Annual Review of Federal Securities Regulation

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

Contents

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Introduction

This Annual Review ("Review") was prepared by the Subcommittee on Annual Review of the Committee on Federal Regulation of Securities of the ABA Business Law Section. The Review covers significant developments in federal securities law and regulation during 2013. The Review is divided into three sections: regulatory actions, accounting statements, and case law 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.

During 2013, the Securities and Exchange Commission (the "Commission") continued to devote its resources to rulemaking required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] Substantial time was devoted to actions necessary to implement the requirements of Title VII of the Dodd-Frank Act to regulate the markets for derivatives. However, despite progress in this area, the Commission has not promulgated final rules related to security-based swaps. Consequently, the survey does not cover regulation of derivative markets. Also, during 2013, the Commission focused on rulemaking required of it by the Jumpstart Our Business Startups Act, or JOBS Act, which was enacted in April 2012.[2] The regulatory section of the survey focuses on that rulemaking.

Generally, the Review does not discuss rules that are narrowly focused. For example, the Review does not address hedge fund and other private fund related rulemaking, nor rulemaking related to registered investment companies, regis-

1. Pub. L. No. 111-203, 124 Stat. 1376 (2010).
2. Pub. L. No. 112-106, 126 Stat. 306 (2012).

tered investment advisers, or municipal advisors. 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.

Regulatory Developments 2013: JOBS Act Related Rulemaking

I. Introduction

As noted in the Introduction above, during 2013, the U.S. Securities and Exchange Commission (the "Commission") continued to devote its resources to rulemaking required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Commission focused on undertaking the rulemaking required in order to implement the mandate of Title VII of the Dodd-Frank Act, which relates to the regulation of the markets for derivatives. However, despite progress in this area, the Commission did not promulgate final rules related to security-based swaps in 2013. As a result, the discussion below focuses on the Commission's rulemaking required by the Jumpstart Our Business Startups Act ("JOBS Act"), which was enacted in April 2012.

II. Jobs Act

A. General

The JOBS Act[1] affects both exempt and registered offerings, as well as the reporting requirements for certain public issuers, and is intended to promote capital formation. Various provisions of the JOBS Act were effective upon enactment; however, other provisions require that the Commission or other agencies conduct studies, or that the Commission undertake rulemaking in order to implement the provisions of the Act.

Title I of the JOBS Act, known as the "IPO on-ramp," was intended to address concerns that regulatory burdens were deterring growing companies from undertaking initial public offerings ("IPOs") in the United States and to modernize the IPO process in order to make the process more accessible.[2] The provisions of Title I were immediately effective. Title II of the JOBS Act directs the Commission to amend its rules to eliminate the ban on general solicitation and general advertising for Rule 506 offerings when actual sales are made only to accredited investors, so long as issuers took reasonable steps to verify those purchasers' status as accredited investors; the Commission must also make comparable changes

1. Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.) [hereinafter JOBS Act].
2. *Id.* §§ 101–108, 126 Stat. at 307–13 (codified in scattered sections of 15 U.S.C.).

to Rule 144A.[3] As discussed below, Title II's changes to Rule 506 and Rule 144A offerings required Commission rulemaking.[4] Title II also permits internet "matchmaking sites" to facilitate offerings under Rule 506 without the need for the sites to register as broker-dealers, provided that the sites limit their services as set out in the Act.[5] Title III establishes a small offering exemption for crowdfunding, and it requires that the Commission undertake rulemaking in order to create a framework for these offerings.[6] Title IV of the JOBS Act creates a new exemption under section 3(b)(2), similar to current Regulation A,[7] for offerings of up to $50 million.[8] Title IV also requires that the Commission undertake rulemaking.[9] Titles V and VI raise the holder-of-record threshold for mandatory registration under the Securities Exchange Act of 1934 ("Exchange Act").[10] In 2013, the Commission moved forward with JOBS Act implementation by promulgating the final rules required by Title II of the Act and by proposing rules to implement Titles III and IV.[11]

B. FAQs and NALs

Shortly following enactment of the JOBS Act, the staff of the Commission ("Staff") provided market participants with guidance on various interpretative matters related to the Act by issuing and posting on the Commission's website answers to Frequently Asked Questions ("FAQs").[12] On February 5, 2013, the Commission's Division of Trading and Markets published answers to a series of FAQs regarding the exemption from broker-dealer registration set forth in Title II of the JOBS Act.[13] Therein, the Staff indicated that section 201 of the JOBS Act does not require further rulemaking, but noted that a platform cannot permit an issuer to conduct a general solicitation in a Rule 506 offering until the SEC promulgates final rules.[14] In response to FAQs, the Staff also noted that the exemption from broker-dealer registration in this section is applicable only when

3. *See id.* § 201(a), 126 Stat. at 313 (codified at 15 U.S.C. § 77d note (2012)).

4. *See infra* Parts II.D–E.

5. JOBS Act, *supra* note 1, § 201(c), 126 Stat. at 314 (codified at 15 U.S.C. § 77d(b) (2012)). Note that, in the JOBS Act, Congress enacted two new subsections, each of which it labelled (b) under section 4 of the Securities Act of 1933.

6. JOBS Act, *supra* note 1, §§ 301–305, 126 Stat. at 315–23 (codified in scattered sections of 15 U.S.C.).

7. 17 C.F.R. §§ 230.251–.263 (2013).

8. JOBS Act, *supra* note 1, § 401, 126 Stat. at 323 (codified at 15 U.S.C. § 77c(b)(2) (2012)).

9. JOBS Act, *supra* note 1, § 401, 126 Stat. at 323 (codified at 15 U.S.C. § 77c(b)(2) (2012)).

10. JOBS Act, *supra* note 1, §§ 501–504, 601–602, 126 Stat. at 325–27 (codified at 15 U.S.C. §§ 78*l*, 78o (2012)).

11. *See infra* Part II.F.

12. *See Jumpstart Our Business Startups (JOBS) Act*, U.S. Sec. & Exch. Comm'n, http://www.sec.gov/spotlight/jobs-act.shtml (last modified Jan. 3, 2014).

13. *See Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act*, U.S. Sec. & Exch. Comm'n (Feb. 5, 2014), http://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm.

14. *Id.* (Answer to Question 1).

securities are offered and sold pursuant to Rule 506.[15] The FAQs also address compensation, to which the Staff responded that:

> Congress conditioned the exemption on a person and its associated persons not receiving any "compensation" in connection with the purchase or sale of such security. Congress did not limit the condition to transaction-based compensation. The staff interprets the term "compensation" broadly, to include any direct or indirect economic benefit to the person or any of its associated persons. At the same time, we recognize that Congress expressly permitted co-investment in the securities offered on the platform or mechanism. We do not believe that profits associated with these investments would be impermissible compensation for purposes of . . . Section 4(b).[16]

To this end, a venture fund may operate a matchmaking site.[17] The FAQs also indicated that the availability of the exemption from broker-dealer registration should not be construed as suggesting that the entity is not otherwise a "broker" or a "dealer," and referred to the guidance provided by the Division of Trading and Markets on the types of activities typically associated with broker-dealer status.[18] The FAQs note that the JOBS Act exemption does not address state registration requirements.[19]

Moreover, in March 2013, the Commission's Division of Trading and Markets issued the first no-action letter ("NAL") under the JOBS Act to FundersClub Inc. ("FundersClub") and FundersClub Management LLC ("FC Management"), providing relief from registration as a broker-dealer under section 15(a)(1) of the Exchange Act if FundersClub and FC Management operated a platform through which its members could participate in Rule 506 offerings.[20] FundersClub identifies start-up companies in which its affiliated fund will invest, and then posts information about the start-up companies on its website so that the information is available only to FundersClub members, who are all accredited investors.[21] The FundersClub members may submit non-binding indications of interest in an investment fund, which fund relies on Rule 506 of Regulation D to conduct the offering.[22] When a target level of capital has been reached, the indication of interest process is closed and FundersClub reconfirms investors' interest and accredited investor status, and negotiates the final terms of the investment fund's investment in the start-up company.[23] Members may withdraw their indications of interest at any time, until the investment fund closes.[24] In this process, FundersClub and FC Management do not receive any compensation; however,

15. *Id.* (Answer to Question 3).
16. *Id.* (Answer to Question 5).
17. *Id.* (Answer to Question 6).
18. *Id.* (Answer to Question 9).
19. *Id.* (Answer to Question 10).
20. *See* FundersClub Inc. & FundersClub Mgmt. LLC, SEC No-Action Letter (Mar. 26, 2013), *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/2013/funders-club-032613-15a1.pdf.
21. *Id.* at 1.
22. *Id.*
23. *Id.* at 1–2.
24. *Id.* at 2.

some administrative fees are charged.[25] FundersClub and FC Management intend to be compensated through their role in organizing and managing the investment funds (at a rate of 20 percent or less of the profits of the investment fund, but never exceeding 30 percent).[26] The Staff noted in the NAL that FundersClub's and FC Management's current activities appear to comply with section 201 of the JOBS Act, in part because they and each person associated with them receive no compensation (or the promise of future compensation) in connection with the purchase or sale of securities.[27] However, once FundersClub, FC Management, or persons associated with them receive compensation or the promise of future compensation, as described in their incoming letter, they will no longer be able to rely on section 201 of the JOBS Act.[28] The Staff issued a similar NAL to AngelList LLC.[29] These letters are narrowly focused, and they do not address whether other registrations (such as registration as an investment adviser) would be required.[30] Also, the letters do not address or comment on any issues related to "general solicitation" or the means by which investors are identified or contacted.[31]

C. Study—Section 108 Report to Congress on Review of Disclosure Requirements in Regulation S-K

In December 2013, the Staff released a study required by section 108 of the JOBS Act.[32] The Commission was mandated to review Regulation S-K in the context of the new class of issuers referred to in the JOBS Act as "emerging growth companies."[33] In connection with this review, the Staff chose to consider the background of the development of disclosure requirements and potential recommendations for revisiting disclosure requirements in a broad manner.[34]

The Staff reviewed, among other things, Regulation S-K, Commission releases, and comment letters on Commission regulatory actions pertaining to Regulation S-K.[35] The Staff also reviewed public comments that were submitted regarding section 108 of the JOBS Act.[36] In light of the focus of the mandate in section 108 of the JOBS Act, the Staff did not review two subparts of Regulation S-K—Regulation AB and Regulation M-A.[37]

25. *Id.*
26. *Id.*
27. *Id.* at 2 n.1, 3–4.
28. *Id.* at 2 n.1.
29. *See* AngelList LLC & AngelList Advisors LLC, SEC No-Action Letter (Mar. 28, 2013), *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/2013/angellist-15a1.pdf.
30. *See id.* at 1–2 & n.4.
31. *See id.* at 3 (noting representation of compliance with Regulation D).
32. *See* U.S. Sec. & Exch. Comm'n, Report on Review of Disclosure Requirements in Regulation S-K (Dec. 2013), *available at* http://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf.
33. *Id.* at 2.
34. *Id.* at 2 n.2, 3.
35. *Id.* at 4.
36. *Id.*
37. *Id.*

The Staff noted that, while the study required by section 108 served as an important starting point, further information gathering and review is warranted in order to formulate specific recommendations regarding specific disclosure requirements.[38] In particular:

> input from market participants is needed to facilitate the identification of ways to update or add requirements for disclosure that is material to an investment or voting decision, ways to streamline and simplify disclosure requirements to reduce the costs and burdens on public companies, including emerging growth companies, ways to enhance the presentation and communication of information and to understand how technology can play a role in addressing any of these issues.[39]

In addition, the Staff noted that economic analysis is necessary to inform any re-evaluation of disclosure requirements.[40]

The Staff recommended the development of a plan to review systematically the Commission's disclosure requirements for public companies, including Regulations S-K and S-X, and the related rules concerning the presentation and delivery of information.[41] Among the factors that should be considered in such a review are disclosure requirements developed through Commission interpretations, as well external factors that may have contributed to the length and complexity of filings and the costs of compliance (e.g., enforcement actions and judicial opinions).[42] After conducting this detailed review, the Staff would make specific recommendations for proposed rule and form changes.[43]

The Staff identified two alternative frameworks for structuring such a review: a comprehensive approach and a targeted approach.[44] The Staff believes that any such review could be more effective if it were to:

- Emphasize a principles-based approach as a critical aspect of the disclosure framework;
- Evaluate the appropriateness of current scaled disclosure requirements and whether further scaling would be appropriate for emerging growth companies or other categories of issuers;
- Evaluate methods of information delivery and presentation, both through the Commission's electronic disclosure system ("EDGAR") and other means; and
- Consider ways to present information that would improve the readability and navigability of disclosure documents, as well as discourage repetition and the disclosure of immaterial information.[45]

38. *Id.* at 6–7, 93.
39. *Id.* at 93–94.
40. *Id.* at 94.
41. *Id.* at 95.
42. *Id.*
43. *Id.*
44. *Id.* at 95–96.
45. *Id.* at 97–99.

In various public remarks, the Chair of the Commission reiterated that the Commission intends to conduct a review of the disclosure requirements for public companies.[46]

D. Final Rules Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings

1. Background

Rule 506 of Regulation D provides a non-exclusive safe harbor for private offerings.[47] The Rule 506 exemption permits sales of an unlimited amount of securities, without registration, to any number of accredited investors and up to thirty-five non-accredited investors, if the appropriate resale limitations are imposed, applicable information requirements are satisfied, and the other conditions of the rule are met.[48] Rule 506 is the most widely used exemptive rule under Regulation D, accounting for the overwhelming majority of capital raised under Regulation D.[49] Rule 144A is a safe harbor exemption from the registration requirements of section 5 of the Securities Act of 1933 ("Securities Act") for certain offers and sales of qualifying securities by certain persons, other than the issuer of the securities.[50] The exemption applies to re-sales of securities to qualified institutional buyers ("QIBs").[51]

Prior to the adoption of the final rules, the availability of Rule 506 was conditioned on the issuer refraining from using general solicitation or general advertising.[52] For some time, market participants and the Staff noted that the prohibition against general solicitation seemed anachronistic in light of changes in communications.[53] In recognition of the concern that the restriction on communications in private offerings impaired capital formation, Title II of the JOBS Act, titled "Access to Capital for Job Creators," required that the Commission undertake rulemaking to revise the prohibition against general solicitation.[54] Specifically, within ninety days following enactment of the JOBS Act, the Commission was mandated to eliminate the prohibition against general solicitation or general advertising for offerings under Rule 506, provided that all purchasers in the

46. *See* Mary Jo White, Chairman, U.S. Sec. & Exch. Comm'n, The Path Forward on Disclosure (Oct. 15, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539878806#.UwIpxDEo5l4.

47. 17 C.F.R. § 230.500(c) (2013).

48. *Id.* § 230.506(b).

49. *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44771, 44773, 44789 (July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239 & 242) [hereinafter Eliminating the Prohibition].

50. *See id.* at 44773.

51. *Id.*

52. *See* 17 C.F.R. § 230.502(c) (2013).

53. *See generally* Eliminating the Prohibition, *supra* note 49, at 44773 (acknowledging that the prohibition extended to unrestricted websites).

54. JOBS Act § 201, 15 U.S.C. § 77d (2012).

offering are accredited investors.[55] In addition, issuers must take "reasonable steps" to verify that such purchasers are accredited investors.[56] Those "reasonable steps" will be determined by the Commission.[57] Within the same time period, Congress also required the Commission to revise Rule 144A(d)(1) to permit the use of general solicitation or general advertising.[58] Conforming changes will be required to ensure that any offering made pursuant to Rule 506 that uses general advertising or general solicitation will not be deemed a "public offering."[59] On August 29, 2012, the Commission proposed amendments to Rule 506 and Rule 144A to implement section 201(a) of the JOBS Act.[60] The proposed amendments sparked numerous comments and final Commission action was not taken until July 10, 2013.[61] The final rules became effective September 23, 2013.[62]

2. Eliminating the Prohibition Against General Solicitation

The amendment to Rule 506 eliminates the prohibition against general solicitation and general advertising contained in Rule 502(c) of Regulation D with respect to offers and sales of securities made pursuant to Rule 506(c), subject to two new provisos.[63] First, all purchasers must be accredited investors.[64] Second, issuers must take reasonable steps to verify that the purchasers of the securities are accredited investors.[65] The amendment also provides that securities may be offered pursuant to Rule 144A to persons other than QIBs, provided that the securities are sold only to purchasers that the seller (or someone acting on the seller's behalf) reasonably believes are QIBs.[66]

The Commission's rules implement a bifurcated approach to Rule 506 offerings. An issuer may conduct a private offering in reliance on Rule 506(b) without using general solicitation or general advertising, by making offers and sales to no more than thirty-five non-accredited investors that meet certain sophistication requirements, or to an unlimited number of accredited investors (or investors that the issuer reasonably believes are accredited investors, but without being

55. *Id.* § 201(a)(1), 15 U.S.C. § 77d note.

56. *Id.*

57. *Id.*

58. *Id.* § 201(a)(2), 15 U.S.C. § 77d note.

59. *Id.* § 201(b), 15 U.S.C. § 77d(b). Note that, in the JOBS Act, Congress enacted two new subsections, each of which it labelled (b) under section 4 of the Securities Act of 1933.

60. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 77 Fed. Reg. 54464, 54481 (proposed Sept. 5, 2012) (to be codified at 17 C.F.R. pts. 230 & 239).

61. *See* Eliminating the Prohibition, *supra* note 49, at 44774, 44805 (to be codified at 17 C.F.R. pts. 230, 239 & 242).

62. *Id.* at 44772.

63. *Id.* at 44804 (to be codified at 17 C.F.R. § 230.506(c)).

64. *Id.* (to be codified at 17 C.F.R. § 230.506(c)(2)(i)).

65. *Id.*

66. *Id.* at 44786, 44804 (to be codified at 17 C.F.R. § 230.144A).

subject to the new verification requirement).[67] Alternatively, under new Rule 506(c), general solicitation and general advertising are permitted so long as:

- the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors;
- all purchasers of securities are accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors, or the issuer reasonably believes that they qualify as accredited investors at the time of the sale of the securities; and
- the conditions of Rule 501 and Rules 502(a) and 502(d) are satisfied.[68]

The Commission noted that an issuer's ability to engage in general solicitation and general advertising extends to offerings made pursuant to Rule 506(c), but not to offerings made pursuant to section 4(a)(2) of the Securities Act.[69]

The Commission also confirmed that private funds that rely on an exclusion from the definition of "investment company" in section 3(c)(1) or section 3(c)(7) of the Investment Company Act of 1940 may make a general solicitation under Rule 506(c) without losing the ability to rely on these exclusions.[70]

3. Reasonable Steps to Verify Accredited Investor Status

The Commission indicated in the final rules that "reasonable efforts" to verify investor status will be a fact-based objective determination based on the Commission's prior principles-based guidance.[71] Rule 506(c) does not mandate any specific procedure that issuers must follow to ensure the reasonableness of the steps they have taken to verify that the purchasers of their securities are accredited investors.[72] In the adopting release, the Commission stated that "[w]hether the steps taken are 'reasonable' will be an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction."[73] The Commission noted that "reasonable efforts" may require consideration of the following:

- The nature of the purchaser. The Commission describes the different types of accredited investors, including broker-dealers, investment companies or business development companies, employee benefit plans, and wealthy individuals and charities.[74]
- The nature and amount of information about the purchaser. "The more information an issuer has indicating that a prospective purchaser is

67. *Id.* at 44775 (preserving existing Rule 506(b)); *see* 17 C.F.R. § 230.506(b) (2013).
68. Eliminating the Prohibition, *supra* note 49, at 44804 (to be codified at 17 C.F.R. § 230.506(c)).
69. *Id.* at 44774.
70. *Id.* at 44784.
71. *Id.* at 44778.
72. *See id.*
73. *Id.*
74. *Id.* at 44779.

an accredited investor, the fewer steps it would have to take, and vice versa."[75]

- The nature of the offering. Issuers may be required to take additional verification steps to the extent that solicitations are made broadly, such as through a website accessible to the general public, or through the use of social media or e-mail. By contrast, less intrusive verification steps may be sufficient if solicitations are directed at investors that are pre-screened by a reliable third party.[76]

The Commission stated that these factors are interconnected, and the more indicia that are in evidence that an investor qualifies as an accredited investor, the fewer steps that the issuer must take to verify status.[77]

In light of expressed concerns regarding the lack of certainty provided by a principles-based inquiry, Rule 506(c) sets forth four non-exclusive methods of verifying accredited investor status for natural persons that will be deemed to meet the "reasonable steps to verify" requirement:

- A review of IRS forms for the two most recent years and a written representation regarding the individual's reasonable expectation of attaining the necessary income level for the current year;
- A review of bank statements, brokerage statements, statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports by independent third parties in order to assess assets, and a consumer report or credit report from at least one nationwide consumer reporting agency in order to assess liabilities;
- A written confirmation from a registered broker-dealer, a registered investment adviser, a licensed attorney, or a certified public accountant that such person or entity has taken reasonable steps to verify that the person is an accredited investor within the prior three months and has determined that the person is an accredited investor; and
- With respect to any natural person who invested in an issuer's Rule 506(b) private placement as an accredited investor prior to the effective date of Rule 506(c) and continues to hold such securities, for any Rule 506(c) offering conducted by the same issuer, an issuer can obtain a certification from the person at the time of sale in the new offering that he or she qualifies as an accredited investor.[78]

Because an issuer has the burden of demonstrating that its offering is entitled to an exemption from the registration requirements of the Securities Act, regardless of the steps an issuer takes to verify accredited investor status, "issuers and

75. *Id.*
76. *Id.* at 44780.
77. *See id.*
78. *Id.* at 44804–05 (to be codified at 17 C.F.R. § 230.506(c)(2)(ii)(A)–(D)).

their verification service providers [should] retain adequate records regarding the steps taken to verify that a purchaser was an accredited investor."[79]

4. Reasonable Belief

The Commission confirmed its view that Congress did not intend to eliminate the existing "reasonable belief" standard in Rule 501(a) of the Securities Act or for Rule 506 offerings.[80] It confirmed that, if a person were to supply false information to an issuer claiming status as an accredited investor, the issuer would not lose the ability to rely on the Rule 506(c) exemption for that offering, provided the issuer "took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor at the time of the sale."[81]

5. Form D Amendments

As amended, Form D requires that issuers conducting an offering in reliance on Rule 506(c) indicate on the form that they are relying on the Rule 506(c) exemption by checking the new box on the form.[82]

6. Final Amendment to Rule 144A

As amended, Rule 144A(d)(1) permits securities to be *offered* to persons other than QIBs, including by means of general solicitation, provided that securities are *sold* only to QIBs or to any person that the seller, or one acting on behalf of the seller, reasonably believes is a QIB.[83] The Commission also noted that the general solicitation now permitted in Rule 144A resales by the initial purchaser to any QIB will not affect the exemptions available under section 4(a)(2) and Regulation S for the initial sale of securities by the issuer to the initial purchaser.[84]

