that “‘[a] number of third-party payers, including commercial payers, have taken and may continue to take the position of not reimbursing our customers for their use of the NC-Stat System’”; Medicare providers in twenty states had at various times said that they would not reimburse under current codes for NC-Stat use; Blue Shield carriers had refused to reimburse on an “experimental and investigational” basis; “lower reimbursement and “higher claim denials” had been reported in “certain regions”; the “future outcome of the reimbursement picture ‘could materially and adversely impact our revenues and profitability’”; certain reimbursement policies seemed to indirectly target NC-Stat use for limited reimbursement; and an AMA committee, which was looking at the applicable codes, “‘could potentially take a position that could reduce or eliminate the reimbursement for the NC-Stat System and could have the impact of deterring usage by our customers.’” Id. at 68.

The NeuroMetrix report for Q2 2007 disclosed that:

We anticipate that revenues in the remainder of 2007 may continue to decline. In the second quarter of 2007, we experienced a decline in revenues of 17.9% from the second quarter of 2006, which we believe primarily resulted from the uncertainty created by the issuance of draft LCDs, final LCDs and coding articles addressing reimbursement for nerve conduction studies and policies issued by commercial payers intended to deter usage or limit the reimbursement for the NC-Stat
reimbursement codes applicable to needle-based testing. Both directors allegedly told the CEO and chief operating officer (“COO”) that the company should not promote doctor use of the codes approved for needle-based testing. Both advised that NeuroMetrix should apply for a device-specific reimbursement code. The first director further advised that promoting use of the wrong codes would constitute Medicare fraud and that the company would be caught if it recommended the wrong codes because a 10 percent surge in the use of a code would likely prompt an investigation.

In affirming the district court’s dismissal of the Rule 10b-5 claim against NeuroMetrix and individual defendants, the First Circuit held that the alleged reimbursement directors’ advice to the company was material. But the court held that NeuroMetrix had no duty to disclose that advice to avoid misleading because the actual resolution of the reimbursement issue was uncertain at the time the company spoke and because the statements that the company did make disclosed the risk that the resolution might prove negative. As the court put it, these developments and other future reimbursement decisions could continue to adversely impact reimbursement for procedures performed using the NC-Stat System. Our revenues in the remainder of 2007 are likely to be impacted by (a) the level of reimbursement, if any, established for procedures performed using the NC-Stat System by these carriers and other third-party payers; (b) whether final LCDs are applied in a manner that places additional restrictions or qualifications on the performance of these procedures; (c) any other reimbursement determinations relating to nerve conduction studies that may be issued by third party payers; (d) any other events causing uncertainty as to the existence or amount of reimbursement physicians are likely to receive for performing procedures using the NC-Stat System or (e) decisions potentially forthcoming from the AMA CPT Editorial Panel regarding reimbursement codes for nerve conduction studies.

203. Id. at 56 (“[t]he omitted material [from the October 27, 2005, press release] . . . was: (1) that the company declined to apply for a new code, even though the reimbursement specialists had informed it that it was necessary . . .; (3) reimbursement specialists had advised that use of the neurology codes was fraud”); id. at 61 (same list for Q3 2005 report); id. at 62 (same omissions listed, among others, for 2005 annual report); id. at 63 (same list for Q1 2006 report); id. at 64 (same omissions from conference call and the periodic report after end of Q2); id. at 66 (same omissions from conference call after Q3); id. at 67 (same omissions from conference call after Q4 2006).

204. Id. at 48.

205. Id.

206. Id.

207. Id. at 70.

208. Id. at 57 (“That experts flatly had informed the principals that the company’s suggested method of billing was unsustainable certainly would have been relevant to a reasonable shareholder’s investment decisions . . . . The complaint’s allegations regarding the Medicare 10% rule and the company’s sales growth are sufficient to demonstrate a significant probability that the noted risks would materialize and that the effect of those risks on the company’s future would be significant.”).

209. As to the October 27, 2005, press release:

At the time . . . , the final resolution of the third-party reimbursement issue was indeed unknown. . . . Although the company took an aggressive, and in the view of some, an unrealistically aggressive view of the appropriate resolution in the promotion of its product, its press release does state explicitly that the ultimate resolution of the issue is unknown and, by reasonable implication, out of its hands.

Id. at 59. As to the Q3 2005 report:

. . . [T]his disclosure is more explicit about the nature of the risks the company faced regarding third-party reimbursement and specifically references the possibility of future government
the company’s statements were “not skewed to present a rosy picture.”\(^{210}\) Moreover, nothing here “suggest[ed] that the expert opinions demonstrated that the danger posed by the reimbursement strategy was, at the time the statement[s were] made, a near certainty of ruin.”\(^{211}\) Instead, the judgments of the reimbursement directors simply constituted “information” that the NeuroMetrix principals “factor[ed] into their decision-making about coding recommendations to buyers of their device.”\(^{212}\) NeuroMetrix “had no obligation to make [those judgments] public simply because [the company and its officers] mentioned the risk associated with non-reimbursement by third-party payers in a profit statement.”\(^{213}\) As the First Circuit elaborated in an order denying rehearing, “NeuroMetrix’s statements acknowledged a risk to its business posed by nonreimbursement for its customers” and “once specific, objective facts solidified that risk, NeuroMetrix both disclosed those facts and spoke with increasing gravity about the risk.”\(^{214}\) Moreover, to the extent that the directors of reimbursement opined on the actions of third parties—such as the AMA committee studying the proper use of the codes that NeuroMetrix recommended physicians use to obtain reimbursement for NC-Stat testing—“the company was entitled to adopt a more tentative and guardedly optimistic position regarding its product’s future in the market” than the view expressed by the experts, at least “absent existing facts that demonstrated the truth of the employees’ opinions.”\(^{215}\)

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... Although cautious in tone and substance, it acknowledged some attention from third-party payers and the significant impact that either that attention or attention from federal regulators could have on the profitability of the business.

\(^{210}\) Id. at 61. As to the 2006 annual report: the “disclosure[s] provide[] more information about the reimbursement landscape than do the company’s earlier statements and reports. We cannot find [them] to be materially misleading under these circumstances.” Id. at 67.

\(^{211}\) Id. at 61.

\(^{212}\) Id. at 59.

\(^{213}\) Id.

\(^{214}\) Id. at 153. The plaintiff sought rehearing in light of the Supreme Court’s decision in Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309 (2011). Id.; see supra notes 103–33 and accompanying text. The First Circuit distinguished the Matrixx facts from those in NeuroMetrix:

[W]e held that the statements actually made by NeuroMetrix in this case were not misleading because of the omission of the employees’ dissenting opinions; the statements actually acknowledged the risks with increasing specificity as the existing facts so warranted. . . . The Supreme Court . . . simply held that Matrixx made a materially misleading statement when it publicly discredited expert opinions despite the fact that it had no independent basis to doubt the accuracy of those opinions.

\(^{215}\) NeuroMetrix, 651 F.3d at 153.

In addition to holding that NeuroMetrix had not violated Rule 10b-5 by failing to disclose the conclusions of its directors of reimbursement, the First Circuit also held that the company had not violated that rule by failing to state that the risk posed by the reimbursement uncertainty was “serious,” saying that “where the level of risk is unknown and the existence of a risk is disclosed, we shall hesitate to conclude that disclosure is misleading merely because it did not state that the risk was ‘serious.’ ” Hill, 638 F.3d at 60. And the court found the description of reimbursement problems by the company, as quoted in the complaint, to be more informative and specific than those that the plaintiff otherwise provided. Id. at 67, 69.

The court of appeals also rejected the argument that NeuroMetrix had failed to disclose “pervasive” reimbursement problems. The First Circuit found the complaint “relatively thin on specific claims
Significance and analysis. Hill comforts companies that disclose risks but do not identify individuals with special training or experience within the company, who have evaluated the risk as more severe than the top management suggests through public statements. But the comfort is limited. The issuer taking advantage of the Hill decision must have itself disclosed the risks, so the case does not cover the instance in which the top management simply makes a judgment that its in-house experts are totally wrong. Moreover, Hill applies to disclosure of risks—by definition bad events that may or may not occur—and may not apply to expert judgment as to existing facts.

Voluntary disclosure and ongoing duty to disclose. In Minneapolis Firefighters’ Relief Ass’n v. MEMC Electronic Materials, Inc., the court considered whether a company, by repeatedly disclosing problems at manufacturing facilities, thereby took on a duty to make such disclosures when they were not otherwise required. MEMC had two manufacturing plants—one in Pasadena and the other in Merano, Italy. MEMC’s 10-K filed in February 2008 warned that a “decrease in . . . manufacturing throughput or yields could have a material adverse effect on . . . operating results” and that “interruption” of operations at either the Pasadena or the Merano plant could hurt “throughputs and yields.” In June 2008, a fire at the Pasadena plant and an exchanger failure at the Merano plant interrupted production at those facilities. The plaintiff alleged that MEMC and its top officers violated section 10(b) of the Exchange Act by failing to report these incidents until the company filed an 8-K on July 23, 2008, which disclosed financial results below the bottom of the company’s target range because of these manufacturing interruptions.

The plaintiff argued that MEMC had a duty to disclose the plant incidents more quickly because the company had—before June 2008—followed a practice of promptly reporting problems that interfered with production. The Eighth Circuit, however, found no “legal authority directly supporting” the plaintiff’s theory that a pattern of disclosure could, without more, create a legal duty to disclose according to that pattern. The court of appeals hesitated “to recognize regarding reimbursement denials,” with the failure “to detail with some greater degree of specificity what these ‘pervasive’ problems were . . . fatal to this allegation.”

216. 641 F.3d 1023 (8th Cir. 2011).
217. 641 id. at 1025.
218. Id. at 1026.
219. Id. at 1026.
220. Id. at 1025, 1026, 1028.
221. Id. at 1028. For example, MEMC had filed 8-Ks in September and October 2007 to disclose a construction problem at the Pasadena plant, and to state that the incident would hurt financial results by about 5 percent and result in a week’s lost production; included in a January 2008 earnings call information about a maintenance problem at the Pasadena plant that would reduce Q1 earnings; filed an 8-K in early April 2008 to reveal premature maintenance at the Pasadena plant to remove chemical deposits, stating that the maintenance caused the company to miss financial targets; and revealed by press release in late April 2008 a gas leak at the Pasadena plant, even though the release stated that MEMC did not believe that the leak threatened financial projections. Id. at 1026. The company similarly reported, quite promptly, potential and actual problems at the Pasadena plant after the class period ended. Id. at 1027.
222. Id. at 1028. The court suggested that the case might have been different had MEMC—just before the Pasadena fire—“told investors the Pasadena and Merano facilities were fully operational or in perfect working order.” Id. at 1029.
a new cause of action absent extraordinary circumstances not present here” in part because “[t]o do so could encourage companies to disclose as little as possible” in order to avoid setting precedents that might be used against them when they failed to disclose in the future.223

Significance and analysis. MEMC answers a question that securities counselors frequently address. The lawyer thinks that the client should, as a matter of fairness to investors or because a materiality question is close, disclose a fact even though the requirement to do so is either unclear or does not exist at all. The client asks whether the company is about to start down a slippery slope—whether disclosing this time or several times will mean that the company must always disclose under similar circumstances in the future. If MEMC controls, the answer is “no.” Of course, MEMC only addresses possible Rule 10b-5 liability for a nondisclosure. The failure to continue a pattern of disclosure could, when it is later found out, have adverse business consequences even if legal—e.g., securities analysts might distrust a company that deviated from such a pattern and so might business counterparties.

Disclosure Under Item 303: An issuer must disclose reasonably expected material impact, on the issuer, of even publicly known trends; an impact may be material if it affects a key portion of the issuer’s business even though the impact on company-wide financial numbers is small; but a plaintiff cannot artificially slice the issuer’s business into slivers in order to define a key portion of the business on which the impact might be significant

Item 303(a)(3)(ii) of Regulation S-K requires disclosure of “any known trends or uncertainties that have had or that the [issuer] reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.”224 Issuers registering sales via Form S-1 must include this disclosure,225 as must issuers filing a Form 10-K.226 Determining whether a particular “trend” or “uncertainty” must be disclosed requires considering whether the impact that the trend or uncertainty could have on the issuer would be material.227 The Second Circuit decided two cases last year in which Item 303 played a

223. Id. at 1029.

The Eighth Circuit also held that the plaintiff had failed to plead scienter, as the complaint itself alleged that the MEMC president and CEO had stated, on July 23 when the company disclosed that the Pasadena plant had suffered a fire in June and that the Merano facility had endured a heat exchanger failure in June, that the company had not publicized those problems earlier “because the estimated anticipated loss—2% below the bottom end of MEMC’s second quarter projections—was immaterial.” Id. at 1026. Given that explanation—and given that (i) MEMC had warned investors expressly that problems at the plants could impact financial results, (ii) the plaintiff did not allege that any executive personally benefited from the alleged fraud, and (iii) there was no legal requirement to disclose the June 2008 problems any earlier than the company did—the benign inference that the defendants simply “did not believe they had a continuing duty to disclose” was more compelling than an inference of fraud. Id. at 1030.


225. SEC Form S-1, Part I, Item 11(h).

226. SEC Form 10-K, Part II, Item 6. Quarterly reports on Form 10-Q must also include Item 303 disclosure, SEC Form 10-Q, Part I, Item 2, but only to the extent of “any material changes” from the end of the last fiscal year to the end of the quarter on which the Form 10-Q reports, 17 C.F.R. § 229.303(b) (2011).

227. The SEC directs that Item 303 analysis proceed so:
critical role. In the first, the court held that Item 303 can require (i) disclosure of the impact of publicly known trends on the issuer and (ii) disclosure of the impact on a particularly significant segment of operations even if the impact is not large in relation to the issuer’s overall financial numbers. In the second, the court cautioned that a company’s business cannot properly be divided into artificial segments in order to activate an Item 303 disclosure obligation.

The plaintiffs in Litwin v. Blackstone Group, L.P purchased common units in the Blackstone initial public offering (“IPO”) and sued under sections 11 and 12(a)(2). Their case rested primarily on omissions, and the Second Circuit observed that an omissions case under these two sections requires that the plaintiff show that the defendants had a duty to disclose either as a result of “an affirmative legal disclosure obligation” or because the offering documents omitted material information “necessary to prevent existing disclosures from . . . misleading.” In vacating the district court’s dismissal of the case, the court of appeals analyzed the duty to disclose as one stemming from Item 303, noting that the “SEC’s interpretive release regarding Item 303 clarifies that the Regulation imposes a disclosure duty ‘where a trend, demand, commitment, event or uncertainty is both [1] presently known to management and [2] reasonably likely to have material effects on the [issuer’s] financial condition or results of operations.’”

In Blackstone, the plaintiffs concentrated on publicly known events that were therefore (at least for pleading purposes) known to Blackstone’s management at the time of the company’s IPO. The only question was whether Blackstone should have disclosed the reasonably likely impact of the events which, in turn, implicated whether such impacts were likely to be “material.” Hence the opinion focuses on materiality. The court proceeded on the notion that a financial effect is presumptively material if it affects a company-wide number by 5 percent or more. The court reasoned that, if an omission affects less than 5 percent of a

Where a trend . . . or uncertainty is known, management must make two assessments:

1. Is the known trend . . . or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.

2. If management cannot make that determination, it must evaluate objectively the consequences of the known trend . . . or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant’s financial condition or results of operations is not reasonably likely to occur.


228. See infra notes 230–57 and accompanying text.

229. See infra notes 258–75 and accompanying text.


231. Id. at 715–16.

232. Id. at 723.

233. Id. at 716 (quoting SEC 303 Interpretation, supra note 227, at 22429).

234. Id. at 718.

235. The court divided its opinion into sections expressly titled as discussions of “materiality.” Id. at 718, 721.

236. Id. at 717 (“five percent numerical threshold is a good starting place for assessing . . . materiality” (quoting ECA & Local 134 IBEW Joint Pension Trust v. JP Morgan Chase Co., 553 F.3d 187, 204 (2d Cir. 2009))), 719 (referring to “the presumptive 5% threshold of materiality”).
company-wide figure so that the presumption does not apply, the question on a motion to dismiss then becomes whether the plaintiffs allege facts that raise a sufficient possibility of “qualitative” materiality under the SEC’s Staff Accounting Bulletin No. 99 (“SAB 99”) to survive a motion to dismiss.237 Among other things, SAB 99 states that a “quantitatively small” financial effect may be material if it “concerns a segment or other portion of the [issuer’s] business that has been identified as playing a significant role in the [issuer’s] operations or profitability.”238

The plaintiffs alleged that the Blackstone offering documents failed to disclose the reasonably expected impact on Blackstone’s future revenues and income of problems at two companies in which Blackstone had invested through the Corporate Private Equity portion of Blackstone’s operations, one of the four segments into which Blackstone itself divided its business.239 First, the plaintiffs charged that the offering documents failed to disclose—in June 2007 when Blackstone conducted its IPO240—how increasing mortgage default rates, particularly in subprime mortgages, were reasonably expected to affect Blackstone’s revenues as a result of Blackstone’s $331 million investment in FGIC Corp., a monoline insurance company that had sold credit default swap protection on collateralized debt obligations and residential mortgage-backed securities linked to subprime mortgages.241 Eventually, Blackstone reported that its Private Equity revenue for 2007 had fallen 18 percent from 2006, with 69 percent of that decline attributable to a reduction in the value of its investment in FGIC.242 Second, the plaintiffs charged that the offering documents failed to disclose the reasonably expected adverse impact on Blackstone’s future financial results from the loss, by Freescale Semiconductor, Inc.—in which Blackstone had invested $3.1 billion—of an exclusive contract to supply Motorola with 3G chipsets.243

Blackstone argued that the increasing problems with subprime mortgages, and Freescale’s loss of supply exclusivity, were “public knowledge” in June 2007 that Blackstone did not have to disclose.244 The Second Circuit, however, held that Item 303 can require a company to disclose the “impact” of a publicly known trend on the issuer, which is “certainly not public knowledge,” and noted that the Blackstone offering documents did not even mention FGIC.245 Turning

237. Id. at 717 (citing SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150 (Aug. 19, 1999) [hereinafter SAB 99]).
239. Litwin, 634 F.3d at 709. Blackstone divided its business into the following parts: Corporate Private Equity, Real Estate, Marketable Alternative Asset Management, and Financial Advisory. Id.
241. Id. at 710–11.
242. Id. at 711.
243. Id. at 711–12.
244. Id. at 718.
245. Id. at 718–19.
then to materiality of the undisclosed impacts, the court of appeals rejected the district court’s conclusion “that a loss in one portfolio company [like FGIC or Freescale] might be offset by a gain in another portfolio company.” Instead, an issuer “is not permitted, in assessing materiality, to aggregate negative and positive effects on its performance fees in order to avoid disclosure of a particular material negative event.” And, while the district court determined that trends affecting Blackstone revenues and earnings from FGIC and Freescale were not material because those investments constituted, respectively, only 0.4 percent and 3.6 percent of the total assets under Blackstone’s management at the time of the IPO, the Second Circuit (after acknowledging that those investments fell “below the presumptive 5% threshold of materiality”) found that the impact on Blackstone from the FGIC and Freescale troubles were sufficiently important to prevent dismissal of the claims based upon them at the pleading stage because of “qualitative factors related to materiality.” In particular, the Corporate Private Equity portion of Blackstone’s business was Blackstone’s “flagship segment” so that “a reasonable investor would almost certainly want to know information related to that segment that Blackstone reasonably expects will have a material adverse effect on its future revenues.” Adding a quantitative flourish to this conclusion, the court of appeals pointed out that, looking at the Corporate Private Equity segment by itself, “Blackstone’s investment in [Freescale] accounted for 9.4% of the Corporate Private Equity segment’s assets under management, and the investment was nearly three times larger than the next largest investment in that segment as reported in Blackstone’s Prospectus.” Taking all of this together, the court concluded that the “omissions relating to FGIC and Freescale were plausibly material.”

In addition to alleging that the offering documents omitted adverse information about the reasonably likely adverse effect on Blackstone of problems faced at

246. Id. at 719.
247. Id. The court suggested that Blackstone might be able to raise this aggregation argument at trial even though it was “no defense on a motion to dismiss.” Id. at 719 & n.11.
248. Id. at 713.
249. Id. at 719.
250. Id. at 720. The court provided this explanation of the important role that Corporate Private Equity played in Blackstone’s business:

... Blackstone makes clear in its offering documents that Corporate Private Equity is its flagship segment, playing a significant role in the company’s history, operations, and value. Blackstone states that its Corporate Private Equity fund is “among the largest . . . ever raised,” and that its “long-term leadership in private equity has imbued the Blackstone brand with value that enhances all of [its] different businesses and facilitates [its] ability to expand into complementary new businesses.” Because Blackstone’s Corporate Private Equity segment plays such an important role in Blackstone’s business and provides value to all of its other asset management and financial advisory services, a reasonable investor would almost certainly want to know information related to that segment that Blackstone reasonably expects will have a material adverse effect on its future revenues.

251. Id.
252. Id. The Second Circuit added, without elaboration, that the failure to disclose problems at these companies “masked a reasonably likely change in earnings” and “‘doubtless had the effect of
the two portfolio companies, the plaintiffs also alleged that the “downward trend in housing prices, the increasing default rates for sub-prime mortgage loans, and the pending problems for complex mortgage securities” would reasonably have been expected to affect Blackstone’s financial results in what the company categorized as its Real Estate segment.253 Although the district court had found no Item 303 violation in Blackstone’s failure to address these issues in the offering documents because the plaintiffs did not link Blackstone’s predominantly commercial real estate holdings to problems in the residential real estate market, the Second Circuit noted that as much as 15 percent of Blackstone’s real estate holdings at the time of the IPO may have been residential.254 Moreover, the offering documents themselves linked the residential and commercial markets, as the registration statement “admit[ted] that ‘the ability of lenders to repackage their [residential] loans into securitizations’ is one factor contributing to the ‘significant[] increase [in] the capital committed to [predominantly commercial] real estate funds.’ 255 And, in any event, “even if the overwhelming majority of Blackstone’s real estate investments [were] commercial in nature, it is certainly plausible for plaintiffs to allege that a collapse in the residential real estate market, and, more important, in the market for complex securitizations of residential mortgages, might reasonably be expected to adversely affect commercial real estate investments.”256 The Real Estate segment of Blackstone’s business included 22.6 percent of the assets that the company managed, and the court concluded that “[a] reasonable Blackstone investor may well have wanted to know of any potentially adverse trends concerning a segment that constituted nearly a quarter of Blackstone’s total assets under management.”257

The Second Circuit employed the same analysis, but reached a different conclusion, in Hutchison v. Deutsche Bank Securities, Inc.258 Like those in Blackstone, the plaintiffs in Hutchison sued for violations of sections 11 and 12(b)(2) based on omissions in offering documents.259 And, like those in Blackstone, the plaintiffs in Hutchison based the defendant’s duty to disclose on Item 303.260
The Hutchison issuer was a real estate financing company, and the plaintiffs alleged that the offering documents failed to reveal troubles about loans to one developer for two real estate projects.\(^{261}\) The Second Circuit inferred from pled facts that the issuer knew, at the time of the offering, about cost overruns at one of those projects,\(^{262}\) but held that it was not reasonably likely—as required to implicate Item 303—the overruns would produce a material effect on the issuer because troubles with the two loans were not material when considered in light of the issuer’s “entire investment portfolio.”\(^{263}\) While the text of the Second Circuit opinion does not set out the math to reach this conclusion, a footnote suggests that the court added the ultimate $7.8 million impairment charge against one loan to $22.6 million that the issuer asserted as damages against the developer in another lawsuit, to find a total of $30.4 million “out of a total [issuer] investment portfolio of $1.1 billion [which] falls well short of [the] 5% threshold and is therefore presumed to be quantitatively immaterial.”\(^{264}\)

Noting that the two loans on which they based their case were “mezzanine loans,” which the issuer’s offering documents defined as “subordinated loans secured by second mortgages on the underlying property or loans secured by a pledge of the ownership interests in the entity that directly or indirectly owns the property,”\(^{265}\) the plaintiffs argued that mezzanine loans were “a notional division or segment in which [the two loans, comprising about 25 percent of the total value of the mezzanine portfolio,]\(^{266}\) could loom as material in quantitative terms.”\(^{267}\) But the Second Circuit found no allegations “that mezzanine loans constitute[d] a component of [the issuer’s] business that [was] of distinct interest to investors other than as another component of [the issuer’s] book of business.”\(^{268}\)

The plaintiffs also argued that the troubles with the loans were material because the price of the issuer’s stock declined after the issuer announced various adverse developments regarding the loans (that one was “nonperforming” and the other on the issuer’s “watch list”; that the issuer was taking a $7.8 million impairment charge on one loan), but the court of appeals attributed no significance to the stock drops because the “press releases [containing the disappointing information about the two loans] were loaded with [other] bad news (largely very bad), any item of which could have caused [the issuer’s] stock price to drop.”\(^{269}\) Moreover, “the fact that the [two loans] were fully collateralized,”\(^{270}\) while not by itself preventing damage to the issuer from a default,\(^{271}\) “militate[d] in favor of finding that

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\(^{261}\) Id. at 481–82.
\(^{262}\) Id. at 486.
\(^{263}\) Id. at 488.
\(^{264}\) Id. at 489 & n.5. The $30.4 million constituted about 2.8 percent of the $1.1 billion.
\(^{265}\) Id. at 481.
\(^{266}\) Id. at 485.
\(^{267}\) Id. at 488.
\(^{268}\) Id.
\(^{269}\) Id. at 490.
\(^{270}\) Id. at 489.
\(^{271}\) The Second Circuit rejected the district court’s conclusion that adequate collateralization of the loans at the time of the offering, by itself, rendered the omissions about the notes immaterial. Id.
a major segment of [the issuer’s] business ultimately was not threatened by the impairment of the loans.\textsuperscript{272} Finding no materiality to the impact that might have been reasonably expected from the information known about the two loans at the time of the offering, the Second Circuit affirmed the dismissal of the case.\textsuperscript{273}

**Significance and analysis.** Attorneys counseling companies on disclosure for offerings or periodic reports to which Item 303 applies should heed the *Blackstone* holding that an issuer may have to discuss a trend or uncertainty even if that trend or uncertainty rests on publicly available facts because investors will not, by the public information, know how the trend or uncertainty will affect the particular company that the lawyer is representing. Counselors should also note that both *Blackstone* and *Hutchison* reflect the Second Circuit’s previous approach to materiality of misstatements or omissions that relate to financial performance—an initial check to determine whether the error or undisclosed number is quantitatively material followed, if that initial quantitative analysis does not reveal materiality, by an examination of the factors that the SEC staff set out in SAB 99 and that can turn a quantitatively small numerical issue into one material for securities law purposes.\textsuperscript{274} Using this analysis, a court may seize on a misrepresentation or an omission that affects a small percentage of a company-wide number but which affects a larger percentage of that number for, as SAB 99 puts it, “a segment or other portion of the [issuer’s] business that has been identified as playing a significant role in the [issuer’s] operations or profitability.”\textsuperscript{275} To encourage a court to do so, a plaintiff may try to define a small segment of the issuer’s business in which the misstated or misleading number constitutes a high percentage.

*Hutchison* correctly holds that courts should not permit plaintiffs to slice out an artificially created segment of the issuer’s business—one that was unimportant to investors at the time the investment community was allegedly misled but instead selected for the very purpose of increasing the importance of a financial number in the later lawsuit. *Blackstone*, however, reflects courts’ willingness to examine closely numbers generated by particular parts of a business that an issuer breaks out for separate discussion and, certainly, numbers produced by a part of a business that an issuer expressly identifies as having special importance.\textsuperscript{276} Attorneys should therefore counsel restraint when a company displays eagerness to highlight different parts of its operations as particularly important to overall success, as doing so sets the company up for an argument that a misstep in one of those operations, even though insignificant to the company overall, is nevertheless material. This may be a particular problem with new operations, as clients may wish

\textsuperscript{272}. Id. at 490.

\textsuperscript{273}. Id. at 491.

\textsuperscript{274}. See, e.g., ECA, Local 134 IBEW Joint Pension Trust of Chi. v. JP Morgan Chase Co., 553 F.3d 187 (2d Cir. 2009).

\textsuperscript{275}. SAB 99, supra note 237, 64 Fed. Reg. at 45152.

\textsuperscript{276}. See supra note 250 and accompanying text.
to trumpet new initiatives as quite important and since such novel efforts may be especially vulnerable to accounting and projection errors.

SEC Enforcement Actions277: An arrangement—to permit one customer to make market timing trades in a mutual fund that constituted 62 percent of the value of all fund trades and that provided a multi-million dollar profit to that customer while other mutual fund shareholders (whom the fund did not permit to make such trades) suffered annual losses of 24 percent or more—was material for trading in the fund shares; a broker who submitted late trades to mutual funds violated section 10(b) and Rule 10b-5 by implicitly representing that trade orders were final by funds’ 4:00 PM net asset value computation; failure to disclose that quarterly numbers benefit from one-time revenue due to an unusual contract or a change in payment schedule under an existing contract can render numbers materially misleading where the one-time benefits permit an issuer to meet analysts’ estimates; a dispute between issuer’s accountants over whether to record revenue, if not referred to an outside auditor, can provide evidence that recording the revenue was misleading; a sentence in a proxy statement saying that options were granted with exercise prices equal to the market prices on the dates of grants was not false—even though options were “backdated” because the dates of the grants preceded the dates on which the company decided to make the grants—since the exercise prices were indeed set at the market prices on the grant dates; an outside director on a compensation committee, who participated in granting options with prices pegged to dates of grants that preceded the decisions to make the grants, did not act with scienter, and was not negligent with respect to a statement about option pricing in a proxy statement, where the director relied on accounting and legal professionals to ensure that the issuer made accurate and appropriate disclosures and the professionals did not perceive that grants of “in the money” options would render the proxy statement misleading; a disgorgement calculation properly denied defendant the benefit of the price paid to buy stock where the defendant offered only a Pink Sheet quotation from low-volume trading to establish the amount paid; the discovery rule governs accrual of a claim for civil penalties under five-year statute of limitations applicable to such penalties; that five-year statute of limitations does not apply to either disgorgement claims or SEC administrative enforcement proceedings seeking cease-and-desist orders; violation of a state entity law restricting distributions to owners may show that a relief defendant had no legitimate claim to proceeds of illegal action paid out of the entity; statute prohibiting discharge in bankruptcy of any debt “for . . . the violation of any of the Federal securities laws” did not apply to prevent the discharge of a debt created by an order requiring an attorney—who was a nominal defendant in an SEC enforcement action—to disgorge an advance on fees that the attorney never earned and that were paid from proceeds of a fraud in which the attorney did not participate; a receiver’s pro rata distribution formula was fair and reasonable even as to investors who had sought to redeem their entire investment; the venue statute governing SEC enforcement actions is not subject to expansion by the location of coconspirator violations

Appeals of SEC enforcement proceedings littered the federal reporter in 2011. The Second Circuit held that a statement touting a mutual fund’s hostility to mar-

277. See also infra note 498 and accompanying text.
ket timing trades was materially false in light of an arrangement permitting a mutual fund shareholder to make hundreds of such trades in fund shares. In a late trading case, that court of appeals also held that a broker implicitly represented that trades he submitted to be executed at a mutual funds’ net asset value (“NAV”) were final before the time at which the funds computed their NAV, with this implied representation false because the broker cooperated with a customer to permit a final decision on the trades after NAV computation. The Ninth Circuit held that failure to disclose material one-time accounting benefits from a particular contract, or from a change in a payment schedule for a large customer, can make financial statements misleading and, in the same case, ruled that internal disagreement among a company’s accountants over recording revenue is relevant to whether recording the revenue misleads. The Eighth Circuit found that the precise words of a proxy statement—describing the exercise price of options as the stock price on option grant dates—were not false even though the grant dates preceded the award dates and that an outside director did not act with scienter with respect to the proxy statement discussing the grants, in part because the director relied on accountants and lawyers. The D.C. Circuit declined to use a Pink Sheet quotation as the amount paid for stock in a disgorgement calculation, and courts of appeals in three opinions refused to deduct business expenses from disgorgement amounts. Two decisions addressed the five-year statute of limitations on SEC actions for civil penalties, with the Second Circuit ruling that the five years begins to run only when the SEC either discovers a fraud or should have discovered it by the exercise of due diligence and the D.C. Circuit holding that the five-year statute does not apply to actions for disgorgement or to limit the time within which the SEC may commence administrative proceedings seeking cease-and-desist orders. Two opinions considered questions specific to nominal or relief defendants, with the Second Circuit relying on state law restricting distributions to owners of limited partnership interests in order to find that the recipients of the distributions had no legitimate interest in the distributed money and hence were properly ordered to disgorge the funds as relief defendants, and the Ninth Circuit ruling that the bankruptcy prohibition against discharge of a debt for violation of the securities laws does not apply to prohibit discharge of a disgorgement obligation incurred by a relief defendant in an SEC enforcement action. The Seventh Circuit approved a receiver’s pro rata distribution of remaining funds from a securities fraud scheme, even as to

278. See infra notes 290–98 and accompanying text.
279. See infra notes 299–308 and accompanying text.
280. See infra notes 309–23 and accompanying text.
281. See infra notes 324–51 and accompanying text.
282. See infra notes 352–60 and accompanying text, particularly at notes 352–58.
283. See infra notes 361–67 and accompanying text.
284. See infra notes 368–73 and accompanying text.
285. See infra notes 374–76 and accompanying text.
286. See infra notes 377–82 and accompanying text.
287. See infra notes 383–86 and accompanying text.
investors who had tried to exercise a right to redeem their entire investment. The D.C. Circuit held that the coconspirator theory of venue is inapplicable to the venue statute governing SEC enforcement actions.

**Market timing.** In 2011, the Second Circuit reversed dismissal of Rule 10b-5 and Securities Act section 17(a) claims that the SEC brought against the COO of an investment adviser to a mutual fund. The SEC also charged violation of the anti-fraud section of the Investment Advisers Act (“IAA”). The Commission alleged that, in exchange for a mutual fund shareholder’s investment in a hedge fund run by the adviser to the mutual fund, the COO (and the mutual fund portfolio manager, also named as a defendant) permitted the shareholder to engage in market timing trades in mutual fund shares from 1999 into August 2002, while simultaneously and actively preventing other shareholders from engaging in such timing trades. On September 3, 2003—after the market timing trades had stopped—the COO, in an attempt to reassure fund shareholders after the New York Attorney General announced an investigation into market timing at mutual funds, posted a statement on the adviser’s website saying:

> [F]or more than two years, [market timing] scalpers have been identified and restricted or banned from making further trades. Purchases from accounts with a history of frequent trades were rejected. Since August 2002, large transactions in the global, international and gold funds have been rejected without regard to the past history. While these procedures were in place they did not completely eliminate all timers.

Rejecting the argument that this statement did not contravene the anti-fraud statutes, the Second Circuit recalled the principle that “‘half truths’—literally true statements that create a materially misleading impression—will support claims for securities fraud.” In this case, the court held “a reasonable investor . . . would conclude that the Adviser had attempted in good faith to reduce or eliminate . . . market timing across the board, whereas, as [the COO] well knew but failed to disclose, the Adviser had expressly agreed to let one major investor . . . engage in a very large amount of . . . market timing.” As to the materiality of the omission, the Second Circuit pointed to size of the market timing trades (up to $20 million/transaction), the number of those trades (836 over the three years), the total dollar value of the trades relative to total trading in the fund (about 62 percent of total volume), and the profitability of the trades in comparison with returns to other fund shareholders ($9.7 million in profit to the timer versus annual losses to other mutual fund shareholders of at least 24.1 percent). The court found

288. See infra notes 387–404 and accompanying text.
289. See infra notes 405–08 and accompanying text.
292. Id. at 55.
293. Id. at 52–53.
294. Id. at 55.
295. Id. at 57.
296. Id.
297. Id. at 58.
the materiality question easily answered: “[T]he notion that a reasonable investor would regard as immaterial the failure to disclose the secret arrangement by which the Fund and its Adviser, in return for a pay-off to another fund, allowed one . . . investor to engage in highly profitable market timing while denying this opportunity to all other investors, borders on the frivolous.”

*Implied representation in late trading scheme.* In *VanCook v. SEC*, the Second Circuit denied a petition to review an SEC administrative enforcement action against a broker. The respondent worked at an introducing broker that, at the time of the violations, cleared through Banc of America Securities (“BOA”). BOA employed a Mutual Fund Routing System (“MFRS”), which permitted brokers to submit buy and sell orders for mutual fund shares by 4:00 PM EST (the time at which the funds set their price by computing net asset value (“NAV”)) but to change the orders by a “review” procedure until 5:15 PM. The “review” procedure was designed to permit brokers to “make corrections after 4:00—not to enter new orders” after that time. The respondent cooperated with customers in a “late trading” scheme by which the customers would submit placeholder orders (“lists of proposed orders, or ‘possible trade sheets’”) by 4:00 PM but then decide whether to proceed with those orders based on news that occurred up to about 5:00 PM, news that could affect whether the shares in a given mutual fund were worth more or less than the NAV calculated at 4:00 PM, which was the price at which the order would execute.

