SECURITIES

THE SECURITIES INDUSTRY IS BUZZING ABOUT RECENT U.S. SUPREME COURT RULINGS AND the U.S. Securities and Exchange Commission's new incentives for whistleblowers under the Dodd-Frank Act. The Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders* (131 S.Ct. 2296 (2011)) has wide reaching implications for primary liability and may change contractual relationships between companies and lead to larger D&O insurance policies.

Our panel of experts discusses these issues as well as governance-only settlements, SEC Director of Enforcement Robert Khuzami, and potential changes in securities practices. They are David Bayless of Covington & Burling; Matthew Larrabee of Dechert; Jonathan Levine of Girard Gibbs; Susan D. Resley and Michael Torpey of Orrick; and Thad A. Davis of Ropes & Gray. The roundtable was moderated by *California Lawyer* and reported by Krishanna DeRita of Barkley Court Reporters.

EXECUTIVE SUMMARY

MODERATOR: What impact will the U.S. Supreme Court's decision in the *Janus* case have on primary liability for securities fraud?

BAYLESS: *Janus* is extraordinarily significant both for private class actions and SEC enforcement actions. It limits the scope of the former, and how the plaintiffs bar will respond remains to be seen. The decision makes very clear that for primary liability under Section 10(b) and rule 10(b)(5), the person responsible is the person who has ultimate authority over the content of the statement, and the decision whether and how to communicate it. That's a pretty tough standard.

The decision will also apply to SEC actions, although the SEC may question that. If they do, it's a loser. There also are questions about the implications for Section 17(a) actions under the Securities Act, whether the same reasoning would apply. But the SEC may challenge that.

Also, the Investment Company Act has a statutory provision that parallels the language in 10(b)(5) about the "maker" of a statement being liable for the statement. The *Janus* decision would apply to it wholesale but, again, the SEC may challenge that.

Historically the SEC tries to avoid Supreme Court decisions they don't like. You saw the Court's displeasure with the SEC when it showed no deference to the SEC's interpretation of an SEC rule.

Will the SEC accept this and try to change cases from primary liability to secondary liability to aiding and abetting, which they can do but the private bar can't? Or will they argue that this decision doesn't apply to them? The decision is interpreting the meaning of 10(b)(5), and I don't see how the meaning can change depending on whether it's a private claim or an SEC claim.

RESLEY: I would be surprised if the SEC did not argue that *Janus* applies only to private actions, but I just don't see courts buying that argument given the strong language in *Janus*. It's unlikely the SEC will re-package "non-speaker" cases as secondary liability or aiding and abetting actions to avoid *Janus*. With that approach the SEC must plead and prove a higher mental state under aiding and abetting theories: actual knowledge versus scienter.

LARRABEE: In the mutual funds industry this decision has been fairly disruptive. The notion that the adviser—who is the central actor in most practical ways in a mutual fund complex—might not have liability, while individual trustees, officers, or the fund, would be liable for making a prospectus statement, is disturbing to many.

However, from the point of view of civil litigation, as opposed to enforcement, it's easy to overstate the importance of *Janus*. We did a little survey after it came out, looking at 25 of the largest mutual funds class actions filed in the last five years alleging, like in *Janus*, that the prospectus was misleading. In 18 of those cases claims were already alleged under Sections 11, 12, and 15 of the '33 Act, which are not affected at all by *Janus*. You can't take the language to "make a statement" from Section 10(b) and inject it into Sections 11 or 12.

TORPEY: Matt [Larrabee], if I were one of the directors of that fund, I'd be a little pissed to think that I might be liable and the advisor who wrote the prospectus would not be.

LARRABEE: The only part of that statement that may be wrong is the word "little." There are all kinds of ideas being kicked around. Do we change the contractual relationship? What are the limits of indemnification? Should I get advice about my D&O insurance program? The demand for D&O insurance went up a factor of X the day that opinion went out.

TORPEY: If you are not a CEO or a CFO, you are not signing a 10K or a 10Q. You do not want your name quoted in a press release or anywhere near any public statements. You don't want to be making statements on conference calls or any of those things if you don't have to. It's not clear to me who the ultimate authority is. If you sign and you are not the ultimate authority, are you liable?

BAYLESS: The ultimate authority for the statement is the entity that issues the SEC filing.

TORPEY: Well, the entity is the speaker for an unattributed statement, but what about signers and attributed statements?