The Commission also clarified that for ongoing Rule 144A offerings that commenced before the effective date of the new rules, offering participants will be entitled to conduct the portion of the offering following the effective date of the new rules using a general solicitation, without affecting the availability of Rule 144A for the portion of the offering that occurred prior to the effective date.[85]

7. Integration with Offshore Offerings

The Commission addressed the interplay between concurrent offerings made outside the United States in reliance on Regulation S and inside the United States

79. *Id.* at 44779.
80. *Id.* at 44782.
81. *Id.* at 44783.
82. *Id.*
83. *Id.* at 44786 (to be codified at 17 C.F.R. § 230.144A(d)(1)).
84. *Id.* at 44786 n.172.
85. *Id.* at 44786.

in reliance on Rule 506 or Rule 144A where there is a general solicitation or general advertising.[86] Of particular concern is the requirement in Regulation S that there be no directed selling efforts in the United States.[87]

The Commission reaffirmed its position that an offshore offering conducted in compliance with Regulation S would not be integrated with a concurrent domestic unregistered offering that is conducted in compliance with Rule 506 or Rule 144A, even if there is a general solicitation or general advertising.[88] This position is consistent with the Commission's views regarding integration of concurrent offshore offerings made in compliance with Regulation S and registered domestic offerings.[89]

8. Commission Guidance

The Staff issued guidance in the form of compliance and disclosure interpretations ("CDIs") relating to Rule 506(c) and Rule 144A.[90]

E. Disqualification of Felons and Other Bad Actors from Rule 506 Offerings

1. Background

On July 10, 2013, the Commission adopted amendments to rules promulgated under Regulation D to implement section 926 of the Dodd-Frank Act.[91] The amendments disqualify offerings involving "bad actors" from reliance on Rule 506.[92] More specifically, the rule disqualifies offerings involving issuers and others—such as underwriters, placement agents, directors, executive officers, and significant shareholders of the issuer—if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws.[93] The Commission proposed the amendments for review and comment on May 25, 2011.[94] In light of concerns raised by investor and consumer advocates that the relaxation of the prohibition against general solicitation in certain Rule 506 offerings would lead to an increased incidence of fraud, the Commission took action on the "bad actor" provisions at the same

86. *Id.*
87. *Id.* at 44786 n.175.
88. *Id.* at 44786.
89. *See id.* at 44786 n.177.
90. *See Compliance and Disclosure Interpretations: Securities Act Rules*, U.S. Sec. & Exch. Comm'n, http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (last updated Jan. 23, 2014).
91. *See* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, 78 Fed. Reg. 44730, 44771 (July 24, 2013) (to be codified at 17 C.F.R. pts. 200, 230 & 239).
92. *Id.* at 44730.
93. *Id.* at 44731, 44770 (to be codified at 17 C.F.R. § 230.506(d)(1)).
94. Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, 76 Fed. Reg. 31518, 31543 (proposed June 1, 2011) (to be codified at 17 C.F.R. pts. 230 & 239).

time as it promulgated Rule 506(c).[95] The final rules became effective on September 23, 2013.[96]

The disqualification provisions apply to all Rule 506 offerings, regardless of whether general solicitation is used.[97] Section 926 of the Dodd-Frank Act required the Commission to adopt rules that would render the Rule 506 exemption unavailable for any securities offering in which certain "felons" or other "bad actors" were involved.[98] The new provisions generally track those in section 926 of the Dodd-Frank Act and Rule 262 of Regulation A promulgated under the Securities Act.[99] Since the final rule became effective, the Staff provided additional guidance on various interpretative matters in a series of CDIs as discussed below. Although it was anticipated that, at least in the short term, the relaxation of the prohibition against general solicitation in certain Rule 506 offerings and Rule 144A offerings would have a significant effect on the exempt offering market, the bad actor disqualification provisions have had a more immediate impact on offering practices. Issuers and financial intermediaries have had to establish policies and procedures and revise documentation in order to address these provisions.

2. Covered Persons

The disqualification provisions in Rule 506(d)(1) apply to the following "covered persons":

- the issuer and any predecessor of the issuer;
- any affiliated issuer;
- any director, executive officer, other officer participating in the offering, general partner, or managing member of the issuer;
- any beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power;
- any promoter connected with the issuer in any capacity at the time of the sale;
- any investment manager of an issuer that is a pooled investment fund;
- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities (a "compensated solicitor");
- any general partner or managing member of any such investment manager or compensated solicitor; or

95. Eliminating the Prohibition, *supra* note 49, at 44771.
96. Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, 78 Fed. Reg. at 44730.
97. *See id.* at 44770 (to be codified at 17 C.F.R. § 230.506(d)).
98. *Id.* at 44730.
99. *See id.* at 44731.

- any director, executive officer, or other officer participating in the offering of any such investment manager or compensated solicitor or general partner or managing member of such investment manager or compensated solicitor.[100]

Although the Commission modeled the "covered persons" of Rule 506(d) after those of Rule 262, there are some differences. For example, "because Rule 506 transactions may involve the use of persons paid for solicitation of purchasers, . . . rather than traditional underwriters, [the Commission] added compensated solicitors as a category of covered persons," whereas Rule 262 specifically references "underwriters."[101] Additionally, the Commission made two key changes to "covered persons" from its earlier proposal. First, "covered persons" is now limited to "executive officers" (i.e., those performing policy-making functions) of the issuer and the compensated solicitor, rather than the more inclusive "officers," as set forth in the proposal and in Rule 262.[102] Second, "covered persons" is now limited to holders of 20 percent (or more) of the issuer's outstanding voting equity securities, rather than 10 percent (or more) as proposed and as set forth in Rule 262.[103]

Rule 506(d)(3) provides that the disqualification provisions do not apply to events relating to any affiliated issuer that occurred before the affiliation arose if the affiliated entity is not (i) in control of the issuer or (ii) under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events.[104]

3. Disqualifying Events

The final rule includes eight categories of disqualifying events:

- Criminal convictions;
- Court injunctions and restraining orders;
- Final orders of certain state regulators (such as those regulating securities, banking, and insurance) and federal regulators, including the U.S. Commodity Futures Trading Commission (the "CFTC");
- Commission disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons;
- Certain Commission cease-and-desist orders;
- Suspension or expulsion from membership in, or suspension or barring from association with a member of, a securities self-regulatory organization ("SRO");

100. *Id.* at 44770 (to be codified at 17 C.F.R. § 230.506(d)(1)).
101. *Id.* at 44733.
102. *Id.* at 44733–34.
103. *Id.* at 44734–35.
104. *Id.* at 44771 (to be codified at 17 C.F.R. § 230.506(d)(3)(i)–(ii)).

- Commission stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.[105]

A discussion of each of these categories appears below.

a. Criminal Convictions

Rule 506(d)(1)(i) provides for disqualification if any covered person had been convicted of any felony or misdemeanor in connection with the purchase or sale of any security, involving the making of any false filing with the Commission, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or compensated solicitor.[106] The rule includes a five-year look-back period for criminal convictions of issuers, their predecessors and affiliated issuers, and a ten-year look-back period for other covered persons.[107]

b. Court Injunctions and Restraining Orders

Similar to Rule 262, Rule 506(d)(1)(ii) disqualifies any covered person from relying on the exemption for a sale of securities if such covered person is subject to any order, judgment, or decree of any court of competent jurisdiction, entered within five years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging, or continuing to engage, in any conduct or practice in connection with the purchase or sale of any security, involving the making of a false filing with the Commission, or arising out of the conduct of business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or compensated solicitor.[108]

c. Final Orders of Certain Regulators

Final orders of regulatory agencies or authorities are covered by Rule 506(d)(1)(iii). That section disqualifies any covered person who is subject to a final order of a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency or an officer of a state performing like functions); an appropriate federal banking agency; the CFTC; or the National Credit Union Administration.[109] Additionally, the order must (A) at the time of such sale, bar the person from (i) associating with an entity regulated by such commission, authority, agency, or officer; (ii) engaging in the business of securities, insurance, or banking; and (iii) engaging

105. *Id.* at 44770–71 (to be codified at 17 C.F.R. § 230.506(d)(1)(i)–(viii)).
106. *Id.* at 44770 (to be codified at 17 C.F.R. § 230.506(d)(1)(i)).
107. *Id.* (to be codified at 17 C.F.R. § 230.506(d)(1)(i)).
108. *Id.* (to be codified at 17 C.F.R. § 230.506(d)(1)(ii)).
109. *Id.* (to be codified at 17 C.F.R. § 230.506(d)(1)(iii)).

in savings association or credit union activities; or (B) constitute a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years of such sale.[110] In a change from the proposal, the Commission added CFTC final orders as disqualification triggers.[111] In adding CFTC final orders, the Commission noted that the CFTC (rather than the Commission) has authority over investment managers of pooled investment funds that invest in commodities and certain derivative products.[112] Consequently, unless Rule 506(d) included CFTC final orders as a disqualifying trigger, regulatory sanctions against those investment managers would not likely trigger disqualification.[113]

Rule 501(g) defines a "final order" as "a written directive or declaratory statement issued by a federal or state agency described in [Rule 506(d)(1)(iii)] under applicable statutory authority that provides for notice and an opportunity for a hearing, which constitutes a final disposition or action by that federal or state agency."[114] Rule 501(g) is based on the definition used by the Financial Industry Regulatory Authority, Inc. in certain of its forms, which implement language of the Exchange Act.[115]

Rule 506(d)(1)(iii)(B) provides that disqualification must result from final orders of the relevant regulators that are "based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct."[116] Despite the suggestions of commenters, the Commission did not define "fraudulent, manipulative, or deceptive conduct," did not exclude technical or administrative violations, and did not limit Rule 506(d)(1)(iii) to matters involving scienter.[117]

d. Commission Disciplinary Orders

Rule 262(b)(3) disqualifies an issuer from reliance on Regulation A if any covered person is subject to a Commission order entered pursuant to section 15(b), 15B(a), or 15B(c) of the Exchange Act, or section 203(e) or (f) of the Investment Advisers Act of 1940 ("Advisers Act").[118] Under those provisions of the Exchange Act and the Advisers Act, the Commission has the authority to order a variety of sanctions against registered brokers, dealers, municipal securities dealers, and investment advisers, including the suspension or revocation of registration, censure, placing limitations on their activities, imposing civil money penalties, and barring individuals from being associated with specified entities and from participating in the offering of any penny stock.[119]

110. *Id.* (to be codified at 17 C.F.R. § 230.506(d)(1)(iii)(A)–(B)).
111. *Id.* at 44740.
112. *Id.*
113. *Id.*
114. *Id.* (to be codified at 17 C.F.R. § 230.501(g)).
115. *Id.* at 44741.
116. *Id.* at 44770 (to be codified at 17 C.F.R. § 230.506(d)(1)(iii)(B)).
117. *See id.* at 44742–43.
118. *Id.* at 44743.
119. *Id.*

Historically, the Commission has required disqualification only for as long as an act is prohibited or required to be performed pursuant to an order.[120] Therefore, censures are not disqualifying, and a disqualification based on a suspension or limitation of activities would expire when the suspension or limitation expired.[121] Rule 506(d)(1)(iv) codified this position, but removed the reference to section 15B(a) of the Exchange Act.[122] No look-back period was added to the rule.[123]

e. Certain Commission Cease-and-Desist Orders

Although not required by section 926 of the Dodd-Frank Act, the Commission added an additional disqualification trigger, using its existing authority previously used to create "bad actor" provisions.[124] Under Rule 506(d)(1)(v), an offering will be disqualified if any covered person is subject to any order of the Commission entered within five years before such sale that, at the time of such sale, orders the person to cease and desist from committing or causing a future violation of (A) any scienter-based antifraud provision of the federal securities laws, including, without limitation, section 17(a)(1) of the Securities Act, section 10(b) of the Exchange Act, and section 206(1) of the Advisers Act, or any rule or regulation promulgated thereunder; or (B) section 5 of the Securities Act.[125] Note that the disqualification provision for section 5 of the Securities Act does not require scienter, which is consistent with the strict liability standard imposed by section 5.[126]

f. Suspension or Expulsion from SRO Membership or Association with an SRO Member

Rule 506(d)(1)(vi) disqualifies any covered person that is suspended or expelled from membership in, or suspended or barred from association with a member of, an SRO for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade.[127] This provision does not include a look-back period.[128]

g. Stop Orders and Orders Suspending the Regulation A Exemption

Rule 506(d)(1)(vii) imposes disqualification on an offering if a covered person has filed (as a registrant or issuer), or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the Commission that, within five years before such sale, was the subject of a refusal order, stop

120. *Id.*
121. *Id.*
122. *Id.* (to be codified at 17 C.F.R. § 230.506(d)(1)(iv)).
123. *Id.*
124. *Id.* at 44743–44.
125. *Id.* at 44770 (to be codified at 17 C.F.R. § 230.506(d)(1)(v)(A)–(B)).
126. *Id.* at 44744.
127. *Id.* at 44770 (to be codified at 17 C.F.R. § 230.506(d)(1)(vi)).
128. *See id.*

order, or order suspending the Regulation A exemption, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued.[129]

h. U.S. Postal Service False Representation Orders

The final disqualification provision is enumerated in Rule 506(d)(1)(viii), which disqualifies any covered person that is subject to a U.S. Postal Service false representation order entered within five years preceding the sale of securities, or is, at the time of such sale, subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the U.S. Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.[130]

4. Reasonable Care Exception

Rule 506(d)(2)(iv) creates a reasonable care exception that would apply if an issuer can establish that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of a covered person.[131] The reasonable care exception helps preserve the intended benefits of Rule 506 and avoids creating an undue burden on capital-raising activities, while giving effect to the legislative intent to screen out felons and bad actors.[132]

In order to rely on the reasonable care exception, the issuer would need to conduct a factual inquiry, the nature of which would depend on the facts and circumstances of the covered persons and the offering.[133] In such an inquiry, an issuer would need to consider various factors, such as the risk that bad actors present, the presence of screening and other compliance mechanisms, the cost and burden of the inquiry, whether other means used to obtain information about the covered persons is adequate, and whether investigating publicly available information is reasonable.[134]

5. Transition Issues

Although the look-back provisions of Rule 506(d) capture disqualifying events prior to the time that the rule became effective, Rule 506(d)(2)(i) provides that

129. *Id.* at 44770–71 (to be codified at 17 C.F.R. § 230.506(d)(1)(vii)).

130. *Id.* at 44771 (to be codified at 17 C.F.R. § 230.506(d)(1)(viii)).

131. *Id.* (to be codified at 17 C.F.R. § 230.506(d)(2)(iv)).

132. *Id.* at 44746. Rule 508 provides that "insignificant deviations" from the terms, conditions, and requirements of Regulation D will not result in the loss of the exemption if the person relying on the exemption can show that: (i) the failure to comply did not pertain to a term, condition, or requirement directly intended to protect that individual or entity; (ii) the failure to comply was insignificant with respect to the offering as a whole; and (iii) a good faith and reasonable attempt was made to comply. *Id.* at 44746 n.190 (citing 17 C.F.R. § 230.508). The Commission does not believe that Rule 508 would cover circumstances in which an offering was disqualified under Rule 506(d). *Id.*

133. *Id.* at 44746–47.

134. *Id.*

disqualification will not arise as a result of triggering events that occurred prior to the date of the amendments.[135] However, Rule 506(e) requires written disclosure to purchasers, at a reasonable time prior to the sale, of matters that would have triggered disqualification except that they occurred prior to the rule's effective date.[136] This disclosure requirement applies to all Rule 506 offerings, regardless of whether purchasers are accredited investors.[137] Failure to make such disclosures will not be an "insignificant deviation" within the meaning of Rule 508; consequently, relief under that rule will not be available for such failure.[138]

6. Additional Guidance Regarding the Bad Actor Disqualification Provisions

The Staff provided additional guidance on the application of the rule through various CDIs, including those issued on November 13, 2013, December 4, 2013, January 3, 2014, and January 23, 2014.[139]

F. Proposed Rules

1. Amendments to Regulation D, Form D, and Rule 156 Under the Securities Act

On the same day that the Commission amended Regulation D in the manner described above, the Commission proposed for review and comment other amendments to Regulation D, Form D, and Rule 156 to address concerns that may arise in connection with issuers engaging in general solicitations under Rule 506(c).[140] An amendment to Rule 503 would require the filing of a Form D not later than fifteen calendar days prior to the commencement of a general solicitation offering under Rule 506(c).[141] In addition, in order to provide the Commission with more information regarding these types of offerings, the issuer would be required to file a final amendment to the Form D within thirty calendar days after the completion of such an offering.[142] Along the same lines, in order to make additional information available to the Commission, the proposal would revise Form D in order to request additional information regarding Rule 506(c) offerings.[143] The Commission also proposed an amendment to Rule 507 in order to promote compliance with the Form D filing requirement by implementing certain disqualification provisions where the issuer and its affiliates failed to

135. *Id.* at 44771 (to be codified at 17 C.F.R. § 230.506(d)(2)(i)).
136. *Id.* (to be codified at 17 C.F.R. § 230.506(e)).
137. *Id.* at 44749.
138. *Id.* at 44749–50.
139. *See Compliance and Disclosure Interpretations: Securities Act Rules*, U.S. Sec. & Exch. Comm'n, http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (last updated Jan. 23, 2014).
140. *See* Amendments to Regulation D, Form D and Rule 156, 78 Fed. Reg. 44806, 44855 (proposed July 24, 2013) (to be codified at 17 C.F.R. pts. 230 & 239).
141. *Id.* at 44851 (to be codified at 17 C.F.R. § 230.503(a)(1)).
142. *Id.* (to be codified at 17 C.F.R. § 230.503(a)(4)).
143. *Id.* at 44852–55 (to be codified at 17 C.F.R. § 239.500).

comply with Form D filing requirements.[144] Rule 507 currently provides that disqualification may be waived by the Commission upon a showing of good cause by the issuer.[145]

The proposal also introduced a new Rule 509. Rule 509 would require an issuer engaging in a Rule 506(c) offering to include certain legends on any written general solicitation materials.[146] The required legends would alert potential investors of the type of offering, that the offering is available only to certain investors, and that the offering may involve certain risks.[147] The proposal also would require that, for a temporary period of two years, issuers must file with the Commission any written solicitation materials.[148] These materials would not be available to the public.[149] The proposal also solicited comment on the definition of "accredited investor" and on whether there should be additional requirements relating to the communications used in a general solicitation.[150]

The Commission also proposed to amend Rule 156 promulgated under the Securities Act to apply its guidance to the sales literature circulated by registered investment companies.[151] The adoption of Rule 506(c) provided the impetus for the Commission to propose amendments to Rule 156.[152] Sales literature has the potential to mislead regardless of the type of offering, the investors' level of sophistication, and whether such literature is used in a general solicitation.[153]

The comment period for the proposal closed,[154] and it is not clear whether the proposed rules will be adopted, or if adopted, the form in which the Commission will adopt them.

2. Proposed Regulation: Crowdfunding

Congress labelled Title III of the JOBS Act as the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012" or the "CROWDFUND Act," which provides a crowdfunding exemption from the registration requirements of the Securities Act.[155] The CROWDFUND Act required rulemaking by the Commission to implement the exemption.[156] The offering ex-

144. *Id.* at 44851–52 (to be codified at 17 C.F.R. § 230.507).

145. *Id.* at 44819 (citing 17 C.F.R. § 230.507).

146. *Id.* at 44852 (to be codified at 17 C.F.R. § 230.509).

147. *Id.* (to be codified at 17 C.F.R. § 230.509(a)).

148. *See id.* (to be codified at 17 C.F.R. § 230.510T). Nonetheless, the material to be submitted to the Commission would not be treated as "filed" or "furnished" for purposes of the Securities Act or the Exchange Act. *Id.* at 44828.

149. *Id.* at 44828.

150. *Id.* at 44828–29.

151. *Id.* at 44825 (to be codified at 17 C.F.R. § 230.156).

152. *Id.* at 44826.

153. *Id.*

154. *Id.* at 44806 (requesting comment on or before September 23, 2013); Amendments to Regulation D, Form D and Rule 156; Re-Opening of Comment Period, 78 Fed. Reg. 61222 (Oct. 3, 2013) (extending comment period to November 4, 2013).

155. *See* JOBS Act §§ 301–302, 15 U.S.C. §§ 77a note, 77d, 77d-1 (2012).

156. Crowdfunding, 78 Fed. Reg. 66428, 66430 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239 & 240) ("Until we adopt rules relating to crowdfunding transactions

emption is subject to a number of monetary limitations. The aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the crowdfunding exemption during the twelve-month period preceding the date of the transaction, cannot exceed $1 million.[157] The aggregate amount sold to any investor by the issuer, including any amount sold in reliance on the crowdfunding exemption during the twelve-month period preceding the date of the transaction, cannot exceed: (A) the greater of $2,000 or 5 percent of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; or (B) 10 percent of the annual income or net worth of an investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000.[158] The transaction must be conducted through a broker or through an entity known as a funding portal.[159] The financial intermediary (broker-dealer or funding portal) is required to act as a "gatekeeper" and undertake certain precautions deemed necessary for investor protection, such as providing investors with certain disclosures, conducting background checks on the issuer's principals, and ensuring that investor funds are returned if the target amount of the offering is not received.[160]

In addition, an issuer must meet specific conditions in order to rely on the exemption, including filing with the Commission and providing to investors and intermediaries information about the issuer (including financial statements, which would be reviewed or audited depending on the size of the target offering amount), its officers, directors, and greater than 20 percent shareholders, and risks relating to the issuer and the offering.[161] In addition, specific offering-related information—such as the use of proceeds of the offering, the target amount for the offering, the deadline to reach the target offering amount, and regular updates regarding progress in reaching the target—is required to meet the conditions of the exemption.[162] To qualify for the exemption, issuers may not advertise the terms of the offering, other than to provide notices directing investors to the funding portal or broker, and issuers must disclose amounts paid to compensate solicitors promoting the offering through the channels of the broker or funding portal.[163]

An issuer that relies on the exemption would be subject to certain ongoing reporting requirements. An issuer would need to file with the Commission and provide to investors, no less than annually, reports of the results of operations and financial statements, all as the Commission may determine is appropriate.[164]

and such rules become effective, issuers and intermediaries may not rely on the exemption provided under Section (4)(a)(6).").