The SEC found that the broker had violated section 10(b) of the Exchange Act and Rule 10b-5. The broker contended that he had only transmitted customer orders and, therefore, had deceived no one in violation of the statute and rule. The Second Circuit agreed with the SEC that the broker had deceived the mutual funds because those funds’ prospectuses stated “that trades would be executed by 4:00 p.m. in order to receive that day’s NAV,” and that therefore the broker’s submission of orders “for execution at the current day’s NAV, [constituted] . . . an implied representation that the orders had been received before 4:00 p.m.” Because the broker knew that the true orders had not been received before 4:00 PM but that customers had made the final decision to proceed or not proceed with a placeholder order after that time, the broker’s implied representation was false and within the purview of Rule 10b-5.

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298. *Id.*
300. *Id.* at 133. An introducing broker is a “‘firm that has the initial contact with the public customer’ but does not itself ‘handle[] the mechanics of order entry, confirmation, clearance of trades, calculation of margin, [or] similar activities.’” *Id.* (quoting *Katz v. Fin. Clearing & Servs. Corp.*, 794 F. Supp. 88, 90 (S.D.N.Y. 1992)).
301. *Id.*
302. *Id.* at 134.
303. *Id.* at 133–35.
304. *Id.* at 132.
305. *Id.* at 139.
306. *Id.* at 140.
307. *Id.* at 134.
308. *Id.* at 141.
Significance and analysis. The SEC has vigorously pursued late traders and securities industry professionals who facilitated late trading. Nevertheless, the notion of “implied representations” is one that deserves careful restriction. No harm was done in VanCook, but in another case it might be easy for the SEC, as a regulator, to imply a representation by an industry professional’s action that the professional did not intend.

One-time accounting benefits. A company that enters into a contract that produces a one-time favorable accounting number, or amends a contract in a way that produces a one-time favorable number, must decide the extent to which it will highlight the unusual transaction when reporting quarterly results. And a company that employs multiple accountants must decide how to resolve disputes between those accountants over reporting transactions. In 2011, the Ninth Circuit decided a case in which a company faced both these decisions, SEC v. Todd. 309

The SEC sued the CEO, CFO, and controller of Gateway, Incorporated. 310 The suit involved two transactions that affected Gateway’s third quarter 2000 financial numbers—one with Lockheed Martin and one with AOL. 311 First, Gateway sold IBM and Sun servers to Lockheed—an unusual deal, as Gateway ordinarily sold customers Gateway computers—and “booked [this] sale of . . . fixed assets as gross revenue.” 312 Second, Gateway and AOL amended a contract so that AOL paid Gateway a fee when Gateway shipped computers, rather than later when computer buyers registered with AOL—thus providing the first payment under the amended contract earlier than usual. 313

Reversing the trial court’s grant of judgment as a matter of law to the CFO and the controller after a jury found them liable for a Rule 10b-5 violation by recording revenue on the Lockheed Martin transaction, 314 the Ninth Circuit held the jury

The court also agreed with the SEC that the broker had violated section 17(a) of the Exchange Act and Rule 17a-3(a)(6), which requires brokers to keep records of, among other things, “the time [an] order was received,” because the broker “omit[ted] from order memos the times that final trading instructions arrived from” late-trading clients. Id.

Somewhat alarmingly, the court also refused to review a $100,000 civil penalty—piled on top of an order to disgorge $544,234.01 plus interest—not only on traditional grounds such as that the respondent had been warned that his late-trading practices were illegal, id. at 143, but also on the ground that the respondent “chose to litigate” while “other individuals [involved in the scheme] chose to settle with the SEC,” id. at 144. In another case last year, the same court of appeals—employing an abuse of discretion standard—affirmed court-imposed civil penalties in part on the ground that the defendant had “attempt[ed] to deceive the court in seeking to escape the consequences of his actions.” SEC v. Milligan, 436 F. App’x 1, 2 (2d Cir. 2011) (quoting district court). It is unclear that proceeding to trial or evading responsibility through dissimulation—inconveniencing the court or administrative judge in the first case and showing disrespect to the tribunal in the second—are appropriate grounds for imposing civil penalties or determining their amount.

309. 642 F.3d 1207 (9th Cir. 2011).
310. Id. at 1212. Gateway is now a subsidiary of Acer, Inc. Id.
311. Id. at 1213–14. The SEC also charged wrongdoing in connection with a third transaction, from which Gateway recorded revenue on an incomplete sale of computers to VenServ, but this summary does not address the court’s treatment of those allegations.
312. Id. at 1213.
313. Id. at 1214.
314. Id. at 1212, 1225.
could have reasonably found that Gateway made a material misrepresentation by including the money from that deal in its third quarter gross revenues, since (i) the SEC presented expert testimony that “it was inappropriate to consider the sale as revenue generating because ‘no company sells its fixed assets on a regular basis’ unless ‘it’s liquidating’”, and (ii) “[r]egardless of whether Gateway’s accounting treatment of the Lockheed transaction technically complied with GAAP, there was evidence to support a finding that booking the transaction as revenue was nonetheless materially misleading to investors” because (a) the controller testified that, although “he eventually grew comfortable with the idea,” he “would not have recognized the transaction as revenue generating” and (b) three other Gateway employees, including a CPA, “all testified that they would not have recognized the proceeds of the Lockheed transaction as revenue.” The court also found substantial evidence to support the jury’s finding that the CFO and controller had scienter with respect to recognizing the Lockheed receipts as revenue because the CFO and controller did not advise the company’s outside auditor of that recognition “until after the release of the third quarter numbers,” whereupon the outside auditor disagreed with the recognition of the revenue and the company restated to remove that revenue.

The Ninth Circuit, in addition, reversed the trial court’s summary judgment to the CEO on a Rule 10b-5 claim alleging that he misled by stating in a conference call with analysts and in a press release that “Gateway was experiencing ‘accelerating revenue growth.’” The court reasoned: “ ‘The statement that “growth” is “accelerating” means that a graph of sales against time shows a concave line,’” demonstrating “[s]ales . . . are not only growing, but growing faster and faster.” The court found a rational fact finder could have concluded that the CEO “misled investors by publicly describing Gateway’s growth as ‘accelerated’ without simultaneously disclosing the unusual nature of the Lockheed and AOL transactions,” and that the government had sufficient evidence to raise a triable issue as to the CEO’s scienter because he “understood . . . the true nature of the Lockheed and AOL transactions,” the recorded numbers from which permitted Gateway to meet analyst estimates.

Significance and analysis. The Todd opinion transmits two warnings. First, when a company’s own accountants disagree on the manner in which to record an economic event that could materially affect the company’s financial results (as by making the difference between the company meeting analysts’ estimates or missing them), the company should refer the matter to its outside auditor for

315. Id. at 1216.
316. Id. at 1217 (emphasis added).
317. Id. at 1217–18.
318. Id. at 1212–13. The CEO “participated in preparing” the press release. Id. at 1213.
319. Id. at 1221 (quoting Ronconi v. Larkin, 253 F.3d 423, 431–32 (9th Cir. 2001)).
320. Id.
321. Id. The court quoted an e-mail from the Gateway CEO to AOL’s president in which the Gateway executive “thanked AOL’s president—who acknowledged that the revised AOL contract deal would allow Gateway ‘to take top line rev[enues]’—for providing Gateway with ‘favorable accounting treatment. It’s helping us.’ ” Id. (alterations in original).
resolution before publishing any numbers (even quarterly numbers). The disagree-
ment between the company’s own personnel may otherwise be used as evidence 
that the numbers resulting from the company’s choice of accounting treatment 
was materially misleading, and the failure to refer the matter to the auditor before 
publishation may be used as evidence that executives making the final decision on 
the accounting, and the company, had scienter. 322 Second, when unusual trans-
actions, or a change in the schedule of payments or charges, generate one-time 
favorable accounting results that are material, the company should clearly dis-
close the nature of the transactions or schedule change before or at the time the 
company publishes the financial statements containing numbers that include the 
one-time effect. Otherwise, the SEC or investors may attack virtually any self-
complimentary statement about those financial statements and, at the least, keep 
a fraud claim based on the statement alive through summary judgment. 323

Options backdating and outside director liability. The year 2011 saw a director 
win an options backdating case in SEC v. Shanahan. 324 The defendant in Shanahan 
served as an “outside director” on the board and compensation committee of a 
public company. 325 The company’s proxy statement said that “[o]ptions granted 
are at an option price equal to the market value on the date the option is granted” 
and that “[t]he Company applies Accounting Principles Board Opinion No. 25” 
(“APB 25”). 326 APB 25 applied to expensing options during the period at issue 
(1996–2002) and required that, if a company set the exercise price in an option 
grant below the share price on the date that the company decided to make the 
option grant, the company had to record a compensation expense in its income 
statement. 327 The defendant director knew that the company awarded options 
with “backdated” award dates that were selected because the closing prices on

In a summary paragraph, the Ninth Circuit wrote:

The fact that Gateway would not have met analysts’ expectations without booking the unusual 
Lockheed and AOL transactions as revenue could lead a reasonable juror to find that Gateway’s 
revenue was not growing “faster and faster” as a characteristic of accelerated growth. If Gateway 
had not met analysts’ expectations or [the CEO] had disclosed the true source of the revenue, the 
investing public would have been alerted to the lesser rate of growth for Gateway’s traditional 
Sources of revenue. Under the circumstances, a rational trier of fact could conclude that [the 
CEO] omitted material information regarding the Lockheed and AOL transactions, which misled 
investors into believing that Gateway was experiencing a higher rate of growth based on its public 
business model than it was achieving in fact.

Id. at 1222.

322. Of course, the court in Todd only held that the evidence was sufficient to support the jury’s 
finding as to the CFO and controller. Conceivably, the jury could have found for the defendants, par-
ticularly on scienter, on the same evidence.

323. Again, the Ninth Circuit only held that the facts created a triable issue as to the misleading 
nature of the statement that revenue was growing at an “accelerating” rate and the scienter of the CEO 
who made that statement. If the Rule 10b-5 claim based on his statement had gone to trial, the SEC 
might have lost that claim.

324. 646 F.3d 536 (8th Cir. 2011).
325. Id. at 539, 542.
326. Id. at 541.
327. Id. at 539–40.
those dates (which would be the exercise prices in the grants) were below the closing prices on the dates that the company decided to make the awards.\textsuperscript{328}

The SEC sued the director for, among other things, violations of section 17(a) of the Securities Act, section 10(b) of the Exchange Act and SEC Rule 10b-5, and section 14(a) of the Exchange Act and SEC Rule 14a-9.\textsuperscript{329} The trial court granted the director judgment as a matter of law at the close of the SEC’s case in chief, and the Eighth Circuit affirmed.\textsuperscript{330} The SEC focused its case on the sentence in the proxy statement that stated, “[o]ptions granted are at an option price equal to the market value on the date the option is granted” (with this and similar sentences called the “Option Pricing Sentence” or “OPS”), and did not attempt to show that the issuer had filed or published financial numbers that were false for failing to include the compensation expense mandated by APB 25.\textsuperscript{331} The court of appeals found that the SEC failed to prove the critical statement was false, since the issuer “literally complied with the OPS because the exercise price was always ‘the closing price of the Stock on the date that the Stock Option [was] granted,’ that is, the date that appeared on the option certificate.”\textsuperscript{332} The SEC nevertheless contended that the OPS was misleading because “the only reasonable reading” of the sentence was that the exercise prices were set at the market price on the date that the company decided to make the option awards.\textsuperscript{333} But the government’s own expert seemed to endorse a close and literal reading of option plans that distinguished between the dates on which a company decided to make awards and the dates of the awards themselves.\textsuperscript{334} The court found the SEC’s proof that the OPS was “materially fraudulent . . . even more deficient,” with materiality supported only by a securities analyst who testified that he would have wanted to know about the backdating because “[a]s an analyst, I would like to know everything.”\textsuperscript{335}

Turning from whether the OPS was materially false or misleading to the outside director’s mental state, the Eighth Circuit reaffirmed that violations of section

\begin{itemize}
\item \textsuperscript{328} Id. at 541–42.
\item \textsuperscript{329} Id. at 541.
\item \textsuperscript{330} Id. at 539.
\item \textsuperscript{331} Id. at 540–41.
\item \textsuperscript{332} Id. at 542–43.
\item \textsuperscript{333} Id. at 543.
\item \textsuperscript{334} The court provided this trial anecdote:

[The SEC’s] only evidence that this was the only reasonable reading of the plain language of the OPS [i.e., that exercise prices matched closing prices on the date the company decided to make awards] was the opinion of statistical expert Heron, who was not qualified as an expert on this question and whose lay opinion was of little if any probative value. Moreover, on cross-examination Heron admitted that a colleague had published a prominent article on the subject noting:

the stock option plans that I have looked at do not explicitly prohibit such activities. The plans generally state that the exercise price should be the market price at the grant date, but do not state that the grant date cannot precede the decision date.

\item \textsuperscript{335} Id.
17(a)(1) and Rule 10b-5 require scienter, and that a violation of Rule 14a-9 by an outside director requires scienter. The court then held that the evidence failed to support a finding of scienter because (i) the director “testified that he relied on [the issuer’s] finance and accounting departments, outside and general counsel, and . . . independent auditors to ensure that the stock option Plans were properly administered and that . . . proxy statements made appropriate and accurate disclosures”; (ii) the company’s “option dating practice was not clearly contrary to the plain language of the OPS”; (iii) “no one at [the issuer], including its outside auditors who monitored compliance with APB No. 25, perceived that the undisclosed grant of ‘in-the-money’ stock options—which had no impact on [the company’s] financial performance—would be a material misstatement or omission”, and (iv) the defendant did not attempt to hide the backdating, but “consistently initialed and contemporaneously dated documents reflecting that Compensation Committee option-granting decisions were finalized on a date later than the grant date reflected on the option certificates.” Accordingly, the evidence supported neither the conclusion that the director intended to deceive nor that he “recklessly failed to see an obvious danger that investors would be materially misled”—one or the other of which would have been required to prove scienter. On much the same reasoning, and because the SEC offered no evidence of a standard of care that the director violated, the court found the government’s proof insufficient to support a finding that the director was negligent with respect to the OPS, as would be required for liability under section 17(a)(2) or section (a)(3).

336. Id. at 541.
337. Id. at 546–47.
338. Id. at 544.
339. Id.
340. Id. at 545.
341. Id.
342. Id.
343. Id. at 544.
344. Id. at 545–46. The court included this passage:

The SEC failed to prove that the OPS was unambiguous. Therefore, determining whether [the director] negligently made untrue material statements of fact or omissions, or engaged in a practice that operated as a fraud or deceit upon purchasers of [the issuer’s] stock, involved complex issues of options accounting; Plan administration; the intricacies of securities filings; and the proper allocation of responsibilities between [the issuer’s] finance and accounting professionals, outside auditors, inside and outside counsel, Board of Directors, and Compensation Committee. As it is undisputed that [the director] was an outside director who had no personal expertise in these matters, that [the issuer] complied with the accounting principles known at that time to apply, and that no one alerted [the director] to any possible concern over [the issuer’s] manner of dating and pricing options issued under the Plan, we agree with the district court that the SEC’s failure to present any evidence that he nonetheless violated an applicable standard of reasonable care was fatal to its case.

Id. at 546. Note, again, that the SEC proceeded on a disclosure case only and did not attempt to prove that the issuer had violated APB 25. Id. at 540.
345. Id. at 541. The court wove together the facts so to reach this conclusion, noting along the way that the years involved in this case were ones during which option expensing was not settled:

The SEC’s proof . . . did not counter [the director’s] undisputed testimony that he did not draft the proxy statements, believed the statements were truthful and accurate, did not perceive that the OPS
Significance and analysis. The Shanahan case is one of the few in which the SEC has pursued an outside director. The Eighth Circuit decision treats outside directors quite favorably, endorsing generally the idea that an outside director’s reliance on professionals for matters such as accounting and SEC disclosure will forestall findings that the outside director had scienter or was reckless or negligent in a way that suffices for a violation of federal securities laws or rules requiring those states of mind. But two SEC trial gaffes suggest that this case is an outlier. First, the defense that the OPS was literally true would, in the ordinary case, have provided little comfort in light of the principle that “half truths”—literally true statements that create a materially misleading impression—will support claims for securities fraud. Even the Eighth Circuit acknowledged that it was “likely that the average investor would read the OPS as stating that ESSI does not issue ‘in-the-money’ stock options.” The defendant was saved here from the application of the rule that half-truths mislead by the admission the defense wrung from the SEC expert that one of his colleagues had published an article reading disclosure of the sort in the OPS as “not stat[ing] that the grant date cannot precede the decision date.” The probability of finding that kind of cross-examination gold in another case is low. Second, the SEC failed entirely to present evidence of any standard of care by which to measure the outside director’s conduct for negligence analysis. The SEC may not omit such testimony in future cases. Clients should not forget that the SEC has in the past shown interest in scaring outside directors so that they monitor SEC filings more closely.

might be misleading in light of [the issuer’s] options dating and pricing practice, and was never made aware of any reason to be concerned that this practice was not fully disclosed.

On this record, we agree with the district court that, absent probative evidence regarding [the director’s] duties as outside director and member of the Compensation Committee, the jury could only speculate as to whether he failed to exercise reasonable care in overseeing [the issuer’s] proxy communications with shareholders. The evidence at trial established, during the time in question, serious debate among accounting professionals as to the appropriate manner in which to price employee stock options, and academic debate surrounding the propriety of retrospectively priced options.

Id. at 547.

The court of appeals also affirmed judgment as a matter of law for the director on the claim that he aided and abetted the issuer’s violations of the Exchange Act. Id. at 547–48. Observing that aiding and abetting liability under section 20(e) required—at the time the director acted—that the aider and abettor had “knowledge” of the underlying violation, the Eighth Circuit concluded that the same reasoning on which it had ruled that the SEC failed to provide evidence sufficient to support a finding that the director had scienter, or acted negligently, sufficed to conclude that the SEC had failed to provide evidence to support a finding that he knew of a violation. Id. at 547–48.

346. The SEC may have been motivated to do so in Shanahan because the director’s father worked at the issuer, and the SEC had evidence—which the trial court excluded—that the director had proposed an outsized option award for his father. Id. at 548.
347. SEC v. Gabelli, 653 F.3d 49, 57 (2d Cir. 2011).
348. Shanahan, 646 F.3d at 544.
349. Id. (quoting the Lie article, see note 334).
350. Id. at 545 (“the SEC presented no evidence, through expert or lay testimony, documentary evidence or otherwise with respect to the degree of care that an ordinarily careful person would use under the same or similar circumstances”); see also supra note 344.
351. See Report of Investigation Pursuant to Section 21(A) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co., 65 SEC
Disgorgement calculation. The D.C. Circuit held last year that the amount to be disgorged in a pump and dump case could be computed by assuming that the defendant paid nothing for the stock when (i) “there was no reliable pre-fraud fair market value for the shares” because the stock had very “low trading volume on an unregulated Pink Sheet”; (ii) the defendant provided no evidence of “the value he in fact exchanged for his shares”; and (iii) the defendant had invoked his Fifth Amendment right, from which the trial court drew an adverse inference. Under these circumstances, the court held that the SEC met its burden to provide a “reasonable approximation” of wrongful profits by proving the full amount of the defendant’s proceeds from sale of the stock. Once the SEC provided that “reasonable approximation,” the “burden . . . shifted to [the defendant] to demonstrate the value of the . . . stock prior to the fraud.” Specifically rejecting the argument that the defendant discharged that burden by relying on the pre-fraud Pink Sheet quotation for the shares, the court reasoned in part “there...
was no evidence that [the defendant] could have sold a million shares at any price during that time” since “the evidence showed that only a small number of [the issuer’s] shares . . . were traded [via the Pink Sheets] during a 30-day period.”

In the same case, the court rejected the defendant’s argument that he could not be liable for the entire amount of the proceeds from the fraud because (i) he had transferred some of those proceeds to another participant in the fraud and (ii) he had no “close relationship” with that other participant except by their collaborative wrongdoing. The D.C. Circuit joined other circuits by holding that collaboration in the commission of a fraud is sufficient for joint and several liability on disgorgement orders—even with no showing that the fraud participants otherwise had a “close relationship.”

A slew of decisions last year considered whether expenses can be deducted in calculating disgorgement amounts. In SEC v. Aerokinetic Energy Corp., the Eleventh Circuit affirmed a district order to disgorge sale proceeds—without deducting “business expenses”—from a fraud involving the sale of securities issued by a company that had supposedly “developed, patented and marketed an alternative energy technology that could generate electricity from static air.” In SEC v. U.S. Pension Trust Corp., the same court affirmed disgorgement over the defendants’ objection that the amount included dollars that they had paid as income taxes. In SEC v. Brown, where the wrongdoing consisted of diverting money that investors had paid into a private investment fund, the Eighth Circuit affirmed an order to disgorge amounts that the defendant claimed to have been transferred for compensation, reimbursement, and assets provided to the fund. Each of these opinions rested on the proposition that expenses cannot be deducted from proceeds of a fraud in order to compute the disgorgement amount. The Second Circuit, on the other hand, acknowledged that some expenses or transfers can be subtracted from gross proceeds of a fraud, but the court did not subtract any amount in the

358. Id. Just before the fraud began, only 10,000 shares of the stock traded on an identified day. Id. at 5. The SEC “estimated that [the defendant’s] proceeds from his sale of over one million Triton shares were $738,473.” Id. (emphasis added).

359. Id. at 9–12.

360. Id. at 10–11. The court explained that joint and several liability may be imposed when defendants either (i) collaborated in a securities violation or (ii) otherwise had a “close relationship.” Id. at 10 (citing SEC v. Hughes Capital Corp., 124 F.3d 449, 455 (3d Cir. 1997); SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1475 (2d Cir. 1996); SEC v. First Pac. Bancorp, 142 F.3d 1186, 1191 (9th Cir. 1998)).

361. 444 F. App’x 382, 384 (11th Cir. 2011) (per curiam).

362. 444 F. App’x 435, 436–37 (11th Cir. 2011) (per curiam).

363. 658 F.3d 858, 860–61 (8th Cir. 2011).

364. Aerokinetic, 444 F. App’x at 385 (rejecting argument for deduction of “expenses [defendants] legitimately incurred” on the ground that “the cases overwhelmingly hold that [h]ow a defendant
case before it because the defendant “failed to show that the transfer reflected a direct transaction cost.”

Significance and analysis. It is a bit hard to conjure up the circumstances in which it would be appropriate to deduct expenses from gross proceeds in computing a disgorgement. It makes sense when a part of the investors’ money is used for legitimate purposes and only part is consumed by the securities wrongdoing—provided that the defendant can separate out the portion legitimately used. It might also be appropriate where the wrongdoing can be separated from a particular expense—like sale expenses where a broker sells a stock in a customer’s account, with the customer’s consent or by the exercise of properly delegated discretion and in accord with appropriate standards for exercising the discretion, but then (pursuant to the broker’s pre-existing plan) steals the money. In the latter case, the sale expenses would have had to be paid even if the net proceeds remained, unstolen, in the customer’s account. But the examples will be few and far between, the defendant will need to prove the expenses and their legitimacy after the SEC provides its “reasonable approximation” of ill-gotten gains, and a court will likely be unsympathetic to a deduction unless the defendant will submit to deposition discovery, which will not be possible in cases where the defendant still faces potential criminal prosecution and so wishes to stand on his or her Fifth Amendment right.

Statute of limitations for civil penalties, disgorgement, and cease-and-desist proceedings. The general statute of limitations for federal penalties provides (with an exception not applicable here) that “an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued.” In 2011, the Second Circuit held that this statute only begins to run when the SEC either (i) discovers the fraud for which it seeks to impose the penalties or (ii) in the exercise of due diligence, should have discovered it. The court held that this “discovery rule” is read into every statute of limitations for

chooses to spend his ill-gotten gains, whether it be for business expenses, personal use, or otherwise, is immaterial to disgorgement” (quoting district court order)); U.S. Pension Trust, 444 F. App’x at 437 (“We know of no authority, and the Individual Defendants cite none, requiring the court to deduct from the disgorgement figure the amount of ill-gotten gains paid to the government in income tax.”); Brown, 658 F.3d at 861 (“[T]he overwhelming weight of authority hold[s] that securities law violators may not offset their disgorgement liability with business expenses.”). But see Brown, 658 F.3d at 862 (Loken, J., concurring in part and dissenting in part) (criticizing the lower court because “[i]t did not consider whether . . . expenses attributable to legitimate investment activities should offset the amount to be disgorged, as other cases have required to ensure that disgorgement is remedial and not punitive”).

366. See, e.g., SEC v. JT Wallenbrock & Assocs., 440 F.3d 1109, 1114–15 (9th Cir. 2006) (recognizing the possibility of deductions in such a case but refusing to permit subtraction because, in that case, the “entire business enterprise and related expenses were not legitimate at all”).
367. Id. at 1114.
fraud—whether or not the statutory language includes that rule—“unless Congress directs otherwise,” which Congress did not do here.\footnote{370} Moreover, the rule that the cause of action accrues only on discovery of the fraud (or when due diligence would have discovered the fraud) applies whether or not a particular defendant actively sought to hide the fraud from discovery.\footnote{371} Accordingly, the district court should not have dismissed the civil penalty claim at the pleading stage because the SEC alleged that it did not discover the fraud until late 2003\footnote{372}—within five years of filing the case on April 24, 2008.\footnote{373}

In another 2011 case addressing the five-year civil penalties statute, the D.C. Circuit held in \textit{Riordan v. SEC} that that statute does not govern SEC claims for disgorgement.\footnote{374} The court reasoned that “disgorgement orders are not penalties, at least so long as the disgorged amount is causally related to the wrongdoing.”\footnote{375} Using the same rationale, the D.C. Circuit held that the five-year statute does not apply to cease-and-desist orders entered in SEC administrative enforcement proceedings, as such orders are not penalties, forfeitures, or fines.\footnote{376}

\textit{Legitimacy of relief defendant’s claim to money.} The SEC may recover money or other property from “nominal” or “relief” defendants who do not commit securities violations where those defendants (i) receive the money or other property generated by the violations and (ii) have no legitimate claim to that money or other property.\footnote{377} In 2011, the Second Circuit, in \textit{SEC v. Rosenthal}, found the first element satisfied as to defendants who received distributions from a limited partnership named Aragon “[b]ecause the balance in the [limited partnership’s] account after the distributions was less than the amount of illicit profits” the limited partnership received, so that “the distributions must necessarily have contained funds subject to disgorgement.”\footnote{378} Quite interestingly, the court of appeals, relying on entity law, found the second element satisfied because the limited

\footnotesize{\raggedright 370. \textit{Id.} at 60.\\ 371. \textit{Id.} Here, the SEC filed suit on April 24, 2008, \textit{id.} at 55, which was more than five years after the last market timing trade in August 2002, \textit{id.} at 54.\\ 372. \textit{Id.} at 59.\\ 373. \textit{Id.} at 55, 60–61 (“[f]inding that at this stage in the litigation defendants have not met their burden of demonstrating that a reasonably diligent plaintiff would have discovered this fraud prior to September 2003”).\\ 374. 627 F.3d 1230, 1234 (D.C. Cir. 2010).\\ 375. \textit{Id.}\\ 376. \textit{Id.} at 1234–35.\\ 377. See \textit{SEC v. Cavanagh}, 155 F.3d 129, 136 (2d Cir. 1998); \textit{SEC v. Colello}, 139 F.3d 674, 677 (9th Cir. 1998).\\ 378. 426 F. App’x 1, 3 (2d Cir. 2011). The court noted that “the ill-gotten gains of the insider trading were commingled in the [limited partnership’s] account,” which the defendants asserted also contained “legitimately obtained assets prior to the illicit trades.” \textit{Id.} The court held that “[t]he SEC is not required to trace specific funds to their ultimate recipients” where the ill-gotten gains have been commingled with clean money \textit{Id.}}
partnership law of Delaware (under which Aragon was formed) prohibited dis-
tributions if “‘after giving effect to the distribution, all liabilities of the limited
partnership . . . exceed the fair value of the [remaining] assets of the limited
partnership.’” 379 Since Aragon itself was liable for disgorgement of the illicit funds
and since the liability for that disgorgement exceeded the funds left in the limited
partnership after the distributions, the distributions were unlawful, and hence the
relief defendants had no legitimate claim to them. 380

Significance and analysis. The Rosenthal opinion emphasizes that proof of the
second element against a relief defendant may, in an SEC enforcement action,
take the attorneys and the court quite outside the securities law. Thus, a relief
defendant arguing that he or she has a legitimate claim to proceeds of a securi-
ties violation because the proceeds were paid to the defendant to satisfy a con-
tract obligation may face a response that “the consideration . . . was actually past
consideration [and] . . . that ‘past consideration is not valid consideration for a
promise.’” 381 And now, with the Rosenthal decision, a transferee might be said to
have no legitimate claim to, for example, a dividend that transferred illicit funds
received by a corporation to a shareholder in violation of the prohibition against
dividends in excess of statutorily defined “surplus” or “net profits for the fiscal
year in which the dividend is declared and/or the preceding fiscal year.” 382

Bankruptcy discharge of relief defendant. In another case addressing nominal or
relief defendants, the Ninth Circuit last year held that, when such a defendant goes
into bankruptcy while subject to an unpaid disgorgement order, the statute pro-
hibiting discharge of a debt “that is for the violation of any of the Federal securities
laws” does not apply to prevent discharge of the debt owed on the disgorgement
order. 383 The court held that the bankruptcy statute “only prevents the discharge
of a debt for a securities violation when the debtor is responsible for that viola-
tion” and does not apply “when the debtor has not committed such a violation.” 384
The debtor in the Ninth Circuit case was an attorney who had received advances
on a contingent fee that he had not thereafter earned. 385 While the advances were
financed with proceeds of a fraud, the “SEC conceded that [the attorney] had not
been found to have committed any securities violations on his own.” 386

379. Id. at 4 (quoting Del. Code Ann. tit. 6, § 17-607(a)).
380. Id. The Second Circuit also held that the trial court properly used the Internal Revenue Ser-
vice’s underpayment interest rate to calculate prejudgment interest. Id.
383. In re Sherman, 658 F.3d 1009, 1012 (9th Cir. 2011).
384. Id.
385. See In re Sherman, 491 F.3d 948, 953–55 (9th Cir. 2007). For a summary of the 2007 deci-
386. Sherman, 658 F.3d at 1010. A dissent argued that the attorney was not “an honest debtor”
who deserved a “fresh start” pursuant to the policy underlying the bankruptcy laws, but a faithless
attorney who pilfered client funds that he held in trust. Id. at 1023 (Fisher, J., dissenting). The ma-
jority responded that the SEC might well have succeeded if it had opposed discharge as violating
11 U.S.C. § 523(a)(4), which prohibits “discharge of debts ‘for fraud or defalcation while acting in a
fiduciary capacity, embezzlement, or larceny.’” Id. at 1017. But the SEC had not sought to do so within
the applicable time limit. Id. at 1018.
Pro rata distribution of funds remaining after fraud. A receiver for six investment pools in SEC v. Wealth Management LLC ordered a distribution of recovered proceeds—about $6.3 million of the $131 million invested—“on a pro rata basis and also imposed a cutoff date after which any redemption distributions would be offset against [any] investor’s total distribution.” Two investors appealed the order. Each had sought to redeem its investment in the investment’s entirety, and one had received a partial redemption payment after the receiver’s cutoff date. Each argued that, as a result of the redemption request, it was a creditor, not just an equity participant, and so entitled to priority in distribution over the other investors, who merely held equity.

The Seventh Circuit affirmed the order by which the trial court approved the receiver’s plan of distribution, an order based on the conclusion that, “[b]ecause the recoverable funds fell far short of the total assets under management,” it was “more reasonable” to distribute pro rata than to “try to trace assets to specific investors.” The court of appeals began “with the principle that where investors’ assets . . . are commingled and the recoverable assets are insufficient to fully repay the investors, ‘equality is equity.’” The court then proceeded to the principle that, in order “[t]o implement an effective pro rata distribution, district courts supervising receiverships have the power to ‘classify claims sensibly,’ which ‘includes the authority to subordinate the claims of certain investors to ensure equal treatment.’” The district court had properly “considered the claims of investors who attempted to redeem their equity and determined that the substance of those claims was identical to the claims of nonredeeming equity” investors. Accordingly, “[b]y subordinating the [appealing investors’] claims and effectuating a pro rata distribution of assets, the district court avoided the inequity of giving some investors preference even though all investors’ claims were substantively the same.”

Specifically responding to the appealing investors’ argument that they should have received preference because they were creditors, the Seventh Circuit held,

387. 628 F.3d 323 (7th Cir. 2010).
388. Id. at 327.
389. Id. at 328. The investors based appellate jurisdiction on the collateral order doctrine. Id. at 330. The Seventh Circuit concluded that all three of the criteria for review under that doctrine were present since (i) “the order conclusively determine[d] . . . how the recovered assets . . . will be distributed”; (ii) the distribution was “important to the defrauded investors and is independent of the merits of the underlying SEC enforcement action”; and (iii) “the order will be effectively unreviewable after the court enters a final judgment because the assets will have been distributed by that point.” Id. at 331.
390. Id. at 328.
391. Id. at 336.
392. Id. at 333. The court drew a distinction between the “investment pools” involved in the case and the “segregated accounts” in which Wealth Management had placed client funds in the past, id. at 327, thus implying that the investors never had segregated accounts in the investment pools.
393. Id. at 333 (quoting Cunningham v. Brown, 165 U.S. 1, 13 (1924)).
394. Id.
395. Id. at 334.
396. Id.
first, that federal receivership law did not require elevation of state law over the
district court’s power to equitably subordinate claims in a distribution. 397 The
court held, second, that the two investors were not creditors under state law any-
way. 398 The investors argued that, by their requests for redemptions, they had
turned themselves from equity holders into creditors of the LLC entities into
which the investment pools were organized. 399 But the Wisconsin limited liability
company act provided that “a holder of an equity interest . . . becomes a creditor
‘[a]t the time that a member becomes entitled to receive a distribution.’ ” 400 Here,
the operating agreement of the relevant fund “permit[ted] the fund’s managing
member to restrict distributions when ‘existing economic or market conditions
or conditions relating to [the fund]’ render[ed] ‘withdrawals or payments of
withdrawals . . . impracticable.’ ” 401 Since the funds had restricted redemptions
to 2 percent per quarter of a member’s equity at the time the appealing inves-
tors sought redemption of their entire interests, the investors were not by their
requests “entitled to receive a distribution” beyond the 2 percent—which they did
receive—and accordingly had “not become creditors.” 402

Significance and analysis. Like the Rosenthal opinion, 403 the Wealth Management
opinion emphasizes the degree to which SEC enforcement issues implicate cor-
porate and unincorporated entity law. Wealth Management also brings home the
sometimes overriding importance of distribution protocols in cases where secu-
rities violations leave a business without the funds sufficient to compensate all
victims. 404

Venue. Section 27 of the Exchange Act provides that the SEC may bring an
enforcement action “in the district wherein any act or transaction constituting
the violation occurred” or “in the district wherein the defendant is found or is
an inhabitant or transacts business.” 405 Last year, the D.C. Circuit held that this
statute cannot be expanded by the coconspirator theory of venue, which permits
venue in any district in which a defendant’s coconspirator committed an action

397. Section 959(b) of Title 28 provides that a receiver “shall manage and operate property . . . ac-
cording to the requirements of the valid laws of the State in which such property is situated.” Id. at 334
(quoting 28 U.S.C. § 959(b)). But here the receiver was liquidating the assets rather than managing or
operating them, and therefore § 959(b) did not apply. Id.
398. Id. at 335.
399. Id. at 327.
400. Id. at 335 (quoting Wis. Stat. § 183.0606) (emphasis added).
401. Id.
402. Id.
403. See supra notes 377–82 and accompanying text.
404. See also In re Bernard L. Madoff Inv. Sec. LLC, 654 F.3d 229 (2d Cir. 2011), (affirming determi-
nation by bankruptcy court that trustee properly applied the Securities Investor Protection Act—in a
case in which investor money had not been invested at all in the securities shown on statements, so that
all statements provided to investors were fictitious except to the extent that they reflected the amounts
the investors put into their accounts and the amounts they withdrew, id. at 232—by interpreting the
“net equity,” to which each investor was ratably entitled under 15 U.S.C. §§ 78fff-2(c)(1)(B), 78fff(11),
id. at 237, to be the amount the investor deposited minus the amount he or she withdrew, instead of
the market value shown on the investor’s last statement, id. at 232, 242).
The court held that section 27 “by its terms forecloses use of the coconspirator theory of venue.” The SEC did not prove that venue lay in the District of Columbia in the case before the D.C. Circuit because the Commission did not prove the defendant committed any action “constituting the violation” in that district.

**Insider Trading:** Issuer was an insider subject to insider trading prohibitions, but a complaint failed to allege scienter where the undisclosed fact was the founders’ sale in a secondary offering at the same time as the issuer sold in a primary offering and plaintiff alleged that the founders’ concealment of their sales hurt the issuer; a tipper violation requires that the defendant understood that information would be used for securities trading, and an alleged tipper can defend on the ground that he or she had a relationship with the putative tippee of sharing confidences that the putative tippee does not repeat or use; an executive does not, when an option vests, “purchase” the option for purposes of section 16 of the Exchange Act.