BAYLESS: But then the question is: Could one or more person, or entity make the same statement? Can you say the CEO signed the 10K, so it's the CEO's statement and also the company's statement?

LARRABEE: The Supreme Court did contemplate the possibility of multiple makers of a statement. The opinion does not suggest two parties can't both be liable.

LEVINE: The opinion represents a further shift in the Court's view of the private right of action under 10(b)(5). The old Supreme Court cases talk about construing the securities laws broadly because sophisticated fraudsters will always find a way to get around narrowly construed statutes and rules. In *Central Bank of Denver, NA v. First Interstate Bank of Denver,* (NA, 511 U.S. 164 (1994)) and *Stoneridge Investment Partners, LLC v. Scientific-Atlanta,* Inc., (552 U.S. 148 (2008)) decisions, the Court said that it would not expand the scope of 10(b)(5). In *Janus*, the Court says that the private right of action must be construed as narrowly as possible. *Janus* is not the status quo, but rather a continuation of efforts by the Court to limit the rights of investors to sue for securities fraud.

LARRABEE: The tide of opinions finding an implied right of action has shifted dramatically, including opinions defining implied rights of action under the ICA.

DAVIS: The private plaintiffs bar will continue to be creative with pleading and test this. The Court used an analogy of a speechwriter who hands a speech to the person talking and only the person talking is in trouble. What if a speaker reading a "teleprompter" is not aware of what they are about to say and it goes out. I think plaintiffs would plead that a person who writes a portion of disclosure and has final say on what's in there is a maker of the statement. But the decision has the greatest impact on third-party advisors to companies making statements.

LEVINE: The Court's decision contains a troubling statement: as long as corporate formalities are honored, even if the corporation is a shell, that will be sufficient to cut off potential liability. That is an invitation for sophisticated people intent on committing fraud to set up corporate structures that provide the kind of escape from liability that is provided for in *Janus*.

LARRABEE: But it's not just corporate formalities. There's an entire statutory scheme under the '40 Act defining how mutual funds have to be set up so the board remains independent of the adviser. There's a structure that regulates the inherent potential conflicts and in *Janus* the fund and adviser complied with the statute. If these two entities are close enough that we are going to call them "one", what are the implications? If you are going to collapse the players here, are you going to do it in all kinds of ways—law firms, investment bankers, underwriters? Where do you draw the line?

LEVINE: What about when there is a viable claim under 10(b)(5) based on an SEC filing that was signed by the board of directors and probably drafted by employees, such as a prospectus? The problem is if ultimate authority always ends up being the board of directors, they are the individuals least likely to have drafted the statements and it will be very difficult to prove scienter or knowledge on their part. This could result in false statements being made with nobody responsible.

BAYLESS: Interestingly, this may have more impact on the SEC than the private, because the private bar will normally sue the CEO or CFO. But the SEC often goes after mid-level executives who don't sign SEC filings, who are not making statements, but supposedly provided substantial participation under the Ninth Circuit standard. I think that's gone.

LARRABEE: That's why there's going to be a lot of pressure on how to prove scienter. How do you impute intent to an entity? There's not a huge amount of law here. Imputing knowledge is one thing; if the CEO knows something, the company normally knows it, too. But imputing scienter across entities is another matter.

MODERATOR: What will be the impact of the Delaware Chancery Court's decision in *In re Massey Energy Co.* (2011 WL 2176479)?

TORPEY: I found the *Massey* opinion interesting not so much for what it holds, but for the practice changes that it may cause. If the Delaware courts take the position that you can't represent the company during the deal and then represent them in litigation, it will have a very significant impact on the way in which law firms get chosen for these pieces of litigation.

Right now, in 90 percent of the cases, the target board is represented in the litigation by the same law firm that represents them in the underlying deal. If the court comes out and says that's not appropriate, that will have a really big impact on the practice of law.

BAYLESS: The trend is against one firm representing a whole bunch of people simultaneously. The Delaware court is sending the same signal: If you give people advice, you can't then represent them in subsequent litigation relating to that advice. Courts and regulatory agencies are concerned about people's interests being represented. They are forcing it through judicial decisions.

TORPEY: A couple of additional opinions like this and you'll see a change in practice. Another Delaware opinion had the same kind of prelude and tested the concept of a corporate governance and settlement, criticizing both the plaintiffs bar and the defense bar for a governance-only settlement. While the court ultimately approved of the settlement, it had so many nasty things to say about the governance-only settlement that it gave me some pause about whether or not I could do those anymore.