157. JOBS Act § 302(a), 15 U.S.C. § 77d(a)(6)(A) (2012).
158. JOBS Act § 302(a), 15 U.S.C. § 77d(a)(6)(B)(i)–(ii) (2012).
159. JOBS Act § 302(a)–(b), 15 U.S.C. §§ 77d, 77d-1 (2012).
160. JOBS Act § 302(b), 15 U.S.C. § 77d-1(a).
161. JOBS Act § 302(b), 15 U.S.C. § 77d-1(b)(1)(A)–(D), (G)–(H).
162. JOBS Act § 302(b), 15 U.S.C. § 77d-1(b)(1)(E)–(F).
163. JOBS Act § 302(b), 15 U.S.C. § 77d-1(b)(2)–(3).
164. JOBS Act § 302(b), 15 U.S.C. § 77d-1(b)(4).

The Commission may also impose any other requirements that it determines appropriate.[165]

Securities sold on an exempt basis under the crowdfunding exemption would not be transferable by the purchaser for a one-year period beginning on the date of purchase, except in certain limited circumstances.[166] The crowdfunding exemption would be available only for domestic issuers that are neither reporting companies under the Exchange Act nor investment companies; Congress also empowered the Commission to render the crowdfunding exemption inapplicable to other issuers.[167] Congress required the Commission to establish "bad actor" disqualification provisions for the crowdfunding exemption that are substantially similar to those of Regulation A.[168]

On October 23, 2013, the Commission proposed rules to implement the CROWDFUND Act.[169] The proposal would create a new part of the Code of Federal Regulations, which part would be comprised of twenty new rules.[170] The proposal acknowledges that regulation of these offerings requires adapting disclosure-based principles and the existing approach to broker-dealer regulation and oversight to an entirely new public offering rubric.[171]

The ability to engage in crowdfunding is not available to all issuers. Rule 100(b) would render the exemption inapplicable to certain issuers, such as foreign issuers and issuers subject to "bad boy" disqualifications.[172] Rule 100(a)(3) would permit an issuer to engage in a crowdfunding offering only through a registered broker-dealer or through a funding portal, while using only one intermediary for a particular offering or concurrent offerings made in reliance on the exemption.[173] The proposal defines "platform" as an internet website or similar electronic medium through which a broker-dealer or a funding portal conducts a section 4(a)(6) offering.[174] The proposed rules set out a regulatory framework for these intermediaries. In the case of funding portals, the regulatory framework is a scaled back version of the framework applicable to broker-dealers.[175] The proposed rules extend in significant ways the duties of intermediaries in crowdfunded offerings. The proposed rules would impose various requirements on intermediaries, including, for funding portals, modified registration requirements, compliance and recordkeeping requirements, investor education obligations, limitations on the permitted activities and compensation of an intermediary, and obligations relating to the mechanics of an offering.[176]

165. JOBS Act § 302(b), 15 U.S.C. § 77d-1(b)(5).
166. JOBS Act § 302(b), 15 U.S.C. § 77d-1(e).
167. JOBS Act § 302(b), 15 U.S.C. § 77d-1(f).
168. JOBS Act § 302(d), 15 U.S.C. § 77d note.
169. Crowdfunding, 78 Fed. Reg. 66428 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239 & 240).
170. *Id.* at 66551 (to be codified at 17 C.F.R. pt. 227).
171. *See id.* at 66430–31.
172. *Id.* at 66551 (to be codified at 17 C.F.R. § 227.100(b)).
173. *Id.* (to be codified at 17 C.F.R. § 227.100(a)(3)).
174. *Id.* at 66552 (to be codified at 17 C.F.R. § 227.100(d)).
175. *Id.* at 66556–60 (to be codified at 17 C.F.R. §§ 227.301–.404).
176. *Id.*

The proposal also set forth disclosure rules that would be applicable to issuers.[177] Under the proposal, an issuer would be required to file disclosures via EDGAR, to provide the requisite disclosures to investors and the relevant intermediary, and to make the necessary disclosures available to potential investors.[178] Form C would be required for the initial disclosure about the offering; amendments to Form C to report material changes would be filed on Form C-A; and progress updates on the offering would be filed on Form C-U.[179] Required annual filings would be made on Form C-AR until the filing obligations terminated, when the issuer would be required to file Form C-TR.[180] Form C would be filed with Commission, and the intermediary could post the filing or provide a link to the filing for investors.[181] Once an issuer completes a crowdfunded offering, it would be subject to limited ongoing filing requirements. Within 120 days of the end of the issuer's fiscal year, the issuer would be required to prepare and file an annual report on Form C-AR.[182] The annual report would update information included in the Form C.[183] This reporting obligation would continue until the issuer became a reporting company, all securities sold in crowdfunded offerings had been redeemed or repurchased by a third party, or the issuer liquidated or dissolved.[184]

The comment period on the proposed rule closed on February 3, 2014,[185] but it is unclear when the Commission will issue final rules.

3. Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act

The JOBS Act established a new exemption under section 3(b) of the Securities Act.[186] The Commission previously exercised authority under section 3(b) when it promulgated Regulation A,[187] which permits private companies to conduct small public offerings without registration.[188] Congress required the Commission to promulgate rules under the newly created statutory exemption, but it imposed no deadline by which the Commission must do so.[189]

Under the new exemption from the general registration requirements, an issuer will be able to offer and sell up to $50 million in securities within a twelve-month period.[190] The issuer may offer equity securities, debt securities,

177. *Id.* at 66552–55 (to be codified at 17 C.F.R. §§ 227.201–.205).
178. *Id.* at 66552 (to be codified at 17 C.F.R. § 227.201).
179. *Id.* at 66554–55 (to be codified at 17 C.F.R. § 227.203).
180. *Id.* at 66555.
181. *See id.* at 66554, 66557 (to be codified at 17 C.F.R. §§ 227.203, .303).
182. *Id.* at 66555 (to be codified at 17 C.F.R. § 227.203(b)).
183. *Id.* at 66554–55 (to be codified at 17 C.F.R. § 227.203).
184. *Id.* at 66554 (to be codified at 17 C.F.R. § 227.202(b)).
185. *Id.* at 66428.
186. JOBS Act § 401(a), 15 U.S.C. § 77c(b)(2) (2012).
187. 17 C.F.R. §§ 230.251–.263 (2013).
188. *See* 17 C.F.R. § 230.251 (2013).
189. JOBS Act § 401(a), 15 U.S.C. § 77c(b)(2).
190. JOBS Act § 401(a), 15 U.S.C. § 77c(b)(2)(A).

and debt securities convertible or exchangeable for equity interests, including any guarantees of such securities.[191] The securities sold pursuant to the exemption can be offered and sold publicly and will not be deemed "restricted securities."[192] The issuer may solicit interest in the offering prior to filing any offering statement with the Commission, subject to any additional conditions or requirements that may be imposed by the Commission.[193] Section 3(b)(2) provides that the securities will be considered "covered securities" for National Securities Markets Improvement Act purposes (and not subject to state securities review) if: (A) the securities are offered and sold on a national securities exchange or (B) the securities are offered or sold only to "qualified purchasers" as defined by the Commission pursuant to the Securities Act.[194] The civil liability provision in section 12(a)(2) will apply to any person offering or selling such securities pursuant to section 3(b)(2).[195]

The JOBS Act provides the Commission with authority to impose other terms, conditions, or requirements that it deems necessary for investor protection, including a requirement that the issuer prepare and file electronically with the Commission and distribute to prospective investors an offering statement and any related documents, including a description of the issuer's business and financial condition, its corporate governance principles, the intended uses of proceeds, and other appropriate matters.[196] The JOBS Act specifies that the Commission must require that the issuer file audited financial statements with the Commission annually.[197] The bad actor disqualification provisions applicable for the exemption must be substantially similar to the disqualification provisions contained in regulations promulgated pursuant to section 926 of the Dodd-Frank Act.[198]

On December 18, 2013, the Commission proposed rules to carry out the congressional mandate of Title IV of the JOBS Act.[199] The proposed rules both retain and modernize the current framework of current Regulation A, by expanding Regulation A into two tiers.[200] Tier 1 would preserve the current offering threshold in Regulation A, which permits an issuer to offer and sell up to $5 million in any twelve-month period, including no more than $1.5 million in securities sold on behalf of selling stockholders.[201] Tier 1 offerings would be subject to state

191. JOBS Act § 401(a), 15 U.S.C. § 77c(b)(3) (2012).
192. JOBS Act § 401(a), 15 U.S.C. § 77c(b)(2)(B)–(C).
193. JOBS Act § 401(a), 15 U.S.C. § 77c(b)(2)(E).
194. JOBS Act § 401(b), 15 U.S.C. § 77r(b)(4).
195. JOBS Act § 401(a), 15 U.S.C. § 77c(b)(2)(D).
196. JOBS Act § 401(a), 15 U.S.C. § 77c(b)(2)(G)(i).
197. JOBS Act § 401(a), 15 U.S.C. § 77c(b)(2)(F)–(G).
198. JOBS Act § 401(a), 15 U.S.C. § 77c(b)(2)(G)(ii).
199. Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, 79 Fed. Reg. 3926, 4065 (proposed Jan. 23, 2014) (to be codified at 17C.F.R. pts. 230, 232, 329, 240 & 260).
200. *Id.* at 3927, 4000 (to be codified at 17 C.F.R. § 230.251(a)).
201. *Id.* (to be codified at 17 C.F.R. § 230.251(a)(1)).

securities review.[202] Tier 2 would provide an exemption for offerings of up to $50 million in any twelve-month period, including no more than $15 million in securities sold on behalf of selling stockholders.[203] Offerings in both tiers are subject to the same basic requirements relating to issuer eligibility, disclosure, and other matters.[204]

The offering exemption would be available to non-reporting companies organized in the United States or Canada, and would not be available to investment companies, companies delinquent in their filing requirements, and issuers subject to certain Commission orders.[205] An issuer would be required to prepare and submit to the Commission for its review an offering statement,[206] but the issuer could request confidential treatment of the submission.[207] The offering statement would then be filed electronically through EDGAR.[208] Consistent with current Regulation A, issuers would be permitted to conduct test-the-waters communications.[209] The proposed rules would incorporate a new investment limit for Tier 2 offerings. The proposal would limit the permissible amount to be invested by any individual to the greater of 10 percent of the individual's net worth or annual income.[210] In addition, the proposed rules contain certain ongoing reporting requirements. An issuer that has conducted a Tier 2 Regulation A offering would be required to make certain limited ongoing SEC filings.[211]

In order to address the most significant impediment associated with current Regulation A, the proposed rule preempts state securities law review for Tier 2 Regulation A offerings.[212] The proposed rule does so by defining a "qualified purchaser" to include any offeree or purchaser in a Tier 2 offering.[213]

The comment period on the proposal closed on March 24, 2014,[214] but it is not clear when the Commission will issue final rules.

202. *Id.* at 3928.
203. *Id.* at 4000 (to be codified at 17 C.F.R. § 230.251(a)(2)).
204. *See id.* (to be codified at 17 C.F.R. § 230.251(b)–(d)).
205. *Id.* (to be codified at 17 C.F.R. § 230.251(b)).
206. *Id.* (to be codified at 17 C.F.R. § 230.251(d)).
207. *Id.* at 4001 (to be codified at 17 C.F.R. § 230.252(c)).
208. *Id.* (to be codified at 17 C.F.R. § 230.252(e)).
209. *Id.* at 4003 (to be codified at 17 C.F.R. § 230.255).
210. *Id.* at 4000 (to be codified at 17 C.F.R. § 230.251(d)(2)(i)(C)).
211. *Id.* at 4003 (to be codified at 17 C.F.R. § 230.257(b)).
212. *See id.* (to be codified at 17 C.F.R. § 230.256).
213. *Id.*
214. *Id.* at 3926.

Accounting Developments 2013

Each year the Financial Accounting Standards Board ("FASB") releases a number of Accounting Standards Updates (each, an "ASU") that provide guidance to entities that produce financial statements in adherence with U.S. generally accepted accounting principles ("GAAP"). The following sections summarize the ASUs released by the FASB during the 2013 calendar year. Among other items addressed in that period, the updates from 2013 made important changes relating to financial reporting for derivatives, joint and several liabilities, investment companies, employee benefit arrangements, net operating losses, and nonpublic entities.

A. Clarifying the Scope of Disclosures About Offsetting Assets and Liabilities

In January 2013, the FASB released ASU No. 2013-01,[1] which addresses the scope of ASU 2011-11 by clarifying that it applies to certain derivatives that are either offset in accordance with Section 210-20-45 or Section 815-10-45 or subject to an enforceable master netting arrangement or similar agreement.[2] Such derivatives include bifurcated embedded derivatives, forward and reverse repurchase agreements, and securities borrowing/lending transactions.[3] ASU 2013-01 also clarifies that other types of financial assets or liabilities subject to a master netting or similar arrangement are exempt from ASU 2011-11's substantial disclosure requirements.[4]

The FASB justified this change as an effort to preclude the excessive and costly disclosures that were arguably required under a technical reading of the previous rule.[5] Prior to ASU 2013-01, a number of parties expressed concern that the broad language of ASU 2011-11 might require disclosures for a much wider variety of contracts than originally contemplated.[6] ASU 2013-01 will also provide users of financial statements with comparable information for reconciling differences with financial statements prepared under International Financial Reporting Standards ("IFRS").[7] ASU 2013-01 is effective for fiscal years beginning on or

1. Fin. Accounting Standards Bd., Accounting Standards Update No. 2013-01, Balance Sheet (Topic 210): Clarifying the Scope of Disclosures About Offsetting Assets and Liabilities (Jan. 2013).
2. *Id.* at 1.
3. *Id.*
4. *Id.*
5. *See id.*
6. *Id.*
7. *Id.* at 2.

after January 1, 2013, and interim periods within those annual periods.[8] Disclosures should be provided retrospectively for all comparative periods presented as well.[9]

B. Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income

In February 2013, the FASB released ASU No. 2013-02,[10] which modifies the reclassification of accumulated other comprehensive income by requiring disclosure of significant reclassifications as income statement line items if the amount being reclassified is required under GAAP to be reclassified in its entirety to net income.[11] Entities are required to cross-reference other GAAP disclosures that provide additional detail for other amounts.[12] This latter method is used for items that are reclassified to the balance sheet instead of the income statement in the same period.[13] Notably, ASU 2013-02 does not change the requirements for reporting net income or other comprehensive income.[14] It pertains only to the presentation of reclassifications.[15]

ASU 2013-02 applies to GAAP-reporting companies that report other comprehensive income.[16] ASU 2013-02 became effective for public entities prospectively for reporting periods beginning after December 15, 2012.[17] For nonpublic entities, the amendment came into effect later, for prospective reporting periods beginning after December 15, 2013.[18] Entities are allowed to adopt the amendments early.[19] Although IFRS reporting entities must reclassify other comprehensive income by component in some instances, ASU 2013-02 goes further by providing specific requirements for such presentation.[20]

C. Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities

In February 2013, the FASB released ASU 2013-03,[21] which was intended to clarify the scope and applicability of certain nonpublic entity disclosures im-

8. *Id.*
9. *Id.*
10. Fin. Accounting Standards Bd., Accounting Standards Update No. 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income (Feb. 2013).
11. *Id.* at 1.
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.* at 2.
18. *Id.*
19. *Id.*
20. *See id.*
21. Fin. Accounting Standards Bd., Accounting Standards Update No. 2013-03, Financial Instruments (Topic 825): Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities (Feb. 2013).

posed on entities with total assets exceeding $100 million that do not qualify for ASU 2011-04's exemption.[22] ASU 2013-03 noted that the "requirement to disclose 'the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2 or 3)' does not apply to nonpublic entities for items that are not measured at fair value in the statement of financial position but for which fair value is disclosed."[23] ASU 2013-03 was effective immediately upon issuance.[24]

D. Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date

In February 2013, the FASB released ASU 2013-04,[25] which provides guidance with regard to joint and several liability arrangements when such obligations are fixed at the reporting date.[26] Only certain obligations are within the scope of ASU 2013-04, including debt arrangements, other contractual arrangements, settled litigation, and judicial rulings.[27] Entities often report such items differently because GAAP does not provide specific reporting guidelines.[28] Some follow liability extinguishment principles, while others follow principles designed for contingent liabilities.[29] ASU 2013-04 eliminates this diversity by applying the same rules to both public and nonpublic entities, provided that other GAAP principles do not apply.[30] ASU 2013-04 requires entities to report joint and several obligations as the sum of (i) the amount that the reporting entity agreed to pay on the basis of its arrangement among its co-obligors and (ii) any additional amount the reporting entity expects to pay on behalf of its co-obligors.[31] Entities are required to disclose the nature and amount of such obligations.[32]

The amendments are effective for fiscal years and interim periods within those years beginning after December 15, 2013.[33] Nonpublic entities fall under the amendment's ambit for fiscal years ending after December 15, 2014, and interim periods and annual periods thereafter.[34] ASU 2013-04 does nothing to resolve

22. *Id.* at 1.
23. *Id.* (quoting Fin. Accounting Standards Bd., Accounting Standards Update No. 2011-04, Fair Value Measurements (Topic 820): Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs 297–98 (May 2011)).
24. *Id.*
25. Fin. Accounting Standards Bd., Accounting Standards Update No. 2013-04, Liabilities (Topic 405): Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date (a Consensus of the FASB Emerging Issues Task Force) (Feb. 2013).
26. *Id.* at 1.
27. *Id.*
28. *See id.*
29. *See id.*
30. *Id.*
31. *Id.*
32. *Id.*
33. *Id.* at 2.
34. *Id.*

disparities between IFRS and GAAP: the former has no specific guidance on recognition, measurement, and disclosure of obligations resulting from such joint and several arrangements.[35] However, International Accounting Standard 37 requires entities to treat as a contingent liability any part of a joint and several liability expected to be met by other parties.[36] This approach mirrors the approach applied in ASU 2013-04.[37]

E. Parent's Accounting for the Cumulative Translation Adjustment Upon Derecognition of Certain Subsidiaries or Groups of Assets Within a Foreign Entity or of an Investment in a Foreign Entity

In March 2013, the FASB released ASU 2013-05,[38] clarifying whether Subtopic 810-10 applies to the release of cumulative translation adjustments into net income when a parent (i) sells part or all of its investment in a foreign entity or (ii) no longer holds a controlling interest in a subsidiary or group of assets within a foreign entity.[39] Subtopic 810-10 requires that a parent deconsolidate a subsidiary or derecognize a group of assets if the parent ceases to have a controlling financial interest.[40] ASU 2013-05 changes the status quo by requiring the release of a cumulative translation adjustment into net income upon the loss of a controlling financial interest in such a subsidiary or group of assets.[41] However, it does not distinguish between sales or transfers pertaining to an investment in a foreign entity and those pertaining to a subsidiary or group of assets within a foreign entity.[42] Subtopic 830-30 provides for the release of the cumulative translation adjustment into net income, but only if a sale or transfer represents a sale or substantially complete liquidation of an investment in a foreign entity.[43] ASU 2014-05 also resolves a disparity relating to the treatment of business combinations created in stages (i.e., step acquisitions) when involving a foreign entity.[44] Following the promulgation of ASU 2013-05, acquisitions will be treated similarly regardless of whether they are one- or two-step transactions.[45]

In practical terms, this means that when a reporting entity ceases to have a controlling financial interest in a subsidiary or group of assets, it must release the cumulative translation adjustment—but only if the sale or transfer results

35. *Id.*
36. *Id.*
37. *Id.*
38. Fin. Accounting Standards Bd., Accounting Standards Update No. 2013-05, Foreign Currency Matters (Topic 830): Parent's Accounting for the Cumulative Translation Adjustment Upon Derecognition of Certain Subsidiaries or Groups of Assets Within a Foreign Entity or of an Investment in a Foreign Entity (a Consensus of the FASB Emerging Issues Task Force) (Mar. 2013).
39. *Id.* at 1.
40. *Id.*
41. *See id.*
42. *Id.*
43. *Id.*
44. *Id.*
45. *See id.*

in a substantially complete liquidation of the foreign entity in which the subsidiary or group of assets were located.[46] However, for an equity method investment that is a foreign entity, a pro rata portion of the cumulative translation adjustment should be released into net income upon a partial sale.[47] This is not true for investments in non-foreign entities: in those cases, the cumulative translation adjustment is released only if the partial sale is a substantially complete liquidation of the foreign entity that contains the equity method investment.[48] For the purposes of ASU 2013-05, sales of an investment in a foreign entity include both (i) events that result in the loss of a controlling financial interest in a foreign entity and (ii) events that result in an acquirer obtaining control of a target in connection with a step transaction.[49]

Some caveats apply. ASU 2013-05 applies only to entities that cease to hold a controlling financial interest in a subsidiary or group of assets within a foreign entity when (i) the subsidiary or group of assets is a nonprofit activity or a business and (ii) there is a cumulative translation adjustment balance associated with that foreign entity.[50] ASU 2013-05 is effective prospectively for fiscal years (including interim periods) beginning after December 15, 2013.[51] For nonpublic entities, the update is effective prospectively for the first annual period beginning after December 15, 2014, and interim and annual periods thereafter.[52] Prior periods should not be adjusted, but early adoption is permitted, although it requires that the update should be applied as of the beginning of the entity's fiscal year of adoption.[53]

F. Services Received from Personnel of an Affiliate

In April 2013, the FASB released ASU 2013-06,[54] clarifying that not-for-profit entities are required to recognize all services received from personnel of affiliates that directly benefit the recipient.[55] Such services should be measured at the cost recognized by the affiliate for providing such services.[56] But if such measurement will significantly overstate or understate the value of the service received, the recipient may elect to recognize costs based on (i) the cost recognized by the affiliate for the personnel providing that service or (ii) the fair value of that service.[57]

46. *See id.* at 2.
47. *Id.*
48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.* at 5.
52. *Id.*
53. *Id.*
54. Fin. Accounting Standards Bd., Accounting Standards Update No. 2013-06, Not-for-Profit Entities (Topic 958): Services Received from Personnel of an Affiliate (a Consensus of the FASB Emerging Issues Task Force) (Apr. 2013).
55. *See id.* at 1.
56. *Id.* at 2.
57. *Id.*

ASU 2013-06 does not contain standards for capturing or estimating the information required to apply the amendment.