Three courts of appeals opinions addressed important insider trading issues last year. The Ninth Circuit reaffirmed that the issuer is an insider for Rule 10b-5 purposes and, on the particular facts in the same decision, found no scienter in the issuer’s failure to disclose stock sales of founders/executives at the same time that the issuer made a primary offering. The Second Circuit held that, to win a tipper case, the government must prove that the defendant understood the tippee would use the material nonpublic information for trading. In the course of resolving a tax issue, the Ninth Circuit held that an executive does not “purchase” an option for section 16 purposes when the option vests.

**Scienter of issuer as insider.** The private company issuer in *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.* sold stock in a primary offering at the same time that the founders/executives sold stock that they personally owned in a secondary offering. The plaintiff bought in the primary offering, and the issuer did not disclose to the plaintiff that the founders/executives were selling in the secondary offering. Among other claims, the plaintiff alleged that the issuer violated Rule 10b-5 insider trading proscriptions by selling the shares in

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407. Id.
408. Id. While the SEC “argue[d] the filing of a Form 10-Q with the SEC was an act in the District constituting a securities fraud violation by [the company for which the defendant worked],” the complaint did not charge the defendant with such a filing. Id. Instead, the SEC alleged that the defendant, who “served as Senior Vice President for Marketing and Network Development,” id. at 712, “had ‘worked on drafting or caused others to draft’ [a] Statement of Work for [a] phony . . . deal,” id. at 713, which had been used to justify recording revenue from the deal, id. at 712.

Since venue was improper, the court of appeals reversed the judgment against the appealing defendant and ordered that the trial court dismiss without prejudice. Id. at 716.
409. See infra notes 412–21 and accompanying text.
410. See infra notes 422–39 and accompanying text.
411. See infra notes 440–62 and accompanying text.
412. 655 F.3d 1039 (9th Cir. 2011), petition for cert. filed, 80 U.S.L.W. 3531 (U.S. Feb. 27, 2012) (No. 11-1069).
413. Id. at 1045.
414. Id.
the primary offering while failing to disclose the material fact that the founders/executives were simultaneously selling their personally owned stock.415 In affirming dismissal of this claim,416 the Ninth Circuit reaffirmed that an issuer is an insider for purposes of Rule 10b-5 insider trading analysis417 and held that “[t]he PSLRA heightened pleading standards for scienter also apply to insider trading claims.”418 Since the plaintiff alleged that the founders/executives’ sales hurt the issuer by making it harder for the company to raise capital and since the issuer was “a corporate entity distinct from the Founders,” the court held that “the Founders’ motivation to commit fraud [by keeping their sales quiet] cannot be automatically ascribed to the [issuer]” because the founders/executives’ “alleged behavior is at odds with the [issuer’s] financial interests.”419 Indeed, the “most plausible” interpretation of the alleged facts was that the issuer was “a victim of the Founders . . . rather than . . . a culpable perpetrator of fraud.”420

Significance and analysis. The holding that the founders/executives’ scienter could not be imputed to the issuer because the omission actually hurt the issuer is a very limited holding. In WPP, the fraud did not benefit the issuer in any respect. If the fraud had benefited the issuer as well as the individual executives, the result would almost certainly have been different.421

Tipper liability dependent on whether tipper understood tippee would use information for trading. The Second Circuit, in United States v. Gansman,422 definitively resolved for that court whether a tipper must understand the information that he or she passes on will be used for securities trading. Gansman worked as an attorney in Ernst & Young’s (“EY”) Transactional Advisory Services Department, where he received nonpublic information about mergers and acquisitions.423 Gansman passed this information on to his lover, who traded on it.424 Prosecuted for tipping on the misappropriation theory,425 Gansman defended on the basis that he had a relation-

415. Id. at 1048. No party “dispute[d] that information regarding whether the Founders were selling their shares . . . [was] material.” Id. at 1048 n.1.
416. Id. at 1055.
417. Id. at 1057.
418. Id. at 1056. This review describes those standards at infra notes 538–44.
419. Id. at 1056–57.
420. Id. at 1057.
421. Cf. RESTATEMENT (THIRD) OF AGENCY § 7.07(2) (2006) (employee’s action imputed to employer unless “it occurs within an independent course of conduct not intended by the employee to serve any purpose of the employer” (emphasis added)); see also Rowe v. Marietta Corp., 955 F. Supp. 829, 833–34 (W.D. Tenn. 1996) (for common law fraud purposes, scienter of the CEO involved in the company’s financial fraud could be imputed to the company because the company itself—as well as the CEO who sold personally owned company stock during the fraud—benefitted from the overstatement of revenues, income, and assets).
422. 657 F.3d 85 (2d Cir. 2011).
423. Id. at 90.
424. Id.
425. Id. The misappropriation theory, as applied to insider trading and tipping under Rule 10b-5, proceeds on the notion that the defendant owed a duty of confidentiality to the source of the information—here that Gansman owed a duty to EY not to pass on to others the nonpublic information that he acquired in the course of his work at EY. See id. at 88 for a general statement of the misappropriation theory.
ship of “trust and confidence” with his lover and therefore did not understand that she would trade on the information that he provided to her.\(^{426}\) He requested an instruction that substantially repeated a definition of trust and confidence contained in the SEC’s rule setting out the relationships on which a misappropriation theory might proceed,\(^{427}\) in order to argue that someone in such a relationship could not be a tipper because he or she would believe that information transferred in the course of the relationship would remain confidential.\(^{428}\) The Second Circuit held that, since Gansman was “entitled to support his general defense” through instructions,\(^{429}\) “the District Court would not have erred”\(^{430}\) by giving the instruction that Gansman requested.\(^{431}\) Such an instruction would have been appropriate because “[i]n prosecuting a putative ‘tipper’ under the misappropriation theory,” the prosecution “must prove as an element of the offense that the tipper conveyed material nonpublic information to his ‘tippee’ with the understanding that it would be used for securities trading purposes.”\(^{432}\) The Second Circuit affirmed Gansman’s conviction\(^{433}\) because the instruction that the court did give the jury “was substantially similar to the one Gansman requested.”\(^{434}\) The lower court’s failure to use the exact words Gansman proposed produced no prejudice because “the government presented ample evidence that Gansman knew or had reason to know that [his lover] was trading on the information he gave her.”\(^{435}\)

\(^{426}\) Id. at 91.

\(^{427}\) Id. The SEC rule reads, in pertinent part,

For purposes of this section, a “duty of trust or confidence” exists in the following circumstances, among others:

\(. . . .\)

(2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality . . . .

17 C.F.R. § 240.10b5-2(b) (2011).

\(^{428}\) Gansman, 657 F.3d at 89–91.

\(^{429}\) Id. at 92.

\(^{430}\) Id. at 94.

\(^{431}\) Gansman proposed the following:

In this case, Mr. Gansman contends that he did not provide Donna Murdoch [Gansman’s love interest] with material nonpublic information with the understanding that Murdoch would use the information to purchase and sell securities. Any material nonpublic information that Murdoch may have received from Mr. Gansman was shared with her as part of a relationship of trust and confidence, in which they had a history and practice of sharing work and personal confidences such that Mr. Gansman reasonably expected that Murdoch would keep any confidences he shared with her confidential, and certainly expected that she would not use those confidences to buy or sell securities. Unbeknownst to Mr. Gansman, Murdoch used information he conveyed to her in confidence to trade securities for her benefit and the benefit of others . . . .

Id. at 89–90.

\(^{432}\) Id. at 92 (emphasis added).

\(^{433}\) Id. at 97.

\(^{434}\) Id. at 91.

\(^{435}\) Id. at 92. For example, he commented to his paramour—after she gave him a computer “as a ‘thank you’ present”—that “I don’t even want to know how much you made with that trade.” Id.
Significance and analysis. In *United States v. Libera*, the Second Circuit expressed a very lax attitude toward the element that a tipper must understand that the putative tippee will trade, with the court essentially holding in *Libera* that the government can prove the tipper’s expectation that the tippee will trade simply with evidence that the tipper knew that he or she was violating a duty by conveying the information.\(^{436}\) In the *Gansman* opinion, which does not mention *Libera*, the court takes a harder line. But the writing in *Gansman* is distressingly cloudy, particularly for a criminal case. While the court said straight out that the tipper must “understand[] that [the information will] . . . be used for securities trading purposes,”\(^{437}\) the court seemingly accepted proof that Gansman “knew or had reason to know that [his lover] was trading on the information he gave her”\(^{438}\)—a standard suggesting that negligence as to this element will suffice.\(^{439}\)

Executive does not “purchase” a security under section 16 when an option vests. The Ninth Circuit last year decided a case at the intersection of tax and securities law. In *Strom v. United States*, the plaintiff sued for a tax refund.\(^{440}\) As the president and CEO of InfoSpace, that plaintiff (Bernee Strom or “Strom”) received stock option grants in 1998, with the options—entitling her to buy shares at $15 each—vesting over time.\(^{441}\) Strom exercised options in 1999 and 2000, at times when the market price for InfoSpace stock far exceeded $15/share.\(^{442}\) While ordinarily an executive must report the excess of market price over exercise price as income in the year in which the executive exercises a non-qualified stock option,\(^{443}\)

\(^{436}\). 989 F.2d 596, 600 (2d Cir. 1993). In *Libera*, the court wrote:

The tipper’s knowledge that he or she was breaching a duty to the owner of confidential information suffices to establish the tipper’s expectation that the breach will lead to some kind of a misuse of the information. This is so because it may be presumed that the tippee’s interest in the information is, in contemporary jargon, not for nothing. To allow a tippee to escape liability solely because the government cannot prove to a jury’s satisfaction that the tipper knew exactly what misuse would result from the tipper’s wrongdoing would not fulfill the purpose of the misappropriation theory, which is to protect property rights in information.

*Id.*

\(^{437}\). *Gansman*, 657 F.3d at 92.

\(^{438}\). *Id.* (emphasis added).

\(^{439}\). On the other hand, one of the leading authorities on insider trading provides what is also a somewhat ambiguous standard:

[It] seems odd—and out of sync with both the misappropriation theory and insider trading theory generally—not to require a showing of some awareness on the part of the tipper that tippee trading was at least foreseeable, if not likely. After all, that is what tipping is.


\(^{440}\). 641 F.3d 1051, 1055 (9th Cir. 2011).

\(^{441}\). *Id.* at 1054.

\(^{442}\). *Id.* at 1054–55.

\(^{443}\). *Id.* at 1055–56 (citing 26 U.S.C. § 83(a) & (e)(3)–(4); 26 C.F.R. § 1.83-7(a)). The court refers to the options here as “compensatory nonstatutory” ones, *id.* at 1055, meaning that they did not qualify for special treatment under 26 U.S.C. § 422, *id.* at 1053 n.1.
an executive need not do so if the shares obtained by the option exercise were not “‘transferable or [were] . . . subject to a substantial risk of forfeiture’” in the year of exercise.\footnote{444. Id. at 1056 (quoting 26 U.S.C. § 83(a)).} Strom contended that the stock she acquired—by exercising her options in 2000—was not transferable without “substantial risk of forfeiture” because she would have been liable to InfoSpace under section 16(b) of the Exchange Act for profits on sales of those shares in 2000,\footnote{445. Id. at 1061. Strom did not need to worry that her exercise of in-the-money options was a purchase countable against sales because such exercises are exempt from section 16(b) computation. 17 C.F.R. 240.16b-6(b) (2011). So, Strom only needed to concern herself with selling shares in 2000 if, within six months of such a sale, she had purchased her company’s shares otherwise than through exercise of in-the-money options. She argued that she had done so through the vesting of options.} and hence her exercise of the options generated no reportable income.\footnote{446. Rule 16b-3 permits awards of options under circumstances that do not constitute a “purchase” for purposes of matching purchases and sales under section 16(b). See 17 C.F.R. § 240.16b-3 (2011). The Ninth Circuit expressed surprise that “the government ha[d] not argued that Strom’s transactions were exempt under Rule 16b-3 or under any other exemption from the prohibitions of § 16(b),” but, as a result, the court did “not address the exemption issue.” Id. at 1067 n.15.}

Section 16(b) creates a cause of action for the issuer against its officers—for the profits on the sale and purchase, or purchase and sale, of the company’s equity securities registered under section 12 of the Exchange Act—when a non-exempt purchase and a non-exempt sale occur within six months.\footnote{447. 15 U.S.C. § 78p(b) (Supp. IV 2010).} Strom contended that she “purchased” options each time options vested, and therefore—since her options were vesting throughout 2000—she could not have sold any stock during that year (including particularly the stock that she acquired by exercising options) without a “substantial risk of forfeiture” of at least part of any sale’s proceeds.\footnote{448. Rule 16b-3 permits awards of options under circumstances that do not constitute a “purchase” for purposes of matching purchases and sales under section 16(b). See 17 C.F.R. § 240.16b-3 (2011). The Ninth Circuit expressed surprise that “the government ha[d] not argued that Strom’s transactions were exempt under Rule 16b-3 or under any other exemption from the prohibitions of § 16(b),” but, as a result, the court did “not address the exemption issue.” Id. at 1067 n.15.} The Ninth Circuit interpreted this text to permit “a taxpayer to postpone the tax consequences attributable to the exercise of options” only “if she can demonstrate that, if she had sold stock and a § 16(b) suit was brought against her, there is an objectively reasonable chance that the suit would have succeeded.”\footnote{449. Id. at 1061. Storm’s transactions were exempt under Rule 16b-3 or under any other exemption from the prohibitions of § 16(b),” but, as a result, the court did “not address the exemption issue.” Id. at 1067 n.15.} By this interpretation, “[a] risk of forfeiture of profits from the sale of stock exists even where a § 16(b) suit with a reasonable chance of success is brought, yet ultimately fails.”\footnote{450. Id. at 1057.} As the court saw it, “the phrase ‘could subject a person to suit’ accounts for the likelihood that, in cases where the application of § 16(b) is not clear, a taxpayer will be unwilling to sell stock for fear of incurring substantial legal expenses defending herself against a § 16(b) suit that could survive a motion to dismiss or summary judgment but might nonetheless fail.”\footnote{451. Id. (footnote omitted).} On the
other hand, there is no “substantial risk of forfeiture” and “[i]t would be senseless to say that . . . rights were ‘not transferable’ if a potential § 16(b) suit threatened no realistic possibility of forcing an insider to disgorge profits from a securities sale.”

In this case, the court held that there was no objectively reasonable chance that Strom’s sale of shares would have subjected her to a section 16(b) forfeiture on the theory that those sales were within six months of a “purchase” through the vesting of stock options. The court rested that conclusion in significant part on a 1991 SEC release in which the agency stated that “vesting of [restricted] stock or the lapse of a forfeiture provision [respecting such stock] is not a reportable event” under section 16(a). Since “any event that triggers liability under § 16(b) must first be a reportable event under § 16(a),” the circumstance that “the SEC did not intend the vesting of restricted stock to constitute a reportable event under § 16(a)” necessarily meant that “the agency also did not intend vesting to constitute a ‘purchase’ under § 16(b).” To the contrary, a 1991 SEC release stated that fixed-priced options are “purchased” “when granted or [otherwise] acquired,” and “the vesting of restricted stock or derivative securities [such as options] is not reportable under § 16(a) and so cannot be a ‘purchase’ under § 16(b).”

Strom argued that, despite that 1991 SEC interpretation, no federal court had decided by 2000 that vesting did not constitute an equity “purchase” under section 16 and therefore she ran an “objectively reasonable” risk that any sale of stock she owned outright would be matched with “purchases” via vesting to create liability to forfeit part of the sale proceeds. But the court of appeals concluded that, even in “the absence of caselaw on the issue,” “[t]he agency’s reasonable interpretation is sufficient to determine that there was no realistic possibility that [Strom] would have been forced to forfeit property from the sale of stock in a § 16(b) suit.” The court of appeals accordingly reversed the district court’s summary judgment by which the lower court had found that Strom was entitled to defer the recognition of income generated by exercising options at a price in excess of her strike price.
Significance and analysis. Assuming that a company grants options through a compensation committee composed solely of non-employee directors, SEC rules exempt the option grant from countable “purchases” for section 16(b) matching purposes, and similarly exempt from countable purchases the exercise of a fixed-price option when the option is in the money. Vesting constitutes the only other step in the sequence that could count as a “purchase” for section 16(b) matching. As the Strom opinion demonstrates, the SEC’s 1991 release means that option vesting does not count for section 16(b) matching, but reaching that conclusion requires some inferential reasoning. To whatever extent there might have been any doubt about the inferences necessary to conclude that vesting is not a “purchase,” the Ninth Circuit opinion removes it.

Criminal Cases: Lay testimony of a relatively inexperienced investor can supply evidence to prove materiality, with a trial court properly rejecting a defense instruction to define “reasonable investor” and properly excluding expert testimony on that definition that is not based on data or methodology; the government had to prove that a CFO made knowing false statements in management representation letters to auditors in order to convict for a criminal violation of Rule 13b2-2; substantive review of a sentence takes into account the variance between the sentence imposed and the range of months that the Sentencing Guidelines recommend; while a district court in the Eleventh Circuit should use the version of the Sentencing Guidelines in effect at the time of the offense, use of the version in effect at the time of sentencing will only violate the Ex Post Facto Clause if there is a substantial risk that using the later version resulted in the imposition of a harsher sentence; the clause in section 32(a) that prohibits imprisonment if the defendant proves that he or she had no knowledge of the SEC rule underlying the conviction may apply even in a case where the defendant pleads guilty to a criminal violation of section 10(b), since a violation of that statute requires a violation of a rule as well.

As in years past, 2011 produced important securities decisions arising in the criminal context. The Ninth Circuit found no error in a trial court’s decision to exclude expert testimony to define the “reasonable investor” to whom a fact must be significant in order that the fact be material and no error in the prosecution relying on the testimony of a lay investor to support materiality. The Ninth Circuit reversed a conviction resting on a CFO’s alleged violation of Exchange Act Rule 13b2-2 because the prosecution had not proved that the CFO understood that his statements in representation letters to the outside auditor were false. The Ninth Circuit also held that a sentence was not substantively unreasonable in part because it was below the range of imprisonment that the Sentencing Guidelines recommended, and the Eleventh Circuit held that use of Sentencing Guidelines effective at the time of sentencing does not violate the Ex Post Facto Clause of the U.S. Constitution unless the Guidelines in effect at the time of the crime

462. Id. § 240.16b-6(b).
463. See infra notes 468–75 and accompanying text.
464. See infra notes 476–99 and accompanying text.
465. See infra notes 500–02 and accompanying text.
recommended a shorter range and the use of more punitive Guidelines effective at the time of sentencing created a substantial risk of harsher punishment in the particular case. The Eighth Circuit found applicable to a prosecution for violation of Exchange Act section 10(b)—a statute—the clause in section 32(a) providing that a defendant in a case prosecuted under section 32 cannot be sentenced to imprisonment if the case is based on the defendant’s violation of a “rule or regulation” and the defendant proves that he or she had no knowledge of such rule or regulation.

Proving materiality through lay testimony. A fact is “material” for securities law purposes if there is a substantial likelihood that a “reasonable investor” would attribute actual importance to the fact in deciding whether to buy or sell the relevant security, taking into account the total mix of information otherwise available and relevant to that decision. In United States v. Sayre, the Ninth Circuit affirmed a conviction for securities fraud by violation of Rule 10b-5 over the defendant’s argument that the trial court both refused to define “reasonable investor” in a jury instruction and excluded the testimony of a defense expert on the meaning of that term. As to the trial court’s rejection of the defendant’s proposed instruction that would have defined “reasonable investor” “as one who ‘practices due diligence before making an investment,’” the court of appeals held that “‘reasonable investor’ is a concept within the jury’s ordinary experience and understanding.” As to the exclusion of the expert’s testimony, the trial court did not abuse its discretion under Federal Rule of Evidence 702, as the expert conceded that he was relying only on his knowledge and experience “‘as a teacher and as someone working in this field as to what it is that makes prices rise’” rather than on “any empirical data or any methodology.” The government apparently had relied for materiality on the evidence of a single investor of very modest experience who testified that she thought the opinions that the defendant offered about a particular issuer were important because the defendant had no interest in the issuer, which was untrue as the defendant was selling the stock of the issuer even while touting its prospects.

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466. See infra notes 503–21 and accompanying text.
467. See infra notes 522–37 and accompanying text.
469. 434 F. App’x 622 (9th Cir.), cert. denied, 132 S. Ct. 353 (2011).
470. Id. at 624.
471. Rule 702 provides:

A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:

(a) the expert’s scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;

(b) the testimony is based on sufficient facts or data;

(c) the testimony is the product of reliable principles and methods; and

(d) the expert has reliably applied the principles and methods to the facts of the case.

FED. R. EVID. 702.
472. Sayre, 434 F. App’x at 624.
473. Id. at 625. The court’s discussion provides details:
Significance and analysis. Lay testimony on materiality and exclusion of expert opinions does not trouble in a case such as Sayre, where the undisclosed truth was that the touter was selling the stock he lauded. And the term “reasonable investor” surely encompasses investors using a wide range of analytical methods. But a problem could arise if the government rested a prosecution on general statements that could grab the attention of a naïf but that an experienced investor might ignore. Such “puffery” should not generate government enforcement actions.

Rule 13b2-2. SEC Rule 13b2-2, among other things, forbids directors and officers of publicly traded companies from “directly or indirectly” “mak[ing] or caus[ing] to be made a materially false or misleading statement to an accountant in connection with . . . [a]ny audit, review or examination of the financial statements of the issuer required to be made” by SEC rules. Management typically provides a letter to the outside auditor representing, among other things, that management believes the financial statements the issuer has prepared and submitted for audit “are fairly presented in conformity with generally accepted accounting principles.” Both the CEO and CFO typically sign the management representation letter. Signing such letters can subject such an officer to criminal liability for violation of Rule 13b2-2 if the representation letter is false and the government can prove that the officer had the requisite mens rea.

In United States v. Goyal, the Ninth Circuit reversed the conviction of the CFO at Network Associates, Inc. (“NAI”), a conviction based in part on an asserted

Id. 474. See SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (“The speculators and chartists of Wall and Bay Streets are also ‘reasonable’ investors entitled to the same legal protection afforded conservative traders.”).

475. See ECA & Local 134 IBEW Joint Pension Trust of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 205–06 (2d Cir. 2009) (JP Morgan Chase’s “numerous misrepresentations regarding its ‘highly disciplined’ risk management and its standard-setting reputation for integrity” constituted “no more than ‘puffery’ which does not give rise to securities violations” because those statements were “too general to cause a reasonable investor to rely upon them”).


477. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, AU § 333.05, .06b, .16 (2011) [CODIFICATION OF AUDITING STANDARDS]. Auditor rules require similar representations from management when the auditor “reviews” quarterly (or, as the accountants call them “interim”) financial statements. Id. AU § 772.24.

478. Id. AU § 333.09 (and signature lines on the illustrative representation letter at AU § 333.16).
Rule 13b2-2 violation by alleged falsehoods in management representation letters. The government contended the representation letters falsely stated (i) the financial statements that NAI had prepared complied with GAAP and (ii) the company had disclosed to the auditor all sales terms. The prosecution focused on end-of-quarter sales that NAI had made to its largest distributor (Ingram Micro or “Ingram”)—sales that included discounts, rebates, and a guarantee that, if Ingram was unable to sell all the product that it bought, a NAI subsidiary would buy the excess back. The government argued that the NAI financial statements did not comply with GAAP because the accounting protocol NAI used to record revenue from the Ingram sales—sell-in accounting that recorded the revenue on shipment of product, reduced by estimates of rebates, discounts, and returns—could not be used because NAI could not reasonably estimate the rebates and returns, and establish proper reserves for them for purposes of reducing the revenue recorded on product shipment. The government contended that the NAI financials failed to conform to GAAP for the second reason that the NAI subsidiary’s commitment to repurchase the NAI product that Ingram could not sell amounted to a “significant obligation for future performance [by NAI] to directly bring about resale of the product” which would preclude reporting the revenue from the Ingram sales using sell-in accounting.

The Ninth Circuit held that, to convict the CFO, the government had to prove he “voluntarily made statements to [the auditor] that he knew were false.” With respect to the first asserted ground on which the government contended that NAI’s financial statements failed to conform to GAAP, the court of appeals held that the prosecution failed to present any evidence either that NAI’s reserves for rebates, discounts, and returns were inadequate or that NAI could not reasonably calculate the rebates, discounts, and returns related to the Ingram sales. While the government offered enough proof for a reasonable jury to find that the second reason the NAI financials did not comply with GAAP—that the repurchase promise on behalf of the NAI subsidiary was a “significant obligation for future performance [by NAI] to directly bring about resale of the product” which would preclude reporting the revenue from the Ingram sales using sell-in accounting.

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479. 629 F.3d 912, 912–14, 922 (9th Cir. 2011).
480. Id. at 916.
481. Id. at 914.
482. Id.
483. Id. at 917–18.
484. Id. at 917.
485. Id. at 916. Rule 13b2-2 does not, itself, contain any mens rea requirement. But section 13(b)(2) of the Exchange Act, under which the SEC adopted the rule, provides that “[n]o criminal liability shall be imposed” except on those who “knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account” that the statute requires. Goyal, 629 F.3d at 916 n.6 (quoting 15 U.S.C. § 78m(b)(4) & (5)). Moreover, the Ninth Circuit, like the Second (see infra note 536 and accompanying text), requires that—in order to convict under section 32(a) for a “willful” violation of a rule issued under the Exchange Act—the government must prove that a defendant took action that the defendant knew was wrong. Id. at 916 (citing United States v. Tarallo, 380 F.3d 1174, 1189 (9th Cir. 2004)).
486. Id. at 917–18.
performance to bring about resale” of the NAI product sold to Ingram, and that therefore NAI could not record the revenue from the Ingram sales using sell-in accounting—the government offered no evidence to show that the CFO understood NAI could not record the revenue given the repurchase obligation.\footnote{487. \textit{Id.} at 918–20.} In particular, the Ninth Circuit held that the government had not shown any “willful \[or\] knowing deception” by (i) the CFO’s “desire to meet NAI’s revenue targets, and his knowledge of and participation in deals to help make that happen”; (ii) his “presumed knowledge of GAAP as a qualified CFO”; and (iii) his “general financial incentive” resulting from “compensation . . . linked to NAI’s success,” with “half of his bonus . . . based on achieving corporate goals.”\footnote{488. \textit{Id.} at 919.} With this proof valueless for the purpose, “no evidence supported a finding that [the CFO] knew that [the NAI subsidiary’s] commitments to repurchase product Ingram could not sell rendered recognition of the revenue immediately on shipment to Ingram a GAAP violation.”\footnote{489. \textit{Id.} at 920.}

The prosecution also contended that the CFO violated Rule 13b2-2 in a criminally culpable way because the management representation letters falsely stated that NAI had “fully disclosed to [the auditor] all sales terms, including all rights of return or price adjustments, and all warranty provisions.”\footnote{490. \textit{Id.} at 920.} The CFO argued that such representations “were not false because [the auditor] had access to all ‘sales terms’ through Ingram’s debit memos,” while the government contended that the representations would only have been true if NAI had provided the auditor with the actual deal letters between NAI and Ingram.\footnote{491. \textit{Id.} at 920–21.} Regarding as “a close question” the dispute over whether the representation letters were false in stating that the company had revealed all sales terms, the Ninth Circuit nevertheless found that the government failed completely to prove that the CFO “willfully and knowingly misled [the auditor]” in this regard.\footnote{492. \textit{Id.} at 921.} On this issue as well, the court of appeals found invalid the government’s inferences of guilty knowledge from the CFO’s “accounting knowledge and participation in [the] transactions” and “his incentives to use the deals to meet NAI’s projected revenue.”\footnote{493. \textit{Id.}} Finally, the Ninth Circuit rejected the district court’s theory that the CFO “could be convicted of lying to [the auditor] because he ‘had an affirmative responsibility—as set forth in the management representation letters—to disclose’ the . . . letters” containing all deal terms.\footnote{494. \textit{Id.}} The court of appeals reasoned that this rule would “make[] a strict-liability crime out of one that requires willful and knowing deception.”\footnote{495. \textit{Id.} at 922.}
Significance and analysis. Goyal shows the peril of signing management representation letters. The representations in those letters are general and sweeping. If the government finds an accounting problem, it will almost certainly consider whether representation letters were false and, accordingly, whether the CEO or CFO or both violated Rule 13b2-2 by signing the letters. While the rule itself contains no mental state requirement, the statutes governing criminal prosecution for its violation require mental states developed in circuit court precedent. Interestingly, the Ninth Circuit this last year not only affirmed that the Department of Justice must prove knowing misrepresentation in order to obtain a criminal conviction based on Rule 13b2-2 but also held that the SEC, in order to pursue a CEO in a civil enforcement action under that rule, needed to show that the CEO “had knowledge that he was signing a false management representation letter.” Accordingly, the government must—in either a civil or criminal enforcement action—show that the officer charged with a Rule 13b2-2 violation knew that his or her statements in the representation letter were false.

The SEC has been quite aggressive in pursuing top management on representation letters. Indeed, while not restricting himself to cases based on such letters, Judge Kozinski in a concurring opinion characterized the Goyal prosecution as “just one of a string of recent cases in which courts have found that federal prosecutors overreached by trying to stretch criminal law beyond its proper bounds” in order to seek convictions based on conduct that does not display “clear evidence of wrongdoing” deserving moral condemnation.

496. An illustrative letter includes the representation that the financial statements offered for audit “are fairly presented in conformity with accounting principles generally accepted in the United States of America” and that the issuer has “made available” to the auditor “all . . . [financial records and related data.” CODIFICATION OF AUDITING STANDARDS, supra note 477, AU § 333.16. But note that the illustrative letter qualifies the representations as being “to the best of [the signatories’] knowledge and belief.” Id.

497. See supra note 485.

498. SEC v. Todd, 642 F.3d 1207, 1224 (9th Cir. 2011) (affirming summary judgment for the officer because the SEC produced no evidence of such knowledge).

499. Goyal, 629 F.3d at 922 (Kozinski, J., concurring). The Ninth Circuit reversed not only the CFO’s conviction on the Rule 13b2-2 counts but also his conviction on counts charging him with a criminal violation of Exchange Act section 10(b) and with making false filings with the SEC. Id. at 915, 922. Those counts rested on the allegation that the revenue numbers in NAI’s financial statements were inflated by including sales to Ingram. Id. at 915–16. The Ninth Circuit held that the government’s proof on those counts failed to supply evidence that would have permitted a jury to find materiality. Id. at 915. To establish that element, the prosecution relied entirely on stipulations that—had NAI employed “sell-through accounting” (under which the company would have recorded revenue only after netting out the actual discounts, rebates, and returns available on the sales) instead of “sell-in accounting” (under which the company recorded revenue on shipment reduced by estimated discounts, rebates, and returns)—that alternative accounting treatment would have “resulted in a revenue figure that is materially less than the reported figure” in each of the relevant financial periods. Id. at 915 & n.5. The Ninth Circuit found all the stipulations inadequate because they were not specific to the Ingram sales, which were the transactions as to which the government offered proof that sell-in accounting was improper. Id. at 915. Since “non-Ingram sales always accounted for most of NAI’s revenues,” “[i]t would have been mere speculation, rather than reasonable inference, for the jury to conclude that applying sell-through accounting to the revenue from the Ingram sales by themselves would have made a material difference in the company’s total revenue figure.” Id. at 916 (internal quotation marks and citation omitted).
Sentencing guidelines. In a case in which a jury convicted two defendants of conspiracy, securities fraud, wire fraud, tax evasion, and money laundering, the Ninth Circuit affirmed one defendant’s ninety-month sentence against a challenge that the sentence was “substantively unreasonable.” Observing that appellate review for substantive unreasonableness requires “consider[ation of] the ‘totality of the circumstances,’ including the degree of variance for a sentence imposed outside of the Guidelines range,” the Ninth Circuit found no reversible sentencing error in part because the term imposed fell “significantly below the Guidelines range of 324 to 405 months.”

In United States v. Wetherald, the Eleventh Circuit considered whether a sentence should be vacated because the district court employed a version of the Federal Sentencing Guidelines effective at the time of sentencing that recommended harsher penalties than the version effective at the time the defendant committed his or her crime. The 2002 Guidelines (in effect at the time of the crimes) recommended imprisonment for 151–188 months for each of the three defendants, while the 2008 Guidelines (in effect at sentencing) recommended imprisonment for 210–262 months. The district court sentenced the defendants—who had been convicted of securities fraud, wire fraud, and in two instances mail fraud and money laundering—to 168, 144, and 108 months. The Eleventh Circuit held that the trial court “should have applied the more lenient Guidelines sentence in effect at the time of the Appellants’ offense.” Noting the split among the circuits on whether use of time-of-sentencing Guidelines violates the Ex Post Facto Clause of the U.S. Constitution, the Eleventh Circuit held that use of later Guidelines with longer sentence ranges violates that clause only if such use “results in a substantial risk of harsher punishment.”

The court reasoned that, even though the Guidelines are only advisory, they still have considerable “force.” They provide the “starting point or “anchor”

500. United States v. Jenkins, 633 F.3d 788 (9th Cir. 2011), cert. denied, 132 S. Ct. 257 (2011); see supra notes 184–94 and accompanying text for additional holdings from Jenkins.
501. Jenkins, 633 F.3d at 809.
502. Id.
504. Id. at 1323.
505. Id. at 1318.
506. Id. at 1319–20.
507. Id. at 1323.
508. Id. at 1320–21.
509. Id. at 1322.
510. Id. at 1321 (“It is true that the Guidelines are no longer mandatory . . . .”); see United States v. Booker, 543 U.S. 220, 246 (2005).
511. Wetherald, 636 F.3d at 1321.
for judges” imposing sentences.512 An appellate court may “presume the reason-
ableness of a sentence that reflects the district court’s proper application of the
Sentencing Guidelines.”513 And “once a sentencing judge correctly applies the
Guidelines range, the defendant’s relief is greatly limited.”514 Accordingly, despite
their nonbinding nature, “the application of the correct Guidelines range is of
critical importance, and it cannot be said that the Ex Post Facto Clause is never
implicated when a more recent, harsher, set of Guidelines is employed.”515 Here,
however, the district court judge had (i) sentenced none of the defendants within
the higher range recommended by the version of the Guidelines in effect at the
time of sentencing; (ii) sentenced only one within the range of the older, more
lenient version; (iii) sentenced the other two to terms below that older, more
lenient range; and (iv) “explicitly stated that he was aware of the conflict between
the [two versions of the] Guidelines and that although he applied the more recent
version, he believed the totality of the circumstances called for a significantly
lower sentence.”516 Accordingly, there was “no evidence that these sentences were
affected by the district court’s reference to the 2008 Guidelines,” no “substantial
risk of [a] harsher punishment” by use of that later and harsher version, and there-
fore no violation of the Ex Post Facto Clause.517

Significance and analysis. Section 905 of the Sarbanes-Oxley Act required the
United States Sentencing Commission to “review and, as appropriate, amend
the Federal Sentencing Guidelines” in order to, among other things, “reflect . . .
the growing incidence of serious fraud offenses” and to “consider the extent to
which . . . the guideline offense levels and enhancements . . . are sufficient to deter
and punish such offenses.”518 The offense levels for white collar crimes have in-
creased since the passage of that law.519 The offense levels, and hence the length of
recommended imprisonment, could increase still more. Even though not manda-
tory, the Guidelines are very, very important to sentencing outcome.520 Where the
Guidelines in force at the time of the offense are more lenient than those in effect at
sentencing, defense lawyers should always argue that the older Guidelines should
be used.521

512. Id. (quoting United States v. Turner, 548 F.3d 1094, 1099 (D.C. Cir. 2008)).
513. Id. (citing Rita v. United States, 551 U.S. 338, 347 (2007)).
514. Id. at 1322; see also supra notes 500–02 and accompanying text (summarizing Jenkins).
515. Wetherald, 636 F.3d at 1322.
516. Id. at 1323–24.
517. Id. at 1324.
519. See U.S. SENTENCING GUIDELINES MANUAL app. C, amend. 653 (2011) (setting out changes effective
in November 2003, and explaining in the “Reason for Amendment” that the changes responded to the
Sarbanes-Oxley prompt).
520. In the fourth quarter of fiscal 2011, over 80 percent of all sentences were either within the
Guideline recommended range or outside the range as a result of a government-sponsored below-
521. Not all circuits agree with Wetherald. For example, the Seventh Circuit holds that use of a
post-violation version of the Guidelines does not violate the Ex Post Facto Clause at all because that
clause “applies only to laws and regulations that are binding.” United States v. Robertson, 662 F.3d
871, 875 (7th Cir. 2011).
No knowledge/no imprisonment clause in Exchange Act section defining criminal offense. Exchange Act section 32(a) provides criminal penalties for willful violations of that act and rules and regulations adopted pursuant to that act. After setting out severe penalties, including imprisonment, the last clause of section 32(a) states that “no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation” (the “no knowledge/no imprisonment clause”). The Eighth Circuit interpreted this provision last year in United States v. Behrens. The defendant pled guilty to one count of criminal violation of Exchange Act section 10(b) and related Rule 10b-5, but the district court sentenced him to sixty months’ imprisonment after ruling that, as a matter of law, he could not raise the no knowledge/no imprisonment clause because it is “inapplicable to people convicted of violating criminal securities laws.”

Vacating the sentence, the Eighth Circuit pointed out that, while the clause is limited to sentencing for violations of “any rule or regulation” and accordingly is not applicable to violations of the sections in the statute, the defendant here was necessarily convicted of violating a “rule” because the statute—section 10(b)—simply forbids purchasing and selling by manipulation or deception “in contravention of such rules and regulations as the Commission may prescribe.” Accordingly, the defendant could not violate section 10(b) unless he violated a rule or regulation—here Rule 10b-5.

The court of appeals also rejected the trial court ruling that “Congress did not intend [for] the protection of the [no knowledge/no imprisonment] clause [to] extend to persons who were charged with knowing their conduct to be in violation of law.” That view—based on the United States v. Knueppel opinion—would restrict application of the no knowledge/no imprisonment clause to cases involving “mere technical violation[s] of an SEC rule or regulation.” The Eighth Circuit found “no support in the text” for limiting the use of that clause to cases in which the defendant committed only a “technical” violation. Observing that a defendant has the burden of proving “no knowledge,” the

523. Id.
524. 644 F.3d 754 (8th Cir. 2011).
525. Id. at 755 (emphasis added).
526. Id. at 757.
527. Id. at 755 (quoting 15 U.S.C. § 78(b) (emphasis added)).
528. Id. (“The plain language of the statute is clear: § 78(b) makes the violation of [an SEC] rule or regulation an element of the offense. To violate the statute, Behrens must have violated an SEC rule or regulation.”).
529. Id. at 756–57 (some internal quotation marks omitted).
530. Id. (citing United States v. Knueppel, 293 F. Supp. 2d 199 (E.D.N.Y. 2003)).
531. Id. at 757 (citing Knueppel, 293 F. Supp. 2d at 204).
532. Id. at 757.
533. Id. at 755 (citing and quoting United States v. Reyes, 577 F.3d 1069, 1079 (9th Cir. 2009)).
court remanded so that the district court could determine whether the defendant carried that burden here. 534

Significance and analysis. The no knowledge/no imprisonment clause presents a puzzle. To be convicted under section 32(a), a defendant must have either (i) “willfully violate[d]” a “provision of [the Exchange Act], or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of [that act]”; or (ii) “willfully and knowingly ma[d]e[, or cause[d] to be made, any statement,” which was “false or misleading with respect to any material fact,” “in any application, report, or document required to be filed [(a)] under [the Exchange Act] or any rule or regulation thereunder . . . or [(b)] in connection with an application for membership or participation therein or to become associated with a member thereof.” 535 In order to have acted “willfully,” the defendant has to have known that his or her action was morally wrong—whether or not the defendant also knew that the action violated the law. 536 The Knueppel interpretation therefore seems strange. If the no knowledge/no imprisonment clause were limited to instances in which a defendant had committed a “mere technical violation,” it is hard to see how any defendant convicted under section 32(a) could prove “no knowledge” because, in order for the defendant to be found guilty, he or she would have to have known that the violating conduct was morally wrong—which would not be true if the violation were “merely technical.” 537

PSLRA Pleading: Where pleadings did not allege the defendants thought that a change in Japanese regulation would have a material effect on their business results, the

534. Id. at 757. The Eighth Circuit does not address just what the defendant must prove he or she did not know. The best reading of the no knowledge/no imprisonment clause is that a defendant cannot be imprisoned if he or she did not know that the violating conduct was contrary to any SEC rule or regulation. It should not be enough that the defendant did not know of the particular rule or regulation that the conduct violated—e.g., Rule 10b-5—as that would permit a great number of defendants to escape prison, no matter how culpable, and would provide an incentive to avoid learning the securities rules.


536. See, e.g., United States v. Kaiser, 609 F.3d 556, 569 (2d Cir. 2010); see also supra note 485.

537. In one other opinion in a criminal case, the Ninth Circuit unsurprisingly held that the government had presented sufficient evidence of materiality to support a guilty verdict where the prosecution provided proof that an options backdating scheme “affected [the issuer’s] reported earnings . . . by almost $1 billion between 2000 and 2004” and that, as a result of the scheme, the company “report[ed] profits in 2001 and 2002 when it should have reported losses, and underreport[ed] losses by almost $500 million in 2003 and 2004.” United States v. Reyes, 660 F.3d 454, 469 (9th Cir. 2011), cert. denied, 80 U.S.L.W. 3510 (U.S. Mar. 19, 2012) (No. 11-1003). The prosecution had also presented testimony of “two actual . . . investors” in the issuer that “they cared about accurately stated earnings.” Id. Although the “investors’ testimony [was] not specific to [the accounting rule requiring that companies record expenses when granting in-the-money options] . . . , it [was] sufficient to help establish materiality in this case because investors care about earnings.” Id. at 470.

In addition, the prosecutors in Reyes introduced the testimony of “a lawyer who supervised proxy voting for Fidelity Investments,” who stated that “Fidelity’s policy was to vote against company plans that allow in-the-money options because it costs the company more money and can affect shareholder returns.” Id. at 469–70. While that testimony related to voting rather than buying or selling, the witness sufficiently related voting to earnings to count his testimony as supporting materiality. Id. at 469.
plaintiffs failed to adequately allege scienter in failing to disclose the regulatory change; holistic review of allegations drove analysis of top executives’ scienter at failing company; allegations were insufficient to raise a strong inference that executive officers acted with scienter in describing loan as “non-recourse”; allegations that defendants failed to make a contractually required disclosure supported the required inference of scienter; plaintiffs failed to adequately allege scienter for failure to disclose wrongdoing by third parties that generated deceptive revenue for the issuer and decreased the value of the service that the issuer provided; no entity or individual scienter was alleged where the complaint did not link guilty knowledge to the defendants making the challenged statements.

The PSLRA538 requires that, when pleading a securities lawsuit under the Exchange Act, “the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.”539 The PSLRA also requires that, where a private Rule 10b-5 plaintiff seeks a monetary recovery, “the complaint shall, with respect to each act or omission alleged to violate [the Exchange Act], state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind,”540 which is scienter in such a case.541 Scienter “refers to a mental state embracing intent to deceive, manipulate, or defraud”542 and also includes severe recklessness, characterized most frequently as conduct “involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the [defendant] must have been aware of it.”543 The Supreme Court has held that, to determine whether a plaintiff satisfies the scienter pleading standard, a court must consider allegations in a complaint, together with judicially noticeable material, and determine whether—taken together and examining both pejorative and benign inferences from all of them—the allegations and noticed facts raise an inference of scienter that is “cogent and at least as compelling as any opposing inference of nonfraudulent intent.”544

Last year, the First Circuit related materiality to scienter in applying these rules to find a complaint deficient where it alleged that the defendants knew of a change in Japanese water testing regulations that could affect company sales but did not allege that defendants expected that change to materially affect worldwide

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542. Id. at 194 n.12.
543. Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044–45 (7th Cir. 1977); see also 8 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3689 n.549 (3d ed. rev. 2004).
The Sixth Circuit relied on a holistic analysis to find scienter allegations sufficient, even though the allegations individually were largely quite general. The Eleventh Circuit applied the PSLRA pleading rules to affirm dismissal in a case in which the defendants allegedly misrepresented the non-recourse status of a debt. The Ninth Circuit found scienter adequately alleged in a case, in part because the defendants assertedly failed to make a contractually required disclosure. The Eleventh Circuit held insufficient allegations that defendants acted with scienter in failing to disclose that third parties with whom the issuer dealt were engaging in “click fraud” that generated deceptive revenue for the issuer and, over the long term, diminished the value of the service that the issuer sold. The Third Circuit affirmed dismissal of a complaint that did not link guilty knowledge with the defendant entities and individuals who made the challenged statements.

**Failure to disclose change in foreign regulations.** In *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Waters Corp.*, the First Circuit wove together materiality and scienter in affirming a trial court dismissal of a Rule 10b-5 action brought against a company that produced water testing equipment and also against its executives. The plaintiff alleged that the defendants learned, in March 2007, that the Japanese government had relaxed regulations that created demand in that country for Waters Corporation’s (“Waters”) products. When the defendants announced second quarter results in July, the CEO said that the first half results were “very encouraging” and that the company’s “prospects continue to look very positive.” Without referring specifically to the change in Japanese rules, he added that “the company was ‘seeing some finalization of investments in places like Japan, where the drinking water regulations . . . spurred a great deal of investment . . . up through 2006’ and that the company was ‘seeing that begin to tail itself off.’” When the company announced third quarter results that topped Waters’ forecast, the CEO acknowledged “‘some softness in [Japanese] demand,’” which the CEO attributed to “‘general economic conditions’” in the course of observing that “‘our competitive position in Japan remains strong and . . . our sales there are likely to pick up.’” When providing fourth quarter results—on January 22, 2008—the company, through the CEO, acknowledged that “‘our sales in Japan were weaker than anticipated due to a combination of a sluggish economic

545. See infra notes 551–68 and accompanying text.
546. See infra notes 569–79 and accompanying text.
547. See infra notes 580–90 and accompanying text.
548. See infra notes 591–620 and accompanying text.
549. See infra notes 621–33 and accompanying text.
550. See infra notes 634–40 and accompanying text.
551. 632 F.3d 751 (1st Cir. 2011).
552. Id. at 753, 762.
553. Id. at 754.
554. Id.
555. Id.
556. Id. at 755 (emphasis omitted).
condition and a change in the testing protocols for drinking water analysis in Japan.”

Addressing the plaintiff’s charge that the defendants had violated Rule 10b-5 by failing to disclose—during the period from and including the announcement of the Q2 2007 results to January 22, 2008—both the change in Japanese regulations and that the change would cause a decline in Waters’ sales in that country, the First Circuit observed that “[t]he question of whether a plaintiff has pled facts supporting a strong inference of scienter has an obvious connection to the question of the extent to which the omitted information is material.” That is so, the court reasoned, because “[i]f it is questionable whether a fact is material or its materiality is marginal, that tends to undercut the argument that defendants acted with the requisite intent or extreme recklessness in not disclosing the fact.” Here, there was no question that the defendants knew of the regulatory change, but there was a question “whether defendants knew or should have known that their failure to disclose [the change] ‘present[ed] a danger of misleading buyers or sellers.’” In this case, “the inference of a nonculpable explanation for the lack of disclosure is much stronger than the inference of scienter . . . as defendants reasonably did not expect that the change in Japanese drinking water testing regulations would itself have a significant impact on Waters’ overall worldwide sales during 2007, such as to require disclosure.”

Waters’ third and fourth quarter global sales beat the company’s projections, and the full-year 2007 sales reached an all-time annual high. Thus, nothing the defendants said about Japan during the period of the alleged fraud was “inconsistent with the forecasted increase in overall sales.” Moreover, while the defendants stated after the fact that the change in Japanese regulations contributed to a 12 percent sales decline in that country during the fourth quarter of 2007, “it is far from evident what fraction of this decline was predictably due to the regulatory change itself.” And Japanese sales did, in fact, rebound—as defendants had predicted—in 2008. For all these reasons, the court apparently reasoned, the defendants might well have failed to understand that the change in Japanese regulations was material, which in turn suggested that the defendants did not act with scienter in failing to disclose the change. Finally, the share price drop after the

557. Id. at 756 (emphasis omitted).
558. Id.
559. Id. at 753.
560. Id. at 757.
561. Id. (citation omitted).
562. Id. at 758 (quoting Greebel v. FTP Software, Inc., 194 F.3d 185, 198 (1st Cir. 1999)).
563. Id. at 758–59.
564. Id. at 759.
565. Id.
566. Id.
567. Id. The court also rejected the plaintiff’s argument that the defendants’ stock sales raised a strong inference of scienter. Id. at 754. Holding that the options Waters’ officers held and could
defendants’ last statement—which acknowledged the contribution of regulatory change to the decline in Japan-originated revenue—may have been caused by reported earnings that fell below expectations (a decline caused by higher costs and expenses) rather than any change in total revenue, and so may have been unrelated to the plaintiff’s case. 568

Significance and analysis. In today’s world, changes in government regulations can affect business results, and companies often sell in many venues, each of which may have its own regulatory scheme. Disclosure of rule changes in multiple countries, and their possible impact on financial results, accordingly presents a significant problem. At the least, Waters suggests that Rule 10b-5 liability for failure to disclose a government rule change that might hurt business can be cabined to those cases in which a company’s executive cadre both knows of the change and either actually predicts that the change will materially affect results or, possibly, is severely reckless in failing to predict such an effect. More generally, Waters emphasizes that the defense in some sense gets two bites at the materiality apple. The defense can contend that the omitted fact was not material, in an objective sense, and win if the court or a jury accepts that argument. But even if the defense loses on objective materiality, it can maintain that, because the individuals involved did not subjectively believe that the omitted fact was material, they had no scienter in failing to reveal that fact.

Holistic consideration of scienter allegations. When it interpreted the special PSLRA pleading requirements, the Supreme Court held that “courts must consider the complaint in its entirety” because “[t]he inquiry . . . is whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard.” 569 The Sixth Circuit applied that principle in Frank v. Dana Corp. 570 The plaintiffs alleged that the CEO and CFO of an auto parts manufacturer violated Rule 10b-5 by making have sold should be considered in computing the percentage of shares that they sold, the First Circuit found that the CEO’s sales during the fraud period did not raise a scienter inference because he (i) sold only 4.82 percent of the stock he could have sold, and (ii) sold only during the third quarter at about $63/share, which was but 10 percent above the $58.58 to which the stock price dropped after the company announced the fourth quarter results and was far below the $80.77 that constituted the class period high. Id. at 760–61. Although the CFO had sold 7 percent of the stock he could have sold during the third quarter of 2007 and 22 percent of the remainder during the fourth quarter, and while these percentages—and the fact that he sold some shares near the fraud period high—could suggest scienter, the plaintiff “failed to allege any facts that these sales were unusual” because the “complaint provided no information about [the CFO’s] trading history.” Id. at 761. As the court reasoned: “Trading histories are not a sine qua non of an allegation of unusual insider trading. Some trades may, from the face of things, be unusual. But [the CFO’s] trades do not fit into this category, and no context is provided.” Id.

568. Id. at 760. The court was unimpressed with the fact that the CEO, in the analyst call at the end of the alleged fraud, said that “he needed to ‘take a little bit of the blame’ ” because “[we] knew that the slope wasn’t going to be as strong forever in these applications, but the downturn came much faster than we anticipated.” Id. at 756 (emphasis omitted). This admission “that [the defendants] should have caught the trend earlier and that it might well have been more prudent for them to have disclosed the change in the Japanese regulations sooner” did not show scienter. Id. at 760.

positive, optimistic statements about the company’s profitability and growth while its drive shaft division was losing money, its light axle division was also suffering, and the company’s largest cost—the cost of steel—increased by 75 to 120 percent.\footnote{Id. at 957.} Reversing the trial court’s dismissal of the case,\footnote{Id. at 964.} the court of appeals first walked through the individual allegations from which the plaintiffs sought a strong scienter inference.\footnote{Id. at 959–61.} But the Sixth Circuit described many of these in terms that provided very few specifics relevant to the CEO and CFO’s knowledge. For example, while the court referred to some internal “tracker” reports that “showed that some of [the company’s] factories were not meeting their budgets”—with some of those reports “falsified” by “factory-level accountants” and those reports then “consolidated into ‘production reports’ . . . [that] were the subject of weekly meetings conducted by [the CFO]”—the court did not report that the complaint alleged the contents of any particular report that supposedly reached the CEO or CFO, or that those executives knew that any of the reports were falsified.\footnote{Id. at 959.} As another example, the court pointed to the Sarbanes-Oxley Act (“SOX”) certificates that the two officers signed in connection with the company’s SEC filings, without identifying any facts that raised any inference that the officers were reckless in signing those certificates or had signed them fraudulently.\footnote{Frank, 646 F.3d. at 961.} A slew of courts (including the Sixth Circuit) have held that SOX certificates, by themselves, do not suggest scienter, even if signed by executives at companies that, as it came out later, included false financial figures in the reports to which the certifications were attached. See, e.g., \textit{In re Skecher U.S.A., Inc. Sec. Litig.}, 273 F. App’x 626, 627 (9th Cir. 2008) (court of appeals not swayed by the complaint’s reference to “weekly updated projections of booked and expected sales” as a basis for knowledge that the projections were fraudulent, as the complaint “fail[ed] to describe with any detail the contents of these interim reports”); see also \textit{infra} note 624.

\footnote{Id. at 959. The court similarly referred to “quarterly ‘SAD reports’ [that] showed the variances in the projected and actual performances of [the company’s] factories”—again without identifying any of the particular variances that the two named officers saw: \textit{Id. at 960. Courts have, in the past, found such allegations insufficient for scienter pleading. See, e.g., In re Skecher U.S.A., Inc. Sec. Litig., 273 F. App’x 626, 627 (9th Cir. 2008) (court of appeals not swayed by the complaint’s reference to ‘weekly updated projections of booked and expected sales’ as a basis for knowledge that the projections were fraudulent, as the complaint ‘fail[ed] to describe with any detail the contents of these interim reports’); see also \textit{infra} note 624.

575. \textit{Frank}, 646 F.3d. at 961. A slew of courts (including the Sixth Circuit) have held that SOX certificates, by themselves, do not suggest scienter, even if signed by executives at companies that, as it came out later, included false financial figures in the reports to which the certifications were attached. See, e.g., \textit{Ley v. Visteon}, 543 F.3d 801, 812 (6th Cir. 2008) (plaintiffs’ reliance on SOX certifications that the company’s CEO and CFO filed with periodic reports containing financial numbers raised no inference of scienter because the plaintiffs alleged no “facts to suggest that [the CEO] or [CFO] had reason to know or should have suspected accounting irregularities or other ‘red flags’ at the time they signed the certifications’); \textit{In re Ceridian Corp. Sec. Litig.}, 542 F.3d 240, 248 (8th Cir. 2008) (rejecting the argument that signatures on SOX certifications supplied scienter because “[a]llegations that accounting errors were discovered months and years later do not give rise to a strong inference that the certifications were knowingly false when made,” and the complaint “fail[ed] to allege specific facts giving rise to an inference that [the individual defendants] knew in May 2003 [when they signed certifications] that Ceridian’s internal accounting controls were deficient”); \textit{Glazer Capital Mgmt., LP v. Magistri}, 549 F.3d 736, 747 (9th Cir. 2008) (a “Sarbanes-Oxley certification is only probative of scienter if the person signing the certification was severely reckless in certifying the accuracy of the financial statements” (internal quotation marks and citation omitted)); \textit{Mizzaro v. Home Depot, Inc.}, 544 F.3d 1230, 1252 (11th Cir. 2008) (SOX certifications could only support scienter if the signatory officers were at least reckless, as by signing despite “red flags” indicating that the company’s accounting was wrong).}
and its collapse at the end of the alleged fraud—(i) it was just as likely the two top officers “recklessly ignored the falsity of their external statements” as that “failed accounting systems [were] to blame” for their comments and (ii) it seemed unlikely that the officers did not know that the company was failing.\textsuperscript{577}

Significance and analysis. The \textit{Frank} decision seems to endorse loose analysis of individual scienter allegations, followed by a holistic summation of inadequate allegations that somehow concludes that a complaint provides a satisfactory pastiche. The Sixth Circuit would have done better to follow the Ninth and Seventh Circuits, which have held that in the rare and extreme case where executive statements are miles away from corporate reality, a court may infer scienter from those facts alone—without a careful parsing of allegations particular to each executive’s knowledge.\textsuperscript{578} Perhaps this is what the Sixth Circuit meant by its observation, “[i]t is difficult to grasp the thought that [the CEO] and [the CFO] really had no idea that [the company] was on the road to bankruptcy.”\textsuperscript{579} But it would have been helpful for the court to emphasize that this will be the rare case. Otherwise, \textit{Frank}’s “holistic” analysis may invite lower courts to rely on a kind of Op-Ed overview that guts the requirement that plaintiffs allege specific facts to raise a strong inference each defendant acted with scienter.

\textsuperscript{576} The company (i) on September 15, 2005, cut projected earnings by half and announced a likely restatement; (ii) on October 10 stated that investors should not rely on prior published financials; on December 30 restated financial numbers for Q1 and Q2 2005, with the restated numbers reducing profit in those quarters by $44 million; and (iii) on January 17, 2006, reported a Q3 2005 loss, of more than $1 billion, together with a write down of more than $900 million—all before defaulting on debt and filing for bankruptcy on March 3, 2006. \textit{Frank}, 646 F.3d at 957–58.

\textsuperscript{577} Here is the key passage:

\begin{quote}
We conclude that Plaintiffs have adequately pleaded a strong inference of scienter when viewing the factors holistically. [The CEO] and [the CFO] ask us to infer that failed accounting systems are to blame here, and we find that inference plausible. However, the inference that [the CEO] and [the CFO] recklessly ignored the falsity of their external statements is at least as plausible as the faulty accounting inference. [The CEO] and [the CFO] were the top two executives of an auto parts manufacturer, and they reported gangbuster earnings during a period of time when the entire auto industry was spiraling toward bankruptcy. They filed these reports, made positive public statements, and asserted the veracity of their financials to government authorities all while one of their key product lines was operating at fifty percent of earnings, multiple factories failed to meet their budgets, and the price of steel rose seventy-five to 120 percent. It is difficult to grasp the thought that [the CEO] and [the CFO] really had no idea that Dana was on the road to bankruptcy. From the first public statement that Dana’s earnings statements might be false, the company fell to its demise in a matter of . . . months.
\end{quote}

\textit{Id.} at 961–62. In addition to the holding set out in the text, the Sixth Circuit ruled that the plaintiffs pled the company’s scienter by pleading the scienter of two top executives. \textit{Id.} at 963.

\textsuperscript{578} See Makor Issues \& Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702, 710 (7th Cir. 2008) (if “General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero,” then “[t]here would be a strong inference of corporate scienter, since so dramatic an announcement would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false”); South Ferry LP, \#2 v. Killinger, 542 F.3d 776, 786 (9th Cir. 2008) (allegations that top management knew of deterioration in core operations “may conceivably satisfy the PSLRA standard in a . . . bare form, without accompanying particularized allegations, in rare circumstances where the nature of the relevant fact is of such prominence that it would be ‘absurd’ to suggest that management was without knowledge of the matter”).

\textsuperscript{579} \textit{Frank}, 646 F.3d at 962.
Allegedly false statement of legal conclusion. In *Durgin v. Mon*, the Eleventh Circuit considered scienter for an allegedly misleading legal description of a loan agreement. The issuer entered into a joint venture with a second company that, in turn, entered into a debt-financed acquisition of homebuilding assets. The lenders required that the issuer, in the words of the Eleventh Circuit, “guarantee it would complete certain [joint venture] construction projects should the [joint venture] default on the loan and reimburse the Lenders for losses arising from fraud, intentional misconduct, waste and misappropriation, or voluntary bankruptcy filed by any party.” The issuer described its obligation on the debt—in press releases, SEC filings, and analyst calls—as “non-recourse.” After the lenders demanded payment on the guarantee and the issuer publicly contested its liability for such payment, the price of the issuer’s stock fell, and investors filed a Rule 10b-5 action against the issuer’s executives, claiming that the “non-recourse” characterization was false and fraudulent. The court of appeals affirmed dismissal of the claim against the executives because the complaint contained “no allegations they: did not reasonably believe the [joint venture] loan was ‘non-recourse’ to [the issuer]; ever told anyone or questioned whether the loan was not ‘non-recourse’; ever read the guarantees, much less believed they required more extensive disclosure; thought any person at [the issuer] was engaging in fraud; or had any reason to believe the guarantees represented a material risk for [the issuer] and its investors.” As the Eleventh Circuit concluded, “even if the loan was not ‘non-recourse’ . . . , the . . . complaint fails to allege defendants knew that.” The court rejected the argument that, because the amount guaranteed equaled 70 percent of the issuer’s assets and because the executives had been involved in the formation of the joint venture and its funding, they were at least reckless in characterizing the guarantee as “non-recourse.” The court held that “it was not ‘highly unreasonable’ or an ‘extreme departure from the standards of ordinary care’ to describe the loan as non-recourse” since “more was required [to trigger the reimbursement guarantee] than non-payment by the [joint venture]”—with that “more” being “losses arising from fraud, intentional misconduct, or waste and misappropriation; or voluntary bankruptcy filed by any party.” As to recklessness, “[e]ven if the loan was not properly characterized as ‘non-recourse,’” the inference that the defendants had been “severely reckless” by that description was “not     

580. 415 F. App’x 161, 163 (11th Cir. 2011).
581. *Id.* at 162.
582. *Id.* at 162–63.
583. *Id.* at 163.
584. *Id.* at 163–65.
585. *Id.* at 167.
586. *Id.* at 165.
587. *Id.*
588. *Id.* at 166–67.
589. *Id.*
as compelling as an inference that, at worst, defendants acted with inexcusable negligence," which is not enough for scienter. 590

Significance and analysis. Durgin addresses the infrequent case in which plaintiffs accuse lay defendants of misleading by a false legal characterization. The decision affirms that the special PSLRA scienter pleading rules apply to allegations that such characterizations were fraudulent.

Scienter inferred in part from failure to make contractually obligated disclosure. The year 2011 produced a relatively rare PSLRA pleading case in the private company setting—WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc. 591 WPP bought stock in Spot Runner, a private company, in a deal including a Right of First Refusal (“ROFR”) and Co-Sale Agreement (i) providing Spot Runner with a ROFR if the Spot Runner founders sought to sell their stock 592 and, if Spot Runner declined, providing WPP and two other sets of investors (referred to in the opinion as “Battery” and “Index”) 593 with a ROFR and (ii) further providing WPP, Battery, and Index with a right to sell their own shares pro-rata into any sale of Spot Runner stock by the founders (the “Co-Sale” right). 594 The ROFR/Co-Sale required that the founders provide notice to Spot Runner, WPP, Battery, and Index before selling any shares that the founders owned. 595 The agreement also provided that the WPP, Battery, and Index rights could be waived by “sixty percent of investor shares ‘voting together.’” 596 But the agreement added that “‘prior to consummating any sale,’” the founders “shall provide[] each Investor with written evidence” that the ROFR/Co-Sale rights had been “‘met or waived.’” 597

In May 2007, Spot Runner sold shares in a primary offering, with WPP buying some of those shares. 598 Two founders were selling some of their stock in a secondary sale at the same time. 599 Spot Runner advised WPP that an institutional investor wanted to buy stock in a secondary market transaction, and Spot Runner sent WPP an “Indication of Interest and Waiver” form to document any interest that WPP might have in selling in the secondary deal and to waive the ROFR/Co-Sale rights respecting the secondary transaction. 600 WPP told Spot Runner that WPP would buy in the primary offering in order to maintain its percentage ownership interest. 601 Starting “a new email chain . . . with the subject line ‘WPP Share Purchase,’” WPP then asked Spot Runner’s general counsel (who was also

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590. Id. at 167.
592. Id. at 1045, 1049. The founders were also company executives. Id. at 1044.
593. Id. at 1049. “Battery” included Battery Ventures VI, L.P.; Battery Investment Partners VI, LLC; Battery Ventures VII, L.P.; and Battery Investment Partners VII, LLC. “Index” included Index Ventures III (Delaware) L.P. and Index Ventures III Parallel Entrepreneur Fund (Jersey) L.P. Id. at 1044–45.
594. Id. at 1045, 1049.
595. Id.
596. Id. at 1049 (quoting agreement).
597. Id. (quoting agreement) (alterations in original).
598. Id. at 1045–46.
599. Id.
600. Id. at 1045.
601. Id. at 1046.
a defendant in this case) “whether there was ‘an existing investor and/or founder selling existing shares related to this offering,’” to which the general counsel responded that “[t]his offering does not involve the sale of any existing shares. It is an entirely new issuance by the Company.” 602 WPP thereafter apparently signed a waiver of its ROFR and Co-Sale rights in the secondary offering. 603 At the end of these communications, WPP bought Spot Runner shares in the primary offering while, “unbeknownst to WPP, [the founders], as well as Battery and Index, sold shares to the institutional investor in the secondary offering.” 604

WPP sued, charging among other things that the founders had violated Rule 10b-5(b) by failing to disclose their sale in the secondary transaction while WPP was buying in the primary offering. 605 Reversing the district court’s dismissal of this claim, 606 the Ninth Circuit first addressed whether the founders had a duty to disclose their sales, since a Rule 10b-5 omission claim depends not only on the materiality of the undisclosed facts (here undisputed by the parties) 607 but also on a duty to disclose. 608 The court held that, at least at the pleading stage, WPP put forward facts supporting such a duty, with the Ninth Circuit finding that duty in the founders’ obligation in the ROFR/Co-Sale contract to give prior notice of their sale to the investors and to provide evidence, before consummating any sale, that the investors’ rights of first refusal or co-sale had either been met or waived. 609 The defendants argued that, since Battery and Index had waived ROFR and Co-Sale rights in the May 2007 secondary offering, and since Battery and Index owned more than 60 percent of the stock holding those rights, their waiver sufficed to waive such rights for all investors, including WPP. 610 But the waiver provision referred to a 60 percent supermajority by the Investors “‘voting together,’” and WPP contended that this required a vote in which all investors participated, not just a “vote” accomplished by Battery and Index signing and submitting waiver forms. 611 The court found WPP’s analysis of the agreement “the far more natural

602. Id.
603. Id. The opinion states that WPP received a “waiver notice, saying that signing the form acknowledged that the rights of co-sale and first refusal under the ROFR/Co-Sale Agreement were being waived by and among the investors,” id. at 1045, then that “WPP . . . executed a waiver form declining to sell its own shares as part of the secondary offering,” id. at 1046.
604. Id. at 1046.
605. Id. at 1046–47.
606. Id. at 1054.
607. Id. at 1048 n.1.
608. Id. at 1048 ("Under Rule 10b-5(b), a defendant can be liable for the omission of material information if he or she has a duty to disclose that information." (citing Chiarella v. United States, 445 U.S. 222, 235 (1980))).
609. Id. at 1048–51, 1054.
610. Id. at 1049. It is hard to track just how WPP dealt with the circumstance that it had signed a waiver. Certainly, WPP argued that any waiver required a vote, rather than simply signing waivers. Id. WPP also argued that the language of the waiver form it signed never waived the right to receive written evidence that either the ROFR/Co-Sale rights were satisfied or had been waived. Id. at 1050. WPP may also have argued that it was induced to sign its waiver form by the fraud that WPP alleged and that therefore its waiver had no legal effect.
611. Id.
interpretation” and that, in any event, the argument that the Battery and Index waivers waived the ROFR and Co-Sale rights could not support the additional argument that those waivers extended to WPP’s right to receive from the founders evidence—prior to a founder sale—that either the ROFR and Co-Sale rights were satisfied or that they were waived.612 Moreover, under the applicable California law, the court had to interpret the agreement to give effect to the parties’ intention, which could be determined under the “somewhat ambiguous” provisions by parol evidence, so that the district court should not have decided the duty to disclose issue against WPP on a motion to dismiss.613

Moving to scienter, the Ninth Circuit held that the complaint “allege[d] facts creating a ‘strong inference’ of [the founders’] scienter.”614 The arguments on this issue largely echoed those on the duty to disclose, with the founders contending that they were relieved of the obligation to notify WPP of their impending sales in the secondary transaction because Battery and Index—holding more than 60 percent of the shares covered by the ROFR/Co-Sale agreement—had waived rights under that agreement not only for themselves but for WPP.615 Acknowledging that the founders presented a “plausible reading of the Agreement,” the court found that the “far more plausible reading . . . requires any waiver to occur only after all investors have an opportunity to vote” and that the entire waiver argument “completely disregards . . . [the] requirement that the Founders need to provide ‘each Investor with written evidence that [ROFR/Co-Sale] requirements have been met or waived prior to consummating any sale.’”616 The court was also influenced by WPP’s allegation that the founders had hidden Spot Runner’s poor financial performance, concluding that the efforts to hide that performance and to avoid disclosing the sales “bespeaks a guilty knowledge.”617

The Ninth Circuit, however, did affirm the district court’s dismissal of the Rule 10b-5(b) claim against Spot Runner’s general counsel based on his e-mail state-

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612. Id.
613. Id. at 1051.
614. Id. at 1052.
615. Id.
616. Id. at 1052–53 (quoting agreement).
617. Id. at 1053.

The Ninth Circuit further held that WPP adequately alleged loss causation. Id. at 1040. Since Spot Runner was privately held, WPP could not plead simply that revelation of the truth about the founders’ sale caused the market price of the company’s stock to fall. Id. In the private company setting, the court observed, “plaintiffs more commonly prove loss by showing that a misrepresentation or omission caused him or her to engage in a transaction and that the revelation of the truth is directly related to the economic loss alleged.” Id. at 1053. Here,

WPP alleges that Founders’ concealment of their own stock sales caused the loss. Specifically, WPP alleges that when Spot Runner revealed that the Founders had been secretly selling their shares (while still encouraging outside investment), the shares it owned in Spot Runner immediately became worthless. WPP alleges, quite plausibly, that no investor would be willing to purchase its shares after the Founders’ alleged “pump and dump” scheme became public knowledge. Although these allegations do not provide detailed share prices, the number of shares currently held, or whether attempts to sell the Spot Runner shares were made, the amended complaint includes a statement of loss causation sufficient to provide “some assurance that the theory has a basis in fact.” Id. at 1054 (citations omitted).
ment that “‘[t]his offering does not involve the sale of any existing shares.’” The court of appeals balanced the fact that (i) the general counsel was, in this e-mail, responding to an e-mail inquiry with the subject “WPP Share Purchase” after WPP had advised that it was buying in the primary sale, which suggested that the general counsel’s reply was limited to the primary sale and was therefore non-fraudulent, against the fact that (ii) the specific WPP question to which the general counsel was responding—whether “‘an existing investor and/or founder [was] selling existing shares related to this offering’”—seemed to refer to the secondary offering, which suggested that the general counsel’s reply was fraudulent. Weighing the competing inferences, the Ninth Circuit concluded that “[p]erhaps the most plausible explanation for the answer [in the attorney’s e-mail] was confusion, as [the general counsel] responded to an internally inconsistent e-mail with a response that suggests he was talking about the primary offering” and held that WPP had not adequately pled the general counsel’s scienter.

Significance and analysis. The WPP decision is important because it recognizes that the duty to disclose, which is an essential element of a Rule 10b-5 omissions case, can arise from a contract. As the decision shows, this is particularly important in the private company setting. WPP also demonstrates that the failure to comply with clear contract disclosure obligations can itself suggest scienter.

*Failure to disclose wrongdoing by third parties generating deceptive revenue and damaging issuer’s business.* In *FindWhat Investor Group v. FindWhat.com*, the Eleventh Circuit provided two holdings worth noting here. The plaintiffs brought a

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618. *Id.* at 1040, 1055.
619. *Id.* at 1046.
620. *Id.* at 1055.

The Ninth Circuit made one other ruling of note. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentalities of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit 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

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.


WPP had asserted, as an alternative to the theory that the founders and the general counsel were liable under Rule 10b-5(b) for false statements and omissions, the theory that the founders and the general counsel were liable under Rule 10b-5(a) and (c) by carrying out “‘a plan, scheme and course of conduct which was intended to and did deceive WPP into continuing to invest in and support [Spot Runner] by concealing from WPP that the Founders of the Company . . . were selling off their shares in large quantities.’” *Id.* at 1057. Holding that the district court properly dismissed the claim based on this theory, the Ninth Circuit ruled that “allegations underpinning a Rule 10b-5(b) omissions claim” cannot be “recast as [a] Rule 10b-5(a) or (c) scheme liability claim.” *Id.*

621. 658 F.3d 1282 (11th Cir. 2011), petition for cert. filed, 80 U.S.L.W. 3624 (U.S. Apr. 16, 2012) (No. 11-1250). This review describes the *FindWhat* case in more detail in the discussion of loss causation at infra notes 751–72 and accompanying text.
Rule 10b-5 action based on the issuer’s false statements and omissions concerning “click fraud” committed not by the issuer but by companies with which the issuer did business.\(^{622}\) That click fraud damaged the issuer’s ability to sell its ad-placement services to advertisers.\(^{623}\) The court of appeals affirmed the district court’s dismissal of the case, insofar as it was based on statements made in a Form 10-K filed on March 5, 2004, because “the Plaintiffs fail[ed] to allege any direct evidence that the Defendants knew about [the] click-fraud problems before [a] June 2004 meeting,” at which the defendants allegedly discussed terminating the issuer’s relationship with two companies allegedly committing click fraud, and “none of the Plaintiffs’ circumstantial allegations of knowledge relate to the time period before June 2004.”\(^{624}\)

In a second holding, the Eleventh Circuit found that a statement during a conference call—“by June [2004] revenue was increasing”—did not mislead, as the plaintiffs argued, because the speaker failed to add that the revenue included dollars generated by click fraud.\(^{625}\) The court held that “a general report about an actual increase in total revenue in the preceding month across the Company as a whole . . . conveyed no message regarding the underlying quality of . . . click

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\(^{622}\) FindWhat, 658 F.3d at 1291–94.

\(^{623}\) Id.