ASU 2013-06 is effective prospectively for fiscal years beginning after June 15, 2014, and interim and annual periods thereafter.[58] A recipient not-for-profit entity may apply the amendments by adjusting all prior periods, but should not adjust the beginning balance of net assets of the earliest period presented.[59] Early adoption is allowed.[60] IFRS does not have industry-specific guidance for not-for-profit entities, so this amendment has no harmonizing effect between the two reporting systems.[61]

G. Liquidation Basis of Accounting

In April 2013, the FASB released ASU 2013-07,[62] which was aimed to clarify when the liquidation method of accounting is to be used. This method requires financial statements to present information relating to expected resources in liquidation by measuring assets by the amount of expected cash proceeds from a liquidation process.[63] Generally, ASU 2013-07 requires an entity to use the liquidation method when liquidation is "imminent."[64] This occurs when the likelihood is "remote" that the firm will return from liquidation, and either (i) a plan of liquidation is approved when there is a remote probability that such plan will be blocked, or (ii) outside forces impose a plan of liquidation, such as with involuntary bankruptcy.[65] But an entity should apply the liquidation basis when a plan was contained in the entity's governing documents only if an approved plan differs from the plan that was specified upon inception.[66] ASU 2013-07 requires disclosure of measurement assumptions, types of costs or incomes, and how long the liquidation process is expected to continue.[67]

ASU 2013-07 applies to all entities except those regulated by the Investment Company Act of 1940.[68] It is effective for annual reporting beginning after December 15, 2013, and interim reporting periods therein.[69] Thereafter, entities should apply the requirements prospectively from the day that liquidation is deemed imminent.[70] Entities can early adopt.[71] However, when the liquidation basis is used in accordance with other topics, such as with terminating employee benefits plans, entities should continue to apply the guidance in such topics

58. *Id.* at 3.
59. *Id.*
60. *Id.*
61. *Id.*
62. Fin. Accounting Standards Bd., Accounting Standards Update No. 2013-07, Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting (Apr. 2013).
63. *Id.* at 1.
64. *Id.*
65. *Id.*
66. *Id.*
67. *Id.* at 2.
68. *Id.* at 1.
69. *Id.* at 2.
70. *Id.*
71. *Id.*

until liquidation is completed.[72] ASU 2013-07 does not harmonize GAAP and IFRS because IFRS does not provide explicit guidance as to when or how the liquidation basis should be applied.[73]

H. Amendments to the Scope, Measurement, and Disclosure Requirements

In June 2013, the FASB released ASU 2013-08,[74] which represents the FASB's effort to clarify when an entity is an "investment company" for GAAP purposes.[75] This relates to the judgment as to when the FASB's Topic 946, which was an attempt to converge IFRS and GAAP with respect to investment companies, should apply.[76] ASU 2013-08's main provisions (i) provide guidance for assessing whether an entity is an investment company, (ii) require the fair value measurement of a non-controlling ownership interest of other investment companies, rather than using the equity method, and (iii) mandate disclosure (a) that an entity is an investment company, (b) of any changes in an entity's investment company status, and (c) of any financial support provided or required to be provided by an investment company to any investees.[77] With respect to the determination of whether an entity is an investment company, the amendments apply a two-tiered assessment that requires an entity to have certain fundamental characteristics of an investment company while allowing judgment with respect to other characteristics.[78] The result is that a type of fair value accounting is used for such entities for which fair value measurement is the most relevant measurement.[79] ASU 2013-08 is not meant to apply to certain real estate entities.[80]

ASU 2013-08 is effective for an entity's reporting periods (both interim and annual) beginning after December 15, 2013.[81] Entities cannot early adopt.[82] For entities that are deemed not to be investment companies under this new standard, they must cease application of Topic 946 upon the effective date of ASU 2013-08.[83] Entities that qualify as investment companies upon the effective date of ASU 2013-08 should apply the guidance prospectively.[84] With respect to convergence with IFRS, ASU 2013-08 provides similar standards for determining whether an entity is an investment company.[85] But the scope of the two

72. *Id.*
73. *Id.*
74. Fin. Accounting Standards Bd., Accounting Standards Update No. 2013-08, Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements (June 2013).
75. *Id.* at 1.
76. *See id.*
77. *Id.* at 2.
78. *Id.*
79. *Id.* at 3.
80. *Id.* at 2.
81. *Id.* at 3.
82. *Id.*
83. *Id.*
84. *Id.*
85. *Id.*

rules is not identical for a few reasons, including because GAAP relies upon legal determinations such as whether a company falls under the ambit of the Investment Company Act of 1940.[86] This consideration is not instrumental to determinations under IFRS.[87] Furthermore, a difference between the two systems has arisen as to how noninvestment company parents should account for interests in investment companies: IFRS rejects using fair value measurement when consolidating, whereas GAAP allows it in some circumstances.[88]

I. Deferral of the Effective Date of Certain Disclosures for Nonpublic Employee Benefit Plans in Update No. 2011-04

In July 2013, the FASB issued ASU 2013-09,[89] which defers indefinitely the effective date of certain disclosures entities would be obligated to report under ASU 2011-04.[90] ASU 2011-04 requires certain quantitative disclosures of unobservable inputs used in Level 3 fair value measurements for investments in the equity securities of the sponsor of a nonpublic employee benefit plan (including affiliates of the sponsor as well).[91] ASU 2013-09 would not affect any qualitative disclosures or other quantitative disclosures that relate to other, non-sponsor equity securities.[92] ASU 2013-09 was effective immediately upon issuance.[93] Plans that are subject to the Securities and Exchange Commission's filing requirements are not permitted to avail themselves of the deferrals contained in ASU 2013-09.[94]

J. Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes

In July 2013, the FASB released ASU 2013-10,[95] which permits reporting entities to use the Fed Funds Effective Swap Rate (OIS) as a U.S. benchmark interest rate for hedge accounting calculations pursuant to Topic 815.[96] Previously only interest rates on direct Treasury obligations of the U.S. Government or

86. *Id.* at 3–4.
87. *Id.* at 4.
88. *Id.*
89. Fin. Accounting Standards Bd., Accounting Standards Update No. 2013-09, Fair Value Measurement (Topic 820): Deferral of the Effective Date of Certain Disclosures for Nonpublic Employee Benefit Plans in Update No. 2011-04 (July 2013).
90. *Id.* at 1.
91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.*
95. Fin. Accounting Standards Bd., Accounting Standards Update No. 2013-10, Derivatives and Hedging (Topic 815): Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes (a Consensus of the FASB Emerging Issues Task Force) (July 2013).
96. *Id.* at 1.

the London Interbank Offered Rate were permitted.[97] This amendment acknowledges the growing exposure to and demand for hedging the Fed Funds Rate following the financial crisis in 2008, and the Fed Funds Rate provides risk managers with a more comprehensive spectrum of interest rate resets to utilize as benchmarks for existing hedge accounting guidance.[98] ASU 2013-10 became effective prospectively for certain new or re-designated hedging relationships that were entered into on or after July 17, 2013.[99] Under IFRS, hedging interest rates are not limited to specified rates, but are to be chosen on the basis that such rates are a separately identifiable component of a financial instrument and reliably measurable.[100]

K. Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists

In July 2013, the FASB issued ASU 2013-11,[101] clarifying the treatment of presentation of unrecognized tax benefits when net operating loss carryforwards, similar tax losses, or tax credit carryforwards exist. Previously no explicit guidance was provided for the treatment of such items in this context.[102] This lack of clarify resulted in some entities reporting unrecognized tax benefits as liabilities and others reporting reductions to deferred tax assets.[103] To resolve this diversity in reporting, the FASB provides the following guidance to reporting entities:

> An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets.[104]

When making this assessment, reporting entities should presume the disallowance of their tax position at the reporting date.[105]

97. *Id.*
98. *See id.*
99. *Id.* at 2.
100. *Id.*
101. Fin. Accounting Standards Bd., Accounting Standards Update No. 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (a consensus of the FASB Emerging Issues Task Force) (July 2013).
102. *Id.* at 1.
103. *Id.*
104. *Id.*
105. *Id.*

ASU 2013-11 is effective beginning after December 15, 2013, for both fiscal years and interim periods within those years.[106] Nonpublic entities must comply with ASU 2013-11 beginning after December 15, 2014, for fiscal years and interim periods within those years.[107] Entities are permitted to early adopt.[108] As IFRS does not include explicit guidance on the presentation of unrecognized tax benefits, ASU 2013-11 does not harmonize GAAP and IFRS.[109]

L. Definition of a Public Business Entity

In December 2013, the FASB issued ASU 2013-12 to preempt ambiguity with respect to the scope of certain reporting frameworks for private companies.[110] This was done to avoid the inconsistency and complexity of multiple definitions and any resulting reporting diversity for entities on the margins of the public/nonpublic entity distinction.[111] ASU 2013-12 specifically identifies types of business entities that are excluded from the scope of the *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies* (the "Guide").[112] The result is a new definition of "public business entity" for the purposes of the GAAP framework.[113] Among other things, this new definition encompasses (i) entities required to furnish financial statements with the Securities and Exchange Commission[114] and (ii) entities that have securities "that are not subject to contractual restrictions on transfer and that . . . by law, contract, or regulation [are] required to prepare U.S. GAAP financial statements . . . and make them publicly available."[115] Conversely, consolidated subsidiaries of public companies are not considered to be "public business entities."[116] It should be noted that, although an entity may qualify under the Guide, such qualification does not mean that the entity shall be eligible to apply all reporting alternatives that are made available to private companies.[117]

The FASB's motivation for this amendment was to address the multiple definitions of the terms "nonpublic entity" and "public entity" throughout GAAP.[118] ASU 2013-12 will determine the scope of the new guidance and identify whether such guidance is appropriate to apply to public business entities.[119] Notably,

106. *Id.* at 2.
107. *Id.*
108. *Id.*
109. *Id.*
110. Fin. Accounting Standards Bd., Accounting Standards Update No. 2013-12, Definition of a Public Business Entity—An Addition to the Master Glossary (Dec. 2013).
111. *Id.* at 1.
112. *Id.*
113. *Id.*
114. *Id.* at 2.
115. *Id.* at 3.
116. *Id.* at 2–3.
117. *See id.* at 3.
118. *Id.* at 1.
119. *See id.*

"public business entity" excludes not-for-profit entities and employee benefit plans that fall under Topic 958 and Topics 960 through 965, respectively.[120] With respect to comparisons between GAAP and IFRS, IFRS's concept of "small and medium-sized entities" remains and distinguishes IFRS's approach for dealing with the public/nonpublic entity distinction.[121]

120. *Id.*
121. *Id.* at 4.

Case Law Developments 2013

Introduction

Important developments in securities law jurisprudence occurred in 2013 in federal district and appellate courts as well as in the U.S. Supreme Court. Perhaps most significant, the Supreme Court agreed to revisit the fraud-on-the-market presumption of reliance that it accepted twenty-five years ago in *Basic Inc. v. Levinson*.[1] While we will have to wait until later in 2014 to see what the Court does with *Basic*'s fraud-on-the-market presumption, the Supreme Court in 2013 addressed important securities law questions dealing with the statute of limitations and a plaintiff's burden at the class certification stage, and it heard argument regarding the reach of the whistleblower-protection provisions of the Sarbanes-Oxley Act of 2002 ("SOX")[2] and the scope of the preclusion provision of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").[3] Moreover, district and appellate courts addressed important questions involving, among other things, confidential witnesses, the fraud-on-the-market presumption, Item 303 of Regulation S-K,[4] "maker of the statement" liability, secondary actors and group pleading, statutes of limitations, statutes of repose, foreign companies in domestic courts, and SLUSA preclusion. This survey reviews important developments in these areas.

Supreme Court Developments

In 2013, the Supreme Court handed down two decisions in cases arising under the securities laws and heard or agreed to hear three other cases that signal the possibility of major changes for securities practitioners.

Gabelli v. SEC

On February 27, 2013, in *Gabelli v. SEC*,[5] a unanimous Court held that the "discovery rule" exception to the statute of limitations for civil penalty actions under 28 U.S.C. § 2462 does not apply to a governmental plaintiff, in this

1. 485 U.S. 224, 250 (1988) (plurality) (holding that it is not inappropriate to apply a rebuttable presumption of reliance supported by the fraud-on-the-market theory).
2. Sarbanes-Oxley Act of 2002 § 806, 18 U.S.C. § 1514A (2012).
3. Securities Litigation Uniform Standards Act of 1998 § 101(b), 15 U.S.C. § 78bb(f)(1)(A) (2012).
4. 17 C.F.R. § 229.303 (2013).
5. 133 S. Ct. 1216 (2013).

case, the U.S. Securities and Exchange Commission (the "SEC"). Under the "discovery rule" exception, which is applicable to cases sounding in fraud, the statute of limitations would not begin to run until the claim is discovered or could have been discovered with reasonable diligence by the plaintiff.[6] Ordinarily, the statute of limitations would begin to run from the date the claim first accrued.[7]

Under the facts in *Gabelli*, Alpert, the chief operating officer of Gabelli Funds, LLC, the investment adviser to the Gabelli Global Growth Fund (the "Fund"), and Gabelli, the Fund portfolio manager, engaged in a market-timing arrangement with an investor in the Fund, Headstart Advisers, Ltd. ("Headstart"), in exchange for Headstart investing in a separate hedge fund run by Gabelli.[8] The market-timing arrangement itself was not illegal, but the SEC alleged that it was fraudulently concealed from other investors in the mutual fund, and it allowed Headstart to achieve up to 185 percent returns while other long-term investors in the fund never realized better than a negative 24 percent return.[9] In response to the SEC's complaint seeking civil penalties for violations of the Investment Advisers Act of 1940, the defendants argued that the claim was untimely, because under 28 U.S.C. § 2462, such civil penalties are subject to a five-year statute of limitations—the SEC filed suit in April 2008, but did not allege a market-timing arrangement later than August 2002.[10] The district court agreed with defendants, but was reversed by the U.S. Court of Appeals for the Second Circuit, which concluded that, for claims sounding in fraud, the "discovery rule" should be read into the relevant statute of limitations even when not explicitly contemplated.[11] The Supreme Court reversed.[12]

The Court explained that the discovery rule, as an exception to the ordinary construction of statutes of limitations, is a court-created doctrine that applies to cases of fraud where the injury is inherently self-concealing.[13] For private actions, this exception is appropriate because "[m]ost of us do not live in a state of constant investigation . . . . And the law does not require that we do so."[14] The Court declined to extend the discovery rule to enforcement actions for civil penalties for the following three reasons.

First, in contrast to private plaintiffs, the SEC *does* live in a state of constant investigation; indeed, constant investigation of fraud is one of the main reasons it exists.[15] Furthermore, the SEC is able to demand "detailed trading information" and "comprehensive books and records" from brokers, dealers, and investment advisers at any time.[16]

6. *Id.* at 1220 (citing SEC v. Gabelli, 653 F.3d 49, 59 (2d Cir. 2011)).
7. *Id.*
8. *Id.* at 1219.
9. *Id.* at 1219–20.
10. *Id.* at 1220.
11. *Id.*
12. *Id.* at 1224.
13. *Id.* at 1221.
14. *Id.* at 1222.
15. *Id.*
16. *Id.*

Second, the discovery rule is fundamentally an equitable doctrine meant to preserve the right to recovery for wronged plaintiffs. In contrast, "the S.E.C. as enforcer is a far cry from the defrauded victim the discovery rule evolved to protect."[17] Although the discovery rule seemingly continues to benefit the government when it is victimized by fraud—the Court cited with approval *Exploration Co. v. United States*,[18] in which the government sought rescission of a fraudulent sale and used the discovery rule to avoid timeliness issues[19]—it does not apply to cases in which the government is seeking to levy a punitive penalty.[20]

Third, the meaning of reasonable diligence—in the context of governmental agencies that have hundreds of employees, overlapping areas of responsibilities, and resource constraints—complicates judicial attempts to apply the discovery rule.[21] Application of the discovery rule to the government proves "far more challenging" than its application to suits by defrauded individuals, a challenge that the Court was unwilling to undertake, absent a mandate from Congress.[22]

Amgen Inc. v. Connecticut Retirement Plans & Trust Funds

On the same day it issued the *Gabelli* opinion, the Supreme Court issued its opinion in *Amgen Inc. v Connecticut Retirement Plans & Trust Funds*.[23] In *Amgen*, the Court held that, in class actions under Rule 10b-5,[24] the materiality of an alleged misrepresentation need not be proved as a prerequisite to class certification when the plaintiff invokes the fraud-on-the-market presumption of reliance.[25] The Court also held that the district court was not required to consider rebuttal evidence on the issue of materiality at the class certification stage.[26] The Court's decision resolved a circuit split on whether, at the class certification stage, a plaintiff must show, and whether the defendant may refute, the materiality of the statements giving rise to the claim.[27]

In *Amgen*, Connecticut Retirement Plans and Trust Funds ("Connecticut Retirement") sought class certification under Rule 23(b)(3) of the Federal Rules of Civil Procedure,[28] alleging that Amgen had made "misrepresentations and

17. *Id.*
18. 247 U.S. 435 (1918).
19. *Id.* at 449.
20. *Gabelli*, 113 S. Ct. at 1222–23.
21. *Id.* at 1223.
22. *Id.* at 1224.
23. 133 S. Ct. 1184 (2013).
24. 17 C.F.R. § 240.10b-5 (2013).
25. *Amgen*, 133 S. Ct. at 1190–91.
26. *Id.* at 1203–04.
27. *Id.* at 1194 (comparing Schleicher v. Wendt, 618 F.3d 679, 687 (7th Cir. 2010) (holding that plaintiff need not prove materiality at class certification stage), *with In re* Salomon Analyst Metromedia Litig., 544 F.3d 474, 484–85, 486 n.9 (2d Cir. 2008) (holding that plaintiff must prove, and defendant may rebut, materiality before class certification), *and In re* DVI, Inc. Sec. Litig., 639 F.3d 623, 631–32, 637–38 (3d Cir. 2011) (holding that plaintiff need not prove materiality before class certification, but defendant may present rebuttal evidence on the issue)).
28. Fed. R. Civ. P. 23(b)(3) (allowing class certification when "the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual

misleading omissions" about the safety and efficacy of two of its major drugs, and that these statements constituted violations of section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 promulgated thereunder during the period in which class members had purchased or sold Amgen securities.[29] To prove reliance on the misstatements, Connecticut Retirement invoked the fraud-on-the-market theory,[30] endorsed by the Supreme Court in *Basic*.[31] This theory creates a rebuttable presumption of reliance, based on the semi-strong form of the Efficient Capital Market Hypothesis ("ECMH"),[32] that in an open and developed or efficient market, the price of a company's stock will reflect all publicly available information about that company.[33] Therefore, courts may presume that, in an efficient market, investors indirectly rely on publicly available information, including misrepresentations, through their reliance on the integrity of the price set by the market.[34]

Amgen conceded that there was an efficient market for its shares during the relevant period, and it did not dispute that Connecticut Retirement met all of the class action prerequisites stated in Rule 23(a).[35] Amgen contended, however, that Connecticut Retirement was obligated to prove that Amgen's alleged misrepresentations and omissions *materially* affected Amgen's stock price in order to meet the predominance requirement of Rule 23(b)(3), which requires that questions of law or fact common to class members predominate over any questions affecting only individual members.[36] Amgen argued that proof of materiality is necessary for invoking the fraud-on-the-market presumption of reliance because immaterial statements or omissions would not affect or distort the price of the security, thereby negating classwide reliance.[37]

The Court explained that materiality is an element of the Rule 10b-5 claim and an essential predicate of the fraud-on-the-market presumption.[38] Under Rule 10b-5, private plaintiffs must prove "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[39] The fraud-on-the-market theory, which creates a rebuttable presumption of reliance, requires the plaintiff to prove "(1) an efficient market, (2) a public statement, (3) that the stock was traded after the statement was made but before the

members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy").

29. *Id.* at 1190, 1193.
30. *Id.* at 1190.
31. Basic Inc. v. Levinson, 485 U.S. 224, 250 (1988) (plurality).
32. *Schleicher*, 618 F.3d at 684–85.
33. *Amgen*, 133 S. Ct. at 1192.
34. *Id.* at 1192–93.
35. *Id.* at 1190–91.
36. *Id.* at 1191.
37. *Id.*
38. *Id.* at 1195.
39. *Id.* at 1192 (quoting Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1317 (2011)).

truth was revealed, and (4) the materiality of the statement."[40] The Court acknowledged that the invocation of the fraud-on-the-market theory has facilitated class action certifications in Rule 10b-5 cases by recognizing the rebuttable presumption of classwide reliance on public material misrepresentations when shares are traded in an efficient market.[41] "Absent the fraud-on-the-market theory, the requirement that Rule 10b-5 plaintiffs establish reliance would ordinarily preclude certification of a class action seeking money damages because individual reliance issues would overwhelm questions common to the class."[42]

The Court found that, because materiality is a substantive element of a Rule 10b-5 claim, failure to show that misstatements or omissions were material would not result in individual questions of reliance overwhelming questions common to the class.[43] "Instead, the failure of proof on the element of materiality would end the case for one and for all; no claim would remain in which individual reliance issues could potentially predominate."[44] The Court concluded that materiality is a question common to the class, and Amgen's contention should be addressed at trial or in a ruling on a summary judgment motion.[45] The Court reasoned that materiality is not appropriately dealt with at the certification stage because Rule 23(b)(3) requires plaintiffs to show that classwide questions of law and fact will predominate over individual questions, not that such classwide questions will be resolved in favor of the class.[46]

In dissent, Justice Thomas, joined by Justices Kennedy and Scalia, argued that *Basic* established materiality as a necessary element of the fraud-on-the-market theory, and if the plaintiffs cannot show materiality, then "it is impossible to say that there has been a fraud on the market at all, and if that is not the case there is no reason to believe that . . . any market participants relied on it."[47] Because materiality is a requirement of the fraud-on-the-market theory, a class action should not proceed without it being proved; otherwise, a subsequent failure to prove materiality would mean that the class never should have been certified in the first place.[48]

Significantly, the *Amgen* decision resolved a split among the circuits regarding proof of materiality at the class certification stage,[49] but it did not alter the requirements to prove a Rule 10b-5 claim or to invoke the fraud-on-the-market presumption. The intriguing aspect of the decision was the willingness of four of the Justices (Alito in a concurrence, and Scalia, Kennedy, and Thomas in dis-

40. *Id.* at 1209 (Thomas, J., dissenting) (citing Basic Inc. v. Levinson, 485 U.S. 224, 248 n.27 (1988)).
41. *Id.* at 1193 (majority).
42. *Id.*
43. *Id.* at 1196.
44. *Id.*
45. *Id.* at 1197.
46. *Id.* at 1191.
47. *Id.* at 1214 (Thomas, J., dissenting).
48. *Id.* at 1210.
49. *Id.* at 1194 (majority).

sent) to revisit *Basic*'s fraud-on-the-market presumption.[50] The opportunity presented itself soon enough in *Halliburton Co. v. Erica P. John Fund, Inc.*[51]

Halliburton Co. v. Erica P. John Fund, Inc.