\(^{624}\) Id. at 1302. The Eleventh Circuit rejected as “wholly speculative” the plaintiffs’ argument that the later events the complaint recited showed an ongoing click-fraud problem of which the defendants were aware in March 2004, given that “there are no facts [alleged in the complaint], much less any that are pled with particularity, demonstrating that the Defendants had such knowledge a full three months” before the June 2004 meeting. Id.

The court also made a number of small points regarding the deficiency of scienter pleading as to the 10-K filed in March 2004. The plaintiffs alleged that the issuer had “an internal computer system called the ‘Interface’ from which executive management could view the Company’s Internet traffic in ‘real-time,’” id. at 1301, but that allegation failed to raise a strong inference of scienter because the plaintiffs failed to plead that the defendants “could and did access the ‘Interface’ system before March 2004, and . . . what they would have seen had they done so,” id. at 1303. The allegation “that it was ‘commonly known’ within [the issuer] that [the two companies involved in the business transactions generating the issuer’s revenue] relied on click fraud” raised no such inference because it was “conclusory and plainly lack[ed] . . . particularity.” Id. at 1303. The defendants’ alleged motive to report revenue created by click fraud in order to meet analyst estimates was insufficient as, if accepted, would suffice for scienter pleading against virtually any public company and its executives. Id. The court also commented on the complaint’s failure to allege that the issuer’s advertising customers—who would have been paying for the click fraud—were making complaints to the issuer, with the court finding that the absence of that allegation provided an “alternative inference[]” that could count against the plaintiffs in analysis of the scienter allegations. Id.

In another case affirming dismissal for plaintiffs’ failure to plead particular facts raising a strong inference of scienter, the Second Circuit held that “several vague and general averments that [individual officers] had access to internal corporate documents and data . . . , including real-time customer and sales information,” did not raise a strong inference that the officers had made allegedly false statements about quarterly earnings prospects with scienter because the plaintiffs “ha[d] not alleged any facts indicating that the content of the reports or data to which [the officers] were privy was inconsistent with their statements.” Inter-Local Pension Fund GCC/IBT v. Gen. Elec. Co., 445 F App’x 368, 370 (2d Cir. 2011) (emphasis added). The court there also found insufficient allegations that the officers had a motive to commit fraud because they “received performance-based compensation tied to the Company’s stock price” and the CEO defendant “may have felt pressure to generate greater returns for shareholders” after “underperform[ing] relative to his predecessor, [the legendary] Jack Welch.” Id.

\(^{625}\) FindWhat, 658 F.3d at 1304–06.
traffic," and therefore did not impose an obligation to disclose adverse information about that traffic. 626

Significance and analysis. The last holding in FindWhat deserves discussion. Rule 10b-5 forbids making statements in connection with securities transactions that mislead because they omit a material fact. 627 More generally, "even absent a duty to speak, a party who discloses material facts in connection with securities transactions assumes a duty to speak fully and truthfully on those subjects." 628 This rule would expand limitlessly if it imposed on companies a requirement to identify all problems affecting financial numbers every time the company published quarterly financial statements. To forestall such a broad disclosure requirement, FindWhat suggests a flat rule that factually correct recitations of past financial performance "do not create liability under Section 10(b)." 629 But FindWhat also suggests a more subtle test—whether the omitted fact contradicts a "natural" implication of the challenged statement. 630 Taking into account the Gateway decision—in which the Ninth Circuit endorsed the view that publication of financial statements without also disclosing one-time transactions or one-time changes in a schedule of payments can mislead even if the financials comply with GAAP 631—companies are well advised to act on the assumption that courts may apply the more subtle rule rather than the categorical one.

Companies should also consider that each periodic report under the Exchange Act has attached to it SOX certifications by the CEO and CFO, in which each of those officers affirm that, "[b]ased on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report." 632 That affirmation

626. Id. at 1306. The court elaborated:

[The] statement [that revenue was increasing in June] did not even mention . . . click traffic or click revenue. No reasonable investor would believe that a conclusory, but apparently accurate, report of company-wide revenue growth naturally implied that all was well within every component of the company that could possibly affect revenue in the future. Otherwise, factual reporting of past earnings—disclosure of which the securities laws always encourage and frequently require—would become a treacherous endeavor indeed. Under the Plaintiffs’ preferred rule, company reports of revenue growth—no matter how factually accurate and no matter the level of generality—would be made at the company’s peril, carrying a concomitant obligation to reveal a detailed picture of every aspect of the company’s operations that could possibly bear on future revenue. This is not the rule.

627. 17 C.F.R. § 240.10b-5(b) (2011).
628. FindWhat, 658 F.3d at 1305 (quoting In re K-tel Int’l, Inc. Sec. Litig., 300 F.3d 881, 898 (8th Cir. 2002)) (alteration omitted).
629. Id. at 1306 (quoting In re Advanta Corp. Sec. Litig., 180 F.3d 525, 538 (3d Cir. 1999)).
630. Id. at 1305–06 (finding no "natural implication" about click fraud from the company’s revenue report; citing with approval to Donald C. Langevoort, Half-Truths: Protecting Mistaken Inferences by Investors and Others, 52 STAN. L. REV. 87, 94 (1999) ("[a] corporation has a duty to neutralize only the ‘natural and normal implication’ of its statements").
631. See supra notes 309–23 and accompanying text.
632. 17 C.F.R. § 229.601(b)(31)(i) (2011) (setting out the exact words for the form certifications, with the quotation from paragraph 3; certifications required by 17 C.F.R. §§ 240.13a-14(a), 240.15d-14(a) (2011)).
is not, by its terms, qualified by reference to GAAP, and the SEC has stated that the “certification statement regarding fair presentation of financial statements and other financial information is not limited to a representation that the financial statements and other financial information have been presented in accordance with ‘generally accepted accounting principles’ and is not otherwise limited by reference to generally accepted accounting principles.”

The wording of the certificates, too, therefore supports an analysis more subtle than that publication of accurate historical results can never require additional explanatory disclosure.

**Scienter of individual or entity “making” statement.** Finally, the Third Circuit affirmed dismissal of a Rule 10b-5 case in which the plaintiffs alleged that a parent, a subsidiary, and executives at each had made false statements regarding the reason for success in a shipping business when the real reason was the undisclosed participation by the subsidiary in a price-fixing conspiracy. The court of appeals approved the district court’s reasoning that the plaintiff alleged misstatements by some executives without adequately alleging those executives’ scienter, and scienter of other executives, without alleging that those executives made the misstatements. The district court had applied the Fifth Circuit’s rule that, in order to plead the scienter of a corporation, a plaintiff must adequately plead the scienter of the corporate officers who “make or issue” the misstatement. While acknowledging that the Sixth and Seventh Circuits recognize that the scienter of a corporation might under limited circumstances be alleged without adequately pleading the scienter of particular individuals inside the company, the Third Circuit found no facts pled in this case that would permit that outcome.

**Significance and analysis.** The Third Circuit opinion is the sort that makes lay persons shake their heads, particularly since the subsidiary—as a company—had pled guilty to price-fixing, three executives had pled guilty, and (as the dissent pointed out) the price fixing conspiracy had continued over more than six years—during which the top officers who made the false statements were “pressed repeatedly by perplexed investors about how [the company’s] regular shipping rate increases in Puerto Rico were possible” in “a declining market.” The rule that the Supreme Court announced in the *Janus Capital* decision may multiply the situations in which it will be difficult to pin scienter on an individual who “makes” a misrepresentation, and hence difficult to establish private Rule 10b-5 liability against an issuer.

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635. Id. at 673–75.
636. Id. at 676 (quoting Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 366 (5th Cir. 2004)).
637. Id. at 676–77 (citing City of Monroe Emps. Ret. Sys. v. Bridgestone Corp., 399 F.3d 651, 690–91 (6th Cir. 2005); Makor Issues & Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702, 710 (7th Cir. 2008)).
638. Id. at 673.
639. Id. at 678–79 (Ambro, J., dissenting).
640. See supra notes 75–102 and accompanying text.
Rule 10b-5 Statute of Limitations: Five-year portion of statute runs from the date of the fraud rather than the date of the injury and is a statute of repose that is not enlarged by equitable estoppel or equitable tolling

The statute of limitations for a private Rule 10b-5 action bars such an action unless “brought not later than the earlier of—(1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation.” In McCann v. Hy-Vee, Inc., the Seventh Circuit considered whether the five-year period begins to run with the fraud or whether its commencement awaits the infliction of injury. The plaintiff had agreed to a divorce order that provided her with both alimony and child support payments through May 2007 and alimony payments alone through August 2012—unless the plaintiff’s former husband, an executive at Hy-Vee, Inc. (“HVI”), sold certain stock in that company, which the plaintiff held in her custody. If he sold that stock, the order required him to forward the proceeds to the plaintiff, but his obligations to make the cash payments would end. The plaintiff alleged that she agreed to that settlement in 2002 only because the HVI CFO falsely told her that her former husband could not sell the HVI shares unless he died, left HVI’s employ, or moved (as by a demotion) out of a position that entitled him to buy stock in HVI. Because of those assurances, she thought that she would receive the cash payments for many years, followed at some distant date by a large lump sum from the sale of the stock.

In fact, her former husband had the right to sell the HVI stock at any time, with the company’s permission. He exercised that right and sold the shares back to the company in June 2007 (sending net proceeds to the plaintiff), thereby cutting off cash payments to the plaintiff that she would otherwise have received through August 2012 and that would have totaled $220,500. The plaintiff sued HVI on September 25, 2009, asserting a claim under Rule 10b-5 for the CFO’s misrepresentations in August 2002.

After the district court dismissed with prejudice on the ground that the plaintiff had filed her complaint more than five years after the alleged “violation,” the plaintiff argued on appeal that the violation was not complete until she had been injured in June 2007 so that her complaint in 2009 fell well within the five-year limitation period. The Seventh Circuit held that “realistically” there had been...
a sale of the stock in August 2002 because the plaintiff received physical custody of the shares “and paid for them by giving up a demand for other concessions in the divorce decree, such as a longer period of alimony—a surrender that constituted valuable consideration for the shares.” The “violation” triggering the commencement of the five-year period did not wait until the sale back to HVI injured the plaintiff by cutting off her cash payments both because (i) a “violation” of Rule 10b-5 “does not require injury” and (ii) a “statute of limitations”—which would not run before injury because it is measured “from the date on which the cause of action accrued”—“is usually expressed as the date on which ‘such claim accrues,’ or ‘the date on which the cause of action arose,’ or similar language, rather than the date of ‘violation,’” which commences the five-year period applicable to Rule 10b-5 cases. Since “[t]he violation . . . defined as it should be—as the misrepresentation—occurred in August 2002, more than five years before the suit was filed,” the lawsuit was “untimely.”

Significance and analysis. The Seventh Circuit’s interpretation of the five-year period as a statute of repose rather than a statute of limitations means that that portion of the statute “bars a suit a fixed number of years after an action by the defendant.” As a statute of repose, the five-year period constitutes “an unyielding and absolute barrier” that neither equitable estoppel nor equitable tolling will extend. Among other things, such a fixed limit permits “business planning” to proceed without “contingent liabilities that linger indefinitely.” Of course, if parties to a transaction (here a divorce settlement) wanted to extend liability for misrepresentations in deal documents, they could do so by a contractual indemnification provision containing its own outer limit on the time during which resulting harm would trigger the indemnification obligation. But a suit to enforce such an indemnification right would be a contract suit, not a securities law suit.

Although [the plaintiff] had no reason in 2002 to doubt what [HVI’s] chief financial officer told her were the limited conditions under which [the plaintiff’s husband] could sell the stock out from under her—[HVI] doesn’t argue that prudence required her to demand documentary proof of the truthfulness of the CFO’s statement to her—she probably discovered that she had been had when she learned that her husband had been authorized to sell the stock even though none of the triggering events that the chief financial officer had mentioned to her had occurred. She learned that in June 2007 and didn’t sue until 27 months later—three months too late.

Id. at 929.
652. Id.
653. Id. at 931. The court reasoned to this conclusion from the legal rule that the SEC can sue for a Rule 10b-5 “violation” “without anyone having suffered harm, which is to say without anyone having relied on a misrepresentation or misleading omission to his detriment.” Id.
654. Id. at 930.
655. Id. at 932 (citations omitted). The court also resisted interpreting the statute in a manner that would permit a plaintiff to discover that the defendant had committed a fraud (a “violation”), but wait to determine whether the investment turned out poorly (an “injury”) and only then go on the clock for the statute. Id. at 931.
656. Id. at 932.
657. Id. at 930–32.
658. Id. at 930 (quoting Beard v. J.I. Case Co., 823 F2d 1095, 1097 n.1 (7th Cir. 1987)) (emphasis added).
659. Id. (internal quotation marks and citation omitted).
660. Id.
Class Certification: Plaintiff need not prove materiality of alleged misstatements in order to obtain class certification

Consistent with the Supreme Court’s decision in the *Halliburton* case, the Ninth Circuit affirmed—over defense objections that the plaintiff failed to prove materiality—an order certifying a class in a Rule 10b-5 action in which the plaintiff alleged that a drug company made misleading statements about the safety and marketing of two drugs used to treat anemia. A Rule 23(b)(3) class can only be certified after the district court “finds that the questions of law or fact common to class members predominate over any questions affecting only individual members.” The need to prove individual reliance would prevent such a finding. The fraud-on-the-market reliance presumption permits plaintiffs to prove reliance by common proof and so win Rule 23(b)(3) class certification. The Ninth Circuit “join[ed] the Third and Seventh Circuits in holding that the plaintiff,” in order to employ that presumption, “must (1) show that the security in question was traded in an efficient market . . . , and (2) show that the alleged misrepresentations were public,” but need not provide “proof of materiality,” which, “like all other elements of a 10b-5 claim, is a merits issue that abides the trial or motion for summary judgment.”

While the defendant argued that if the challenged statements were not material classwide reliance would fail because the statements would not have affected the market price, the court responded that since materiality is a “standalone merits element,” either plaintiffs would prove that element down the litigation road (in which case the fraud-on-the-market presumption would apply to make reliance common to the class) or plaintiffs would not prove materiality (in which case the claim would fail as to all plaintiffs for want of that essential element). In either case, “the plaintiffs’ claims stand or fall together—the critical question in the Rule

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661. See supra notes 135–50 and accompanying text.

The complaint alleges four actionable misstatements. First, Amgen supposedly downplayed the FDA’s safety concerns about its products in advance of an FDA meeting with a group of oncologists. Second, Amgen allegedly concealed details about a clinical trial that was canceled over concerns that Amgen’s product exacerbated tumor growth in a small number of patients. Third, Amgen purportedly exaggerated the on-label (that is, for FDA-approved uses) safety of its products. And fourth, Amgen allegedly misrepresented its marketing practices, claiming that it promoted its products solely for on-label uses when it in fact promoted significant off-label usage, in violation of federal drug branding statutes. *Id.* at 1172–73.
663. FED. R. CIV. P. 23(b)(3).
664. Basic Inc. v. Levinson, 485 U.S. 224, 242 (1988) (“Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented [the plaintiffs] from proceeding with a class action, since individual issues then would have overwhelmed the common ones.”).
665. *Id.* at 242, 250 (finding certification appropriate).
666. Amgen, 660 F.3d at 1172.
667. *Id.* at 1175.
23 inquiry.” Accordingly, the plaintiffs’ ability to establish materiality would not affect whether common questions predominate; the plaintiffs therefore “need not prove materiality to avail themselves of the fraud-on-the-market presumption of reliance at the class certification stage” and “need only allege materiality with sufficient plausibility to withstand a 12(b)(6) motion.”

The Ninth Circuit further held that, since materiality was not a matter for Rule 23(b)(3) concern, the defendant did not have the right to rebut the fraud-on-the-market presumption at the class certification stage by showing “that FDA announcements and analyst reports about [the defendant’s] business publicized the truth about the safety issues” related to the defendant’s drugs and therefore any misstatements by the defendants could not have not been incorporated into the drug company’s stock price—a price that (as the defense argued it) reflected the already disclosed state of affairs. That rebuttal proof, the court held, would go to the materiality of the alleged misstatements—not a question on a Rule 23 motion.

Ending with clear direction, the Ninth Circuit wrote that “[t]he only elements a plaintiff must prove at the class certification stage are whether the market for the stock was effi cient and whether the alleged misrepresentations were public.” As neither was contested here, the trial court properly certified the class.

Significance and analysis. This Ninth Circuit opinion, together with Halliburton, should discourage merits litigation at the class certification stage. But, as set out in the discussion of Halliburton, the question of whether the misstatement or the revelation of the truth behind it moved the market can be relevant to whether the market was effi cient and so might still be shoe-horned into the class certification proceedings—even though evidence on that same question would come in at trial on the materiality and loss causation elements.

Reliance: Sophisticated investor could not justifi ably rely on representations regarding liquidity of auction rate securities in light of written disclaimers, including disclaimers available online; investors who would have sold even if they had known the truth could not prove reliance

A private Rule 10b-5 plaintiff must prove reliance on the asserted misstatement or omission. While presumptions dominate the analysis of reliance in the class action setting, two cases from 2011 addressed that element in non-class cases.

668. Id.
669. Id. at 1177.
670. Id.
671. Id.
672. Id.
673. Id.
674. See supra note 150 and accompanying text.
675. For an additional case addressing reliance, see infra notes 804–17 and accompanying text.
677. The purchaser or seller of a security trading in an effi cient market presumptively relies on a public misstatement because the misinformation in it affects the price at which the purchaser or seller bought or sold. Amgen, 660 F.3d at 1173 (citing Basic Inc. v. Levinson, 485 U.S. 224 (1988)). The purchaser or seller of a security also presumptively relies on a material omission that the defendant had a duty to disclose. 4 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 12.10[4] (6th ed. 2009).
The Second Circuit affirmed dismissal of a sophisticated investor’s claim for fraud by misrepresentations that auction rate securities would remain liquid because express written cautions advised that the defendant and its affiliates undertook no obligation to bid in order to prevent auction failures.\textsuperscript{678} And the Eleventh Circuit affirmed summary judgment against the sellers of LLC interests, ruling that the plaintiffs could not invoke the presumption that they relied on omitted facts where the undisputed evidence established that the plaintiffs would have sold even if they had known those facts.\textsuperscript{679}

Sophisticated investor could not rely on statements contradicted by express warnings. In \textit{Ashland Inc. v. Morgan Stanley & Co.}, a special purpose LLC (“AshTree”) organized by a global chemical company (Ashland Inc.) (collectively “Ashland”) purchased student-loan backed auction rate securities (“ARS”).\textsuperscript{680} Holders of ARS—long-term bonds with interest rates periodically reset at auctions—enjoyed liquidity as long as the periodic auctions “succeeded,” that is, so long as the number of buyers (or holders) exceeded the number of sellers.\textsuperscript{681} AshTree bought student-loan backed ARS after Ashland’s long-time investment advisor moved to Morgan Stanley and urged that investment.\textsuperscript{682} The advisor represented that the ARS provided liquidity because Morgan Stanley had never conducted a failed auction and, if demand proved weak at an auction, Morgan Stanley affiliates would step in and place sufficient bids so that the auction would succeed.\textsuperscript{683} As the credit crisis developed and some ARS auctions conducted by other investment firms failed, the advisor continued to assure Ashland that the student-loan backed ARS that AshTree held remained liquid.\textsuperscript{684} But when AshTree tried to sell ARS in about February 2008, it encountered difficulty and discovered that Morgan Stanley was no longer stepping in to place bids in order to assure that auctions did not fail.\textsuperscript{685} Ashland sued Morgan Stanley under section 10(b) of the Exchange Act, claiming among other things that Morgan Stanley had fraudulently misrepresented the liquidity of the ARS and failed to disclose that it was not committed to placing bids to ensure auction success.\textsuperscript{686}

\textsuperscript{678.} See infra notes 680–98 and accompanying text. \\
\textsuperscript{679.} See infra notes 699–721 and accompanying text. \\
\textsuperscript{680.} 652 F.3d 333, 335 (2d Cir. 2011). \\
\textsuperscript{681.} Id. \\
\textsuperscript{682.} Id. \\
\textsuperscript{683.} Id. \\
\textsuperscript{684.} Id. at 336. \\
\textsuperscript{685.} Id. \\
\textsuperscript{686.} Id. At some auctions, AshTree had elected to “hold” ARS. As the court explained: A “hold” order, which is the default for current investors, means that the investor will continue to hold the securities regardless of the clearing rate. By contrast, a “hold-at-rate” order means that the investor will retain the securities only if the clearing rate is at, or above, a rate specified by the investor.

\textit{Id.} at 336 n.1. The district court had dismissed claims based on decisions to hold because \textit{Blue Chip Stamps v. Manor Drug Stores}, 421 U.S. 723, 747–49 (1975) limits standing in private Rule 10b-5 actions to purchasers and sellers of securities, excluding those who “hold” securities on the basis of asserted fraud. Since the Second Circuit decided the appeal on the reliance issue, it declined to
Affirming the district court’s dismissal of the case, the Second Circuit held that a plaintiff’s reliance on an asserted fraud must be “reasonable,” and cannot be reasonable “if, through minimal diligence, the investor should have discovered the truth.” Determining whether a particular investor’s reliance was reasonable, the court held, requires consideration of a number of factors, including the investor’s “sophistication and expertise . . . in financial and securities matters . . . [and the investor’s] access to . . . relevant information.” Ashland conceded that it was “a sophisticated investor.” Ashland also had access to plain, written warnings that Morgan Stanley provided as a result of a settlement between Morgan Stanley and the SEC. Those warnings stated that, while Morgan Stanley routinely placed bids at ARS auctions to prevent failures, Morgan Stanley was not required to do so, and investors should not assume that such bids would be placed. Those warnings therefore “explicitly disclosed the very liquidity risks about which [Ashland] claim[ed] to have been misled” and Ashland had access to the cautions, as it admitted receiving them after initially buying the ARS and before later auctions. Moreover, and interestingly for this review, the court noted that “[r]egardless of precisely when [Ashland] received the [warnings] in writing, [the warnings were] . . . also available online, and [Ashland] could have easily discovered [them] through minimal diligence.” Taking all this into account, the court found that Ashland failed to plead the reasonable reliance necessary for Rule 10b-5 recovery.

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determine whether an ARS owner who “holds” at an auction satisfies the purchaser/seller standing requirement. Ashland, 652 F.3d at 337 & n.2.
687. Id. at 339.
688. Id. at 337–38 (quoting Brown v. E.F. Hutton Grp., Inc., 991 F.2d 1020, 1032 (2d Cir. 1993)).
689. Id. at 338 (quoting Brown, 991 F.2d at 1032).
690. Id. (internal quotation marks omitted).
691. Id. at 336, 338.
692. Id. The court provided the text of the warnings:
The SEC-ordered statement included several relevant disclosures. It stated that “Morgan Stanley is permitted, but not obligated, to submit orders in auctions for its own account either as a bidder or a seller and routinely does so [in] its own discretion.”
693. Id. at 336. It further explained that
Morgan Stanley routinely places one or more bids in an auction for its own account to acquire ARS for its inventory, to prevent a failed auction or to prevent an auction from clearing at a rate that Morgan Stanley believes is higher than the market for similar securities at the time it makes its bid . . . . [However,] Morgan Stanley is not obligated to bid in any auction to prevent an auction from failing or clearing at an off-market rate. Investors should not assume that Morgan Stanley will do so.
694. Id. (citations omitted).
695. Id.
696. Id. at 339. Since Ashland’s state law claims for common law fraud, promissory estoppel, breach of fiduciary duty, and negligent misrepresentation also required reasonable reliance, the Second Circuit affirmed dismissal of those claims as well. Id.
Significance and analysis. The Ashland opinion falls into a well-established line of authorities holding that sophisticated purchasers cannot rely for Rule 10b-5 private claims on oral representations that contradict clear written disclosure. While even a sophisticated investor may not parse through all the disclosure prose that the securities law requires issuers to provide or all the warnings on websites, the requirement that such an investor do so or risk forfeiting a later lawsuit based on contradictory representations by a broker provides incentive for experienced investors to protect themselves. Moreover, in the Ashland case itself, the critical disclosure language had been required by a settlement between Morgan Stanley and the SEC, making it presumably harder for the court to avoid attributing considerable importance to that caution. Finally, the court’s ruling that the availability of warnings on the web affects reliance makes the posting of such warnings well worthwhile.

Investors cannot rely on omissions that would not have affected their purchases or sales had the investors known the omitted facts. In contrast with Ashland, in which truthful and formal written disclosure precluded reliance on contrary and less formal representations, Ledford v. Peeples presented a case in which the plaintiffs could not prove reliance because they would have sold their securities even if


698. Ashland suffered similar disappointment in a lawsuit against another broker, as the Sixth Circuit affirmed a district court dismissal of a complaint alleging, among other things, violation of Rule 10b-5 in the sale to Ashland of ARS. Ashland, Inc. v. Oppenheimer & Co., 648 F.3d 461, 468–71 (6th Cir. 2011). The Sixth Circuit focused on Ashland’s failure to plead facts supporting a strong inference that Oppenheimer had scienter, id. at 469 (discussing the pleading requirement), particularly Ashland’s “fail[ure] to provide any facts explaining why or how Oppenheimer possessed advance, non-public knowledge that underwriters would jointly exit the ARS market and cause its collapse [by failing to place supporting, proprietary bids] in February 2008,” id. at 470. Although the Sixth Circuit conceded it was “possible” that Oppenheimer had such knowledge, the court found “the more compelling explanation” to be “that the near-spontaneous collapse of the ARS market caught Oppenheimer and its employees off guard.” Id.; see also Kadel v. Flood, 427 F. App’x 778, 778 (11th Cir. 2011), cert. denied, 132 S. Ct. 1019 (2012) (affirming dismissal of Rule 10b-5 action against mortgage and lending company for allegedly concealing purchases of subprime mortgage securities). While the defendants in Kadel may have “expressed mistaken confidence in [the issuer’s] financial well-being and furthermore engaged in business practices that contributed to [the issuer’s] demise, the facts alleged did not give rise to a strong inference that [the defendants] knew that their statements were fraudulent or were reckless.” Id. at 780. Instead, “the stronger inference is that appellees simply failed to predict the eventual collapse of the housing and subprime mortgage market, and, as a result, were ill-prepared to respond when those markets crashed.” Id.

In also affirming dismissal of Ashland’s promissory estoppel claim, the Sixth Circuit (like the Second Circuit in the opinion summarized in the text) pointed to warning language, this time in “Oppenheimer’s online ARS Brochure,” which “explicitly warned that [Oppenheimer was] ‘not obligated to submit a bid to prevent an auction failure,’ and ‘provide[d] no assurance . . . as to the outcome of any auction.’ ” Ashland, 648 F.3d at 472. With that written warning available, Ashland could not have justifiably relied on alleged Oppenheimer promises “(1) that the ARS were ‘safe and liquid,’ (2) that Oppenheimer and the lead underwriters ‘would ensure the liquidity of’ these ARS, and (3) that Oppenheimer and the lead underwriters ‘had the intent and ability to never allow Ashland to be left holding illiquid’ ARS.” Id. at 472. The court’s conclusion that Ashland could not have justifiably relied on such statements also supported dismissal of Ashland’s claim for negligent misrepresentation. Id. at 473.

they had known the truth. A group led by Brenda Smith (the “Smith group”) held the other half of the LLC interests. The DynaVision group supplied the initial capital for the business, and the Smith group provided management, as well as sales contacts and selling expertise.

The LLC’s operating agreement included a put-and-call buy/sell provision by which either group could offer to purchase the interests held by the other group, with the other group then either having to sell at the proposed price or buy out the offering group at that price. After Shelby Peeples unsuccessfully offered to buy the LLC, and then unsuccessfully offered to buy the DynaVision group’s interests in the LLC—both at prices that the DynaVision group believed too low—the Smith group invoked the put-and-call provision of the operating agreement by offering to buy out the DynaVision group’s LLC interests for $3.5 million. Before opting to sell their interests to the Smith group, the DynaVision group asked Peeples whether he was involved with the Smith group’s put-and-call offer, and Peeples denied that he was. That statement was false. In fact, Peeples had loaned the money to the Smith group, and after that group bought out the DynaVision group, the Smith group caused the LLC to sell all its assets to Peeples in exchange for cash and multi-year employment agreements with signing bonuses.

The members of the DynaVision group brought this suit under, among other laws, section 10(b) of the Exchange Act and Rule 10b-5. The district court granted Peeples’ motion for summary judgment, and the Eleventh Circuit affirmed. The court of appeals held that, in order to prove reliance, the DynaVision group “had to demonstrate that but for Peeples’s statements, [the] DynaVision [group] would not have sold its interest but, instead, would have bought the [Smith group’s] interests.” The court found “no direct evidence” that the DynaVision group “would have elected to buy [the Smith group’s] interests had Peeples admitted that he was providing the money” to the Smith group.

700. Id. at 1256.
701. Id. at 1226.
702. Id.
703. Id.
704. Id. at 1227.
705. Id. at 1229. The case involved a second LLC which, for a time, owned the land on which the carpet company’s business was located. Id. at 1227. This summary omits the complexities raised by the transfer of the land from the second LLC to the first.
706. Id. at 1229–30.
707. Id. at 1231.
708. Id. at 1234. The DynaVision group also asked the Smith group whether Peeples was providing the financing for the put-and-call offer, and the Smith group denied that Peeples was doing so. Id. at 1231.
709. Id. at 1236.
710. Id. at 1240–41.
711. Id. at 1263.
712. Id. at 1249.
and, after examining circumstantial evidence, determined “that, as a matter of law, DynaVision’s principals would have sold even if they had known about Peeples’s involvement.”

The central problem, from the DynaVision group’s point of view, was that the put-and-call buy/sell provision of the operating agreement required that, in order for the DynaVision group to turn down the Smith group offer, the DynaVision group had to buy the Smith group interests. The DynaVision group “lacked the expertise necessary to operate [the LLC’s] factory and market [the LLC’s] product.” The DynaVision group “could not have persuaded [the Smith group] to remain with the company, obtained a management team to replace them, or located a buyer for [the LLC], even if Peeples admitted his involvement.” Accordingly, when the Smith group invoked the put-and-call buy/sell provision, the DynaVision group “had to choose between purchasing [the Smith group’s] interest[s] and risking the loss of their investment or selling their interest[s] for a $3.5 million profit.” Since knowing that Peeples was providing the financing for the Smith group would not have changed any of these key facts, the DynaVision group “had no option but to sell,” and “Peeples’ misrepresentations played no causative role in the DynaVision [group’s] decision to sell to [the Smith group].” The DynaVision group therefore could not prove reliance.

Significance and analysis. Peeples presents the odd case in which a buyer or seller very much wants information that will make no difference to a buy or sell decision. Interestingly, the Eleventh Circuit focused on the economics facing the DynaVision group, summing up the reasoning at one point with these words: “Faced with [the] alternatives, [the DynaVision group] had to choose the one that satisfied their economic self-interest: They had to sell.” And just as interestingly, the Eleventh Circuit blessed resolution of the case on summary judgment.

In another case, perhaps, a court might find reliance if the plaintiff could credibly contend that—as can happen, particularly in the small business context—emotions played a large role in the purchase or sale and that the plaintiff would have risked financial hari-kari if he or she had known a fact that would have triggered an emotional buy or sell response. On the other hand, perhaps an investor could not “reasonably” rely on a fact that carried psychological but no economic importance.

713. Id. at 1249–50.
714. Id. at 1250 (emphasis omitted).
715. Id. at 1253 (emphasis omitted).
716. Id. at 1255.
717. Id. at 1256.
718. Id. The court went on to affirm summary judgment on state law claims, involving fiduciary duty issues, id. at 1258–63, but this summary does not extend to a discussion of those claims.
719. Id. at 1256.
720. Id. at 1263.
721. Here, one of the DynaVision group members had testified that “we didn’t really have a choice . . . . We didn’t have a management group. . . . The day the put and call came in, I wouldn’t give two cents for finding a group to replace [the Smith group].” Id. at 1256 & n.101 (citing the deposition testimony given in state court, Ledford v. Smith, 618 S.E.2d 627, 634–35 (Ga. Ct. App. 2005)).
Loss Causation: News that regulators met and did not consider an LBO, and the failure of the company to issue a press release after another regulator approved the deal did not reveal an alleged fraud by failure to disclose that the LBO would not close; corrective disclosure date for loss causation provides constructive notice for statute of limitations; false statements that perpetuate a fraud can cause loss to those who purchase after those statements.

Both statute and caselaw require a private Rule 10b-5 plaintiff to prove that the asserted fraud caused the plaintiff economic loss. Last year, the Fourth Circuit rejected allegations that fraud about renegotiation or termination of a leveraged buyout leaked into the market—and thereby caused loss—by news that regulatory bodies had met but failed to approve the deal. The Second Circuit held that a complaint alleging a corrective disclosure for Rule 10b-5 loss causation purposes thereby also identified the date on which the statute of limitations began to run for a section 11 claim. And the Eleventh Circuit held that statements perpetuating a fraud can cause loss.

Loss causation for failed buyout. The plaintiffs in Katyle v. Penn National Gaming, Inc. alleged that, after Penn National announced that it had entered into an LBO agreement with private equity buyers, the company and individual defendants violated section 10(b) of the Exchange Act by making statements that misled by failing to disclose that they were negotiating with the buyers for either a lower price or deal termination. Ultimately, on July 3, 2008, Penn National announced that the deal had terminated. Affirming a district court dismissal of the case, the Fourth Circuit considered whether the plaintiffs adequately alleged loss causation by pleading that the fraud leaked into the market, and caused the Penn National stock price to drop, via news of meetings by regulators who had to approve the deal and by analyst opinions about the probability that the LBO would go forward.

The court held that plaintiffs in a Rule 10b-5 case must plead loss causation with a degree of specificity at or close to that required by Federal Rule of Civil Procedure 9(b). Acknowledging the possibility that the truth about a fraud can
leak out over time and that therefore “neither a single complete disclosure nor a fact-for-fact disclosure of the relevant truth to the market is a necessary prerequisite to establishing loss causation (although either may be sufficient),” 733 the court framed the question as whether the alleged “disclosures gradually revealed to the market the undisclosed truth about Penn’s fraudulent press releases.” 734

With that standard in mind, the court first addressed whether the fraud was revealed by information that the Maine, Louisiana, and Missouri gaming regulators had in one instance canceled a meeting at which the LBO was to be discussed and in two other instances met without approving the LBO. 735 Given that these disclosures (on June 16, June 17, and June 25, 2008) followed a June 6 announcement by Penn National and the buyers that the closing deadline had been extended until October 13, the disclosures of regulatory inaction “did nothing to discount the possibility that state regulators would approve the LBO before the extended closing deadline or that the LBO would ultimately be consummated,” 736 let alone that Penn National “had been perpetrating a fraud on the market by failing to disclose in numerous press releases its knowledge about the status of the LBO.” 737

Turning next to two June 24 analyst reports—one of which stated that “the markets have become increasingly convinced that the company’s acquisition will not be completed” and the other of which referred to “significant uncertainty” and “unsubstantiated speculation as to whether or not the pending buyout deal will go through” and concluded that “any opinion about whether or not the deal will close or not close is pure speculation” 738—the Fourth Circuit held that neither

whether the necessary causal link exists.” 733 (footnote and citations omitted)). In the accompanying note, the court elaborated:

The PSLRA . . . does not address the pleading standards applicable to the . . . elements of a § 10(b) claim [other than misrepresentation and scienter], and so presumably the pleading standard of Rule 9(b) still applies to those elements. While the Supreme Court has not specifically addressed whether loss causation must be pled with particularity after enactment of the PSLRA, in Teachers’ Ret. Sys. [v. Hunter], 477 F.3d [162,] 186 [(4th Cir. 2007)], we recognized that “[a] strong case can be made that because loss causation is among the circumstances constituting fraud for which Rule 9(b) demands particularity, loss causation should be pleaded with particularity.” (internal quotation marks omitted). Uncertainty has arisen because in Dura Pharm[s], Inc. [v. Broudo], 544 U.S. [336,] 346–47 [(2005)], the Court applied Rule 8’s “a short and plain statement” pleading standard to allegations of loss causation. Fed. R. Civ. P. 8(a)(2). But because the complaint in that case could not satisfy Rule 8’s lesser standard, much less Rule 9(b)’s stricter standard, the Court only “assume[d], at least for argument’s sake, that neither the Rules nor the [PSLRA] impose any special further requirement [beyond Rule 8] in respect to the pleading of proximate causation or economic loss.” Dura Pharm[s], Inc., 544 U.S. at 346 (emphasis added).

Id. at 471 n.5 (parallel citations omitted). Rule 9(b) requires that “[i]n alleging fraud . . . , a party must state with particularity the circumstances constituting fraud.” Fed. R. Civ. P. 9(b).

733. Penn Nat’l, 637 F.3d at 472.
734. Id. at 472–73.
735. Id. at 473–75, with the specific disclosures that “(1) on June 16 . . . the Maine Harness Racing Commission cancelled a meeting scheduled to address the LBO, (2) on June 17 . . . the Louisiana Gaming Control Board held a meeting without taking action on the LBO, and (3) on June 25 . . . the Missouri Gaming Commission held a meeting without approving the LBO,” id. at 473.
736. Id. at 473–74.
737. Id. at 473.
738. Id. at 475–76 (emphasis omitted).
report implied or suggested that Penn National had failed to disclose information about the deal.\textsuperscript{739} Moving last to the fact that Penn National did not issue a press release following a favorable June 24 decision on the LBO by the Illinois gaming regulator, the court of appeals rejected the notion that "Penn’s non-announcement of [this] positive news . . . constitutes a corrective disclosure" as failure to do so did not show that Penn knew—when it made its earlier statements during the period March 20, 2008, through June 6, 2008—that "the deal was off."\textsuperscript{740}

\textbf{Significance and analysis.} The decision seems right but parts are oddly phrased. To the extent that the omissions consisted of objective facts regarding the LBO deal—e.g., attempts to renegotiate the price or negotiate a termination fee—the court might have focused on the distance between the "disclosures" that the plaintiffs offered and those objective facts.\textsuperscript{741} But the opinion says several times that the disclosures did not reveal fraud, which implies that a disclosure adequate for loss causation by a subsequent stock price drop would require disclosure that the defendants had fraudulent intent.\textsuperscript{742} That would be true only to the extent that the statements the defendants made included (at least implicitly) an opinion or prediction that the transaction would be consummated—which, in turn, could only be false for securities law purposes if (among other things) the defendants did not believe that opinion or prediction.\textsuperscript{743} Perhaps the court’s odd focus resulted from the circumstance that, in the court’s view, the market “well understood the risk” that the transaction might not close, so that, perhaps, the only undisclosed fact of significance was the defendants’ subjective assessment that the deal would crater.\textsuperscript{744}

\textsuperscript{739} Id.
\textsuperscript{740} Id. at 476. Elaborating, the court wrote:

[W]e are at a quandary to understand how speculation about the LBO’s prospects based on Penn’s failure to issue a press release on June 24 announcing the Illinois Gaming Board’s approval of the buyout translates into knowledge of the relevant truth, namely that from March 20, 2008 through June 6, 2008, Penn issued a series of fraudulent press releases because Penn knew then the deal was off.

\textsuperscript{Id. at 476–77.}

\textsuperscript{741} The concurrence seems to take this more traditional view, reasoning that the three regulatory non-actions did not “reveal[] in any way that Penn and other parties to the buyout were discussing terminating or restructuring the transaction” and that the two analyst reports did not “disclose[] . . . that the parties were terminating or renegotiating the deal.” Id. at 480–81 (Wynn, J., concurring).

\textsuperscript{742} For example, the court states that the three instances in which gaming authorities either canceled a meeting or met and did not discuss the LBO revealed nothing “about the fraudulent nature of Penn’s prior press releases and the undisclosed knowledge behind them,” id. at 475 (emphasis added), and later states that the complaint had to allege “facts to show the disclosures revealed to the market something about the fraudulent nature of the press releases on which Plaintiffs purportedly relied to their detriment because only then could the press releases have caused Plaintiffs’ economic loss,” id. at 478 (emphasis added).


\textsuperscript{744} The buyout price was $67/share. Penn Nat’l, 637 F.3d at 467. The Fourth Circuit summarized some of the market information so:

Plaintiffs do not argue that “negative investor inferences” drawn from the disclosures “were a foreseeable materialization of the risk concealed” by Penn’s fraudulent press releases. . . . The
Relationship between loss causation and statute of limitations. In Amorosa v. AOL Time Warner, Inc., the Second Circuit held last year that a corrective disclosure, evidently pled in order to allege loss causation for Rule 10b-5 and Rule 14a-9 claims, started the running of the statute of limitations for the plaintiff’s section 11 claim.\(^{745}\) The court reasoned that “[t]he corrective disclosure date is the same as the constructive notice date for purposes of limitations.”\(^{746}\)

Significance and analysis. Securities Act section 13 provides that a plaintiff bringing a section 11 action must sue by the earlier of (i) “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” and (ii) “three years after the security was bona fide offered to the public.”\(^{747}\) The statute of limitations for a Rule 10b-5 case, however, has been extended so that a plaintiff bringing an action under that rule must sue by the earlier of (i) two years “after the discovery of the facts constituting the violation” (with that two-year period running from the time that a reasonably diligent plaintiff would have discovered those facts)\(^{748}\) and (ii) five years after the violation occurred.\(^{749}\) But the plaintiff bringing a Rule 10b-5 claim must also plead facts to show the loss causation element of that claim.\(^{750}\) Plaintiffs’ counsel should read the Second Circuit opinion as a warning that, when pleading loss causation for a Rule 10b-5 claim in a case in which the plaintiff also

alleged disclosures told the market nothing factually about the deal’s prospects that it had not already heard, repeatedly. We have already discussed the price trend of Penn’s shares over the course of 2008[, downward from the $62.12 immediately after announcement of the deal, id. at 467]. . . . Based upon activity in the options market, Lehman Brothers [in April 2008] estimated at best a 32% probability the deal would close as written. Two weeks later, on April 16, thedeal.com reported the Penn deal was “trading so badly [around $40 per share] that it could become a foregone conclusion that the buyers seek a price cut or want out of the buyout.” The report noted the fact “[t]hat Deutsche Bank and Wachovia are leading the Penn financing does not boost confidence as the buyout comes closer to its funding dates.”

\(^{745}\) 409 F. App’x 412, 415 (2d Cir. 2011) (plaintiff bringing Rule 10b-5 and Rule 14a-9 claims required to plead loss causation), 416 (corrective disclosure begins statute of limitations period).

\(^{746}\) Id. at 416.


\(^{748}\) Merck & Co. v. Reynolds, 130 S. Ct. 1784, 1795 (2010).


\(^{750}\) See supra note 723 and accompanying text.
alleges a section 11 claim, counsel should be sure that the loss causation facts for
the first cause of action do not create a problem under the shorter statute of limitations
that applies to the second.

Loss caused by repetition of false statements. In a fraud running for several months
or even years, the defendants are likely to make a series of false statements or
omissions, some of which or most of which simply repeat earlier falsehoods or
omit the same facts. In FindWhat Investor Group v. FindWhat.com,751 the Eleventh
Circuit addressed loss causation for such later, repetitive misrepresentations or
omissions. MIVA, Inc. (“MIVA,” formerly FindWhat, Inc.) had contracts with
companies, called MIVA’s “distribution partners,” by which MIVA could place on
the partners’ websites advertisements for MIVA’s clients.752 Those clients consisted
of third-party companies that sought to drive, to their own websites, the internet
users visiting the websites of MIVA’s partners.753 The third-party companies bid
for “keywords” which, if typed during a visit to a MIVA distribution partner’s web-
site, would cause the third party’s advertisement to appear on the user’s screen.754
If the user clicked on the advertisement and thereby moved to the third-party
advertiser’s own website, the advertiser would pay MIVA an amount equal to the
successful bid that the third party had made for the particular keyword that had
activated the advertisement.755 If more than one third party bid for a keyword,
then the highest bidder’s advertisement would enjoy the best placement on the
user’s screen when the user typed in the keyword, with the advertisements for the
other third-party advertisers who bid on the keyword appearing in progressively
less favorable positions depending on their bids.756

MIVA shared with its distribution partners a portion of the payments that the
third-party advertisers paid to MIVA.757 Since the distribution partners therefore
received money when an internet visitor to their sites clicked through to the sites
of the third-party advertisers, the distribution partners had an incentive to engage
in “click fraud,” which used various means—including spyware, browser hijack-
ing, and “bots”—to create click-throughs from their websites to those of the third-
party advertisers, simulating the migration of internet users from the distribution
partners’ sites to those of the advertisers.758 Investors who bought MIVA stock
“alleg[ed that] . . . around 2003, two of MIVA’s top revenue-generating dis-
tribution partners (‘Saveli’ and ‘Dmitri’)—who together generated almost one-
third of MIVA’s revenue during 2003, 2004, and 2005, and represented about
36 percent of MIVA’s click revenue—began using click fraud.”759 While click fraud
provided short-term revenue gains to both MIVA and its distribution partners, it

751. 658 F.3d 1282 (11th Cir. 2011), petition for cert. filed, 80 U.S.L.W. 3624 (U.S. Apr. 16, 2012)
(No. 11-1250).
752. Id. at 1291.
753. Id.
754. Id.
755. Id.
756. Id.
757. Id.
758. Id. at 1292–93.
759. Id. at 1292 (quoting complaint).
hurt MIVA’s revenue over the longer haul because fraudulent click-throughs generated no sales for the third-party advertisers, which in turn reduced the amount they would bid for keywords.  

Suing under Rule 10b-5, the plaintiffs alleged that MIVA and two officers made a series of eleven misrepresentations, and statements that misled by omissions, during a class period running from September 3, 2003, to May 4, 2005. After the district court dismissed the case as to all but two alleged misstatements, it granted summary judgment as to those last two on the ground that the plaintiffs raised no triable issue as to loss causation. The defendants made two of those alleged misstatements late in the alleged fraud—in a conference call on February 23, 2005, and in a Form 10-K filed on March 16, 2005. In each, the company stated that it had stopped doing business with distribution partners who accounted for $70,000 in revenue per day—a veiled reference to Saveli and Dmitri, the alleged click-fraud perpetrators—even though, the plaintiffs alleged, MIVA had not terminated those relationships.

On the motion for summary judgment, the defendants presented an expert report that conceded that MIVA’s stock price had been inflated by 26.11 percent before the February 2005 conference call, and contended that the price was inflated by the same amount after the company filed the Form 10-K in March 2005. The trial court concluded that, since the two statements had therefore not affected MIVA stock price inflation, the plaintiffs could not show loss causation as to those statements. Vacating the summary judgment granted on this ground, the Eleventh Circuit reasoned: “fraudulent misstatements that prolong inflation can be just as harmful to subsequent investors as statements that create inflation in the first instance,” and “[b]ecause thousands of shares . . . are purchased each day, . . . a falsehood that endures within the marketplace for a longer period of time, all else being equal, will cause greater harm than one that endures for a shorter period of time.”

\[760. \text{Id. at } 1291–92.\]
\[761. \text{Id. at } 1294.\]
\[762. \text{Id. at } 1294–95.\]
\[763. \text{Id. at } 1295.\]
\[764. \text{Id. at } 1307.\]
\[765. \text{Id. at } 1307–08.\]
\[766. \text{Id. at } 1307, 1313–14.\]
\[767. \text{Id. at } 1306–07.\]
\[768. \text{Id. at } 1317.\]
\[769. \text{Id. at } 1315–16 \text{ (emphasis added). With a rhetorical flourish, the court added:}\]

Defendants whose fraud prevents preexisting inflation in a stock price from dissipating are just as liable as defendants whose fraud introduces inflation into the stock price in the first instance. We decline to erect a per se rule that, once a market is already misinformed about a particular truth, corporations are free to knowingly and intentionally reinforce material misconceptions by repeating falsehoods with impunity. Defendants who commit fraud to prop up an already inflated stock price do not get an automatic free pass under the securities laws.

\[\text{Id. at } 1317.\]
Significance and analysis. The loss causation issue arose in FindWhat because the trial court concluded that “‘the inflation in the stock price was caused by statements made prior to the class period in this case.’” Absent statute of limitations issues, that should be a rare case. Moreover, the district court’s focus—when analyzing loss causation—on the date that the stock price was initially inflated seems odd, given that the Supreme Court expressly rejected stock price inflation as a test for loss causation, and opted instead for stock price decrease on revelation of the truth or omitted facts. While courts have in recent years analyzed individual misstatements for loss causation, that analysis seems best suited to the case in which different statements concern different subjects (e.g., product quality and accounting numbers) rather than the case in which all statements concern one subject. Where the statements concern the same subject, the court should analyze loss causation simply by considering whether the revelation of truth about that subject caused a drop in the stock price. If so, that should suffice (absent confounding facts identified by expert testimony) to show loss causation as to all misstatements on that subject within the class period, whether made early or late in the alleged fraud and whether they contain new information or not.

Auditor Liability Under Rule 10b-5: Scienter allegations were insufficient where the plaintiffs charged that an auditor misinterpreted an accounting rule; allegations were sufficient where the plaintiff alleged that an auditor failed to follow up on “red flag” facts; Rule 10b-5 case against an auditor rested on alleged misrepresentations rather than on the omitted facts that the plaintiffs alleged the financial statements should have included and, therefore, the presumption that plaintiffs rely on material omissions did not apply. Rule 10b-5 actions against auditors generated three noteworthy appellate opinions in 2011. The Tenth Circuit ruled insufficient allegations that an auditor had scienter when it allegedly misinterpreted an accounting rule, while the Ninth Circuit found auditor scienter adequately pled by charges that the auditor failed to follow up “red flags” signaling options backdating. The D.C. Circuit held that plaintiffs could not employ the presumption that they relied on material omissions against an auditor that, by providing its audit opinion, made affirmative statements the court found to have encompassed the omissions.

No auditor scienter pled for alleged misinterpretation of accounting rule. As when suing other defendants in private Rule 10b-5 cases, plaintiffs suing an auditor

770. Id. at 1314 (quoting district court).
771. See Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342, 344 (2005) (“Normally, in cases such as this one (i.e., fraud-on-the-market cases), an inflated purchase price will not itself constitute or proximately cause the relevant economic loss.” . . . “[T]he Restatement of Torts, in setting forth the judicial consensus, says that a person who ‘misrepresents the financial condition of a corporation in order to sell its stock’ becomes liable to a relying purchaser ‘for the loss’ the purchaser sustains ‘when the facts . . . become generally known’ and ‘as a result’ share value ‘depreciate[s].’” (quoting RESTATEMENT (THIRD) OF TORTS § 548A)).
773. See infra notes 777–86 and accompanying text.
774. See infra notes 787–803 and accompanying text.
775. See infra notes 804–17 and accompanying text.
must allege facts supporting a “strong inference” that the auditor had scienter. In *Dronsejko v. Grant Thornton*, the Tenth Circuit applied the scienter pleading standard to affirm dismissal of a complaint against an auditor where plaintiffs based their case not on the auditor’s failure to find facts but rather on the auditor’s application of generally accepted accounting principles (“GAAP”) to known facts. *Grant Thornton* (“GT”) provided clean opinions on the 2002, 2003, and 2004 financial statements issued by *iMergent*—a company that sold software licenses, with half of *iMergent’s* revenue derived from licenses sold on Extended Payment Terms Arrangements (“EPTAs”) under which customers paid for the software over twenty-four months. While *iMergent* recognized 100 percent of the revenue for such sales at the time they were made, the company (as it disclosed in SEC filings) only collected 53 percent of the revenue—a practice that later led to a restatement. The plaintiffs sued GT under Rule 10b-5, alleging that it recklessly certified the *iMergent* statements because GT knew that only 53 percent of the EPTA revenue was collected and the applicable accounting rule—Statement of Position 97-2 (“SOP 97-2”)—required that “collectability” be “probable” in order that revenue be recognized.

The Tenth Circuit characterized the case as one in which “[t]he problem . . . came not in conducting the audit itself, but rather in applying the facts to the relevant [accounting rule]—allegedly without any support.” The court then rejected the view that GT had no support for its view that collection of 53 percent of the EPTA revenue rendered EPTA revenue “collectible” within the meaning of SOP 97-2 because SOP 97-2 referred to FASB Statement 5, “which defines ‘probable’ as ‘likely to occur’—a definition that does not, on its face, rule out a ‘more likely than not’ standard.” While the plaintiffs pointed to two accounting sources “that indicate that the threshold for ‘probable’ under SOP 97-2 may be greater than 53%,” (i) both sources “allude[d] to the controversy over the meaning of probably”; (ii) one authority (an FASB Staff Implementation Guide) was “low on the hierarchy

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776. *See supra* notes 538–44 and accompanying text.
777. *Dronsejko* 632 F.3d 658 (10th Cir. 2011).
778. *Id.* at 672.
779. *Id.* at 667.
780. *Id.* at 661–62.
781. *Id.* The court states that *iMergent* restated its financials for 2002–2004 as a result of improper revenue recognition. *Id.* at 661. The court also says that the company “recognized bad debt expense associated with these sales, which reduced its total income” and that “*iMergent* wrote off the uncollectible EPTA accounts against an allowance for doubtful accounts, with the allowance established at the time of sale.” *Id.* at 662. While this suggests that the misreporting affected only the revenue line, that the company had included disclosures that revealed the revenue protocol and so avoided confusion, and that the income was clean in each year, the district court opinion refers to the “under-accrual of the allowance for bad debts” and states that *iMergent* told the market it would have to restate its financials “to correct the fact that revenue and income” for the years 2002 through 2004 “had been improperly reported.” In re *iMergent* Sec. Litig., Master File No. 2:05-CV-204, 2009 WL 3731965, at *3–4 (D. Utah Nov. 2, 2009) (emphasis added). Further, the appellate opinion reports that the company’s restatement turned earnings into losses for the three years that the restatement covered. *Dronsejko*, 632 F.3d at 663.
782. *Dronsejko*, 632 F.3d at 662.
783. *Id.* at 667.
784. *Id.* at 668.
of sources used to interpret GAAP”; (iii) the other source suggested that something like 78 percent was used in practice but did “not establish or even suggest that the 78% rate is the correct interpretation”; and (iv) in any event “the complaint [did] not allege that [GT] knew about the relevant authorities yet ignored them.” All in all, while GT’s interpretation “may have been incorrect or even negligent,” the facts alleged did not raise a strong inference of Rule 10b-5 recklessness—“that [GT’s] conduct was an ‘extreme departure from the standards of ordinary care,’ or that ‘no reasonable accountant would have made the same decision[] if confronted with the same facts.’”

Auditor scienter alleged by assertions that auditor failed to pursue “red flags.” New Mexico State Investment Council v. Ernst & Young LLP787 presented the very different case in which a plaintiff did not fault the auditor for analysis of an accounting rule but alleged a securities fraud788 by delivery of a clean opinion after failing to seek additional facts in the face of red flags and accepting facially inaccurate documents as satisfactory evidence on which to base an audit opinion. Ernst & Young (“EY”) provided a clean opinion in 2005 for Broadcom Corporation’s (“Broadcom”) 2003–2005 financial statements789 even though, as the plaintiff alleged, EY “knew . . . or was deliberately reckless in not knowing that” the opinion was false and misleading because Broadcom had backdated stock options (i.e., granted options with exercise prices set at stock prices from dates preceding the actual dates of the grants) without taking the required charge for doing so in years covered by the 2005 opinion.790 As a result of backdating options without taking required

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785. Id. at 667.
786. Id. at 668 (internal citations omitted) (quoting City of Phila. v. Fleming Cos., 264 F.3d 1245, 1258 (10th Cir. 2001); PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 694–95 (6th Cir. 2004)).
787. 641 F.3d 1089 (9th Cir. 2011).
788. Id. at 1092 (Rule 10b-5 claim).
789. Id. at 1094.
790. Id. Backdating options is not illegal, but—under the accounting rules in effect at the time of the grants here—if the backdating resulted in an exercise price below the price of the stock on the date of the option grant, the company granting the options had to take a charge equal to the difference between exercise price and the date-of-grant price, with that charge spread out over the period during which the options vested. Id. at 1093.

Broadcom options vested over four years. Id. The plaintiffs focused on option grants in 2000, id. at 1095, 2002 and 2003, id. at 1100. The 2000 grant should have produced expense charges in each of the four years 2000–2003, the 2001 grant in each of the years 2001–2004, and the 2003 grant in each of the years 2003–2006. See, e.g., id. at 1099. Broadcom’s 2005 financial statements included income statements for 2003, 2004, and 2005 because SEC rules require that year-end audited financial statements include income statements for the year just ended (e.g., 2005) and the two previous years (e.g., 2004 and 2005). 17 C.F.R. § 210.3-02(a) (2011). The backdating without expense charges reduced costs and inflated income in each of those years.
expense charges, Broadcom eventually restated the financials for not only all of the years covered by the 2005 opinion, but for additional years as well.\textsuperscript{791}

In reversing the district court’s dismissal of the case against EY,\textsuperscript{792} the Ninth Circuit relied in part on the principle that the inference of an auditor’s scienter is strengthened if the plaintiff alleges that the auditor failed to investigate after seeing “red flags.”\textsuperscript{793} Turning to the first of the two option grants on which the case centered—the grant in May 2000—the plaintiffs pointed to the content of various e-mails to show that EY accountants had expressed concern over the date used to determine the exercise price for the options covered by that grant and concern that the company might have to record as much as $700 million in compensation expenses as a result of choosing that particular date to determine the price.\textsuperscript{794} Despite knowing that the grant was “suspicious” in its timing, that it was the largest in Broadcom’s history, and that it could have a clearly material $700 million impact on expenses,\textsuperscript{795} EY allegedly concluded that the grant did not require any expense (because it was not backdated) based on “a single conversation” with the Broadcom CFO who described but did not provide a “‘Guideline Matrix’ for calculating the number of options awarded to each employee.”\textsuperscript{796} As the court read the complaint, “EY neither received nor relied on any documents from Broadcom before EY signed off on the May 2000 grant, thereby violating [generally accepted auditing standards].”\textsuperscript{797}

Moving to the second grant—on June 21, 2001—plaintiff alleged that Broadcom “specifically consulted with EY . . . to determine whether a compensation charge was necessary.”\textsuperscript{798} EY determined that Broadcom needed to take no charge after first receiving “unsigned draft minutes” and then receiving a unanimous written consent signed after the death of one compensation committee member and therefore at a time when the compensation committee did not have a quorum with which to act.\textsuperscript{799} The Ninth Circuit concluded that, “[w]hile the

\textsuperscript{791.} N.M. St. Inv Council, 641 F.3d at 1093.
\textsuperscript{792.} Id. at 1103.
\textsuperscript{793.} Id. at 1098.
\textsuperscript{794.} Id. at 1096.
\textsuperscript{795.} Id. at 1098.
\textsuperscript{796.} Id. at 1097.
\textsuperscript{797.} Id.
\textsuperscript{798.} Id. at 1100.
\textsuperscript{799.} Id.
Complaint indicates that Broadcom executives may have attempted to deceive EY, there is an equal inference that EY overlooked significant events without further questioning or investigation.\textsuperscript{800} For the court, EY’s “failure . . . to follow up . . . and . . . sign[ing] off on these options . . . after reviewing false documentation . . . sufficiently [pled] an audit so deficient that the audit amounted to no audit at all.”\textsuperscript{801}

Significance and analysis. Both the Tenth and the Ninth Circuits commented on the possibility of applying some specially high scienter standard for auditors but ultimately did not employ such a standard—the Tenth because it found no special rule necessary to decide the case and the Ninth because it concluded that no such special rule should exist.\textsuperscript{802} It is a bit hard to know why there should be a special rule for auditors—one that makes it harder for plaintiffs to plead and prove cases against them than against other Rule 10b-5 defendants. Auditors practice in a learned profession. But so do attorneys and, arguably, so do the biostatisticians and doctors who attempt to determine whether a drug or medical device is efficacious and whether it has adverse side effects.

Auditors operate in a world of rules—generally accepted auditing standards and generally accepted accounting principles. But those rules provide a more solid backdrop for determining whether particular conduct is reckless than when businessmen or businesswomen—operating outside a specific and detailed code—allegedly commit securities fraud. That solid background arguably renders application of the general standard easier when it is applied to auditors than to businessmen or businesswomen.

Where the accounting rules require judgment, the requirement that the auditor exercised judgment with scienter, combined with the requirement that the falsity

\textsuperscript{800}. Id.

\textsuperscript{801}. Id. (citing \textit{In re Software Toolworks Inc.}, 50 F.3d 615, 628 (9th Cir. 1994)).

The court also found that EY’s failure to follow up on the two grants was particularly suspicious because EY had “presided over or participated in” reforms that Broadcom undertook in 2003 to ensure that it complied with accounting rules when granting options. \textit{Id.} at 1101. The court further found the size of the expenses relevant because “the auditing standards do give strong guidance to auditors to dig deeper once there are questionable circumstances surrounding such material transactions.” \textit{Id.} at 1102. The court summarized the “red flags” that should have prompted EY to investigate more thoroughly:

These include . . . the deceased member of the compensation committee, option grant dates that were sporadic, suspiciously long delays between the award of stock options and the [unanimous written consent] approving the grant, and option grant dates set at or near the low stock price for the quarter in which the options were granted followed by a typical price surge soon after the dates of the option awards.

\textit{Id.}

\textsuperscript{802}. \textit{See} Dronsejko v. Grant Thornton, 632 F.3d 658, 665 (10th Cir. 2011); \textit{N.M. St. Inv. Council, 641 F.3d at 1095.} The Tenth Circuit in \textit{Dronsejko} commented that “sister-circuits have developed a recklessness standard specifically for Section 10(b) claims against outside auditors but then stated that it “need not decide whether to adopt an auditor-specific standard” because the complaint failed under the generally applicable standard. 632 F.3d at 665, 666 (citations omitted). The Ninth Circuit, on the other hand, rejected the entire notion of a special set of rules for auditor scienter. \textit{N.M. St. Inv. Council, 641 F.3d at 1095 (citing South Ferry LP, No. 2 v. Killinger, 542 F.3d 776, 784 (9th Cir. 2008)).}
of the auditor opinion be shown both subjectively (auditor did not believe the opinion) and objectively (facts provided no reasonable basis for the opinion), should—if rigorously applied—afford all the protection that auditors should enjoy.

Perhaps auditors need additional protection because they are especially vulnerable to destruction from open market Rule 10b-5 lawsuits with potentially enormous damages. But it seems odd for courts to impose a special rule to protect auditors for this reason. Arguably, legislative action—such as by a damage limitation—is a more appropriate avenue for such policy-driven concern.

Case against auditor who certified financials was based on misrepresentation so that presumption of reliance on material omissions did not apply. The In re Interbank Funding Corporation Securities Litigation plaintiffs sued Interbank’s auditor. Interbank had organized a series of funds that purchased and restructured distressed loans. The auditor had publicly opined that Interbank’s financial statements were accurate and conformed to GAAP. The plaintiffs alleged that Interbank had been running a Ponzi scheme involving transactions between Interbank and the multiple funds. In a proposed amended complaint, the plaintiffs alleged that the auditor had violated Rule 10b-5 by attesting to the accuracy of the Interbank financial statements—and their conformity with GAAP—because the financials failed to disclose related-party transfers (presumably between Interbank and the different funds), failed to reveal the loan losses suffered by one of the funds, and were marred by “‘a single constant omission: the class members were not informed they were investing in a Ponzi scheme.’” Affirming the district court’s denial of the motion to file an amended complaint because the amendment would be futile, the D.C. Circuit agreed with the lower court that the complaint did not plead reliance.

On appeal, the plaintiffs limited their reliance argument to a contention that, because they were suing on the basis of omissions, the court should presume reliance under Affiliate Ute Citizens v. United States. The court of appeals, however, held that the auditor’s public attestation “to the accuracy of numerous Interbank balance sheets as well as [to] the fact that the balance sheets conformed with

803. See infra notes 874–82 and accompanying text.
805. Id. at 216.
806. Id. at 216, 220.
807. Id. at 216.
808. Id. at 216 (quoting complaint), 217 (proposed amended complaint at issue on appeal asserted only section 10 claims against the auditor), 214 (named plaintiff had “alleged that she purchased securities of InterBank Funding Corporation” and sued on behalf of those similarly situated).
809. Id. at 217.
810. Id. (relying on Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972)). In Affiliated Ute, the Court applied a presumption of reliance in a situation “involving primarily a failure to disclose.” 406 U.S. at 153. The Interbank plaintiffs had asserted in the district court, but dropped by the time of the appeal, two additional arguments: (1) that they pled actual reliance on the auditor; and (2) that they should benefit from a “fraud-created-the-market” reliance presumption. 629 F.3d at 218 (highlighting plaintiffs’ decision to advance only the Affiliated Ute argument on appeal).
“GAAP” were “‘positive statements,’ which encompassed [the auditor’s] other alleged misdeeds pertaining to the nondisclosure of Interbank’s inter-fund transfers” and other omissions.811 Similarly, the allegation that the balance sheets omitted to state that Interbank was operating a Ponzi scheme rested on the affirmative misstatement of balance sheets, as a Ponzi scheme’s balance sheets would, if accurate, reflect diminishing equity.812 Since “[n]o court of appeals has applied the Affiliated Ute presumption in a case involving a claim that primarily alleges affirmative misrepresentations,”813 and since the plaintiffs pled that the auditor “did make express attestations, which were affirmative misrepresentations that encompassed the alleged omissions,” the “Affiliated Ute presumption” was “inapplicable.”814

Significance and analysis. Where there is an efficient market—as in a case where the plaintiffs have traded in an active secondary market for a public company’s securities—plaintiffs plead misrepresentations in order to take advantage of the “fraud-on-the-market” reliance presumption.815 But where the plaintiffs either bought in a private offering or bought in an initial public offering—both instances in which no efficient market sets the price after reacting to any misrepresentations—that fraud-on-the-market presumption does not apply.816

811. Interbank Funding, 629 F.3d at 220 (citation omitted).
812. Here was the court’s analysis:

Appellants argue that their claims are . . . premised on [the auditor’s] alleged omission of the fact that Interbank operated as a Ponzi scheme in Interbank’s financial statements . . . . Most of these financial statements were balance sheets. A balance sheet reflects a company’s financial position at a particular point in time by showing assets (resources controlled by the company), liabilities (creditors’ claims on the company’s resources), and stockholders’ equity (stockholders’ claims on the company’s resources). The accounting model of a balance sheet can be represented by the following equation:

\[ \text{Assets} = \text{Liabilities} + \text{Stockholders’ Equity} \]

See Fred Phillips et al., Fundamentals of Financial Accounting 12–13 (3d ed. 2011). The balance sheets of a profitable company would show increasing assets and concomitant increases in stockholders’ equity over time as the company’s investments gained value. By contrast, the balance sheets of a Ponzi scheme—which “generally describes a pyramid-type investment scheme where investors are paid profits from newly attracted investors promised large returns on their principal investments,” In re Fin. Federated Title & Trust, Inc., 309 F.3d 1325, 1327 n.2 (11th Cir. 2002)—would show decreasing assets as available cash is depleted to pay out promised rates of return to investors. Because the Ponzi scheme’s liabilities would not decrease as new investors continued to contribute capital, the balance sheets would show decreasing stockholders’ equity as the scheme paid out rates of return. Consequently, appellants’ characterization of [the auditor’s] failure to disclose the Ponzi scheme as an omission is off the mark. The label “Ponzi scheme” is simply a popular characterization of a fraudulent business practice that an accurate representation of the balance sheets would reveal. In order to operate as a Ponzi scheme, Interbank’s financial statements necessarily misrepresented the company’s financial position in order to attract new investors, and [the auditor] affirmatively misrepresented the accuracy of these statements by stating that they fairly presented Interbank’s financial position and conformed with GAAP.

Id. at 220.
813. Id. at 219.
814. Id. at 221.
815. See supra note 140 and accompanying text.
816. For a holding that the fraud-on-the-market presumption does not apply in the IPO context, see In re Initial Pub. Offerings Sec. Litig., 471 F.3d 24, 42–43 (2d Cir. 2006).
Accordingly, plaintiffs in private issue cases or IPO cases may want to plead only omissions, in order to invoke the Affiliated Ute presumption. The Interbank reasoning may frustrate that strategy where an affirmative statement by defendants arguably “encompassed” the omissions and therefore the presumption that securities purchasers relied on omitted material facts does not apply.\textsuperscript{817}

\textbf{Section 11: Statutory definition of “underwriter” did not extend to rating agencies that assisted investment banks in structuring mortgage-backed securities; plaintiff waived right to proceed in state court by failure to move for remand until after losing motion to dismiss; plaintiffs could not bring section 11 claim on sales of securities plaintiffs did not purchase; allegations of falsity must provide some degree of specificity; allegations that credit ratings were false required assertion that credit rating agencies did not believe the ratings they awarded.}

Section 11 creates liability for a limited set of defendants, but the section is hard on those defendants as it imposes virtually absolute liability on issuers, and liability on others tempered principally by an affirmative “due diligence” defense.\textsuperscript{818} The Second Circuit held last year that ratings agencies were not properly sued as “underwriters” in a section 11 case, despite the agencies’ participation in structuring the securities sold.\textsuperscript{819} The First Circuit held that (i) plaintiffs can waive their right to bring a section 11 case in state court; and, in the same opinion, further held that (ii) plaintiffs could not sue on behalf of purchasers who bought securities the plaintiffs did not purchase; (iii) plaintiffs must include some specificity in their allegations that statements in a registration statement were false; and (iv) allegations that credit ratings in registration statements were false failed for want of pleading that (a) the registration statements inaccurately reported the ratings, or (b) the agencies did not honestly award the ratings, or (c) the ratings lacked any basis, or (d) the ratings omitted critical information.\textsuperscript{820}

Ratings agencies not underwriters. Section 11 of the Securities Act imposes liability for misrepresentations or omissions in registration statements on (among others) “every underwriter” for a registered offering.\textsuperscript{821} The Securities Act defines “underwriter” to include “any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking” and “any person who . . . participates or has a participation in the direct or indirect underwriting of any such undertaking.”\textsuperscript{822}

\textsuperscript{817}. Indeed, the D.C. Circuit commented:

\textit{Had the financial statements not included [the auditor’s] express certification, [the auditor’s] silence about these errors might have been akin to the silence of the bank managers in Affiliated Ute. But [the auditor] did make express attestations, which were affirmative misrepresentations that encompassed the alleged omissions cited in the appellants’ complaint. The Affiliated Ute presumption is therefore inapplicable. Interbank Funding, 629 F.3d at 221.}


\textsuperscript{819}. See infra notes 821–42 and accompanying text.

\textsuperscript{820}. See infra notes 843–82 and accompanying text.


\textsuperscript{822}. Id. § 77b(11).
The Second Circuit applied this definition in 2011. The plaintiffs purchased mortgage pass-through certificates, created by pooling mortgages, dividing the rights to cash flows from those mortgages into tranches with different levels of risk, and selling certificates providing those rights out of the different tranches. The underwriters for the offerings created different risks for different tranches by, for example, subordinating the rights of some tranches to others. The degree of risk for any given tranche proved key to the sale of the certificates, as some investors wished to take only limited risk, and the rating for a tranche—provided by one of the established rating agencies (Standard & Poor’s, Moody’s Investors Service, Inc., and Fitch, Inc.) (collectively the “Rating Agencies”)—provided investors with the most important information about that risk.

The plaintiffs bought certificates, to many of which the Rating Agencies had awarded their highest credit rating on the basis (the plaintiffs alleged) of models that accounted for neither the more risky loans originated over time (e.g., sub-prime, interest only, negative amortization) nor deteriorating loan underwriting standards. The plaintiffs lost money when the Rating Agencies downgraded the certificates’ credit ratings in 2008.

The plaintiffs alleged that the Rating Agencies had participated with investment banks in designing the mortgage pools and certificates, particularly by advising the investment bankers—as the bankers created the pools and tranches—on the credit enhancements that would very likely lead to high credit ratings for particular tranches cut out of particular mortgage pools. The plaintiffs contended that, by participating in the creation of the securities in this way—"structur[ing] the

824. Id. at 171. Trusts that owned the pools issued the certificates, which were the securities at issue in this case. Id.
825. Id.
826. Id. at 171–72.
827. Id. at 171, 173.
828. Id. at 173.
829. Id. at 172. The court summarized the allegations as follows:

[Plaintiffs] allege that the Rating Agencies, which ordinarily serve as passive evaluators of credit risk, exceeded their traditional roles by actively aiding in the structuring and securitization process. Specifically, plaintiffs allege that issuing banks engaged particular Rating Agencies through a “ratings shopping” process, whereby the Rating Agencies reviewed loan-level data for a mortgage pool and provided preliminary ratings. The banks then negotiated with the Rating Agencies regarding the amount of credit enhancements and percentage of AAA certificates for each mortgage pool. By thus “play[ing] the agencies off one another” and choosing the agency offering the highest percentage of AAA certificates with the least amount of credit enhancements, the banks purportedly “engendered a race to the bottom in terms of rating quality.”

During and after this negotiation, the Rating Agencies engaged in an “iterative process” with the banks, providing “feedback” on which combinations of loans and credit enhancements would generate particular ratings. In the course of this dialogue, issuers adjusted the certificates’ structures until they achieved desired ratings. As one Moody’s officer described the process: “You start with a rating and build a deal around a rating.” Plaintiffs submit that the Rating Agencies thus helped determine the composition of loan pools, the certificates’ structures, and the amount and kinds of credit enhancement for particular tranches.