On November 15, 2013, the Supreme Court granted the petition for writ of certiorari in *Halliburton Co. v. Erica P. John Fund, Inc*.[52] In *Halliburton*, the plaintiffs, represented by the Erica P. John Fund ("EPJ Fund"), alleged that they suffered material losses as a result of Halliburton's fraudulent misrepresentations concerning understated liability for asbestos claims, overstated revenues, and its exaggerated cost savings and efficiencies from an earlier merger.[53] In September 2007, the EPJ Fund moved to certify a class of all persons who purchased Halliburton common stock during the class period.[54] The district court found that the plaintiffs failed to establish the predominance requirement under Rule 23(b)(3) because they had not established loss causation, as required under controlling precedent of the U.S. Court of Appeals for the Fifth Circuit.[55] On appeal, the Fifth Circuit affirmed the district court's denial of class certification for the same reason.[56] The Supreme Court granted certiorari and unanimously reversed the judgment of the Fifth Circuit, holding that plaintiffs need not prove loss causation at the class certification stage.[57] The Court, however, remanded the case to the lower court to address any further arguments against class certification that Halliburton had preserved.[58]

Subsequent to its 2011 decision in *Halliburton I*, the Court issued its opinion in *Amgen*, holding that a plaintiff need not prove materiality to invoke the fraud-on-the-market presumption of reliance at the class certification stage.[59]

On remand to the district court, Halliburton argued that the class should not be certified because its evidence revealed that the alleged fraud did not "impact" or "distort" the market price, thereby rebutting the presumption of reliance under the fraud-on-the-market theory.[60] The district court refused to consider Halliburton's evidence on the issue, finding that price impact evidence did not bear on the critical inquiry of whether common issues predominated under Rule 23(b)(3).[61] The Fifth Circuit affirmed the district court's decision, stating that, in order to certify a potential class, the only element at issue is whether

50. *Id.* at 1204 (Alito, J., concurring) (stating that "reconsideration of the *Basic* presumption may be appropriate"); *id.* at 1208 n.4 (Thomas, J., dissenting) (describing the *Basic* presumption as "questionable" and suggesting that the presumption should be revisited).

51. 718 F.3d 423 (5th Cir.), *cert. granted*, 82 U.S.L.W. 3119 (U.S. Nov. 15, 2013) (No. 13-317).

52. 82 U.S.L.W. 3119 (U.S. Nov. 15, 2013) (No. 13-317).

53. *Erica P. John Fund*, 718 F.3d at 426.

54. *Id.* at 426–27.

55. *Id.* at 427.

56. *Id.*

57. Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2183 (2011) [hereinafter *Halliburton I*].

58. *Id.* at 2187.

59. *See supra* notes 23–51 and accompanying text.

60. *Erica P. John Fund*, 718 F.3d at 427.

61. *Id.*

common questions predominate pursuant to Rule 23(b).[62] While the court acknowledged that price impact evidence could appropriately be provided at trial to refute reliance, it concluded that price impact should not be considered at class certification under the analytical framework provided by the *Amgen* Court.[63]

Amgen and *Halliburton I* left two questions open: whether the fraud-on-the-market presumption should be overruled or modified, and whether, at the class certification stage, the defendant may rebut the presumption by offering evidence that the alleged misrepresentations did not distort the market price of the stock. These two questions were presented in Halliburton's petition for certiorari,[64] which the Court granted on November 15, 2013.[65] Specifically the Court agreed to consider:

> (1) Whether th[e] Court should overrule or substantially modify the holding of *Basic* . . . , to the extent that it recognizes a presumption of classwide reliance derived from the fraud-on-the-market theory [and] (2) Whether, in a case where the plaintiff invokes the presumption of reliance to seek class certification, the defendant may rebut the presumption and prevent class certification by introducing evidence that the alleged misrepresentations did not distort the market price of its stock.[66]

In its petition for certiorari, Halliburton argued that *Basic* should be overruled because in the twenty-five years following the Court's acceptance of the ECMH, "scholars have roundly rejected its approach to market efficiency."[67] "*Basic*'s central economic premise . . . has been almost universally repudiated."[68] Although the ECMH showed early promise, real-world experiences, such as the 1998–2001 technology bubble and the 2008 economic crisis, have brought the theoretical underpinnings of *Basic* into question.[69] Moreover, as Justice Ginsberg stated in a footnote to the *Amgen* decision, a central problem with *Basic* is that "efficiency is not a binary, yes or no question."[70] "[E]fficiency is rarely uniform even for a single stock."[71] "A stock might trade efficiently some of the time, for some information types, but then trade inefficiently at other times, for other information types."[72] For that reason, Halliburton argued, the "presumption should be re-

62. *Id.* at 432.

63. *Id.* at 433–35.

64. Petition for Writ of Certiorari, Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317 (U.S. Sept. 9, 2013), 2013 WL 4855972 [hereinafter Halliburton Petition].

65. 82 U.S.L.W. 3119 (U.S. Nov. 15, 2013) (No. 13-317).

66. Halliburton Petition, *supra* note 64, at *i.

67. *Id.* at *11.

68. *Id.* at *12.

69. *Id.* at *14–15.

70. Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 133 S. Ct. 1184, 1197 n.6 (2013) (noting that Amgen advanced an "argument founded on modern economic research tending to show that market efficiency is not 'a binary, yes or no question'" (quoting Donald C. Langevoort, Basic *at Twenty: Rethinking Fraud on the Market*, 2009 Wis. L. Rev. 151, 167)); *see* Halliburton Petition, *supra* note 64, at *16.

71. Halliburton Petition, *supra* note 64, at *16.

72. *Id.* (quoting Geoffrey Rapp, *Re-wiring the DNA of Securities Fraud Litigation:* Amgen's *Missed Opportunity*, 44 Loy. U. Chi. L.J. 1475, 1484 (2013)).

fashioned to require affirmative proof that the market price was distorted by the particular misrepresentations at issue."[73]

Moreover, Halliburton argued that *Basic*'s presumption that common issues of reliance predominate is inconsistent with the Supreme Court's recent class certification jurisprudence.[74] In so arguing, Halliburton relied on *Wal-Mart Stores, Inc. v. Dukes*,[75] in which the Court emphasized that "plaintiffs must 'affirmatively demonstrate compliance' with Rule 23 and thereby 'prove in fact' that common issues predominate before a district court may certify a class."[76] Halliburton also cited *Comcast Corp. v. Behrend*,[77] in which the Court held that certification is improper when proponents do not actually satisfy the predominance requirement with evidentiary proof.[78]

Overruling or modifying *Basic* would likely result in a major change in the securities litigation landscape. The class action device could conceivably be greatly curtailed in Rule 10b-5 misrepresentation cases, resulting in multiple individual actions, likely brought by large investors. Oral argument in *Halliburton* occurred on March 5, 2014.[79]

Lawson v. FMR LLC

On November 12, 2013, the Supreme Court heard oral argument in *Lawson v. FMR LLC* on the issue of whether an employee of a privately held contractor or subcontractor of a public company is protected from retaliation under the whistleblower-protection provision of SOX.[80] In *Lawson*, the U.S. Court of Appeals for the First Circuit held that section 806 of SOX[81] does not extend retaliation protection to the employees of privately held companies that have contracted with publicly held companies, reversing the decision of the district court.[82] During oral argument before the Court, the Justices expressed concern about the potential reach of section 806 to private contractors of officers of public corporations.[83] The Justices were equally concerned about excluding certain types of contractors from section 806, focusing specifically on accounting firms

73. *Id.* at *18.
74. *Id.* at *21.
75. 131 S. Ct. 2541 (2011).
76. Halliburton Petition, *supra* note 64, at *21 (quoting Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct. 2541, 2551 (2011) (emphases and ellipses removed)).
77. 133 S. Ct. 1426 (2013).
78. Halliburton Petition, *supra* note 64, at *21.
79. Transcript of Oral Argument, Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317 (U.S. Mar. 5, 2014), *available at* http://www.supremecourt.gov/oral_arguments/argument_transcripts/13-317_e18f.pdf.
80. 670 F.3d 61 (1st Cir. 2012), *cert. granted*, 81 U.S.L.W. 3007 (U.S. May 20, 2013) (No. 12-3).
81. Sarbanes-Oxley Act of 2002 § 806, 18 U.S.C. § 1514A (2012).
82. *Lawson*, 670 F.3d at 67–68, 83.
83. *See* Oral Argument at 5:03, Lawson v. FMR LLC, No. 12-3, 2014 WL 813701 (U.S. Mar. 4, 2014), *available at* http://www.oyez.org/cases/2010-2019/2013/2013_12_3 (Justice Breyer asked whether the statute protects a gardener from a private gardening company that contracted with the public company).

and law firms.[84] Ultimately, the Court held that, "based on the text of [section 806], the mischief to which Congress was responding, and the earlier legislation Congress drew upon, . . . the provision shelters employees of private contractors and subcontractors, just as it shelters employees of the public company served by the contractors and subcontractors."[85]

Chadbourne & Parke LLP v. Troice

On October 7, 2013, the Supreme Court heard oral argument in *Chadbourne & Parke LLP v. Troice*,[86] which addressed the scope of the preclusion provision of SLUSA.[87] Under this provision, "covered class actions" alleging misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security and based on state law may not be maintained in any state or federal court, where "covered security" generally refers to any security traded on a national exchange.[88] The underlying consolidated cases dealt with a Ponzi scheme conducted by R. Allen Stanford and related entities, including the Stanford International Bank.[89] Investors were sold certificates of deposit ("CDs") issued by the bank and were assured that the CDs were backed by safe investments, at least some of which met the definition of "covered security."[90] "Covered securities," however, were never purchased.[91] Stanford used the proceeds of the sale of new CDs to make interest and redemption payments on outstanding CDs sold under the scheme.[92] The Fifth Circuit, reversing the lower court decision and adopting the test employed by the Ninth Circuit, held that SLUSA preclusion could not apply because the fraudulent scheme was not more than "tangentially related" to a covered security transaction.[93] Other U.S. Courts of Appeals, specifically the Second, Sixth, and Eleventh Circuits, adopted an approach more likely to result in preclusion.[94] Although one Justice seemingly

84. *Id.* at 28:58, 29:10 (Justice Ginsburg asked whether a whistleblower had no protection against retaliation by an accounting firm or a law firm).

85. Lawson v. FMR LLC, No. 12-3, 2014 WL 813701, at *3 (U.S. Mar. 4, 2014).

86. Transcript of Oral Argument, Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058 (2014) (No. 12-79), 2013 WL 5845707.

87. Roland v. Green, 675 F.3d 503 (5th Cir. 2012), *cert. granted in part sub nom.* Chadbourne & Parke LLP v. Troice, 81 U.S.L.W. 3067 (U.S. Jan. 18, 2013) (No. 12-79).

88. SLUSA § 101(b), 15 U.S.C. § 78bb(f)(1)(A) (2012); *Roland*, 675 F.3d at 506.

89. *Roland*, 675 F.3d at 506, 508.

90. *Id.* at 508–10.

91. *See id.* at 508.

92. *Id.*

93. *Id.* at 519–20 ("[A] misrepresentation is 'in connection with' the purchase or sale of securities if there is a relationship in which the fraud and the stock sale coincide or are *more than tangentially related* . . . ." (quoting Madden v. Cowen & Co., 576 F.3d 957, 965–66 (9th Cir. 2009))).

94. *See, e.g.*, Romano v. Kazacos, 609 F.3d 512, 522 (2d Cir. 2010) (finding that SLUSA's "in connection with" standard is met where plaintiff's claims turn on injuries caused by acting on misleading investment advice—that is, where plaintiff's claims "necessarily allege," "necessarily involve," or "rest on" the purchase or sale of securities); Segal v. Fifth Third Bank, N.A., 581 F.3d 305, 310 (6th Cir. 2009) (stating that fraud allegations that "depend on" transactions in covered securities meet the "in connection with" requirement); Instituto de Prevision Militar v. Merrill Lynch, 546 F.3d 1340, 1349 (11th Cir. 2008) (holding that the fraud is in connection with the purchase or sale of securities under

tipped his hand,[95] oral argument provided little guidance on how the Court would rule. Ultimately, the Court held that SLUSA's preemption provision does not apply when plaintiffs allege that they purchased uncovered securities (that is, CDs that are not traded on a national exchange), but defendants falsely assured plaintiffs that the uncovered securities were backed by covered securities.[96]

Appellate and District Courts

As discussed below, the district and appellate courts addressed a number of important securities law issues in 2013—some interpreting recent guidance from the Supreme Court and others highlighting issues not yet resolved by the Court.

Confidential Witnesses

As securities class actions have become more common, both Congress, through the Private Securities Litigation Reform Act of 1995 ("PSLRA"),[97] and the Supreme Court, through decisions like *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,[98] have heightened the pleading requirements for such suits to stem the filing of weak or dubious cases. One of the consequences of the heightened pleading requirements has been the increased use of confidential witnesses by plaintiffs that now conduct pre-pleading investigations to find individuals willing to provide information supporting their allegations. A trio of cases in 2013 dealt with the risks and consequences of using such witnesses.

1. *Fort Worth Employees' Retirement Fund v. J.P. Morgan Chase & Co.*

In *Fort Worth Employees' Retirement Fund v. J.P. Morgan Chase & Co.*,[99] the U.S. District Court for the Southern District of New York held that the identity of confidential informants in securities complaints is not protected work product.[100] As a consequence, it is not enough for a plaintiff to provide a list of witnesses that includes the informants; rather, the plaintiff must specifically identify the informants.[101] If the plaintiff fears that some of the informants might be subject

SLUSA if either the fraud induced plaintiffs to invest with the defendants, or the fraudulent scheme coincided and depended upon the purchase or sale of covered securities).

95. Oral Argument at 25:55, Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058 (2014) (No. 12-79), *available at* http://www.oyez.org/cases/2010-2019/2013/2013_12_79 (Justice Scalia stated that "there has been no purchase or sale here" and "it can't be in connection with a purchase or sale that has never occurred").

96. Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058, 1062 (2014).

97. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

98. 551 U.S. 308 (2007).

99. No. 09 Civ. 3701 (JPO) (JCF), 2013 WL 1896934 (S.D.N.Y. May 7, 2013).

100. *Id.* at *1.

101. *See id.*

to retaliation, it can submit ex parte affidavits setting forth particularized facts to substantiate such fears, and the court can then take measures to protect those witnesses.[102]

2. *City of Pontiac General Employees' Retirement System v. Lockheed Martin Corp.*

In *City of Pontiac General Employees' Retirement System v. Lockheed Martin Corp.*,[103] Judge Jed S. Rakoff issued a memorandum opinion discussing the potential costs and benefits of relying on confidential witnesses or informants to meet heightened pleading requirements.[104] Judge Rakoff had denied the defendants' motion to dismiss a section 10(b) claim partly in reliance on statements attributed to the confidential witnesses.[105] After the defendants deposed five key confidential witnesses who had been identified during discovery, they filed a motion for summary judgment arguing that the witnesses had either recanted or denied making the statements.[106] The identities had been revealed pursuant to a protective order, but the plaintiff alleged that the witnesses had changed their stories because of pressure exerted by the defendant after learning the witnesses' identities.[107] Noting that the parties' competing assertions raised serious questions that implicated the integrity of the adversary process, the court, sua sponte, directed that the five witnesses and the plaintiff's investigator testify in court.[108]

Judge Rakoff observed that "some, though not all, of the [confidential witnesses] had been lured by the investigator into stating as 'facts' what were often mere surmises, but then, when their indiscretions were revealed, felt pressured into denying outright statements they had actually made."[109] Three of the witnesses denied making the statements attributed to them in the amended complaint.[110] Two of the witnesses acknowledged the substance of the statements attributed to them by the plaintiffs but claimed that the pleading "did not always convey the nuances of what they had told" the investigator.[111] Because the only witnesses that the court found credible had acknowledged the essential accuracy of the reports of the plaintiff's investigator, the court denied the motion for summary judgment, and the parties then entered into a settlement that the court later approved.[112] The court's sole purpose in issuing the memorandum opinion was to focus attention on the reliance on private inquiries of confidential witnesses and

102. *Id.* at *2.
103. 925 F. Supp. 2d 633 (S.D.N.Y. 2013).
104. *See id.* at 634–35.
105. *Id.* at 635–36.
106. *Id.* at 636.
107. *Id.*
108. *Id.*
109. *Id.* at 637.
110. *Id.*
111. *Id.*
112. *See id.* at 638; City of Pontiac Gen. Emps.' Ret. Sys. v. Lockheed Martin Corp., 954 F. Supp. 2d 276 (S.D.N.Y. 2013) (approving settlement).

the problems that this approach tends to create for defendants and plaintiffs.[113] The court commented that "[i]t seems highly unlikely that Congress or the Supreme Court, in demanding a fair amount of evidentiary detail in securities class action complaints, intended to turn plaintiffs' counsel into corporate 'private eyes' who would entice naive or disgruntled employees into gossip sessions that might help support a federal lawsuit," while noting that this was an inevitable consequence of the PSLRA and cases like *Tellabs*.[114]

3. *City of Livonia Employees' Retirement System & Local 295/Local 851 v. Boeing Co.*

In *City of Livonia Employees' Retirement System & Local 295/Local 851 v. Boeing Co.*,[115] the appellate court remanded the case to the district court with directions to consider Rule 11 sanctions against plaintiffs' lawyers.[116] *City of Livonia* was a securities class action in which the plaintiffs alleged that executives at Boeing had publicly stated that they expected a prototype airplane to achieve a development milestone on schedule even though they knew, based on confidential tests conducted by Boeing, that the milestone would be significantly delayed.[117] The plaintiffs relied on the statements of a single confidential informant to allege that the executives should have known of the impending delay.[118] However, when the informant's identity was revealed to Boeing, the statements made in the complaint could not be substantiated.[119] In particular, the plaintiffs had described the informant as a "Boeing Senior Structural Analyst Engineer and Chief Engineer" who had direct access to and knowledge of the failed tests.[120] After investigation, Boeing found that the witness was in fact an engineer employed by a contractor, not by Boeing itself, and that he very likely did not have access to, or first-hand knowledge of, the test results because he had worked on a different model of plane and would not have had general access to confidential Boeing information.[121] In a deposition conducted by Boeing, the witness denied "virtually everything" attributed to him in the plaintiffs' complaint.[122]

Unlike the judge in *City of Pontiac*, the *City of Livonia* district judge did not require the witness to testify—not only did the plaintiffs state that they had no interest in attempting to rehabilitate the witness,[123] but the judge was of the opinion that the conduct of the plaintiffs' lawyers had "amounted to a fraud on the court."[124] Plaintiffs' counsel had not met with the witness before submitting

113. *City of Pontiac*, 952 F. Supp. 2d at 638.
114. *Id.*
115. 711 F.3d 754 (7th Cir. 2013).
116. *Id.* at 762.
117. *Id.* at 757.
118. *Id.* at 759.
119. *Id.* at 760.
120. *Id.* at 759.
121. *Id.* at 760–61.
122. *Id.* at 760.
123. *Id.* at 761.
124. *Id.* at 760.

the complaint, which was based on his alleged statements, even though their own investigator had "qualms" about the informant because the witness offered information about Boeing's chain of command that was at odds with the investigator's knowledge of Boeing's corporate hierarchy.[125] Judge Posner, writing for the U.S. Court of Appeals for the Seventh Circuit, found that such information should have been a red flag for the plaintiffs' lawyers and that their failure of inquiry seemed to be motivated by a fear of what they might find.[126] These cases serve as reminders to plaintiffs' counsel to exercise care in conducting investigations and to defendants' counsel to test aggressively the legitimacy of confidential witnesses.

Fraud-on-the-Market Presumption

As discussed above, the viability of the fraud-on-the-market presumption is currently before the U.S. Supreme Court in the *Halliburton* case and is expected to be resolved in 2014.[127] Nevertheless, numerous courts addressed the presumption in 2013.