Id. (citations omitted).
certificates . . . to achieve desired ratings, which was a necessary predicate to the securities’ distribution in the market—\textsuperscript{830}—the Rating Agencies became “underwriters,” and the plaintiffs therefore named the Rating Agencies as defendants on the plaintiffs’ section 11 claims.\textsuperscript{831}

Affirming district court dismissal of those claims,\textsuperscript{832} the Second Circuit looked first to the “plain language” of the statute and “conclude[d] that common to all categories of persons identified as ‘underwriters’ by the plain language of [the Securities Act definition] is activity related to the actual distribution of securities.”\textsuperscript{833} And “[n]othing in the statute’s text supports expanding the definition of underwriter to reach persons not themselves participating in such purchases, offers, or sales, but whose actions may facilitate the participation of others in such undertakings.”\textsuperscript{834} While the circle of liability encompasses those who “participat[e] in the direct or indirect underwriting of any such undertaking,”\textsuperscript{835} “‘the participation must be in the statutorily enumerated distributional activities, not in non-distributional activities that may facilitate the eventual distribution by others.’”\textsuperscript{836} Here, while “[t]he complaints contain extensive descriptions of the Rating Agencies’ activities in structuring the certificate transactions, dictating the kinds and quantity of loans or credit enhancements needed for desired ratings, and providing modeling tools to traders to pre-structure loan pools,” the “plaintiffs failed to allege that defendants ‘participated in the relevant’ undertaking: that of purchasing securities from the issuer with a view towards distribution, or selling or offering securities for the issuer in connection with a distribution.”\textsuperscript{837}

\textsuperscript{830} Id. at 175.
\textsuperscript{831} Id. at 170–71.
\textsuperscript{832} Id. at 189.
\textsuperscript{833} Id. at 176. Section 11 imposes liability on:

(1) every person who signed the registration statement; (2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted; (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner; (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him; (5) every underwriter with respect to such security.  15 U.S.C. § 77k(a) (2006) (emphasis added).

\textsuperscript{834} Lehman Bros., 650 F.3d at 177.
\textsuperscript{835} 15 U.S.C. § 77k(a).
\textsuperscript{836} Lehman Bros., 650 F.3d at 181.
\textsuperscript{837} Id. at 182–83 (quoting the district court in In re Lehman Bros. Sec. & ERISA Litig., 681 F. Supp. 2d 495, 499 (S.D.N.Y. 2010)).

The court noted, in support of this conclusion, that the alleged Rating Agencies’ conduct occurred too early in the process to constitute underwriting, with their “efforts in creating and structuring certificates” in “the initial stages of securitization, not during efforts to disperse certificates to investors.” Id. at 183. The Second Circuit attributed no importance—in the determination of whether the Rating Agencies were “underwriters”—to the credit ratings that the Agencies provided, as these would be relevant not to whether the Agencies were within the category of section 11 defendants defined by the word “underwriter” but whether they were in the category of “experts” defined by section 11(a)(4). Id.
Significance and analysis. Section 11 “specific[ally] enumerate[s] . . . liable parties.” The Second Circuit reaffirmed that stretching the categories of identified defendants would threaten the limitation embodied in that specific enumeration. In the course of doing so, the court provided comfort to a variety of participants in the offering process, emphasizing that section 11 liability does not reach to “a number of persons necessary to the creation of securities, such as banks that originated the underlying loans, traders who structured the transactions, or experts who did not consent to being named,” also specifically referencing attorneys who do not provide expert opinions for inclusion in offering documents. This language accords with long-standing law that forbids the expansion of section 11 liability through aiding and abetting and conspiracy theories.

Plumbers’ Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp. last year offered the First Circuit an opportunity to provide rulings ranging from the proper court in which to litigate the case, to adequacy of pleading, to the substantive standard for falsity of an opinion. Nomura Asset purchased

In a second holding, the court of appeals affirmed dismissal of the control person claims against the Rating Agencies. Id. at 185–88. The Second Circuit ruled that the definition of “control” for purposes of that liability under section 15 of the Securities Act is the same as the definition of control for purposes of that liability under section 20(a) of the Exchange Act, and consists of “the power to direct or cause the direction of the management and policies of [the primary violators], whether through the ownership of voting securities, by contract, or otherwise.” Id. at 185 (citing SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1472–73 (2d Cir. 1996) (quoting 17 C.F.R. § 240.12b-2)). The court then concluded that the alleged ability of the Rating Agencies to “influence[] the primary violators by providing advice and feedback on appropriate loan prices and structures” and “advice and ‘strategic direction’ on how to structure transactions to achieve particular ratings” did not approach the “power to direct the primary violators’ management and policies.” Id. at 186–87 (internal citations omitted). The court wrote:

“All allegations of advice, feedback, and guidance fail to raise a reasonable inference that the Rating Agencies had the power to direct, rather than merely inform, the banks’ ultimate structuring decisions. Put another way, providing advice that the banks chose to follow does not suggest control. Id. at 187. Moreover, the plaintiffs’ allegations that the investment banks played the three different Rating Agencies off each other by “ratings shopping” suggested that the Agencies did not control the bankers. Id. at 184.

838. Id. at 184.

839. Id. (“[P]laintiffs’ theory would render these narrowly drawn categories meaningless.”). It was on this basis that the Second Circuit rejected the argument of one plaintiff, who contended that the Rating Agencies were “underwriters” not only because they participated in structuring the securities but because they “allegedly participat[ed] in drafting and disseminating offering documents.” Id. The court held that, while a participant in the preparation of offering documents can (under limited and defined circumstances) become an “expert” and so join the ranks of section 11 defendants under section 11(a)(4), “merely commenting on draft offering documents does not constitute the requisite participation in underwriting.” Id. at 184–85. To hold otherwise “would eviscerate the ‘specific categories of individuals defined in § 11 as the proponents of the [registration] statement,’ making ‘anyone who commented on a draft statement, however innocently, a guarantor of every assertion’ therein.” Id. at 184 (quoting In re Refco, Inc. Sec. Litig., No. 05 Civ 8626, 2008 WL 3843343, at *3 (S.D.N.Y. Aug. 14, 2008)).

840. Id.

841. Id. at 184 & n.12.


843. 632 F.3d 762 (1st Cir. 2011).
mortgages and transferred them to eight trusts, which then issued certificates, which were the securities in the case.\textsuperscript{844} The plaintiffs purchased certificates from two of the trusts but sued—under sections 11 and 12(a)(2)\textsuperscript{845} of the Securities Act—on behalf of a putative class consisting of purchasers from all eight trusts,\textsuperscript{846} alleging that the registration statements and prospectuses for sales of all the certificates contained false statements concerning the underwriting standards used to make the underlying mortgages,\textsuperscript{847} false statements concerning the appraisals of properties underlying those mortgages,\textsuperscript{848} and misleading statements about the certificates’ credit ratings.\textsuperscript{849} The court of appeals affirmed dismissal of all claims arising out of sales of certificates by the six trusts from which the plaintiffs did not purchase, affirmed dismissal of the remaining claims to the extent they rested on misrepresentations regarding appraisals or misleading statements about credit ratings, and vacated the dismissal of claims based on sales by the two trusts from which the plaintiffs bought insofar as those claims were based on misrepresentations about underwriting standards.\textsuperscript{850}

\textit{Plaintiff waiver of right to proceed in state court.} The First Circuit addressed two procedural points: First, section 22 of the Securities Act provides that federal and state courts have “concurrent” jurisdiction over “all suits in equity and actions in law brought to enforce any liability or duty created by [that act],” and further provides—with exceptions either not applicable here or assumed away by the court—that “no case arising under this [Act] and brought in any State court of competent jurisdiction shall be removed to any court of the United States.”\textsuperscript{851} The plaintiffs in \textit{Nomura Asset} originally filed in state court, then, when the defendants removed to federal court, the district court granted a motion to dismiss.\textsuperscript{852} In response to the plaintiffs’ argument on appeal that the district court had lacked jurisdiction, the First Circuit held that the nonremoval provision in section 22 is “a waivable right,” and had been waived here by failure to assert it until after the district court ruled against the plaintiffs on the motion to dismiss, because that interpretation “achieves the statute’s aim to protect the plaintiff’s preference for a state forum, but . . . prevents the mischief of allowing a party to sit on an objection, raising it only if and when the objector is dissatisfied with the result.”\textsuperscript{853}

\textit{Plaintiff can only sue on behalf of those purchasing a security that the plaintiff bought.} Addressing a second procedural point, the court of appeals noted that the

\begin{footnotesize}
\begin{enumerate}
\item[844.] \textit{Id.} at 766.
\item[846.] \textit{Id.} at 766–67.
\item[847.] \textit{Id.} at 772–73.
\item[848.] \textit{Id.} at 774.
\item[849.] \textit{Id.} at 774–75.
\item[850.] \textit{Id.} at 776–77.
\item[851.] 15 U.S.C. § 77v(a) (2006 & Supp. IV 2010). The court of appeals “assum[ed] that this limitation” on removal applied and specifically stated that it was not addressing any complications to that assumption created by the Class Action Fairness Act. \textit{Nomura Asset}, 632 F.3d at 767 & n.3.
\item[852.] \textit{Nomura Asset}, 632 F.3d at 766–67.
\item[853.] \textit{Id.} at 768.
\end{enumerate}
\end{footnotesize}
plaintiffs only purchased certificates issued by two of the eight trusts, and af-
affirmed dismissal of claims based on purchases of certificates from the six other
trusts. 854 Acknowledging that other circuits do not uniformly prohibit plaintiffs
from including in their case claims based on securities they did not purchase
themselves, and that the Supreme Court has not given clear guidance on that
issue, the First Circuit relied on its own precedent to hold that—at least where the
case does not provide the plaintiffs with “the same incentive to litigate the coun-
terpart claims”—the case should not “proceed, whether as a class action or not,
against defendants not implicated in any of the wrongs done to the named plain-
tiffs.” 856 The First Circuit extended that rationale even to dismissal of claims—
insofar as based on sales by the six trusts—against a defendant who was also a
defendant on the claims based on sales by the two trusts from which the plaintiffs
purchased because “the named plaintiffs [had] no stake in establishing liability as
to misconduct [by that defendant] involving the sales of those certificates” from
the other six trusts. 857

Allegations of falsity require some specificity. Turning from jurisdictional and
standing matters to substantive pleading, the appellate court recognized that
the allegations of false and misleading statements needed to include sufficient
facts to be facially plausible, 858 and that “courts increasingly insist that more spe-
cific facts be alleged where an allegation is conclusory [or] . . . implausible.” 859
Applying this standard, the First Circuit found sufficient the allegations that the of-
ferring documents misrepresented underwriting standards used to grant mortgage
loans the trusts held. The offering documents referred to a specific “‘key’ loan
originator”—stating that that originator “used ‘underwriting guidelines [that
were] primarily intended to evaluate the prospective borrower’s credit standing
and ability to repay the loan, as well as the value and adequacy of the proposed
mortgaged property as collateral.’ ” 860 The complaint then alleged that that loan
originator “‘routinely violated’ its lending guidelines and instead approved as

854. Id. at 768–71, 776.
855. Id. at 770.
856. Id. at 769 (citing Barry v. St. Paul Fire & Marine Ins. Co., 555 F.2d 3 (1st Cir. 1977), aff’d, 438
U.S. 531 (1978)). To explain why the “same incentive” was not present for the plaintiffs to litigate the
claims based on purchases from the other trusts, the court wrote:

In our case, as in others involving mortgage-backed securities, the necessary identity of issues
and alignment of incentives is not present so far as the claims involve sales of certificates in the
six trusts. Each trust is backed by loans from a different mix of banks; no named plaintiff has
a significant interest in establishing wrongdoing by the particular group of banks that financed
a trust from which the named plaintiffs made no purchases. Thus, the claims related to the six
trusts from which the named plaintiffs never purchased securities were properly dismissed, as
were the six trusts and defendants connected to only those six trusts.

Id. at 771.
857. Id.
858. Id. (citing Ashcroft v. Iqbal, 129 S. Ct. 1937, 1949 (2009)).
859. Id. at 773 (citations omitted). While the court did not say so, the court appeared to use a
Rule 8 standard to evaluate the complaint, and the opinion contains no mention of Rule 9.
860. Id. at 772 (quoting prospectus supplements for these shelf-registered offerings).
many loans as possible, even ‘scrub[bing]’ loan applications of potentially disqualifying material,” with such practices a part of that originator’s “‘business model,’ [which was] aimed at milling applications at high speed to generate profits from the sale of such risky loans to others.”

The “sharp drop in the credit ratings [of the certificates] after the sales and the specific allegations as to [an originator that the offering documents identified as ‘key’] offer[ed] enough basis to warrant some initial discovery aimed at these precise allegations.”

The court reached the opposite conclusion respecting the allegations that the offering documents falsely “stated that ‘[a]ll appraisals’ were conducted in accordance with the ‘Uniform Standards of Professional Appraisal Practice’ (‘USPAP’).” The complaint “allege[d] in a single general statement that the appraisals underlying the loans at issue here failed to comply with USPAP requirements.” And, unlike the allegations regarding the underwriting standards, there was “no allegation that any specific bank that supplied mortgages to the trusts” did not use complying appraisals. Instead, the complaint included a conclusory assertion that appraisers were coerced into providing appraisals with higher values than justified. The First Circuit refused to countenance such pleading because, if allowed, it would permit “virtually every investor in mortgage-backed securities” to survive a motion to dismiss and commence fishing expedition discovery.

Falsity of credit rating opinion. The First Circuit also found insufficient the allegations that the offering documents misled by saying (i) in some cases, that Standard & Poor’s or Moody’s had given the certificates particular ratings or (ii) in other

861. Id. Similarly, the prospectus supplements stated that, under the underwriting guidelines for that originator, “the prospective borrower must have a credit history that demonstrates an established ability to repay indebtedness in a timely fashion”; and ‘employment history is verified through written or telephonic communication.’” Id. at 772 n.9. The plaintiffs alleged that “contrary to the registration statement, borrowers did not ‘demonstrate[] an established ability to repay indebtedness in a timely fashion’ and employment history was not ‘verified.’” Id. at 772–73.

862. Id. at 773–74. Reversing the district court, the First Circuit found that the complaint pled misrepresentations regarding the underwriting in spite of cautions in the offering documents that the “underwriting standards . . . typically differ from, and are . . . generally less stringent than, the underwriting standards established by Fannie Mae or Freddie Mac”; that “certain exceptions to the underwriting standards . . . are made in the event that compensating factors are demonstrated by a prospective borrower”; and that [the identified “key” originator] “originates or purchases loans that have been originated under certain limited documentation programs” that “may not require income, employment or asset verification.”

. . . Neither being “less stringent” than Fannie Mae nor saying that exceptions occur when borrowers demonstrate other “compensating factors” reveals what plaintiffs allege, namely, a wholesale abandonment of underwriting standards. That is true too of the warning that less verification may be employed for “certain limited documentation programs designed to streamline the loan underwriting process.” Plaintiffs’ allegation of wholesale abandonment may not be proved, but—if accepted at this stage—it is enough to defeat dismissal.

Id. at 773.

863. Id. at 774 (alteration in original).

864. Id.

865. Id. (emphasis added).

866. Id.

867. Id.
cases, that the trusts would not sell the certificates unless one of those rating agencies awarded the certificates “an ‘investment grade’ rating . . . S&P (AAA through BBB) or Moody’s (Aaa through Baa3).” The court held that the ratings were “opinions purportedly expressing the agencies’ professional judgment about the value and prospects of the certificates” and that an opinion could only be misleading “if it does not represent the actual belief of the person expressing the opinion, lacks any basis or knowingly omits undisclosed facts tending seriously to undermine the accuracy of the statement.” The ratings were not misleading under this test simply because, as the plaintiffs alleged, the ratings “were based on ‘outdated models, lowered ratings criteria, and inaccurate loan information.’” Opinions are not false or misleading, for securities law purposes, if they “were honestly held when formed but simply turn out later to be inaccurate” or simply because those expressing the opinions “could have formed ‘better’” ones. Since “the ratings—inherently opinions and not warranties against error—were accurately reported by defendants . . . nothing more [was] required so long as the ratings were honestly made, had some basis, and did not omit critical information.” The plaintiffs did not allege any such facts to plausibly suggest the absence of any of those conditions.

Significance and analysis. Nomura Asset repeats a legally incorrect definition of a false or misleading opinion. The court states that an “opinion may . . . be misleading if it does not represent the actual belief of the person expressing the opinion, lacks any basis or knowingly omits undisclosed facts tending seriously to undermine the accuracy of the statement.” The First Circuit traces this standard back to a 1989 Ninth Circuit opinion, which said:

A projection or statement of belief contains at least three implicit factual assertions: (1) that the statement is genuinely believed, (2) that there is a reasonable basis for that belief, and (3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement. A projection or statement of belief may be actionable to the extent that one of these implied factual assertions is inaccurate.

868. Id. at 774–76.
869. Id. at 775.
870. Id.
871. Id.
872. Id. at 775–76 (citation omitted).
873. Although the plaintiffs pled that the rating agencies provided high ratings in order to win future business and “quote[d] individuals at the rating companies to support that proposition and to suggest that some inside the company thought that ratings were skewed,” the complaint “stop[ped] short of alleging expressly that the leadership of S&P or Moody’s believed that their companies’ ratings were false or were unsupported by models that generally captured the quality of the securities being rated.” Id. at 775.
874. Id. at 775 (emphasis added).
875. In re Apple Computer Sec. Litig., 886 F.2d 1109, 1113 (9th Cir. 1989).
After the Ninth Circuit published that formula, the Supreme Court unequivocally held in 1991 that “mere disbelief” by the speaker or writer of an opinion “should not suffice for liability” on the opinion in the securities law context.\(^{876}\) Instead, the Supreme Court held that an actionable opinion must “rest on a factual basis,”\(^{877}\) and that showing it to be false in a securities law case requires “demonstrat[ing] something false or misleading in what the statement expressly or impliedly declare[s].”\(^{878}\) The Second and Ninth Circuits have recently held that, in order for an opinion to be false, it must be both (i) subjectively false in that the speaker or writer does not believe it at the time that he or she offers the opinion and (ii) objectively false in that one or more facts that the opinion expresses or implies is not true.\(^{879}\)

Today, a court should find an opinion (including a prediction, which is simply a type of opinion) false or misleading for securities law purposes only if (i) the speaker or writer did not believe the opinion at the time he or she provided it and (ii) the opinion was objectively false either because (a) it had no reasonable basis or (b) the speaker or writer knew a fact that he or she did not disclose at the time of offering the opinion and that seriously undermined the opinion.\(^{880}\) The First Circuit test recited in \textit{Nomura Asset} does not match this correct formulation. Most alarmingly, the First Circuit’s use of the word “or” would permit a plaintiff to plead and prove an opinion false in a securities case simply by pleading and proving that the defendant did not believe the opinion—a proposition that is directly contrary to Supreme Court authority. In addition, the First Circuit at least suggests that a plaintiff, in order to show objective falsity by referring to the basis of the opinion, must plead and prove that the opinion “lacks any basis,” while the correct test permits a plaintiff to show objective falsity by pleading and proving that the opinion lacked any “reasonable” basis—as the Ninth Circuit held.\(^{881}\)


\(^{877}\) \textit{Id.} at 1093.

\(^{878}\) \textit{Id.} at 1096.

\(^{879}\) Fait v. Regions Fin. Corp., 655 F.3d 105, 110 (2d Cir. 2011), summarized infra notes 174–83; Rubke v. Capitol Bancorp Ltd., 551 F.3d 1156, 1162 (9th Cir. 2009) (holding opinions actionable “only if the complaint alleges . . . that the statements were both objectively and subjectively false or misleading”).

\(^{880}\) See McGuire v. Dendreon Corp., 688 F. Supp. 2d 1239, 1243 (W.D. Wash. 2009) (stating that the court “is, frankly, at a loss to account for the proliferation of Apple Computer-based rulings in the wake of \textit{Virginia Bankshares}”).

\(^{881}\) As the Ninth Circuit pointed out, the opinion might also be objectively false or misleading for failure to disclose a fact that seriously undermined it. See 15 U.S.C. § 77k(a) (2006) (creating liability for “omit[ting] to state a material fact . . . necessary to make the statements [in the registration statement] not misleading”); 15 U.S.C. § 77l(a)(2) (2006) (creating liability for selling a security “by means of a prospectus or oral communication, which . . . omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading”); 17 C.F.R. § 240.10b-5(b) (2011) (making it unlawful, in the purchase or sale of a security “[t]o . . . omit 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”); see also Securities Act Rule 408(a), 17 C.F.R. § 230.408(a) (2011) (“In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are
The First Circuit’s carelessness did not produce a miscarriage in *Nomura Asset*. As the court pointed out, the plaintiffs never pled facts to show that the rating agencies—let alone the defendants—subjectively believed that the ratings were false. But *Nomura Asset* is not the only recent opinion to misstate the test for false opinions.\(^{882}\) Perpetuating the wrong legal standard will eventually produce opinions that err in their results as well as in their reasoning.

**Securities law violation as a defense to contract liability:** Under section 29(b) of the Exchange Act, borrowers could raise violations of margin regulations as an affirmative defense in a suit on their loan obligations even though they might not have a cause of action for violation of the margin rules or be within the “zone of interests” to be protected by those rules.

Exchange Act section 29(b) provides that “[e]very contract made in violation of any provision of” the act “or of any rule or regulation” adopted under the act “and every contract . . . the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of” the act or any such rule or regulation “shall be void . . . as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract.”\(^{883}\) In *Costello v. Grundon*, the plaintiff asserted the rights of a bank against former employees of Comdisco, Inc. (“Comdisco”), who borrowed money from the bank through a shared investment plan (“SIP”) to finance the purchase of Comdisco stock that Comdisco would hold until the employees repaid the bank through sale of the shares.\(^{884}\) With some exceptions, a participating employee could not sell the stock during the first year of ownership, could sell during the second and third years but would have to share 50 percent of profits with Comdisco, and could sell after three years and keep all profits himself or herself.\(^{885}\) Comdisco had a right of first refusal when the employee decided to sell; its compensation committee could impose additional restrictions on the timing, amount, and form of stock sales; and the employee could not use the stock as collateral for another loan.\(^{886}\) Comdisco guaranteed the loans from the bank to the employees to provide the money employees used to buy the stock.\(^{887}\)

Comdisco filed for bankruptcy.\(^{888}\) As this was an event of default under the terms of the loans, the bank accelerated the amounts due, and Comdisco settled

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\(^{884}\) *Costello v. Grundon*, 651 F.3d 614, 618 (7th Cir. 2011).

\(^{885}\) Id. at 618–19.

\(^{886}\) Id. at 631.

\(^{887}\) Id. at 618.

\(^{888}\) Id. at 620.
its liability on the guarantees by paying the bank in exchange for assignment of the bank’s rights against the employees, which the Comdisco Litigation Trustee sought to enforce by suing the employees in the action here. 889 The employees responded by asserting, among others, an affirmative defense under section 29(b) because the loans and guarantees violated the margin rules in Regulations G and U. 890 The district court granted summary judgment to the Litigation Trustee, 891 and the Seventh Circuit vacated that judgment. 892

The court of appeals held, first, that the trial court had erred in ruling that the employees could not assert the defense under section 29(b) because they had no private right of action under that section for violation of Regulations G and U and no right of action under section 7(d), pursuant to which those regulations issued. 893 The Seventh Circuit reasoned that, generally, any obligor can defend on the basis that a contract violates federal law and that “[n]o private right of action under a statute is necessary to assert a violation of that statute as an affirmative defense.” 894 Moreover, by its terms, section 29(b) “provides the [employees] with the right to raise violations of the [Exchange] Act and margin regulations defensively to preclude enforcement of a contract.” 895 Indeed, since section 29(c) 896 sets out “circumstances under which a loan or extension of credit cannot be avoided” by an asserted violation of the Exchange Act or the regulations under that law, that subsection “implies that a loan or extension of credit can be avoided under other circumstances.” 897 For all these reasons, the district court was also wrong in ruling that the employees could not assert a section 29(b) defense, based on violations of Regulations G and U, because the employees “were outside the ‘zone of interests’ protected by the margin regulations.” 898 While a “zone of interests”

889. Id.
890. Id. at 621–22.
891. Id. at 620–21.
892. Id. at 641.
893. Id. at 629.
894. Id. at 624.
895. Id. at 625.
896. Subsection (c) provides:

Nothing in this chapter shall be construed (1) to affect the validity of any loan or extension of credit (or any extension or renewal thereof) made or of any lien created prior or subsequent to the enactment of this chapter, unless at the time of the making of such loan or extension of credit (or extension or renewal thereof) or the creating of such lien, the person making such loan or extension of credit (or extension or renewal thereof) or acquiring such lien shall have actual knowledge of facts by reason of which the making of such loan or extension of credit (or extension or renewal thereof) or the acquisition of such lien is a violation of the provisions of this chapter or any rule or regulation thereunder, or (2) to afford a defense to the collection of any debt or obligation or the enforcement of any lien by any person who shall have acquired such debt, obligation, or lien in good faith for value and without actual knowledge of the violation of any provision of this chapter or any rule or regulation thereunder affecting the legality of such debt, obligation, or lien.

897. Costello, 651 F.3d at 627.
898. Id. at 629.
analysis constitutes “a limitation of prudential standing to maintain an action,” it is not relevant to assertion of an affirmative defense.\textsuperscript{899}

\textbf{Securities Litigation Uniform Standards Act: }Exception for cases that “involve[] the purchase or sale of securities by the issuer . . . exclusively from or to holders of equity securities of the issuer” did not save from SLUSA preclusion a case alleging that fraud induced owners of mutual fund shares to hold those shares; on a motion to remand, a district court can dismiss a case with prejudice based on SLUSA preclusion; Sixth and Seventh Circuits split over whether misrepresentation or omission allegations must be critical to the plaintiff’s case in order that SLUSA apply.

SLUSA defines a “covered class action” as a lawsuit brought on behalf of more than fifty persons.\textsuperscript{900} SLUSA requires that covered class actions be based on federal securities law and proceed in federal court if plaintiffs allege “an untrue statement or omission of a material fact in connection with the purchase or sale” of a “covered security”—essentially a security listed on a national exchange.\textsuperscript{901} SLUSA forbids—in a covered class action, whether brought in federal or state court—claims for fraud in the purchase or sale of a covered security where the claims rest

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\textsuperscript{899} Id. The Seventh Circuit decision includes many other holdings, three of which deserve footnote description. First, the court held that the record showed a genuine issue of material fact as to whether the bank had violated the margin rules. Id. at 629–30. While the documents for the SIP stated that “the Loan is not secured by the stock,” that the “shares do not serve as collateral for the loan,” that “the loan is not a margin loan,” id. at 619, and that the bank had not relied on the shares in extending the credit (and was therefore entitled to the “good faith” non-reliance exception in 12 C.F.R. § 221.3(g)(1), which would have saved the bank from some but not all of the regulatory violations), certain facts suggested that the bank had relied on the stock:

Some of the [employees’] financial statements support a reasonable inference that the statements could not reasonably support the loan. For example, a loan was made in excess of $1,000,000 to one borrower (05-737) who reported no net worth to the Bank, another loan was made to another borrower (05-745) for almost ten times his net worth, and loans were made to two other borrowers (05-735 & 05-726) for more than five times their net worths. Id. at 630. Second, while Comdisco’s outside counsel had sought and obtained an opinion from an attorney at the Federal Reserve Bank of Chicago that the SIP would not violate Regulations G and U, the Seventh Circuit—while acknowledging that the Fed attorney’s “letter is some indication that the regulations were not violated,” id. at 632—held that the letter was not “conclusive[ ]” on that point, id., given (i) that the letter expressly qualified the opinion on the absence of restrictions on the stock, while in fact the stock was restricted by Comdisco’s right of first refusal, the right of its compensation committee to impose conditions on the timing, amount, and manner of sale, and the prohibition on the employees’ use of the stock as collateral for other loans; and (ii) that the letter addressed only whether the bank would violate Regulations G and U by participating in the SIP, not whether Comdisco would do so by providing its guarantee, id. at 631. On the latter point, the court “emphasize[d] that the issue is not whether the stock directly secured the Bank’s loans, but whether the stock indirectly secured the loans and/or secured the guaranty.” Id. at 633. Third, in the course of holding that the district court wrongly decided against the employees’ affirmative defense that the SIP violated Rule 10b-5 on the basis of a scienter argument that the Trustee raised in a reply, id. at 634–37, the Seventh Circuit held that the special scienter pleading rules with their emphasis on weighing competing inferences, see supra notes 538–44 and accompanying text, do not “change[] the well-established summary judgment standard” under which “a court may not weigh the evidence or decide which inferences should be drawn from the facts.” Id. at 636.


on state common or statutory law. If plaintiffs file a covered class action in state court—asserting state law claims based on misrepresentations or omissions in the purchase or sale of a covered security—defendants can remove the case to federal court. The federal court can dismiss the case as precluded by SLUSA.

Last year, the Sixth Circuit held that the SLUSA exemption for cases based on purchases by an issuer from existing stockholders did not apply where mutual fund shareholders sued to recover losses incurred because they abstained from exercising redemption rights. In the same decision, that court ruled a district court properly dismissed a complaint—based on SLUSA preclusion—in response to a motion to remand and further held that any allegation of a misrepresentation or omission in connection with the purchase or sale of a security brings SLUSA into play, even if that allegation is not material to the claims a plaintiff pleads.

Taking a different view on that last issue, the Seventh Circuit expressed sympathy with the notion that SLUSA should not apply if fraud allegations are extraneous detail in a complaint, but affirmed dismissal in the case before it because the asserted breach of fiduciary duty would not, in the appellate court’s opinion, succeed unless the defendants had committed fraud in the sale of the securities involved.

Exemption for cases based on issuer sales to or purchases from existing shareholders. SLUSA expressly exempts certain state law actions from its reach, including a “covered class action” if it involves “the purchase or sale of securities by the issuer . . . exclusively from or to holders of equity securities of the issuer.” The Sixth Circuit interpreted that exclusion last year in Atkinson v. Morgan Asset Management, Inc. The plaintiffs had purchased redeemable shares in open-end mutual funds. They sued in state court, asserting state law causes of action, based on the theory that they would have redeemed their shares and exited the funds had they understood that the defendants would take “unjustified risks in allocating the funds’ assets” and would “conceal[] these risks from shareholders.” The defendants removed the case to federal court and the district court—enforcing

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903. Id. §§ 77p(c), 78bb(f)(2).
904. Merrill Lynch, Pierce, Fenner & Smith v. Dabit, 547 U.S. 71, 87 (2006) (SLUSA “denies plaintiffs the right to use the class-action device to vindicate” certain state-law claims); Kircher v. Putnam Funds Trust, 547 U.S. 633, 643 (2006) (“§ 77p(c) ‘provides that any class action described in subsection (b) that is brought in a State court shall be removable to Federal district court, and may be dismissed pursuant to the provisions of subsection (b)” (quoting S. REP. NO. 105-182, at 8 (1998))); id. at 644 (“[i]f the action is precluded, neither the district court nor the state court may entertain it, and the proper course is to dismiss”).
905. See infra notes 908–18 and accompanying text.
906. See infra notes 919–27 and accompanying text.
907. See infra notes 928–38 and accompanying text.
909. 658 F.3d 549 (6th Cir. 2011).
910. Id. at 551.
911. The plaintiffs asserted thirteen claims “for breach of contract, violations of the Maryland Securities Act, breach of fiduciary duty, negligence, and negligent misrepresentation.” Id. at 552.
912. Id.
SLUSA preclusion—dismissed the case with prejudice after the plaintiffs moved to remand.\footnote{913. \textit{Id.}} On appeal, the plaintiffs argued that SLUSA did not apply because their case fell within the exception for cases involving purchase or sale of securities by the issuer.\footnote{914. \textit{Id.}} Affirming the dismissal,\footnote{915. \textit{Id.} at 557.} the Sixth Circuit rejected this argument because the plaintiffs did not allege any purchase or sale by the issuer, only that the plaintiffs had held their redeemable securities and suffered harm because they had not sold back to the issuer through a redemption.\footnote{916. \textit{Id.} at 553.} The court acknowledged that the plaintiffs’ purchase of shares in the funds—including purchase of the redemption right—constituted a purchase of securities, but the plaintiffs alleged no wrongdoing in connection with that purchase, and the Sixth Circuit held that “a fund’s redemption obligation under an already-acquired” share does not “amount[] to an indefinitely extending ‘purchase’ ” within the meaning of the SLUSA exception.\footnote{918. \textit{Id.} (emphasis omitted).}

\textit{Enforcing SLUSA preclusion by dismissing in ruling on a motion to remand}. Beyond its interpretation of the SLUSA exemption, the court of appeals provided two other particularly interesting holdings in \textit{Atkinson}. The Sixth Circuit rendered the first in considering the plaintiffs’ argument that they had not had a fair opportunity to amend their complaint because the district court simply dismissed it with prejudice in the course of ruling on the plaintiffs’ motion to remand.\footnote{919. \textit{Atkinson}, 658 F.3d at 556.} The Sixth Circuit responded that the plaintiffs “misunderstand the SLUSA process,” in which a motion to remand “itself poses a ‘jurisdictional issue.’ ”\footnote{920. \textit{Id.} (quoting \textit{Kircher v. Putnam Funds Trust}, 547 U.S. 633, 643–44 (2006)).} As the Supreme Court put it in the case that the Sixth Circuit cited, “[i]f the court finds that ‘the action is precluded [so that remand is inappropriate], neither the district court nor the state court may entertain it, and the proper course is to dismiss.”\footnote{921. \textit{Id.}}
What allegations of misrepresentations or omissions “in connection with” the purchase or sale of security implicate SLUSA. In a second additional Atkinson holding, the court of appeals rejected the plaintiffs’ alternative argument that, if the SLUSA exception did not save their case, their claims were not covered by SLUSA at all because they did not allege any “‘untrue statement or omission of a material fact.’” 922 The Sixth Circuit pointed to introductory portions of the complaint in which the plaintiffs charged “that Defendants ‘fail[ed] to provide truthful and complete information about the Funds’ portfolios,’” with the court noting further that (i) the breach of contract claims included “allegations . . . that Defendants misrepresented assets, created prospectuses with misleading financial information, and failed to disclose material information during audits”; (ii) the breach of fiduciary duty claims included allegations “that Defendants employed false financial statements and less-than-full disclosures”; and (iii) the “negligence claims [included allegations] that Defendants withheld material facts.” 923 While the plaintiffs argued that these averments did not trigger SLUSA because none of their state law claims “require[d] fraud as a necessary element,” 924 the Sixth Circuit held that SLUSA applies to a covered class action brought by “any private party alleging an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security,” 925 so that its application depends not on “whether the complaint makes ‘material’ or ‘dependent’ allegations of misrepresentation in connection with buying or selling securities . . . [but] whether the complaint includes these types of allegations, pure and simple.” 926 This raised the further issue of whether the district court, instead of dismissing with prejudice, should have permitted the plaintiffs to amend in order to avoid SLUSA by removing the nonessential language asserting fraud, an issue that the Sixth Circuit resolved by holding that “fraud-based concepts invade each of Plaintiffs’ claims, making efforts at artful amendment futile.” 927

The Seventh Circuit took a seemingly more liberal view last year on the question of whether allegations of fraud—without claims for fraud—activate the SLUSA preclusion, but still affirmed a dismissal in Brown v. Calamos. 928 The

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922. Id. at 554 (quoting 15 U.S.C. § 77p(b)(1)).
923. Id. at 554–55.
924. Id. at 555.
926. Atkinson, 658 F.3d at 555 (quoting Segal v. Fifth Third Bank, N.A., 581 F.3d 305, 311 (6th Cir. 2009), cert. denied, 130 S. Ct. 3326 (2010)).
927. Id. at 556. The court also rejected the argument that the plaintiffs should have been allowed to amend in order to reduce the number of plaintiffs to below fifty and thereby escape the definition of a “covered class action.” Id. The court wrote:

We find Plaintiffs’ class-shaving argument . . . unavailing; distilled to its essence, we read the argument as positing that dismissal with prejudice is never permitted in SLUSA cases because a class could always amend to sufficiently limit its numbers. This is not how SLUSA works. Plaintiffs originally could have filed a class action with up to forty-nine members without worry of SLUSA; but once a case is a “covered class action,” or has more than fifty members, the action “may [not] be maintained” if it is based on allegations of fraud.

Id.
928. 664 F.3d 123 (7th Cir. 2011), petition for cert. filed, 80 U.S.L.W. 3573 (U.S. Mar. 23, 2012) (No. 11-1173).
plaintiffs purchased common stock in a closed-end investment company and sued for breach of fiduciary duty because the fund redeemed auction-market preferred stock ("AMPS") and replaced that portion of the fund’s capital structure with shorter term, higher rate debt. The plaintiffs alleged “that the reason the fund redeemed the AMPS . . . was that . . . the fund’s parent . . . wanted to curry favor with the investment banks and brokerage houses that were facing lawsuits both from regulatory agencies and from disappointed customers who had purchased AMPS thinking their investment would always be liquid.” After the defendants removed the state-filed case to federal court, the district court dismissed the action as barred by SLUSA. Affirming this dismissal, the Seventh Circuit in Brown faced something of the same argument that the Sixth Circuit analyzed in Atkinson—that any misrepresentations or omissions were “inessential to the plaintiff’s success” and therefore could not trigger SLUSA preclusion. Noting the Sixth Circuit’s “literalist approach” that finds SLUSA applicable if the claim includes fraud allegations, even if only as background, and contrasting that with a Third Circuit approach that finds SLUSA inapplicable if the fraud allegations are only “extraneous detail,” the Seventh Circuit held that the plaintiffs in Brown would fail even under a test “close to the Third Circuit’s” because “[t]he allegation of fraud would be difficult and maybe impossible to disentangle from the charge of breach of the duty of loyalty that the defendants owed their investors.” Without deception about it, the Calamos board—which was “a unitary board, responsible to the entire family of funds,” and therefore could have had the “responsibility . . . to make tradeoffs to the disadvantage of investors in one of the funds for the sake of the welfare of the family as a whole”—might not have violated any fiduciary duty by the conduct that the plaintiffs alleged. Accordingly, “[t]he fact that the complaint disclaim[ed] any claim of fraud [could not] save it” given that “the breach appear[ed] to rest on an allegation of fraud.”