1. *GAMCO Investors, Inc. v. Vivendi, S.A.*

In *GAMCO Investors, Inc. v. Vivendi, S.A.*,[128] the *Basic* presumption of reliance was successfully rebutted.[129] In the *GAMCO* case, the plaintiffs brought a securities fraud action under section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder alleging that the defendant's material misstatements and omissions regarding its liquidity artificially inflated the price of its shares and that plaintiffs were harmed in reliance on that inflated price in connection with their purchases of Vivendi American Depositary Shares ("ADSs").[130] The sole issue in the case was whether Vivendi could refute the fraud-on-the-market presumption of reliance.[131] The defendant offered evidence that the plaintiffs made their investment decisions using a methodology that identifies companies that are selling at substantial discounts to their intrinsic Private Market Values ("PMV").[132] The PMV is the price that an informed industrialist would be willing to pay for a company if each of its segments was valued independently in a private market sale.[133] The PMV is separate and distinct from a company's market capitalization.[134] Judge Shira A. Scheindlin concluded that the fraud-on-the-market presumption is rebuttable when the plaintiff did not rely on the market

125. *Id.* at 762.
126. *Id.*
127. *See supra* notes 52–79 and accompanying text.
128. 927 F. Supp. 2d 88 (S.D.N.Y. 2013).
129. *Id.* at 104.
130. *Id.* at 90.
131. *Id.* at 91.
132. *Id.* at 94.
133. *Id.* at 94–95.
134. *Id.* at 95.

price of the security as an accurate measure of its intrinsic value.[135] The plaintiffs did not rely on the inflated market price of defendant's shares as an accurate measure of intrinsic value when making their investment decisions.[136] The court found, instead, that the decisions to purchase the ADSs were based on the PMV, and that Vivendi's liquidity crisis was irrelevant to the plaintiffs' investment decisions, other than that the disclosure made Vivendi a more attractive investment by increasing the spread between Vivendi's PMV and its market price.[137] Therefore, Vivendi had successfully rebutted the fraud-on-the-market presumption of reliance.[138]

2. *Hawaii Ironworkers Annuity Trust Fund v. Cole*

In *Hawaii Ironworkers Annuity Trust Fund v. Cole*,[139] the U.S. District Court for the Northern District of Ohio denied a motion for class certification in a case alleging scheme liability under section 10(b) of the Exchange Act and Rule 10b-5(a)–(c) promulgated thereunder against former corporate officers of Dana Corporation.[140] To establish classwide reliance, the plaintiff invoked the fraud-on-the-market presumption.[141] Applying the rigorous analysis required under Rule 23 and citing *Amgen*, the court stated that a plaintiff in a securities fraud action need not prove materiality at the class certification stage.[142] Nevertheless, a plaintiff seeking to invoke the presumption of reliance must demonstrate that the defendant's deceptive conduct was known publicly.[143] The plaintiff contended that it satisfied the "public-disclosure requirement because the deceptive conduct at issue—defendants' falsification of Dana's financial results—was communicated to the public through Dana's required quarterly press releases and financial reports."[144] The court found that, to invoke the fraud-on-the-market presumption in a scheme liability case, it is not enough to show that the result of the defendant's conduct was known publicly.[145] A plaintiff must establish that a defendant's deceptive conduct was disclosed publicly.[146] The court distinguished its previous ruling that defendants' scheme was communicated to the investing public when it denied defendants' motion to dismiss because, at that point, the court was required to accept as true plaintiff's allegations.[147] Therefore, while the court could accept at face value the plaintiff's claim that Dana's press release conveyed defendants' deceptive conduct to the

135. *Id.* at 100.
136. *See id.* at 102.
137. *Id.* at 97.
138. *Id.* at 104.
139. No. 3:10CV371, 2013 WL 4776258 (N.D. Ohio Sept. 4, 2013).
140. *Id.* at *1–2, *10.
141. *Id.* at *4.
142. *Id.*
143. *Id.* at *5.
144. *Id.* (internal quotation marks omitted).
145. *See id.* at *5–6.
146. *Id.* at *6.
147. *Id.* at *6–7.

public when ruling on a motion to dismiss, the court, at the class certification stage, was required to analyze rigorously the sufficiency of the plaintiff's allegations to determine whether the deceptive conduct was communicated to the public.[148] The court found that the only evidence the plaintiff offered to show public disclosure—three Dana press releases—did not communicate the deceptive conduct in which defendants allegedly engaged.[149] Because there was no public disclosure of the deceptive scheme, the plaintiff could not establish class-wide reliance under the fraud-on-the-market theory.[150] Accordingly, the class did not meet the predominance requirement of Rule 23.[151]

3. *Smilovits v. First Solar, Inc.*

Smilovits v. First Solar, Inc. was one of the first district court cases from the Ninth Circuit to apply *Amgen*.[152] In *Smilovits*, the U.S. District Court for the District of Arizona certified a class of shareholders in a securities action that alleged First Solar made misrepresentations to investors to inflate its stock price.[153] To satisfy Rule 23(b)(3), plaintiffs invoked a fraud-on-the-market theory of reliance, and they argued that, because a fraud-on-the-market presumption of reliance would either be proved or would fail for the class as a whole, common issues necessarily would predominate and thus the court did not need to make an inquiry into the efficiency of the market for First Solar stock at the class certification stage.[154] The court rejected the plaintiffs' theory.[155] Conducting its own efficiency analysis of the market for First Solar shares, the court found that the defendant did trade in an efficient market based on the fact that the stock was traded on NASDAQ[156] and that the five factors articulated in *Cammer v. Bloom*[157] slightly favored a finding of market efficiency.[158] The court concluded that plaintiffs had shown market efficiency by a preponderance of the evidence, that the fraud-on-the-market theory was warranted, and that common issues would predominate in light of the fraud-on-the-market theory of reliance.[159]

4. *Meyer v. Greene*

In *Meyer v. Greene*,[160] the U.S. Court of Appeals for the Eleventh Circuit affirmed the dismissal of a consolidated class action securities fraud complaint

148. *Id.* at *7.
149. *Id.* at *8.
150. *Id.* at *10.
151. *Id.* at *3–4, *10.
152. No. CV12-00555-PHX-DGC, 2013 WL 5551096 (D. Ariz. Oct. 8, 2013).
153. *Id.* at *1, *14.
154. *Id.* at *3.
155. *Id.*
156. *Id.* at *6.
157. 711 F. Supp. 1264, 1286–87 (D.N.J. 1989).
158. *Smilovits*, 2013 WL 5551096, at *7–13.
159. *Id.* at *14.
160. 710 F.3d 1189 (11th Cir. 2013).

for failure to plead loss causation adequately.[161] In that case, investors alleged that the defendant, St. Joe Company, and its current and former officers defrauded them by failing to write down the value of certain assets in periodic disclosures filed with the SEC.[162] The Eleventh Circuit determined that "in a fraud-on-the-market case, the plaintiff must prove not only that a fraudulent misrepresentation artificially inflated the security's value but also that 'the fraud-induced inflation that was baked into the plaintiff's purchase price was subsequently removed from the stock's price, thereby causing losses to the plaintiff.'"[163] A "corrective disclosure" used to reveal to the market the pertinent truth that was previously concealed or obscured by the company's fraud must present facts to the market that are publicly revealed for the first time.[164] In an effort to prove loss causation, the plaintiffs alleged that there had been several "corrective disclosures": (1) a presentation given by hedge fund investor David Einhorn suggesting St. Joe's assets were significantly overvalued, (2) St. Joe's disclosure of an informal SEC inquiry, and (3) St. Joe's announcement that the SEC's informal inquiry had ripened into a "private order of investigation."[165] The court found that Einhorn's presentation was not a corrective disclosure sufficient to establish loss causation because it contained a disclaimer stating that all information was "obtained from publicly available sources" and thus the presentation did not contain facts newly presented to the market.[166] In addition, "the mere repackaging of already-public information by an analyst or short-seller is simply insufficient to constitute a corrective disclosure."[167] Moreover, St. Joe's two disclosures of the SEC investigation were not "corrective disclosure" because the disclosures did not reveal to the market that the company's previous statements were false or fraudulent.[168]

Regulation S-K, Item 303

Several cases in 2013 dealt with the disclosure of known trends and uncertainties under Item 303 of Regulation S-K.[169] Generally, these cases have adopted a qualitative rather than quantitative approach to such disclosure.

1. *Silverstrand Investments v. AMAG Pharmaceuticals, Inc.*

For example, in *Silverstrand Investments v. AMAG Pharmaceuticals, Inc.*,[170] the U.S. Court of Appeals for the First Circuit found that the plaintiffs plausibly pled

161. *Id.* at 1192.
162. *Id.*
163. *Id.* at 1195 (quoting Hubbard v. BankAtlantic Bancorp, Inc., 688 F.3d 713, 725 (11th Cir. 2012)).
164. *See id.* at 1196–98.
165. *Id.* at 1193, 1197–1202.
166. *Id.* at 1198.
167. *Id.* at 1199.
168. *Id.* at 1201.
169. 17 C.F.R. § 229.303 (2013) (Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A")).
170. 707 F.3d 95 (1st Cir. 2013), *cert. denied*, 81 U.S.L.W. 3707 (U.S. Oct. 7, 2013) (No. 12-1457).

actionable omissions under Item 303 when the issuer failed to disclose twenty-three reports of Serious Adverse Events ("SAEs") associated with the defendant's major drug in the issuer's registration statement filed pursuant to the Securities Act of 1933 (the "Securities Act").[171] Citing *Panther Partners Inc. v. Ikanos Communications, Inc.*,[172] the First Circuit rejected a mechanical approach to determine if a known trend or uncertainty could have a material effect on the company.[173] Rather, the question was whether the SAEs, in the context in which they occurred, created uncertainties or risks that the defendant needed to disclose under Item 303.[174] The court stated that it could reasonably infer that the defendants knew the twenty-three SAEs could have prompted FDA action in connection with the drug, and that such intervention (which was not unlikely) would have meant trouble for the defendant.[175]

2. *Mallen v. Alphatec Holdings, Inc.*

In *Mallen v. Alphatec Holdings, Inc.*,[176] the U.S. District Court for the Southern District of California found that the plaintiffs failed to state an Item 303 claim because they did not plausibly allege a material misrepresentation in, or omission from, the offering prospectus concerning the defendant's unsalable inventory.[177] The plaintiffs alleged, among other things, that the facts related to the defendant's inventory constituted "known trends or uncertainties" that defendants had a duty to disclose under Item 303.[178] The court rejected this argument, stating that the plaintiffs failed to allege sufficient facts to show that the defendant knew at the time of the offering the material impact of any inventory problems or that any material impacts were reasonably likely to occur in the future.[179] The court contrasted the facts presented to those alleged in *Panther Partners* and found the facts presented by the plaintiffs regarding the inventory were broad and vague in comparison.[180]

171. *Id.* at 97.

172. 681 F.3d 114 (2d Cir. 2012).

173. *Silverstrand Invs.*, 707 F.3d at 105 ("[O]ur analysis under Item 303 . . . cannot be limited to simple arithmetical computations."); *id.* at 106 ("Item 303's disclosure obligations . . . do not turn on restrictive mechanical or quantitative inquiries." (citation omitted)).

174. *Id.* at 105.

175. *Id.* at 104.

176. No. 10-cv-1673-BEN (MDD), 2013 WL 1294640 (S.D. Cal. Mar. 28, 2013).

177. *Id.* at *3, *12–13.

178. *Id.* at *12.

179. *Id.*

180. *Id.* at *13 (contrasting plaintiffs' broad description with the "critical allegations" in *Panther Partners*, 681 F.3d at 121–22, which included the facts that: (1) the company received an increasing number of complaints about the defective products from two of its largest customers constituting 72 percent of the company's revenue; and (2) the company knew at the time that, as a result of the defects, it might have to accept returns on all the products that it had sold to those two customers).

3. *Johnson v. Sequans Communications S.A.*

In *Johnson v. Sequans Communications S.A.*,[181] the U.S. District Court for the Southern District of New York dismissed claims that the defendants were aware of a steep decline in WiMAX wireless technology and failed to disclose that decline when offering securities to the public.[182] Sequans, a designer and supplier of semiconductor chips for cellular telephones, was required to disclose in its initial public offering registration statement "any known trends or uncertainties . . . that are reasonably likely to have a material effect on the company's net sales or revenues, income from continuing operations, profitability, liquidity or capital resources, or that would cause reported financial information not necessarily to be indicative of future operating results or financial condition."[183] The court differentiated the situation in *Johnson* from that in *Panther Partners* in two respects.[184] First, the complaint in *Panther Partners* pled facts that raised a plausible inference that the defendants in that case were aware of the uncertainty at issue, including receiving calls from customers of product failures and holding board discussions relating to product failures.[185] The *Johnson* plaintiffs made conclusory allegations of knowledge.[186] There were no allegations that Sequans ever received information alerting it of a decline in the WiMAX market.[187] Second, the offering materials in *Panther Partners* contained generic cautionary language.[188] The Sequans offering documents contained specific warnings of the uncertainty concerning the WiMAX market, which could decline significantly due to the anticipated deployment of a competing technology and due to anticipated increase in competition for new customers.[189]

These cases demonstrate the need to be diligent in crafting the MD&A and Risk Factor sections of periodic reports and registration statements. While the familiar admonitions of being specific and avoiding boilerplate certainly continue to apply, attention to the qualitative basis of disclosure and trend analysis are appropriate. Meaningful cautionary statements that normally accompany risk factors should be reviewed periodically and updated to reflect accurately business and other risks.

"Maker of the Statement" Liability

In *Janus Capital Group, Inc. v. First Derivative Traders*,[190] the Supreme Court held that, for purposes of Rule 10b-5(b), the maker of a statement is the person

181. No. 11 Civ. 6341 (PAC), 2013 WL 214297 (S.D.N.Y. Jan. 17, 2013).
182. *Id.* at *10–11.
183. *Id.* at *11 (quoting Item 5(d) of Form 20-F, which closely resembles Item 303 of Regulation S-K).
184. *Id.* at *12.
185. *Id.*
186. *Id.*
187. *Id.*
188. *Id.*
189. *Id.*
190. 131 S. Ct. 2296 (2011).

or entity with ultimate authority over the statement, including its content and whether and how to communicate it.[191] In 2013, several appellate and district court cases addressed the issues of secondary actor liability and group pleading following *Janus*.

1. *Fezzani v. Bear, Stearns & Co.*

In *Fezzani v. Bear, Stearns & Co.*,[192] the U.S. Court of Appeals for the Second Circuit addressed whether a participant in a fraudulent "pump-and-dump" scheme could be liable in a private Rule 10b-5 action if that participant had never directly interacted with any of the defrauded parties but had provided services that were indispensable for the commission of the fraud.[193] The case arose out of a boiler-room scheme run by A.R. Baron, a broker-dealer, starting in 1992.[194] The defendant in the case on appeal was Isaac R. Dweck, a Baron investor, who provided short-term financing for the scheme and allowed Baron to "park" securities in his accounts at other firms in order to artificially create the appearance of a liquid market in exchange for ownership positions in certain companies and a guaranteed return on the parking arrangements.[195]

The court concluded that the allegations were pleaded with sufficient particularity for a governmental action against Dweck for aiding and abetting Baron's fraud, but the failure to allege that Dweck had ever communicated with any of the plaintiffs or that they had traded based on specific reliance on his involvement was fatal to the private Rule 10b-5 claim.[196] Citing both *Janus*[197] and *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,[198] the court found that "only the person who communicates the misrepresentation is liable in private actions under section 10(b)" and therefore the plaintiffs were required to have alleged more than knowing participation in the fraud in order to state a valid claim.[199]

Judge Lohier, in dissent, argued that claims against someone who engages in securities *manipulation* can proceed on a fraud-on-the-market basis.[200] According to Judge Lohier, the relevant analysis is "whether a defendant has engaged in a manipulative transaction that sends a false pricing signal to the market or conveys a misleading impression to the investing public."[201] Under this theory, the person that actually communicates the price to a defrauded investor is not the only liable entity.[202]

191. *Id.* at 2302.
192. 716 F.3d 18 (2d Cir. 2013).
193. *Id.* at 20–25.
194. *See id.* at 20.
195. *Id.* at 21–22.
196. *Id.* at 25.
197. 131 S. Ct. 2296 (2011).
198. 552 U.S. 148 (2008).
199. *Fezzani*, 716 F.3d at 25.
200. *Id.* at 25–26 (Lohier, J., dissenting).
201. *Id.* at 28 (internal citations, quotation marks, and alterations omitted).
202. *Id.* at 29.

2. *In re DVI Inc. Securities Litigation* and *Derby City Capital, LLC v. Trinity HR Services*

Two cases dealt with the following question: can legal counsel be liable for their role in alleged securities fraud? In the first, *In re DVI Inc. Securities Litigation*,[203] the law firm Clifford Chance was included as a defendant in a securities class action against its client, Diagnostic Ventures, Inc. ("DVI"), on the grounds that Clifford Chance violated section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder by facilitating a scheme to defraud DVI investors by drafting misleading financial reports, conspiring to hide material financial information about DVI, and thwarting an SEC investigation of DVI.[204] The plaintiffs asserted a "creator theory" of liability, whereby Clifford Chance would be liable as the "'creator, mastermind, and instigator' of DVI's scheme to defraud" because it had knowingly played a substantial role in drafting the financial statements.[205] The district court, ruling in favor of Clifford Chance on summary judgment, held that this theory was "not viable."[206] Under *Janus*, even if Clifford Chance had in fact developed the fraudulent scheme and aided DVI in drafting misleading financial reports, DVI retained "ultimate authority" over the statements.[207]

Likewise, in the second case, *Derby City Capital, LLC v. Trinity HR Services*,[208] legal counsel who had prepared and filed allegedly fraudulent Schedule 13Ds with the SEC on behalf of his client was not liable under a Rule 10b-5 theory because the client was the filer of record and there were no allegations that counsel had falsely attributed the filings to his client.[209]

3. *In re Satyam Computer Services Ltd. Securities Litigation*

The Southern District of New York considered the question of whether group pleading survived *Janus* in *In re Satyam Computer Services Ltd. Securities Litigation*,[210] which dealt with extensive fraud at an Indian computer services company that had overstated its assets on SEC filings by over one billion dollars.[211] The directors of Satyam who had served on the Audit Committee, which was responsible for overseeing the financial reporting and ensuring the accuracy of the financial statements, were alleged to have violated section 10(b) of the Exchange

203. No. CIV-03-5336, 2013 WL 56073 (E.D. Pa. Jan. 4, 2013).
204. *Id.* at *1.
205. *Id.* at *6 (quoting plaintiff's brief).
206. *Id.*
207. *Id.* at *7.
208. 949 F. Supp. 2d 712 (W.D. Ky. 2013). A third case with a similar fact pattern, *In re Allstate Life Insurance Co. Litigation*, No. CV-09-08162-PCT-GMS, 2013 WL 2474508 (D. Ariz. June 10, 2013), held that *Janus* had no impact on state securities law and that states could define their securities actions more broadly than federal law. *Id.* at *9. In that case, the court held that, under Arizona law, it was for a jury, as finder of fact, to determine whether a law firm that had drafted certain loan documents was a substantial participant with actual knowledge of misstatements in those documents. *Id.* at *3, *6.
209. *Derby City Capital, LLC*, 949 F. Supp. 2d at 742–44.
210. 915 F. Supp. 2d 450 (S.D.N.Y. 2013).
211. *Id.* at 457.

Act and Rule 10b-5 promulgated thereunder for their role in issuing misleading prospectuses and financial statements.[212] The plaintiffs relied on the group pleading doctrine, arguing that the Audit Committee defendants were corporate insiders with direct involvement in the day-to-day operations of Satyam.[213] The defendants argued that the effect of *Janus* was to limit liability to those who had ultimate authority for the content of the statements, and this replaced the broader group pleading approach.[214] The court disagreed, stating that the holding in *Janus* dealt with the responsibility of one corporation for the falsehoods of another corporation, and was thus readily distinguishable on the grounds that the Audit Committee defendants were "charged with responsibility for false statements made by the Company itself."[215]

4. *In re Anadarko Petroleum Corp. Class Action Litigation*

The application of *Janus* arose in the litigation surrounding the 2010 oil spill in the Gulf of Mexico, following the Macondo well blowout and explosion on the Deepwater Horizon drilling rig.[216] Anadarko Petroleum Corp. ("Anadarko") acquired a 25 percent interest in the Macondo well from BP, which retained a 65 percent interest and which also operated the drilling rig; the remaining 10 percent was owned by MOEX Offshore 2007 LLC.[217] BP agreed to give Anadarko, which was a non-operating partner, access to extensive real-time information about operations on the rig.[218] In addition, Anadarko had to approve BP's drilling activities that cost more than $500,000.[219] At issue for the court was a motion to dismiss the consolidated securities claims against Anadarko and three of its executives arising from alleged misrepresentations both before and after the spill.[220]

Two claims against Anadarko raised questions about "maker of the statement" liability. First, the plaintiffs alleged that Anadarko was liable under the Exchange Act for failing to correct misrepresentations in the Initial Exploration Plan ("IEP") and the Oil Spill Response Plan ("OSRP") filed by BP with the Department of Interior, even though the filings were made before Anadarko acquired its position in the well.[221] The plaintiffs argued that federal regulations provide that any co-lessee—here, Anadarko—is jointly and severally responsible for fulfilling the obligations to file the IEP and the OSRP, that *Janus* held that a party with a statutory obligation to make a statement was liable under securities law if that statement is false, and that Anadarko was therefore liable for failing to cor-

212. *Id.* at 460–61.
213. *Id.* at 477.
214. *Id.* at 477 n.16.
215. *Id.*
216. *In re* Anadarko Petroleum Corp. Class Action Litig., 957 F. Supp. 2d 806, 810 (S.D. Tex. 2013).
217. *Id.* at 811.
218. *Id.* at 811–12.
219. *Id.* at 812.
220. *See id.* at 810.
221. *Id.* at 813–14.

rect the filings after becoming a co-lessee.[222] The court declined to address the interpretation of the federal filing regulations on the ground that the plaintiffs' reading of *Janus* was incorrect: the presence of a statutory obligation to make a statement is not, by itself, enough to turn a party into the "maker of the statement."[223] Because "Anadarko literally could not have 'made' the misleading statements within the documents," as it was not involved with the well when the documents were filed, *Janus* precludes a finding of liability.[224]

Second, the plaintiffs alleged that Anadarko was liable for public misrepresentations made by BP after the oil spill on the ground that the operating agreement required Anadarko's approval for statements made to the press.[225] The defendants countered, on a factual basis, that the plaintiffs had not shown that Anadarko had actually approved the statements, and that the agreement permitted BP to make statements to the public in the case of emergencies.[226] The court disregarded that dispute as inappropriate to resolve at the motion to dismiss stage, and instead noted that, even if it accepted the allegations that Anadarko had in fact approved the misrepresentations, they still were not makers of the statement under *Janus*.[227] The facts in *Janus* dealt with an investment adviser that allegedly wrote misleading statements with knowledge of their misleading nature but did not have "ultimate authority" over the statements because they were filed with the SEC by another corporation; the district court failed to see a "principled distinction" between the investment advisor's actions and Anadarko's possible approval of the statements about the spill.[228] Barring allegations that Anadarko directed BP as to when or where to make the statements or that the statements were made in Anadarko's name, the defendants cannot be held to have had ultimate authority or control over them and *Janus* "seems to mandate the conclusion that Anadarko is not liable."[229]

5. *SEC v. Benger*

SEC v. Benger[230] continued a line of precedent holding that *Janus* does not apply to claims by the SEC arising from violations of section 17(a) of the Securities Act.[231] The defendants were charged with engaging in an international boiler-room scheme that targeted hundreds of foreign investors, through which

222. *Id.* at 828 & n.8 (citing 30 C.F.R. § 250.146(a)).
223. *Id.* at 828–29.
224. *Id.* at 829.
225. *Id.* at 833.
226. *Id.*
227. *Id.* at 834.
228. *Id.* at 833–34.
229. *Id.* at 834.
230. 931 F. Supp. 2d 904 (N.D. Ill. 2013).
231. Section 17(a) bars "any person in the offer or sale of any securities . . . by . . . interstate commerce . . . [from] (1) . . . employ[ing] any device, scheme, or artifice to defraud, or (2) . . . obtain[ing] money or property by means of any untrue statement of a material fact . . . , or (3) . . . engag[ing] in any [fraudulent] transaction, practice, or course of business." 15 U.S.C. § 77q(a) (2012).

the defendants fraudulently took 60 percent of the investors' money as commissions.[232] At issue in this particular case was the liability of the parties who hired the sales agents who made cold calls to prospective investors.[233] *Janus* did not preclude liability under section 17(a) for two reasons.[234] First, in *Janus*, the Court analyzed what it means to "make" a statement under Rule 10b-5.[235] Unlike Rule 10b-5, section 17(a) goes beyond the making of statements and deals with the commission of the fraud, rendering *Janus* inapplicable.[236] Second, *Janus* was motivated, at least in part, by policy concerns about the expansion of the judicially created private right of action under Rule 10b-5.[237] Because section 17(a) does not create a private right of action, those policy concerns are not present.[238]

6. *SEC v. Levin*

SEC v. Levin[239] dealt with what might be considered the inverse of the fact pattern in *Janus*: instead of a defendant attempting to avoid liability by arguing that it only drafted documents at the behest of another, controlling entity, the defendant in *Levin* argued that he was not liable—despite being the owner and manager of the entity that made the statements—because he had not drafted the statements.[240] The case arose out of the $1.2 billion Ponzi scheme run by Scott Rothstein, in which Rothstein purportedly sold investors the rights to confidential settlement agreements.[241] The defendants in the case were George Levin, the co-owner (along with his wife) and managing member of Banyon 1030-32, a Nevada limited liability company, and Frank Preve, an employee of Levin.[242] Beginning in 2007, Levin, through Banyon, offered investors promissory notes to enable the company to purchase the settlement agreements from Rothstein.[243] Contrary to representations—which were drafted by Preve—to Banyon's investors, Banyon sent money to Rothstein before receiving from Rothstein any confirmations that settlement funds were available for disbursement or any executed documents.[244] In early 2009, a slowdown in investments led Rothstein to miss payments, and he claimed to Levin and Preve that he was facing disbarment and that no more payments would be made unless he received $100 million.[245] To raise the money, Levin and Preve created Banyon Income

232. *See* SEC v. Benger, No. 09 C 676, 2013 WL 593952, at *1 (N.D. Ill. Feb. 15, 2013).
233. *Benger*, 931 F. Supp. 2d at 905; *Benger*, 2013 WL 593952, at *3.
234. *Benger*, 931 F. Supp. 2d at 905–07. The court previously dismissed the SEC's Rule 10b-5 claims to prevent extraterritorial application of the rule and conform with *Morrison*. *Benger*, 2013 WL 593952, at *8–13 (applying Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869 (2010)).
235. *Benger*, 931 F. Supp. 2d at 905–06.
236. *Id.* at 906.
237. *Id.*
238. *Id.*
239. No. 12-21917-CIV, 2013 WL 5588224 (S.D. Fla. Oct. 10, 2013).
240. *Id.* at *1, *14.
241. *Id.* at *1.
242. *Id.*
243. *Id.*
244. *Id.* at *2–3.
245. *See id.* at *3.