Significance and analysis. Both Atkinson and Brown reflect a judicial enthusiasm in finding that SLUSA applies, and in strictly construing its exceptions. That inclination may stem from the circumstance that the statute itself sought to stifle

929. Id. at 125–26.
930. Id. at 126.
932. The Seventh Circuit found in the complaint both an alleged misrepresentation (that the common stockholders would indefinitely profit from the leverage provided by AMPS) and an alleged omission (“that the fund might at any time redeem AMPS on terms unfavorable to the common shareholders because motivated by the broader concerns of the entire family of 20 Calamos mutual funds”). Brown, 664 F.3d at 127.
933. Id.
934. Id. at 127–29.
935. Id. at 130.
936. Id. at 130–31.
937. See also, e.g., Demings v. Nationwide Life Ins. Co., 593 F.3d 486 (6th Cir. 2010) (interpreting strictly the exception for suits brought by states, political subdivisions of states, and state pension plans).
efforts of plaintiffs’ counsel to avoid the limitations on securities class actions created by the PSLRA by bringing such actions in state court.\footnote{938. Merrill Lynch, Pierce, Fenner & Smith v. Dabit, 547 U.S. 71, 81–82 (2006).} It is otherwise hard to explain holdings such as those in \textit{Atkinson}, where the court endorsed a dismissal with prejudice instead of offering an opportunity for the plaintiffs to replead to remove fraud allegations if they could, and \textit{Brown}, where the court simply speculated that the plaintiffs could not formulate their case without fraud allegations due to the unitary board that the various Calamos funds shared.

**Additional Cases:** Share “sterilization” was not available as a remedy in a private section 13(d) action where adequate disclosure of defendant’s control ambitions occurred approximately six months before the shareholder vote; documents created in an internal investigation did not fall outside the protection of the attorney-client privilege simply because they addressed steps the company could take to avoid in the future the circumstances generating the possible liability that prompted the investigation, and did not fall outside that protection simply because the company required communications during the investigation to proceed through counsel for the purpose of protecting the communications by the privilege; prohibition against use, to prove predicate violation for civil RICO action, of conduct actionable as Rule 10b-5 fraud applied even though the civil RICO plaintiff could not have sued under Rule 10b-5 because the plaintiff could only have alleged that the defendant aided and abetted the 10b-5 violation; statutes do not authorize FINRA to bring actions to collect fines that it imposes; the National Association of Securities Dealers’ (“NASDAQ”) absolute immunity for regulatory actions barred suit for allegedly misleading statements by which the NASD sought proxies to amend its bylaws in order to facilitate consolidation of regulatory functions with the New York Stock Exchange (“NYSE”); limited liability partnership interests were investment contracts and therefore securities; limited liability company interests were not investment contracts where, although the purchaser lacked the technical expertise to run the business operations, the investor participated extensively in the businesses’ finances and the business was able to continue even after the promoter left; two Eleventh Circuit decisions addressing whether sales of condominium units were investment contracts due to related rental management agreements reached different conclusions; terms of stock purchase agreement determined that a purchase occurred in the United States and therefore, in the sale of a security not traded on a U.S. exchange, Rule 10-5 applied

Courts of appeals decided a plethora of other noteworthy securities cases last year. The Second Circuit held that a court properly denies a share sterilization remedy in a section 13(d) action where it is possible to order adequate disclosure in time for shareholder consideration before a vote.\footnote{939. See infra notes 948–57 and accompanying text.} The First Circuit held that documents generated in an internal investigation did not forfeit the protection of the attorney-client privilege simply because the purpose of the investigation was to help the company avoid future liability for actions like those generating the inquiry, or because the protocols for the investigation required that documents be routed through attorneys for the purpose of clothing them with the protections
that the privilege provides.\textsuperscript{940} The Second Circuit ruled that the exclusion prohibiting civil RICO actions based upon conduct actionable as securities fraud bars a RICO suit by a plaintiff, even when that plaintiff could not sue under Rule 10b-5 because the plaintiff had only an aiding and abetting action under that rule.\textsuperscript{941} That same circuit found that the Exchange Act provides no statutory basis for FINRA suits to collect fines that FINRA levies on members\textsuperscript{942} and also that SRO immunity barred an action against NASD alleging misstatements in a proxy statement seeking a bylaw amendment necessary for transfer of enforcement authority to FINRA.\textsuperscript{943} Multiple decisions applied the definition of “investment contract” to determine whether purchasers had bought a “security”—with the Eleventh Circuit holding that limited liability partnership interests in local telephone service businesses were investment contracts,\textsuperscript{944} the Fifth Circuit ruling that an LLC interest held by an investor who participated in the financial management of a business was not an investment contract,\textsuperscript{945} and the Eleventh Circuit authoring two decisions that are difficult to reconcile and that considered whether purchases of condominiums in developments intended for short-term rentals were investment contracts.\textsuperscript{946} Finally, the Eleventh Circuit held that the purchase of nonexchange-traded stock in a transaction that closed by its terms with the delivery of documents to a courier service in the United States was subject to Rule 10b-5 under the test enunciated by the Supreme Court in 2010 to determine the territorial reach of that rule.\textsuperscript{947}

\textit{Section 13(d) remedy}. Section 13(d) of the Exchange Act requires that a group of shareholders together owning more than 5 percent of an equity security registered under section 12 of the Exchange Act file a Schedule 13D within ten days of the group’s formation, where the group is formed for the purpose of acquiring, holding, voting, or disposing of the security.\textsuperscript{948} In \textit{CSX Corp. v. Children’s Investment Fund Management, LLP}, two hedge funds purchased stock in CSX Corporation (“CSX”).\textsuperscript{949} The funds communicated with each other, and—by November 2006—were communicating with CSX and with banks about actions that might increase CSX’s value, including a possible leveraged buyout.\textsuperscript{950} The funds did not file a Schedule 13D until December 19, 2007.\textsuperscript{951} In early January 2008, the

\textsuperscript{940} See infra notes 958–62 and accompanying text.
\textsuperscript{941} See infra notes 963–68 and accompanying text.
\textsuperscript{942} See infra notes 969–75 and accompanying text.
\textsuperscript{943} See infra notes 976–79 and accompanying text.
\textsuperscript{944} See infra notes 980–86 and accompanying text.
\textsuperscript{945} See infra notes 987–95 and accompanying text.
\textsuperscript{946} See infra notes 996–1021 and accompanying text.
\textsuperscript{947} See infra notes 1022–28 and accompanying text.
\textsuperscript{949} 654 F.3d 276, 278 (2d Cir. 2011) [hereinafter CSX 2011]. The funds also entered into cash-settled total-return equity swaps with bank counterparties. Id. at 280. The panel disagreed over whether “the long party to such swap agreements may have or be deemed to have beneficial ownership of shares purchased by the short [counter]party as a hedge” against the counterparty’s risk. Id. at 279. The court avoided that question by deciding the case on the basis of the shares that the funds owned outright. Id.
\textsuperscript{950} Id. at 281.
\textsuperscript{951} Id.
funds began a proxy fight to elect a minority slate of CSX directors.\footnote{952 Id.} CSX sued the funds, alleging that they had failed to timely file the Schedule, and the district court—among other things—found a violation, enjoined the funds from further violations, and denied CSX’s prayer for relief that would have prohibited the funds from voting the shares they owned at the upcoming shareholders’ meeting.\footnote{953 Id. at 281–82.} While the Second Circuit in 2008 affirmed the district court order denying the share sterilization remedy,\footnote{954 CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP, 292 F. App’x 133, 133–34 (2d Cir. 2008).} the court did not explain its reasoning until this last year.\footnote{955 CSX 2011, 654 F.3d at 286.} The explanation was brief: “the interests that section 13(d) protects ‘are fully satisfied when the shareholders receive the information required to be filed,’” as they did here because “the Funds’ section 13(d) disclosures occurred in December 2007, approximately six months before the June 25, 2008 shareholders’ meeting.”\footnote{956 Id. (quoting Treadway Cos. v. Care Corp., 638 F.2d 357, 380 (2d Cir. 1980)).} “[A]n injunction prohibiting the voting of shares is inappropriate when the required disclosures were made in sufficient time for shareholders to cast informed votes.”\footnote{957 Id. at 287. The court did “not reach” “the question of what remedies might be appropriate when disclosure that is timely with respect to a proxy contest is not made.” Id.}

Attorney-client privilege in internal investigation. Companies regularly conduct internal investigations of possible regulatory or other legal violations in a way calculated to shield from discovery the documents that the investigation generates.\footnote{958 Barry F. McNeil & Brad D. Brian, Overview: Initiating an Internal Investigation and Assembling the Investigative Team, in INTERNAL CORPORATE INVESTIGATIONS 1, 10–11 (Barry F. McNeil & Brad D. Brian eds., 3d ed. 2007); see also Dennis J. Block & Nancy E. Barton, Implications of the Attorney-Client Privilege and Work-Product Doctrine, in INTERNAL CORPORATE INVESTIGATIONS, supra 17, 17–91.} Last year, the First Circuit rejected an argument that such documents were not protected by the attorney-client privilege because the investigation was run “to help the company avoid similar problems in the future” and that therefore the documents were “unrelated to the provision of legal advice.”\footnote{959 Miss. Pub. Emps.’ Ret. Sys. v. Bos. Scientific Corp., 649 F.3d 5, 30 (1st Cir. 2011).} The court held that “focus[ing] on ways to prevent similar mistakes in the future [here the production and sale of a medical device producing adverse side effects] . . . was highly relevant to [the company’s] potential liability and consequently directly related to providing legal advice to [the company’s] management.”\footnote{960 Id. at 31.} The court similarly rejected the argument that materials created during the investigation were not privileged because the company’s employees were instructed to route written communications to each other through counsel.\footnote{961 Id. at 30–31.} The court held that “[i]n taking [this] step[] to protect attorney-client privilege . . . [company counsel] did not manufacture privilege but rather protected it.”\footnote{962 Id.}
Exclusion of securities-related conduct from civil RICO claims. No civil RICO claim can rest on “conduct that would have been actionable as fraud in the purchase or sale of securities.”\(^{963}\) Last year, the Second Circuit held that this prohibition applies to prevent a RICO action based upon securities fraud, even if the plaintiff would not have had standing to sue for recovery on that securities fraud.\(^{964}\) The court concluded that “the plain language of the statute ‘does not require that the same plaintiff who sues under RICO must be the one who can sue under securities laws.’”\(^{965}\) Moreover, the Conference Committee Report for the statutory prohibition stated that “the RICO Amendment’s purpose was to ‘remove [as a predicate act of racketeering] any conduct that would have been actionable as fraud in the purchase or sale of securities,’” rather than “removing ‘any claim that would have been actionable.’”\(^{966}\) Thus, the prohibition prevented the plaintiff in the case, which had invested in the infamous Madoff scheme, from bringing a civil RICO claim against JP Morgan on the ground that Morgan had continued to trade with Madoff after knowing he was diverting his customer’s funds,\(^{967}\) even though the caselaw forbidding private aiding and abetting claims under Rule 10b-5 also prohibited the plaintiff from bringing a Rule 10b-5 claim against Morgan.\(^{968}\)

FINRA authority to sue for unpaid fines. In a decision important to broker-dealers, the Second Circuit held that FINRA cannot bring court actions to collect fines that it imposes.\(^{969}\) While the Exchange Act grants FINRA the authority to impose


\(^{964}\) MLSMK Inv. Co. v. JP Morgan Chase & Co., 651 F.3d 268, 277 (2d Cir. 2011).

\(^{965}\) Id. at 278 (quoting In re Enron Corp. Sec., Derivative & ERISA Litig., 284 F. Supp. 2d 511, 620 (S.D. Tex. 2003)).


\(^{967}\) Id. at 272.

\(^{968}\) Id. at 274.

In one other case applying the prohibition against basing a RICO action on a securities fraud, the Ninth Circuit affirmed denial of a motion for summary judgment premised on the ground that the prohibition barred the plaintiff’s lawsuit. Rezner v. Bayerische Hypo-Und Vereinsbank AG, 630 F.3d 866 (9th Cir. 2010), cert. denied, 132 S. Ct. 115 (2011). The plaintiff sued the architects of a tax avoidance plan, the losses from which the IRS disallowed. \(^{969}\) Id. at 868–69. The plan required the plaintiff to obtain an interest in a loan and, in order to do so, the plaintiff pledged a brokerage account containing municipal bonds. \(^{969}\) Id. at 868. While a pledge of securities is a “sale” for securities law purposes, \(^{969}\) id. at 871, the misrepresentations in the case had to do with the tax treatment of the loan, not the pledge of the municipal bonds, \(^{969}\) id. at 872. Accordingly, the plaintiff did not seek to base his RICO case on “any conduct that would have been actionable as fraud in the purchase or sale of securities.” 18 U.S.C. § 1964(c) (2006). The plaintiff had made his own decision to pledge the bonds (instead of other assets) as collateral in order to use losses generated by the loan, so that the municipal “securities were merely a happenstance cog in the scheme.” \(^{969}\) Rezner, 630 F.3d at 872.

\(^{969}\) Fiero v. Fin. Indus. Regulatory Auth., 660 F.3d 569 (2d Cir. 2011). The case arose after FINRA fined John J. Fiero and Fiero Brothers, Inc. (the “Fieros”) $1 million for violating Rule 10b-5, \(^{969}\) id. at 572, FINRA had sued the Fieros for the $1 million in New York state court, and the New York Court of Appeals had ruled that the state court did not have jurisdiction because the Exchange Act provides for exclusive federal jurisdiction. \(^{969}\) Id. at 572–73. After these state court proceedings, the Fieros filed this lawsuit in federal district court for a declaration that FINRA had no authority to bring judicial actions seeking to collect fines, and FINRA counterclaimed for the fine. \(^{969}\) Id. at 573.
fines. Since the act does expressly grant the SEC the authority to sue for civil penalties and for other relief, Congress was “well aware of how to grant an agency access to the courts to seek judicial enforcement of specific sanctions” and, “[h]ad Congress intended [FINRA to] judicial[ly] enforce[] [its fines], [Congress] would surely have provided” for such enforcement. The Second Circuit observed that FINRA is not without a remedy against a broker-dealer that refuses to pay a fine, as FINRA can, on the basis of that refusal, revoke the broker-dealer’s FINRA membership, thereby excluding the broker-dealer from the securities industry in the United States. And the court somewhat provocatively commented that it “of course intimate[d] no opinion on the validity of a properly promulgated rule authorizing fine collection through judicial proceedings.”

970. FINRA consolidated the regulatory operations of the National Association of Securities Dealers, Inc. and the New York Stock Exchange and is now the “sole” SRO supervising broker-dealers in the United States. Id. at 571 n.1. Exchange Act section 15A(b) grants SROs the “authority and obligation to appropriately discipline[]” their members for violation of any provision of the Exchange Act, the rules or regulations promulgated thereunder, or their own rules, “by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.” Id. at 574 (quoting 15 U.S.C. § 78o-3(b)(7)).

971. Id. at 574.

972. Id. at 574–75 (citing Exchange Act § 21(d), 15 U.S.C. § 78u(d)). The court noted that section 21(d) and (f) grants the SEC authority to sue for an injunction against an SRO member who is breaking or is about to break an SRO rule (provided that either the SRO “is unable or unwilling to take appropriate action against such person” or “such action is otherwise necessary or appropriate in the public interest or for the protection of investors”), id., and that the SEC “takes the position that it has the authority to bring an action in a federal district court to enforce any order it issues that affirms sanctions, including fines, imposed by FINRA,” id. at 575 n.7.

973. Id. at 575. The Second Circuit, like the New York Court of Appeals, see supra note 969, rejected the option that FINRA could bring a common law action in state court to recover a penalty on the theory that all FINRA members signed a contract obligating them to obey the SRO’s rules and that failure to pay a fine that FINRA imposed therefore violated a contractual obligation. Id. at 575–76. The Second Circuit ruled that such FINRA actions, which might be filed in state court (just as FINRA had sued the Fieros in New York state court, supra note 969), could “undermine[]” the exclusive federal jurisdiction provision in the Exchange Act:

FINRA contract enforcement actions may bristle with Exchange Act legal issues because the most serious fines levied by FINRA will be for member violations of the Act. For example, the Fieros were charged with a violation of Section 10(b) of that Act. State court enforcement of FINRA fines might well, therefore, entail interpretation of the Exchange Act notwithstanding the exclusive jurisdiction of the federal courts.

Id. at 576.

974. Id. The Second Circuit further noted that NASD, FINRA’s predecessor (see supra note 970), had relied “exclusively upon its powers to revoke the registration of or deny reentry into the industry to punish members who [did] not comply with sanctions” until 1990, when the SRO announced a policy (approved by the SEC) that NASD would bring court actions to collect fines. Id. But the action against the Fieros was “said to be the first case brought under that policy,” id., and the NASD’s “longstanding practice” of declining to bring such actions implicated the axiom that “the want of assertion of power by those who presumably would be alert to exercise it, is . . . significant in determining whether such power was actually conferred.” Id. at 576–77 (quoting FTC v. Bunte Bros., 312 U.S. 349, 352 (1941)). Moreover, Congress knew that the NASD was relying on other enforcement methods rather than suing on its own, and “left that reliance unaltered,” reinforcing the conclusion that Congress did not intend that the SRO have authority to sue. Id. at 577.

975. Id. at 578 n.10.
SRO immunity. The Second Circuit also held the “absolute immunity” that SROs and their officers enjoy from “private damages suits in connection with the discharge of their regulatory responsibilities” shielded the NASD and its officers from liability for allegedly false statements made in a proxy solicitation seeking votes of NASD members to amend the NASD bylaws in order to close the asset purchase by which the regulatory functions of the NASD and the regulatory arm of the NYSE could combine into FINRA.\footnote{Standard Inv. Chartered, Inc. v. Nat’l Ass’n of Sec. Dealers, Inc., 637 F.3d 112, 114–16 (2d Cir. 2011), cert. denied, 132 S. Ct. 1093 (2012). The amendment changed NASD’s “one member, one vote” rule into a protocol “that distributed votes based upon the size of the member firm.” \textit{Id.} at 115. \textit{Id.} at 114, 117.} Affirming the district court order dismissing the case,\footnote{\textit{Id.} at 116 (quoting the district court).} the court of appeals agreed with the lower court that (i) “[a]lthough the shareholder vote for which the proxy statement was issued did not constitute a vote on the regulatory consolidation itself, the approval of the by-law amendments was . . . a necessary prerequisite to the completion of that consolidation” and (ii) the amendment of the bylaws was itself an exercise of NASD’s “rule-making authority,” which rendered the proxy solicitation—“the only vehicle available . . . for amending [those] bylaws”—“plainly ‘incident to the exercise of regulatory power.’”\footnote{\textit{Id.} (quoting \textit{SEC v. Wetherald}, 636 F.3d 1315, 1325 (11th Cir. 2011), alteration in original) (quoting \textit{SEC v. Merch. Capital, LLC}, 483 F.3d 747, 754 (11th Cir. 2007)).} The circumstance that the NASD could not amend its bylaws without SEC approval reinforced the conclusion that the NASD was exercising its regulatory power in soliciting proxies for the amendment.\footnote{\textit{Id.} at 117.} 

Application of “investment contract” definition. Both principal federal securities statutes include “investment contracts” within the definition of “security.”\footnote{15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (2006 & Supp. IV 2010).} For purposes of these definitions, “[a]n investment contract . . . means a contract, transaction or scheme whereby a person [1] invests his money in a [2] common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party.”\footnote{\textit{Id.} at 117.} The “solely” in the fourth part of the definition “should not be taken literally,” but “should require proof only that ‘the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.’”\footnote{1 LOUIS LOSS ET AL., FUNDAMENTALS OF SECURITIES REGULATION 380–81 (6th ed. 2011) (quoting \textit{SEC v. Glenn W. Turner Enters., Inc.}, 474 F.2d 476, 482 (9th Cir. 1973)).} In 2011, the Eleventh and Fifth Circuits combined to author four opinions applying the investment contract definition, all of which concentrated on the last element of the test.

First, the Eleventh Circuit ruled proof in a criminal case sufficient to support a jury conclusion that limited liability partnership interests in local telephone service businesses were investment contracts.\footnote{United States v. Wetherald, 636 F.3d 1315, 1325 (11th Cir.), cert. denied, 132 S. Ct. 360 (2011).} Addressing the fourth element—with “‘solely’ . . . not ‘interpreted restrictively’”\footnote{\textit{Id.} (quoting \textit{SEC v. Merch. Capital, LLC}, 483 F.3d 747, 754 (11th Cir. 2007)).}—the court pointed
to evidence that (i) “[t]he partnerships were sold as having the advantage of [the managing company’s] expertise”; (ii) “[i]nvestors . . . had no [industry] experience or knowledge” and were “assured” that none was needed; (iii) investors did not “vote on important decisions”; (iv) investor “committees had no power, met over the telephone, and were largely symbolic”; (v) “investors did not control disbursement of funds”; (vi) the organizer told a public utility commission “that the investors merely provided funding and had no say in the operations”; and (vii) when the business began to collapse, the investors could not even obtain financial statements.  

The jury could find the fourth element of an investment contract on such proof because “the economic reality” showed the “‘dependency of the investor[s] on the . . . managerial skills of [the] promoter.’”

Second, the Fifth Circuit affirmed summary judgment against a plaintiff who had purchased interests in an LLC that produced frac sand, a “specialty sand used by oil and gas companies to increase the productivity of wells.” The organizer received a 50 percent interest in the LLC “in return for (1) his experience in constructing gravel plants; (2) the engineering technology to construct a gravel and frac sand plant; (3) the ultimate design and engineering for the plant to be used by the business; and (4) his technical experience to develop a strategy and business plan.” The investor bringing this suit under Rule 10b-5 was made what the court called “managing partner” and “was given the authority to ‘execute all documents and do all things necessary and proper to sell, encumber, purchase, alienate or enter into any contracts whatsoever with (immovable) property owned by [the LLC] and otherwise exercise all authority as Managing Partner.’” Moreover, the plaintiff “signed every check paid out by [the business]” and “signed numerous contracts on [the business’s] behalf, including the lease for the land upon which the gravel and sand facility was to be built.” And the plaintiff “owned and directed” a corporation that “performed numerous financial and administrative services” for the LLC, which included “maintaining [the business’s] books and records, generating [the business’s] financial reports, receiving and possessing [the

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985. Id. at 1326.
986. Id. at 1325 (quoting Merch. Capital, 483 F.3d at 755). In another opinion that lacks the factual detail to justify discussion in the text, the Ninth Circuit ruled that a jury in a criminal case saw sufficient evidence to conclude that “certificates of deposit” were investment contracts, and hence securities. United States v. Sumeru, 449 F. App’x 617, 620–21 (9th Cir. 2011).
988. Id. at 587.
989. Id. at 588.
990. Id. at 587. The court, and the parties, used the word “partner,” and the court referred to the business as a “joint venture.” For example, the court began its analysis by saying that “[b]ecause [the business] is a joint venture, Nunez must overcome the ‘strong presumption’ that a general partnership or joint venture interest is not a security.” Id. at 589 (citation omitted). The court did not explain why an LLC should be classified as a “joint venture” or why the presumption should otherwise apply to an LLC (which might be appropriate if, for example, the state statute under which the LLC was organized borrowed heavily from the law governing general partnerships).
991. Id. at 587.
992. Id.
business’s] bills for payment, paying bills, setting up accounts, and generating [the business’s] . . . account records." 993

Despite this extensive participation in the LLC’s management, the plaintiff claimed that his role was sufficiently passive that his LLC interest satisfied the fourth element of the investment contract test “because he lacked experience in sand and gravel mining, . . . was forced to rely on [the organizer,] and was unable to intelligently exercise his managerial powers.” 994 The Fifth Circuit found no triable issue of fact in this argument, both because (i) the plaintiff indisputably “not only had the knowledge and expertise to exercise authority over [the business’s] finances” but actually participated in management decisions such as to initially operate the business with LLC members rather than contracting that operation out to a third party and (ii) the organizer was not indispensable, since the business had continued even after the organizer left it. 995 The Fifth Circuit agreed with a Fourth Circuit opinion that a business frequently involves the diverse talents of different participants and the circumstance that one participant provides one talent and other participants provide other talents does not mean—for purposes of deciding whether their interests in the business satisfy the fourth element of the investment contract test—that each of them is so dependent on the others that each has bought a security.

The third and fourth investment contract cases from 2011—both decided by the Eleventh Circuit—involved the sale of condominiums and related management arrangements. In *Bamert v. Pulte Home Corp.*, 996 plaintiffs bought units from Pulte in a newly constructed complex in Orlando, Florida. 997 They alleged that, before closing on their units, they also entered into contracts by which Osceola Management & Consulting, Inc. (“OMC”) would manage the condominiums as short-term rental properties. 998 Each condominium purchase agreement required the buyer to hold the purchased unit for one year, but also included acknowledgments that (i) Pulte had not induced the purchase “with any promises of economic benefits available from renting” the unit; (ii) the buyer understood he or she was “under no obligation to participate in or enter into any rental pool agreement, which might be available”; and (iii) Pulte was “not affiliated with any real estate brokers or managerial companies involved with short term rental programs” at

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993. *Id.* The investor argued that the work done by his *corporation* did not count in determining whether he was simply a passive investor who purchased a security because he performed that work “in a different capacity” than in his capacity as a member of the LLC. *Id.* at 587 n.4. The court characterized this as a “somewhat bizarre argument” that, if “[t]aken to its logical extreme,” would permit even a promoter doing all the work at an LLC to contend that he or she was only a passive investor provided that he or she performed the work through a separate business entity. *Id.*

994. *Id.* at 589.

995. *Id.* at 590–91.

996. 445 F. App’x 256 (11th Cir. 2011) (per curiam).

997. *Id.* at 258. The plaintiffs brought, among others, claims that the defendants had sold securities without complying with the registration requirement in section 5 of the Securities Act and had violated Rule 10b-5 in the sales.

998. *Id.* at 257, 261.
the development.\textsuperscript{999} The plaintiffs, however, alleged that the promoters sold the condos by offering a package by which buyers would purchase units from Pulte and obtain mortgage loans through Pulte but would contract with OMC, which would rent the units out short term, using the rental revenue to pay all costs of the condos (including mortgage payments) so that the buyers would purchase the units “risk free” and enjoy “effortless” ownership.\textsuperscript{1000} If rental revenues exceeded costs, OMC would retain that short-term profit, while the plaintiffs “would benefit from any appreciation to the value of the property during that time.”\textsuperscript{1001}

The Eleventh Circuit held that, for the fourth element of the investment contract definition (whether profit is expected from the efforts of others), “‘the crucial inquiry’” revolved around “‘the amount of control that the investors retain.’”\textsuperscript{1002} Here the plaintiffs did not successfully allege that, simply by buying the condominiums, they purchased investment contracts because the purchase agreements—aside from the one-year holding period—“treat[ed] Plaintiffs as ordinary real estate investors” who were “free . . . to reside in the units or to rent them out” and, if they chose to rent, were “in no way obligate[d] to contract with OMC or any other property manager.”\textsuperscript{1003} However, since the plaintiffs alleged that Pulte, the broker that sold the units, and OMC all acted together to sell a package consisting of the condos and their management,\textsuperscript{1004} “viewing the larger scheme through the lens of the representations made by [the broker], as Pulte’s alleged agent, and the rental agreements with OMC—which were entered into before closing on the condominium units—the transaction . . . does have the elements of an investment contract.”\textsuperscript{1005} Addressing in particular the fourth element in the investment contract definition, the Eleventh Circuit found that once they “contracted with OMC” “for the management of the properties as short-term rental units,” “Plaintiffs no longer retained significant control over their units, and in turn, over their investments.”\textsuperscript{1006} The court of appeals accordingly reversed dismissal of the plaintiffs’ case.\textsuperscript{1007}

One day after deciding Bamert, the Eleventh Circuit (via a different panel) reached a different conclusion in Alunni v. Development Resources Group, LLC, where the court of appeals affirmed summary judgment for the defendants, finding

\textsuperscript{999} Id. at 260.  
\textsuperscript{1000} Id. at 258.  
\textsuperscript{1001} Id.  
\textsuperscript{1002} Id. at 262–63 (quoting Albanese v. Fla. Nat’l Bank of Orlando, 823 F.2d 408, 410 (11th Cir. 1987)).  
\textsuperscript{1003} Id. at 263.  
\textsuperscript{1004} The broker was called The Wear Group. Id. at 258.  
\textsuperscript{1005} Id. at 265.  
\textsuperscript{1006} Id. at 265.  
\textsuperscript{1007} Id. at 268.
no genuine issue of fact that the fourth element of the investment contract test was present.\textsuperscript{1008} The plaintiffs had purchased individual condominiums in an apartment complex in Florida,\textsuperscript{1009} with the ultimate goal of converting it into a hotel.\textsuperscript{1010} Conversion into a hotel would await the expiration of the leases of those tenants in the apartments at the time the units were sold.\textsuperscript{1011} Apparently during this interim period, the purchase contract required the owners—if they rented their units during approximately the first year after purchase—to rent through a property management company that the condominium seller selected,\textsuperscript{1012} with a rent guarantee by the seller.\textsuperscript{1013} Thereafter, “the plaintiffs were free to lease their units or occupy them themselves,” and “free to choose whatever management company they wished.”\textsuperscript{1014} Since they could “control their units themselves” and “were not dependent on management skills of others because they had the ability to control the profitability of their individual condominium units,”\textsuperscript{1015} they had put their money into “a real estate contract, not an investment contract.”\textsuperscript{1016} The circumstance that “the plaintiffs ‘delegated management duties or [chose] to rely on some other party [did] not establish dependency’” of the type needed to satisfy the fourth element of the investment contract definition.\textsuperscript{1017} Although the plaintiffs argued that they lived in locales far from the apartment complex and bought the condominiums as investments, the court noted that the “real estate rentals at issue here do not entail the kind of specialized knowledge or equipment present in many cases that have found third-party dependency.”\textsuperscript{1018}

Significance and analysis. The decision that purchasers of limited liability partnership interests in telephone companies satisfied the fourth element of the “investment contract” test because they relied on the skills of others does not

\begin{footnotes}
\item[1008] 445 F. App’x 288 (11th Cir. 2011) (per curiam). The court relied on the same uncontested facts to hold that the second element of the definition—investment in a “common enterprise”—was absent. Id. at 296.
\item[1009] Id. at 290, 292.
\item[1010] Id. at 291–92.
\item[1011] Id. at 292.
\item[1012] Since the units were apartments before the organizer purchased the complex, id. at 290–92, in late June 2006, id. at 291, any purchaser of a condominium unit took that unit subject to the lease executed by any apartment dweller occupying the unit, id. at 293. If the lease expired, the unit purchaser could occupy the unit, lease it out, or leave it vacant. Id. Purchasers had to acknowledge that they intended ultimately to place the unit they bought in a “short-term rental pool.” Id. For about the first year—apparently lasting until the earlier of (i) June 30, 2007, (ii) the date the purchaser occupied the unit, or (iii) the date the purchaser placed the unit in the short-term rental pool, id. a purchaser could rent a unit out through the company that sold the unit, id. at 291, 296.
\item[1013] Id. at 293.
\item[1014] Id. at 296.
\item[1015] Id.
\item[1016] Id. at 298.
\item[1017] Id. (quoting Gordon v. Terry, 684 F.2d 736, 741–42 (11th Cir. 1982)).
\item[1018] Id. at 297. Compare with SEC v. W.J. Howey Co., 328 U.S. 293, 296 (1946) (“The investors are predominantly business and professional people who lack the knowledge, skill and equipment
\end{footnotes}
surprise. Nor does the decision that a participant in an LLC did not crucially rely on others where the participant actively managed the company’s financial matters—although this decision contains important language that reliance on others for part of the management of a business does not mean that an active participant in that business buys an “investment contract.”

The two condominium decisions, however, create uncertainty. Bamert seems in line with the time-honored notion that a deal’s economic reality, rather than the parsed words of a purchase agreement, will determine whether the seller offered an “investment contract.” According, the allegations that the condominiums and a management agreement to rent them out were sold as a package, with the package put together by the land seller and the management company working together, seems comfortably sufficient at the pleading stage to allege the fourth element of the investment contract test. The Alunni facts seem similar in that the whole idea was to turn the complex in which plaintiffs bought units into a hotel—with rental management of the units initially given over to the seller/promoter and the condominium owners, through an association, then choosing a permanent manager for the hotel.

necessary for the care and cultivation of citrus trees.”), and Eberhardt v. Waters, 901 F.2d 1578, 1581 (11th Cir. 1990) (“Furthermore, because of the technical nature of the embryo operation and Eberhardt’s inexperience, any control granted to the investors in . . . brochures [for purchase of cattle] was illusory and insufficient to disqualify the investment as a security.”). The Eleventh Circuit also commented that the condominium buyers need not have rented at all but “could have chosen to re-sell . . . for a profit” in order to benefit from the investment. Alunni, 445 F. App’x at 297.

The court was unimpressed with the plaintiffs’ sworn statements that they had bought the condominiums on the basis of the promoters’ pitch that they were making “a totally passive investment” in what would be a hotel run by a management company, id. at 292, 298, because “the purchase agreements”—which contained statements that buyers could not rely on oral representations and that the deal was limited to the language of those written agreements, id. at 292–93—“demonstrated that it was a real estate purchase agreement, that many of the units were subject to existing long-term leases, and that short-term leasing was not immediately available,” id. at 298.

1019. See Howey, 328 U.S. at 298, 302 (explaining the origins of the term “investment contract” by stating that “[f]orm was disregarded for substance and emphasis was placed upon economic reality,” and therefore in that case “the crucial issue . . . turns on whether the contracts for the land and the contracts for the management of the property were in reality separate agreements or merely parts of a single transaction”).

1020. Oddly, the court goes out of its way to criticize SEC guidance stating that “the offering of condominium units in conjunction with . . . any rental arrangement or similar service . . . offered or sold with emphasis on the economic benefits to the purchase to be derived from the managerial efforts of the promoter” constitutes the sale of an investment contract, and hence a security. Bamert v. Pulte Home Corp., 445 F. App’x 256, 264 n.9 (11th Cir. 2011) (per curiam) (quoting Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development, Securities Act Release No. 33-5347 (Jan. 4, 1973), 1973 WL 158443) (alteration omitted). The Eleventh Circuit states that this guideline is not entitled to deference and is “unpersuasive” to the extent that the guideline “ignores . . . the focus on the control retained by the condominium purchaser.” Id.

Yet, the court then views the transaction as a whole—purchase of the condominiums with accompanying entry into a management contract—as an investment contract (at least for pleading purposes) because the management contract (as one would ordinarily expect) deprived the purchaser of control. Id. at 264–66 & n.10 (purchasers did not retain control by reason of their ability to participate in booking guests as, realistically, they “relied on OMC’s expertise and efforts in locating and securing tenants”).

1021. Alunni, 445 F. App’x at 293, 296.
that long-term management choice made the difference and provided them, at least collectively, with sufficient control to prevent a finding that the profits would be derived, crucially, from the efforts of others.

Territorial reach of Rule 10b-5. In *Morrison v. National Australia Bank Ltd.*, the Supreme Court held that section 10(b) applies “only” to “transactions in securities listed on domestic exchanges, and domestic transactions in other securities,”1022 with the latter category defined as “purchase[s] or sale[s] . . . made in the United States.”1023 In *Quail Cruises Ship Management Ltd. v. Agencia de Viagens CVC Tur Limitada*, the plaintiff purchased the stock of a company that owned a cruise ship.1024 Vacating a district court order dismissing the case for want of jurisdiction, the Eleventh Circuit pointed to allegations that the transaction closed in Miami when the parties “submit[ted] the stock transfer documents by express courier.”1025 The court looked to the “purchase and sale agreement [which] confirms that it was not until this domestic closing that title to the shares was transferred to [the plaintiff].”1026 Since “that transfer of title constituted a sale,” and that sale occurred in the United States, the plaintiff alleged facts sufficient to meet the “territorial” test,1027 which provides the “bright-line” for determining whether a transaction in a non-exchange-traded security enjoys Rule 10b-5 protection.1028

Significance and analysis. The bright-line test elevates the importance of closing provisions in stock purchase agreements and similar documents for sales of other securities. Clear statements that events in the United States close a transaction should be sufficient for application of Rule 10b-5. Purchasers may favor such statements for just that reason. Contrarily, sellers who want to avoid the possibility of expensive Rule 10b-5 litigation in U.S. courts may seek language clearly stating that events outside the United States transfer title to the securities.

1022. 130 S. Ct. 2869, 2884 (2010).
1023. *Id.* at 2886.
1024. 645 F.3d 1307, 1309 (11th Cir. 2011) (per curiam).
1025. *Id.* at 1310 (quoting complaint).
1026. *Id.*
1027. *Id.* at 1310–11.
1028. *Id.* at 1310.