Fund ("BIF"), a limited partnership with Banyon as the general partner.[246] The private placement memorandum ("PPM") for BIF contained misrepresentations similar to those in the Banyon presentations.[247]

Levin argued that, because he had drafted neither the Banyon presentations nor the BIF PPM, *Janus* precluded liability because it required that a party both have ultimate authority over a document and have actually drafted or prepared it in order to be considered the maker of a statement.[248] The court flatly rejected this interpretation, holding that *Janus* says that the maker of the statement is the person with ultimate authority over the statement, regardless of whether that person drafted it.[249] Furthermore, in *Janus*, the two entities were legally independent of each other and the Supreme Court saw no reason to "disregard the corporate form."[250] The *Levin* court distinguished *Janus* because Levin and Preve were acting as agents of Banyon and BIF, which, as juridical persons, can act only through their agents.[251] Finally, the court noted but made no ruling on the question of whether *Janus* applies at all to actions by the SEC because one of the stated motivations for the holding was a reticence to expand a judicially created private cause of action.[252]

Secondary Actor Liability

In 2013, a number of cases in the Second Circuit dealt with the question of whether secondary actors, such as auditors or clearing brokers, could be liable for the transgressions of their clients.

1. *In re Longtop Financial Technologies Ltd. Securities Litigation*

A pair of cases in the Southern District of New York dealt with the issue of auditor liability. *In re Longtop Financial Technologies Ltd. Securities Litigation*[253] concerned Longtop Financial Technologies, Ltd. ("Longtop"), a company providing information technology services to Chinese financial companies and which retained Deloitte Touche Tohmatsu CPA Ltd. ("DTTC") as an outside auditor.[254] The plaintiffs brought the case against Longtop, certain Longtop executives, and DTTC, on behalf of all persons who bought Longtop ADSs on the New York Stock Exchange from 2007 to 2011, alleging that: (i) Longtop and its executives violated section 10(b) of the Exchange Act and Rule 10b-5 promulgated there-

246. *Id.* at *4.
247. *See id.*
248. *See id.* at *14; Motion of Defendant George G. Levin to Dismiss the Amended Complaint and Incorporated Memorandum of Law at paras. 5–6, SEC v. Levin, No. 12-21917-CIV, 2013 WL 5588224 (S.D. Fla. Oct. 10, 2013), 2013 WL 1826613.
249. *Levin*, 2013 WL 5588224, at *14.
250. *Id.* at *14 n.5 (quoting Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2304 (2011)).
251. *Id.*
252. *Id.*
253. 939 F. Supp. 2d 360 (S.D.N.Y. 2013).
254. *See id.* at 366.

under, (ii) the executives violated section 20(a) of the Exchange Act, and (iii) DTTC violated section 10(b) and Rule 10b-5.[255] The claims against DTTC arose out of various frauds undertaken by Longtop to inflate its financial position, including hiring employees through a shell company to hide its labor costs and falsifying its cash positions.[256] DTTC had issued unqualified audit opinions on behalf of Longtop from June 2009 to May 2011, but in May 2011 announced its resignation as Longtop's auditor in a letter stating that the cause of the resignation was the deliberate interference with its auditing and an admission by Longtop's CEO that the company's books were fraudulent.[257] The complaint alleged that DTTC had been aware of internal control deficiencies at the company and of "red flags at Longtop that gave rise to a significant risk of management fraud," and that it incurred liability by recklessly issuing audit opinions despite this knowledge.[258] The court dismissed the claims against DTTC, finding that the allegations failed to show anything other than failure to detect fraud; the violation of such standards established, at most, negligence, not the requisite scienter.[259]

The court stated that, in order to establish the scienter necessary for a Rule 10b-5 claim on the part of an outside auditor, plaintiffs must show conduct that was "highly unreasonable, representing an extreme departure from the standards of ordinary care."[260] In addition, the PSLRA creates heightened pleading requirements in private securities fraud cases that plaintiffs must allege facts that give rise to an inference of scienter at least as strong as opposing inferences that could be drawn from the same facts.[261] Although DTTC did identify control deficiencies at Longtop, the fact that internal control deficiencies existed is not notice of actual fraud.[262] Furthermore, the allegations failed to show that DTTC ignored the violations: it made plans to address the identified problems, and it included notice of the deficiencies in public filings made with the SEC.[263] The fact that DTTC identified risk factors at a company ultimately discovered to be engaged in fraud does not expose DTTC to legal liability because it failed to catch the fraud—to do so would "vitiate" the purpose of the Exchange Act in establishing honest securities markets.[264] According to the court, the complaint did "little more than allege, had DTTC performed a better audit, Longtop's fraud would have been uncovered sooner"; thus, the most compelling inference from the allegations is that DTTC was duped by Longtop, not that it recklessly facilitated Longtop's fraud.[265]

255. *Id.* at 364–65.
256. *Id.* at 366.
257. *Id.*
258. *Id.* at 367 (quoting complaint).
259. *Id.* at 390.
260. *Id.* at 377 (quoting Meridian Horizon Fund, LP v. KPMG (Cayman), 487 F. App'x 636, 640 (2d Cir. 2012)).
261. *Id.* at 375 (citing Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 324 (2007)).
262. *Id.* at 386–88.
263. *Id.* at 368.
264. *Id.* at 388.
265. *Id.* at 391.

2. *Iowa Public Employees' Retirement System v. Deloitte & Touche LLP*

Iowa Public Employees' Retirement System v. Deloitte & Touche LLP[266] dealt with the unraveling of a Ponzi scheme run by Paul Greenwood and Stephen Walsh from 1996 to 2009 at WG Trading Company, LP ("WGTC"), a registered broker-dealer, which had engaged Deloitte & Touche LLP ("D&T") as an outside auditor.[267] The scheme had involved a registered investment adviser, Westridge Capital Management, Inc. ("WCM"), selling limited partnership interests in WGTC, either directly or by selling promissory notes through WG Trading Investors, LP ("WGTI"), a limited partner of WGTC controlled by Greenwood and Walsh.[268] The Iowa Public Employees' Retirement System ("IPERS") invested roughly $500 million with WCM in 2007 and 2008, $427 million of which was placed in WGTC through WGTI.[269] D&T had issued clean audit opinions for WGTC from 2001 to 2007, and from 2005–2007 had issued reports on WGTC's internal controls that stated that there were no material weaknesses.[270] IPERS had been provided with several of D&T's reports prior to investing.[271] In 2009, the SEC began an investigation of WGTC and WGTI and quickly uncovered the fraud.[272] IPERS's claim against D&T arose out of allegations of aiding and abetting violations of section 10(b) of the Exchange Act, on the ground that D&T's auditing practices were "so deficient that the audits amounted to no audits at all" because it ignored numerous red flags about the relationship between WGTC and WGTI and internal controls that led the SEC examiner to state in 2009 that the "fraud was not that hard to uncover."[273] IPERS further alleged that it was reckless for D&T to issue clean audits for WGTC without having investigated its relationship with WGTI and WCM.[274]

The court agreed with the defendant that the SEC's discovery of a Ponzi scheme does not support an allegation that an earlier independent auditor was reckless in failing to discover the scheme, especially in this case, when the SEC examined records not made available to D&T.[275] In particular, the irregularities that the SEC found were not revealed through an investigation of WGTC, but rather by comparing WCM's books and WGTC's books.[276] The plaintiff's arguments that D&T should have reviewed records not within the scope of its engagement were allegations of negligence, not recklessness sufficient to state a claim under the PSLRA.[277] It is not enough to allege that D&T should have

266. 919 F. Supp. 2d 321 (S.D.N.Y. 2013).
267. *Id.* at 326.
268. *Id.* at 326–27.
269. *Id.* at 327.
270. *Id.* at 328.
271. *Id.*
272. *Id.* at 327.
273. *Id.* at 328 (quoting Complaint ¶¶ 49, 50).
274. *Id.* at 329.
275. *Id.* at 335–36.
276. *Id.* at 335.
277. *Id.* at 335–36.

requested the records of WCM or WGTI; rather the complaint needs to plausibly allege that no reasonable auditor with access to WGTC's records would have decided to issue a clean audit opinion for WGTC. As a matter of law, auditors have no obligation to expand their audit to include non-client entities and cannot be held accountable for red flags in their records.[278]

The court also found that the plaintiff's allegations that D&T had recklessly ignored numerous red flags in WGTC's books were insufficient to establish scienter because it found that only one or two of the alleged red flags were visible in WGTC's records and pled with sufficient particularity.[279] The failure to follow up on these isolated transactions suggests negligence, not the willful blindness needed to establish recklessness as a basis for scienter.[280] The court agreed with the plaintiff that red flags must be considered in the aggregate, but noted that IPERS had made general allegations about the movement of funds between WGTC and WGTI and had failed to identify which specific transactions in WGTC's records should have been red flags for D&T.[281] The generality of these allegations could not be cured simply by aggregating them together.[282]

3. *Levitt v. J.P. Morgan Securities, Inc.*

In *Levitt v. J.P. Morgan Securities, Inc.*,[283] the U.S. Court of Appeals for the Second Circuit adopted a two-category approach for determining the fiduciary duties of a clearing broker to the clients of the introducing broker.[284] The case involved a class action brought against Bear Stearns Securities Corporation for its alleged violation of section 10(b) of the Exchange Act in its role as the clearing broker for Sterling Foster & Co., a broker-dealer that engaged in a market manipulation scheme.[285] As a "clearing broker," Bear Stearns maintained accounts and executed trades for customers of Sterling Foster, which acted as the "introducing broker," and Bear Stearns contractually delegated its "know your customer" responsibilities to Sterling Foster as permitted by NYSE Rule 382, including "determining the authorization and legality of each transaction" in each Sterling Foster customer account.[286] This arrangement was properly disclosed to Sterling Foster's customers.[287] The plaintiffs sued on behalf of Sterling Foster customers harmed by its scheme to fraudulently sell the shares of certain insiders

278. *Id.* at 336–37.
279. *Id.* at 341–43.
280. *See id.* at 339.
281. *Id.* at 338 (citing *In re* Refco, Inc. Sec. Litig., 503 F. Supp. 2d 611, 658–60 (S.D.N.Y. 2007)).
282. *Id.* at 341 (citing Stephenson v. PricewaterhouseCoopers, LLP, 768 F. Supp. 2d 562, 578 (S.D.N.Y. 2011)).
283. 710 F.3d 454 (2d Cir. 2013).
284. *Id.* at 465–68.
285. *Id.* at 456. J.P. Morgan appears as the defendant-appellant in the case due to its 2008 acquisition of Bear Stearns. *Id.* at 456 n.1.
286. *Id.* at 458–59 (quoting from the April 14, 1994, agreement between Sterling Foster and Bear Stearns).
287. *Id.* at 459.

at companies for which Sterling Foster underwrote the IPOs.[288] Defendants appealed the certification of the class on the grounds that they owed no fiduciary duty of disclosure to the plaintiff class and that they had not participated in the scheme to such an extent that they had a duty to disclose.[289]

The court held for the defendants, and in doing so set out a two-category approach for determining the duties of a clearing broker to the customers of an introducing broker.[290] The first category is clearing brokers that provide "normal clearing services," which incur no liability for the transgressions of the introducing broker, even if the clearing broker was alleged to have known of the fraud by the introducing broker,[291] or to have allowed the introducing broker's fraud to continue by failing to enforce margin requirements.[292] In the second category, a clearing broker incurs liability by shedding its role as clearing broker and assuming direct control of the introducing broker's operations and the manipulative scheme, for instance by placing employees at the office of the introducing broker,[293] by approving or declining certain trades,[294] or by directing fraudulent trades.[295] Some sort of direct participation by the clearing broker is required to create a duty to disclose in order to protect the intended ability of clearing brokers and introducing brokers to contractually allocate responsibilities between themselves under Rule 382.[296] The court additionally noted, but did not address, the question of whether market manipulation itself creates a duty to disclose because it found that Bear Stearns was not directly involved with Sterling Foster's scheme.[297] The plaintiffs alleged, at most, that Bear Stearns was aware of Sterling Foster's manipulation and that it may have violated NASD and Federal Reserve rules and regulations in connection with the IPOs.[298] Although the district court had relied on the alleged violations by Bear Stearns of Federal Reserve Board's Regulation T,[299] the appellate court found that, because Regulation T was promulgated under section 7 of the Exchange Act, for which no private right of action exists, construing a violation of Regulation T as a material omission under section 10(b) would essentially create a private right of action for violations of Regulation T.[300]

288. *Id.* at 459–60.

289. *Id.* at 456–57.

290. *Id.* at 466–68 (reviewing Fezzani v. Bear, Stearns & Co., 592 F. Supp. 2d 410 (S.D.N.Y. 2008); Cromer Fin. Ltd. v. Berger, 137 F. Supp. 2d 452 (S.D.N.Y. 2001); Berwecky v. Bear, Stearns & Co., 197 F.R.D. 65 (S.D.N.Y. 2000); *In re* Blech Sec. Litig., 961 F. Supp. 569 (S.D.N.Y. 1997)).

291. *Id.* at 466 (citing *Fezzani*, 592 F. Supp. 2d at 425).

292. *Id.* (citing *Cromer*, 137 F. Supp. 2d at 471–72).

293. *Id.* (citing *Berwecky*, 197 F.R.D. at 67).

294. *Id.*

295. *Id.* at 467 (citing *Blech*, 961 F. Supp. at 584).

296. *Id.*

297. *Id.* at 467 n.9.

298. *Id.* at 468.

299. 12 C.F.R. pt. 220 (2013).

300. *Levitt*, 710 F.3d at 469 (citing Bennett v. U.S. Trust Co. of N.Y., 770 F.2d 308, 312 (2d Cir. 1985)).

4. *In re Amaranth Natural Gas Commodities Litigation*

The Second Circuit also examined aiding and abetting liability under the Commodities Exchange Act ("CEA") in *In re Amaranth Natural Gas Commodities Litigation*.[301] J.P. Morgan Futures, Inc. served as the clearing broker and futures commission merchant ("FCM") for Amaranth, a hedge fund that engaged in derivative trading in natural gas and that allegedly manipulated the prices of natural gas.[302] Traders who had purchased natural gas futures while the manipulation was allegedly ongoing brought an aiding and abetting claim under section 22 of the CEA[303] against J.P. Morgan Futures and its parent companies.[304] The appellate court agreed with the district court that the plaintiffs had failed to state a claim against the defendants because they had failed to show that J.P. Morgan Futures knew of Amaranth's intentions to manipulate the markets and intended to help it do so.[305]

The court stated that the standard for aiding and abetting under the CEA is the same as that for aiding and abetting under federal criminal law and that, therefore, a complaint states "a claim for aiding and abetting under 7 U.S.C. § 25 when it plausibly alleges conduct that would constitute aiding and abetting under 18 U.S.C. § 2."[306] Consequently, the court embraced Judge Learned Hand's classic formulation of criminal aiding and abetting liability from *United States v. Peoni*; such liability requires the defendant to "in some sort associate himself with the venture, that he participate in it as something that he wishes to bring about, that he seek by his action to make it succeed."[307] *Peoni* articulates aiding and abetting liability as depending on the "relationship between a defendant's knowledge, intent, and the nature of the assistance given."[308] Applying this standard, the court affirmed the lower court dismissal of the claims against J.P. Morgan Futures because the allegations in the complaint were not sufficient to support actual knowledge of manipulation by Amaranth.[309] In particular, plaintiffs failed to meaningfully allege that J.P. Morgan Futures did more than perform routine clearing services for Amaranth.[310] Relying on *Greenberg v. Bear, Stearns & Co.*[311] and *Levitt v. J.P. Morgan Securities, Inc.*,[312] the court found that none of the allegations established that J.P. Morgan Futures knew of Amaranth's manipulation or intended to take part in it.[313]

301. 730 F.3d 170 (2d Cir. 2013).
302. *Id.* at 172.
303. 7 U.S.C. § 25(a) (2012).
304. *Amaranth*, 730 F.3d at 172.
305. *See id.*
306. *Id.* at 182.
307. *Id.* (quoting United States v. Peoni, 100 F.2d 401, 402 (2d Cir. 1938)).
308. *Id.* at 183.
309. *Id.*
310. *Id.* at 183, 185–86.
311. 220 F.3d 22, 29 (2d Cir. 2000) (holding that routine clearing services do not constitute aiding and abetting under New York law).
312. 710 F.3d 454, 468 (2d Cir. 2013) (holding that providing clearing services does not trigger primary liability under section 10(b) of the Exchange Act); *see supra* notes 283–300 and accompanying text.
313. *Amaranth*, 730 F.3d at 185–86.

STATUTES OF LIMITATIONS

The *Gabelli* decision was applied in two cases arising in the Second Circuit.

1. *SEC v. Wyly*

In *SEC v. Wyly*,[314] the court concluded that the fraudulent concealment doctrine[315] survived *Gabelli*, but in an altered form.[316] In *Wyly*, the SEC charged Samuel and Charles Wyly with insider trading through 2004, due to their use of offshore trusts to hide their ownership of, and trading in, shares of public companies, where they served as directors.[317] The SEC alleged that the defendants illicitly gained roughly $550 million, and it sought civil penalties under section 21(d)(3) of the Exchange Act for fraud and false filing, and penalties under section 21A of the Exchange Act for insider trading.[318] The SEC entered into tolling agreements with the Wylys in 2006, but argued that the Wylys' fraudulent concealment prior to those agreements supported equitable tolling.[319]

In the Second Circuit, tolling under the fraudulent concealment doctrine requires that: "(1) the defendant wrongfully concealed material facts relating to defendant's wrongdoing; (2) the concealment prevented plaintiff's discovery of the nature of the claim within the limitations period; and (3) plaintiff exercised due diligence in pursuing the discovery of the claim during the period plaintiff seeks to have tolled."[320] The court found this test to be suspect following *Gabelli* to the extent that it "encompasses the discovery rule," and the court therefore concluded that the doctrine tolls the statute of limitations for a claim that has already accrued if the defendant takes active steps—beyond the self-concealing fraudulent acts—to prevent the plaintiff from timely suing.[321] In particular, the SEC, in order to take advantage of the fraudulent concealment doctrine, would need to allege acts "sufficiently separate from the substantive fraud at issue,"[322] such as "by promising not to plead the statute of limitations or by spoliating evidence."[323] In this case, because the court found that the SEC had failed to allege any acts of concealment beyond a failure to confess the fraud, both the section 21(d)(3) and 21A claims were time-barred.[324]

314. 950 F. Supp. 2d 547 (S.D.N.Y. 2013).

315. This doctrine tolls "the running of an applicable limitations period when the defendant takes steps beyond the challenged conduct itself to conceal that conduct from the plaintiff." Gabelli v. SEC, 133 S. Ct. 1216, 1220 n.2 (2013).

316. *Wyly*, 950 F. Supp. 2d at 555–56.

317. *Id.* at 550.

318. *Id.* at 550, 554.

319. *Id.* at 553.

320. *Id.* at 555 (quoting Koch v. Christie's Int'l PLC, 699 F.3d 141, 157 (2d Cir. 2012)).

321. *Id.*

322. *Id.* at 557.

323. *Id.* at 556 (internal footnotes and quotation marks omitted).

324. *Id.* at 557–58.

2. *SEC v. Pentagon Capital Management PLC*

The *Gabelli* decision was also applied by the Second Circuit in *SEC v. Pentagon Capital Management PLC*.[325] In that case, the appellate court affirmed a lower court determination that Lewis Chester and two Pentagon entities violated section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, as well as section 17(a) of the Securities Act, in connection with a market-timing and late-trading scheme.[326] The lower court imposed joint and several liability for a disgorgement award and a civil penalty, each in the amount of $38,416,500, finding that the disgorgement award amount was appropriate because it was a reasonable approximation of the profit made through the late trades.[327] Because the violation involved "fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement" and "directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons," the lower court awarded the maximum civil penalty, in this case the gross amount of the pecuniary gain.[328]

The appellate court vacated the civil penalty award and remanded it for reconsideration in light of *Gabelli*: "In *Gabelli*, the Supreme Court held that the so-called 'discovery rule,' which tolls a statute of limitation for crimes that are difficult to detect, does not apply to toll the five-year statute of limitation for fraud cases in SEC enforcement actions."[329] Therefore, any profit earned through late trading occurring more than five years before the SEC instituted the suit against the defendants could not be included as part of the civil penalty.[330] The court also reversed the imposition of joint and several liability for the amount of the civil penalty as an error of law, citing the statutory language requiring that such awards be based on the "gross amount of pecuniary gain to such defendant."[331] The court found that the statutory language "does not provide room for the district court's interpretation that the civil penalty be imposed jointly and severally."[332] The court also reviewed the disgorgement award, found no abuse of discretion regarding the amount awarded, and affirmed the imposition of joint and several liability.[333]

Statutes of Repose

The Second Circuit, in *Police & Fire Retirement System of Detroit v. IndyMac MBS, Inc.*,[334] considered whether the tolling rule set forth in *American Pipe &*

325. 725 F.3d 279 (2d Cir. 2013).
326. *Id.* at 280–81.
327. *Id.* at 287.
328. *Id.* (quoting 15 U.S.C. §§ 77t(d), 78u(d)(3)).
329. *Id.* (citing Gabelli v. SEC, 133 S. Ct. 1216, 1221–24 (2013)).
330. *Id.*
331. *Id.* at 288 (quoting 15 U.S.C. § 77t(d)(2)).
332. *Id.*
333. *Id.*
334. 721 F.3d 95 (2d Cir. 2013).

Construction Co. v. Utah[335] applies to the statute of repose in section 13 of the Securities Act,[336] and whether "relation back" under Rule 15(c) of the Federal Rules of Civil Procedure[337] allows non-party members of a putative class to avoid a statute of repose by amending the class complaint and intervening as named parties.[338] The court held that *American Pipe* does not apply to statutes of repose, and that Rule 15(c) cannot be used to revive claims that were previously dismissed for lack of jurisdiction.[339]

The case arose from approximately one hundred offerings of mortgage pass-through certificates[340] made by IndyMac MBS, Inc. from 2005 to 2007.[341] Two separate class actions were filed against IndyMac and certain of its officers, directors, and underwriters for violations of sections 11, 12(a), and 15 of the Securities Act related to these offerings. These actions were consolidated by the district court, and lead plaintiffs were appointed for the consolidated actions, pursuant to the PSLRA.[342] The district court then dismissed the claims arising from offerings not purchased by the lead plaintiffs for want of standing.[343] Those dismissed claims involved securities bought by the Detroit Police and Fire Retirement System and other members of the asserted class, who were not named plaintiffs in the action.[344] These parties moved to intervene in the action in order to assert claims regarding the securities that they had bought but the named plaintiffs had not.[345]

Although the three-year statute of repose set forth in section 13 had run on these claims, the putative plaintiffs advanced two arguments as to why this intervention ought to be allowed.[346] First, they argued that the *American Pipe* tolling rule applied to the statute of repose, and so their claims were not

335. This rule states that "the commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class who would have been parties had the suit been permitted to continue as a class action." Am. Pipe & Constr. Co. v. Utah, 414 U.S. 538, 554 (1974).

336. Section 13 states, in relevant part:

> In no event shall any such action be brought to enforce a liability created under [section 11] or [section 12(a)(1)] of this title more than three years after the security was bona fide offered to the public, or under [section 12(a)(2)] of this title more than three years after the sale.

15 U.S.C. § 77m (2012).

337. Rule 15 states:

> An amendment to a pleading relates back to the date of the original pleading when (A) the law that provides the applicable statute of limitations allows relation back; (B) the amendment asserts a claim or defense that arose out of the conduct, transaction, or occurrence set out—or attempted to be set out—in the original pleading; or (C) the amendment changes the party or the naming of the party against whom a claim is asserted . . . .

Fed. R. Civ. P. 15.

338. *IndyMac*, 721 F.3d at 100–01.

339. *Id.* at 101.

340. A mortgage pass-through certificate is a type of mortgage-backed security that entitles the owner to a portion of the revenue stream from a pool of residential mortgage loans. *Id.* at 102 n.5.

341. *See id.* at 102.

342. *Id.* at 101–02.

343. *Id.* at 103.

344. *Id.*

345. *Id.*

346. *Id.*

time-barred.[347] Second, they argued that Rule 15(c) permitted the new claims to relate back to the original complaint.[348]

The court rejected the idea that *American Pipe* applies to statutes of repose.[349] It began by noting that statutes of repose are significantly different from statutes of limitation because they "create a *substantive* right in those protected to be free from liability."[350] Furthermore, statutes of repose are "absolute and not subject to equitable tolling."[351] Despite disagreement about whether the *American Pipe* Court grounded its tolling rule on principles of equity or law, namely Rule 23,[352] the court found that this distinction was irrelevant with respect to section 13 because the tolling rule—whether grounded in equity or law—did not apply to the statute of repose in section 13.[353] If the *American Pipe* rule is equitable, then it did not apply to statutes of repose because they are not subject to equitable tolling.[354] If the rule is legal, its application was impermissible because the statute of repose creates a substantive right to be free from liability and the Rules Enabling Act[355] forbids the use of the Federal Rules of Civil Procedure to enlarge or modify a substantive right. Thus, Rule 23 could not be used to trump the right created by section 13.[356]

Turning to the second argument, the court found that Rule 15(c) relation-back does not allow members of a class who are not named parties in an action to intervene as named parties to revive claims that were dismissed from the original complaint for want of jurisdiction.[357] The claims were dismissed by the district court because none of the named plaintiffs had purchased securities in the offerings about which the intervenors complained and therefore the named plaintiffs lacked standing.[358] Allowing a later intervention to revive those claims is barred by the longstanding rule that "if jurisdiction is lacking at the commencement of a suit, it cannot be aided by the intervention of a plaintiff with a sufficient claim."[359]

347. *Id.*
348. *Id.*
349. *Id.* at 109.
350. *Id.* at 106 (quoting Amoco Prod. Co. v. Newton Sheep Co., 85 F.3d 1464, 1472 (10th Cir. 1996) (emphasis in the original)).
351. *Id.* at 107 (internal quotation marks omitted).
352. *Id.* at 107–08; *compare* Joseph v. Q.T. Wiles, 223 F.3d 1155, 1167 (10th Cir. 2000) (legal tolling), *In re* Merck & Co., Inc. Sec., Derivative & "ERISA" Litig., No. MDL 1658 (SRC), 2012 WL 6840532, at *4–5 (D.N.J. Dec. 20, 2012) (same), *and In re* Morgan Stanley Mortg. Pass-Through Certificates Litig., 810 F. Supp. 2d 650, 667–68 (S.D.N.Y. 2011) (same), *with* Footbridge Ltd. Trust v. Countrywide Fin. Corp., 770 F. Supp. 2d 618, 625–26 (S.D.N.Y. 2011) (equitable tolling), *and In re* IndyMac Mortg.-Backed Sec. Litig., 793 F. Supp. 2d 637, 642–43 (S.D.N.Y. 2011) (following *Footbridge*).
353. *IndyMac*, 721 F.3d at 109.
354. *Id.*
355. 28 U.S.C. § 2072(b) (2012).
356. *IndyMac*, 721 F.3d at 109.
357. *Id.* at 111–12.
358. *Id.* at 111.
359. *Id.* (quoting Disability Advocates, Inc. v. N.Y. Coal. for Quality Assisted Living, Inc., 675 F.3d 149, 160 (2d Cir. 2012)).

Following the IndyMac decision, Public Employees' Retirement System of Mississippi ("MPERS"), a proposed intervenor in the district court decision and an appellant in the appeals court proceeding, filed a petition for a writ of certiorari with the Supreme Court.[360] In its petition, MPERS argued that the Second Circuit's opinion in IndyMac conflicted with the Tenth Circuit's opinion in *Joseph v. Wiles*,[361] which held that *American Pipe* tolling did apply to section 13.[362] MPERS also argued that the Second Circuit opinion was inconsistent with certain Federal Circuit opinions[363] and that district courts have reached conflicting conclusions as to the applicability of *American Pipe* tolling to statutes of repose.[364] Supreme Court intervention was necessary, MPERS argued, because of the disruption caused by the Second Circuit opinion on established class action practices.[365] On March 10, 2014, the Court granted certiorari.[366] Specifically, it will consider if the filing of a putative class action serves, under the *American Pipe* rule, to satisfy the three-year time limitation in section 13 of the Securities Act with respect to the claims of putative class members.[367]

If the Supreme Court upholds the *IndyMac* decision, class action litigation will likely be significantly affected. Large investors may need to decide more promptly whether to opt out of a class as opposed to waiting until well after the class action has commenced and discovery is underway or completed. Increased litigation could result from earlier intervention in class actions by institutions seeking to protect their rights. Nevertheless, the case may encourage companies to negotiate settlements by reducing the risk of an indeterminately large opt-out exposure. Additionally, the enforceability of private tolling agreements relating to statutes of repose will likely be brought into question.

Foreign Issuers in Domestic Courts

Two Southern District of New York cases considered when purchasers may pursue claims of securities fraud against foreigners in U.S. courts consistent with *Morrison v. National Australia Bank Ltd.*[368]

1. *Arco Capital Corps. v. Deutsche Bank AG*

Arco Capital Corps. v. Deutsche Bank AG[369] dealt with claims arising from Deutsche Bank's sale of debt securities referencing a pool of credit default swaps

360. Petition for Writ of Certiorari, Pub. Emps.' Ret. Sys. of Miss. v. IndyMac MBS, Inc., No. 13-640 (U.S. Nov. 22, 2013), 2013 WL 6185615 [hereinafter MPERS Petition].
361. 223 F.3d 1155 (10th Cir. 2000).
362. MPERS Petition, *supra* note 360, at *1, *8.
363. *Id.* at *12.
364. *Id.* at *2, *15.
365. *Id.* at *2.
366. 82 U.S.L.W. 3371 (U.S. Mar. 10, 2014) (No. 13-640).
367. MPERS Petition, *supra* note 360, at *i.
368. Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2888 (2010) (restricting the extraterritorial application of section 10(b) and Rule 10b-5 of the Exchange Act by limiting causes of action thereunder to (1) the purchase or sale of any security listed on an American stock exchange or (2) the purchase or sale of any security that occurred in the United States).
369. 949 F. Supp. 2d 532 (S.D.N.Y. 2013).

based on investments in emerging markets.[370] Arco alleged that Deutsche Bank misrepresented the quality of the underlying investments and illicitly took payments to which it knew it was not entitled.[371] Both Arco and Deutsche Bank are foreign companies, and the securities were sold by a Deutsche Bank subsidiary based in the Cayman Islands.[372]

Following the ruling in *Morrison* and the Second Circuit's clarification in *Absolute Activist Value Master Fund Ltd. v. Ficeto*,[373] the district court concluded that securities transactions are domestic when: (1) the transaction involves securities traded on a domestic exchange, (2) irrevocable liability was incurred in the United States, or (3) title was passed in the United States.[374] Because Arco's transaction did not fall into the first category, the transaction needed to fit into one of the other two categories.[375] The court found that Arco's delivery of funds to a trustee in New York selected by Deutsche Bank rendered the subscription agreement irrevocably binding, because after such delivery, Deutsche Bank no longer could revoke its acceptance.[376] The use of banks in the United States to purchase securities of a foreign issuer does not, without more, satisfy the *Morrison* test,[377] but here both the delivery of the funds and the assignment of interest occurred in the United States and therefore the transaction was domestic under *Morrison*.[378]

2. *In re Satyam Computer Services Ltd. Securities Litigation*

The issues involved in pleading domesticity under *Morrison* also arose in the case of *In re Satyam Computer Services Ltd. Securities Litigation*,[379] which dealt with a purported massive fraud at Satyam, an Indian technology company that was alleged to have fraudulently overstated its assets by more than $1 billion.[380] The securities of Satyam are listed on Indian stock exchanges and its ADSs also trade on the New York Stock Exchange.[381] Because of their extraterritorial na-

370. *See id.* at 535.
371. *Id.* at 538–39.
372. *Id.* at 535.
373. 677 F.3d 60, 67–71 (2d Cir. 2012).
374. *Arco*, 949 F. Supp. 2d at 541.
375. *Id.*
376. *Id.* at 536, 543.
377. *Id.* at 541–42.
378. *Id.* at 542–43. Arco's claims, however, were ultimately dismissed as time-barred. *Id.* at 543–46. Based on *Arnold v. KPMG LLP*, 334 F. App'x 349 (2d Cir. 2009), the court held that the five-year statute of repose (and two-year post-discovery deadline) for Rule 10b-5 actions, *see* 28 U.S.C. § 1658(b) (2012), begins to run on the date that the parties commit to the transaction and not on the date of the final misrepresentation, if that date is after the transaction. *Arco*, 949 F. Supp. 2d at 544–45. Because Arco could have discovered the facts constituting the fraud within two years of the date upon which a reasonable diligent plaintiff would have had sufficient information to adequately plead scienter, the complaint was untimely. *Id.* at 545–46. The court noted that, in all previous cases where the statute had run from the date of the last misrepresentation and not the purchase, those misrepresentations had occurred before the purchase. *Id.* at 544.
379. 915 F. Supp. 2d 450 (S.D.N.Y. 2013). This case is discussed above with regard to the impact of the *Janus* decision. *See supra* notes 210–15 and accompanying text.
380. *Satyam*, 915 F. Supp. 2d at 457, 460.
381. *Id.* at 459.

ture, the court dismissed two sets of claims against Satyam's directors: the purchase by MPERS of Satyam common stock on Indian exchanges and the exercise of options in Satyam ADSs by an American employee of Satyam.[382]

MPERS attempted to distinguish its purchase of Satyam shares on Indian exchanges from the facts of *Morrison* by noting it was an American purchaser, whereas *Morrison* dealt with a "foreign-cubed" transaction, where foreign purchasers bought securities from foreign issuers in a foreign country.[383] The court dismissed this effort, citing *In re Vivendi Universal, S.A. Securities Litigation*[384] for the proposition that *Morrison* bars claims arising from transactions in foreign securities on foreign exchanges, even if the purchaser is American.[385] Likewise, the employee who exercised options to buy Satyam ADSs attempted to distinguish his claim from *Morrison* on the grounds that, although the options were exercised in India and the ADSs were transferred in India, the transaction dealt with a security listed on an American exchange.[386] Again, the court disagreed; if a security is crosslisted on a domestic exchange, transactions concerning that security that occur entirely in another country are not domestic transactions.[387]

SLUSA

1. *Freeman Investments, L.P. v. Pacific Life Insurance Co.*

In *Freeman Investments, L.P. v. Pacific Life Insurance Co.*,[388] the U.S. Court of Appeals for the Ninth Circuit revived plaintiffs' breach of contract and breach of the duty of good faith and fair dealing claims, previously dismissed by the district court, holding that the claims were not precluded by SLUSA even if such claims related to the purchase or sale of a covered security.[389]

The plaintiffs purchased variable life insurance policies from Pacific Life Insurance Company, and they later brought a putative class action against Pacific alleging breach of contract, breach of the duty of good faith and fair dealing, and unfair competition under California state law.[390] The plaintiffs also claimed the statute of limitations should toll because the defendant concealed the actions giving rise to the plaintiffs' claims.[391] Pacific moved to dismiss the complaint, arguing that the class action was precluded by SLUSA, which "bars (1) class actions (2) brought under state law, whether styled in tort, contract or breach of fiduciary duty, that (3) in essence claim misrepresentation or omission (4) in connec-

382. *Id.* at 473–76.
383. *Id.* at 473–74.
384. 765 F. Supp. 2d 512, 532 (S.D.N.Y. 2011).
385. *Satyam*, 915 F. Supp. 2d at 474.
386. *Id.* at 475.
387. *Id.* (citing *Vivendi*, 765 F. Supp. 2d at 531; *In re* Royal Bank of Scot. Grp. PLC Sec. Litig., 765 F. Supp. 2d 327, 336 (S.D.N.Y. 2011); *In re* Alstom SA Sec. Litig., 741 F. Supp. 2d 469, 472 (S.D.N.Y. 2010); Sgalambo v. McKenzie, 739 F. Supp. 2d 453, 487 (S.D.N.Y. 2010)).
388. 704 F.3d 1110 (9th Cir. 2013).
389. *Id.* at 1118.
390. *Id.* at 1113–14.
391. *Id.* at 1114.

tion with certain securities transactions."[392] The district court granted the defendant's motion to dismiss in its entirety.[393]

On appeal, the parties disputed only the last two elements of the SLUSA preclusion test, specifically, "[d]o the state law claims, no matter how labeled, in substance allege (3) misrepresentation or omission (4) in connection with the purchase or sale of securities?"[394] With regard to the "misrepresentation or omission" element, the Ninth Circuit reasoned that the plaintiffs cannot avoid preclusion through artful pleading that removes the covered words but not the covered concepts.[395] Yet, in this case, the plaintiffs did not need to show that the defendant fraudulently misrepresented the cost of insurance or omitted critical details in order to prevail on the breach claims; they needed only to persuade the court that theirs is the better reading of the contract.[396] The Ninth Circuit further determined that the plaintiffs had not made a stealth allegation of fraudulent omission with their tolling argument, so the allegation that the defendant hid its breach of contract did not convert the breach claims into claims of fraudulent omission.[397] The court held the claims of breach of contract and breach of the duty of good faith and fair dealing were not precluded by SLUSA and directed the district court to grant the plaintiffs leave to amend their complaint to eliminate references to hidden loads, knowing concealment, and wrongful conduct, as these concepts are irrelevant to the plaintiffs' breach claims and tolling claims.[398] The court concluded that the district court correctly dismissed the plaintiffs' unfair competition claim, as that claim was precluded by SLUSA.[399] The Ninth Circuit found that the "in connection with the purchase or sale of a covered security" requirement for SLUSA preclusion was satisfied because the defendant's engaging in fraud or misrepresentation that drained the plaintiffs' investment had "more than some tangential relation to the securities transaction."[400]

2. *In re Herald*

In *In re Herald*,[401] the U.S. Court of Appeals for the Second Circuit affirmed the district court's dismissal of the plaintiffs' claims as preempted by SLUSA.[402] The plaintiffs brought aiding and abetting and unjust enrichment claims against JPMorgan Chase & Co. ("JPMorgan") and the Bank of New York Mellon ("BNY"), where accounts were held by Bernard L. Madoff Investment Securities ("Madoff Securities"), which operated a Ponzi scheme.[403] The Second Circuit reasoned

392. *Id.* (numerals added).
393. *Id.*
394. *Id.* at 1115.
395. *Id.*
396. *Id.*
397. *Id.* at 1116.
398. *Id.*
399. *Id.*
400. *Id.* at 1116–17.
401. 730 F.3d 112 (2d Cir. 2013).
402. *Id.* at 119–20.
403. *Id.* at 115–17.

that the fact that Madoff Securities may not have actually executed its pretend securities trades did not take this case outside the ambit of SLUSA.[404] On the face of plaintiffs' complaints, "the liability of JPMorgan and BNY [was] predicated, not on these banks' relationship with [the] plaintiffs or their investments in the feeder funds, but on the banks' relationship with, and alleged assistance to, Madoff Securities' Ponzi scheme, which indisputably engaged in purported investments in covered securities on U.S. exchanges."[405] The district court correctly found that the original complaints' claims against these defendants were "integrally tied to the underlying fraud committed by Madoff, for whom JPMorgan and BNY served as bankers."[406] Indeed, "JPMorgan's and BNY's relationship to the Madoff fraud was alleged to be far more than incidental."[407] "The complaints, fairly read, charge[d] that JPMorgan and BNY knew of the fraud, failed to disclose the fraud, and helped the fraud succeed—in essence, that JPMorgan and BNY were complicit[] in Madoff's fraud."[408] "These allegations were more than sufficient to satisfy SLUSA's requirement that the complaint allege a 'misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security.'"[409]

3. *Holtz v. J.P. Morgan Securities LLC*

In *Holtz v. J.P. Morgan Securities LLC*,[410] Judge John W. Darrah dismissed a putative class action brought on behalf of J.P. Morgan's financial advisory clients as precluded by SLUSA.[411] The plaintiffs brought claims for breach of contract, breach of fiduciary duty, and unjust enrichment, alleging the defendant "required their financial advisers to strongly push and sell the defendant['s] own proprietary mutual funds and investments, as opposed to those funds and investments managed by third parties[, even when doing so was] . . . contrary to clients' interests."[412] The plaintiffs attempted to limit the nature of their pleadings to admissions by the defendants regarding their obligations to the plaintiffs,[413] and they specifically disclaimed that their allegations were not to be construed as allegations of fraud, misrepresentation, or material omission.[414] However, the court held the plaintiffs' disclaimer of fraud alone was not sufficient to avoid SLUSA,[415] and the substance of their allegations, when considered in their entirety, amounted to a claim of a fraudulent scheme in connection with

404. *Id.* at 118.
405. *Id.* at 118–19.
406. *Id.* at 119 (quoting district court).
407. *Id.*
408. *Id.*
409. *Id.* (quoting SLUSA § 101(b)(1)(B), 15 U.S.C. § 78bb(f)(1)).
410. No. 12-cv-7080, 2013 WL 3240181 (N.D. Ill. June 26, 2013).
411. *Id.* at *5.
412. *Id.* at *1.
413. *Id.* at *4.
414. *Id.* at *1.
415. *Id.* at *3.

the sale of securities.[416] Dismissing the plaintiffs' complaint as precluded by SLUSA, the court reasoned that it would be "difficult and maybe impossible to disentangle" the allegations of fraud from the plaintiffs' contractual and fiduciary duty claims.[417]

Conclusion

2013 was an important year in federal court securities litigation.

The *Amgen* decision, important on its own, signaled the potential for a major change in class actions under section 10(b) and Rule 10b-5 by questioning the fraud-on-the-market presumption. The Supreme Court's grant of certiorari in *Halliburton* sets the stage for this potential change to become a reality in 2014.

In early 2014, the Court issued its opinion in *Chadbourne & Park LLP v. Troice*,[418] holding that SLUSA does not encompass a class action in which the plaintiffs allege (1) that they purchased uncovered securities (CDs that are not traded on any national exchange), but (2) that the defendants falsely told the victims that the uncovered securities were backed by covered securities.[419] The majority specified that its holding would permit plaintiffs to recover under state law, and not limit, in any significant way, the federal government's ability to pursue the fraudsters.[420] The dissent, however, disagreed with the consequences of the Court's decision. "The Court's narrow interpretation . . . will inhibit the SEC and litigants from using federal law to police frauds and abuses that undermine confidence in the national securities markets . . . [and will subject advisors] to . . . costly state-law litigation based on . . . transactions that are in fact regulated by the federal securities laws."[421] The implication of *Chadbourne & Park LLP* will be addressed for years to come.

The *Gabelli* decision could result in the SEC bringing civil enforcement actions more quickly, and so perhaps 2014 will see an increase in these sorts of cases. Likely actions resulting from federal court decisions in 2013 also point to increased care in the use of confidential witnesses and careful crafting of known trends and uncertainties and risk factors in disclosure documents, with emphasis on qualitative disclosure.

A Supreme Court decision upholding *IndyMac* could result in more class action opt outs by large investors much sooner in the process than is currently the case, and the decision could encourage companies to negotiate settlements by reducing the risk of an indeterminately large opt-out exposure. If the Supreme Court does use *Halliburton* to at least pare back fraud-on-the-market and other Circuit Courts follow *IndyMac*, 2014 could be a year in which it is more difficult for private plaintiffs to launch securities class actions and much easier for com-

416. *Id.* at *4.
417. *Id.*
418. 134 S. Ct. 1058 (2014).
419. *Id.* at 1062.
420. *Id.* at 1062–63.
421. *Id.* at 1074 (Kennedy, J., dissenting).

panies to settle those actions. Ultimately, however, this may increase the litigation costs for public corporations by pushing institutional investors into forgoing class actions and pursuing their claims individually.

Finally, the impact of the Court's holding in *Lawson*, which addressed the applicability of whistleblower protection to subcontractors of a reporting company, could prove significant for public and private companies.