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>
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LARRABEE: The *Massey* opinion doesn't do much to inflate the value of derivative claims; it contains a fairly thoughtful dissertation on why they are not worth much in many circumstances.

TORPEY: He was critical of the derivative plaintiffs bar, and they have to try some of these back-end cases in order to establish their value. The days of losing the injunction, keeping the back-end case, and then settling it for a small amount of money later on are going to wane.

DAVIS: Chancellor Strine wanted it to be outside counsel giving the opinion. If it's the outside lawyer, which firm gets to litigate the claims? Can it be the same one? Who is going to be the valuation expert? That sort of process focus is also being applied to settlements. In the *Scully v. Nighthawk Radiology Holdings, Inc.,* (C.A. No. 5890-VCL (Transcript of Courtroom Status Conference) (Dec. 17, 2010)) and *In re Revlon, Inc. Shareholders Litig.,* (990 A.2d 940 (Del. Ch. 2010)) cases, Vice Chancellor Laster skewered both sides for forum shopping and putting up a "disclosure only" settlement. Strine did some of the same in his letter opinion in the Dynergy case. (See *In Re Dynegy Inc. Shareholders Litigation,* (C.A., 2011 WL 1005201(Del. Ch. Mar, 16, 2011).) There's a lot of procedural focus on everybody minding their P's and Q's.

LEVINE: Also interesting is the belief that shareholders are going to get these disclosures and read them all and then be able to make an informed decision about fairly complicated valuation matters.

LARRABEE: The emphasis on "investors can vote with their feet," really got a lot of weight. But how informed is a vote really going to be on the value of this derivative claim?

TORPEY: The truth is nobody reading that proxy will really have an understanding about the value of those derivative claims because they can't be valued yet. Even experienced plaintiffs lawyers and defense lawyers wouldn't be able to tell you the value.

LARRABEE: He basically felt he had enough information to conclude that these derivative claims were not material in the sense of being enough to stop a much larger merger. To that extent, he evaluated their merits.

DAVIS: Despite that the derivative suit drove the stock price and economics of the deal, the looming derivative claim can't be the acknowledged reason for approving the deal. It's all about saying the magic words or not, and observing the process the Delaware courts insist on.

MODERATOR: How are the SEC's new whistleblower rules, issued under the Dodd-Frank Act, effecting retroactivity, cooperation initiatives, and internal investigations?

RESLEY: The provision drawing the most comment is the 120-day "look back," which applies when a whistleblower reports possible violations to his or her company before approaching the SEC. That whistleblower has 120 days from the time that he or she reports wrongdoing to the company before approaching the SEC. Once the whistleblower contacts the SEC, that individual can be awarded a bounty if that "original information" leads to a successful prosecution of the SEC action. In practice, this provision puts the onus on a company to vet and self-report what could be a very serious wide-ranging issue within a very short period of time. This is significant because the SEC's Cooperation Initiative credits companies and individuals who report early. As a result, a company may not be able to provide a full and complete report to the SEC within 120 days, but it should at least contact the SEC within that period to advise the agency that it is investigating a possible securities law violation.

The 120-day provision also means that companies must beef up their compliance programs and procedures for reporting and responding to allegations of potential wrongdoing because the clock begins to run when the violation is reported.

The 120-day provision may never be in play if a whistleblower opts to bypass the company and go directly to the SEC. But under either scenario, as soon as the whistleblower knocks on the SEC's door, the SEC may have direct communications with the whistleblower, even if the whistleblower is a current employee.

LARRABEE: Conversely, the SEC has created some risk for itself. They were very aggressive in rejecting thoughtful commentary about how these rules would undermine the internal corporate compliance function. Having said that in a courageous, bold way, they've put a target on their back. The SEC should be concerned about creating a haystack full of whistle-blowing complaints, and picking out the three that aren't the needle. Missing the key complaint is pretty dangerous for them as a policy matter.

DAVIS: The notion that it's going to happen in 120 days is fanciful. Think of the backdating cases and the complexity of fixing the exercise dates, actual grant dates, and figuring out who did what over many years—that took six, nine, twelve months. The quality of information delivered by a whistleblower is lower than what a fulsome investigation would be.

It also encourages gaming behavior by the whistleblower. The SEC has to wait for them to initiate contact, but who is going to define what initiation means? Obviously there's constant pressure if the person seeking the bounty thinks that the investigation won't reveal everything that they would like to report; they'll start it internally—to try and get a bonus on the bounty—and then go to the SEC anyway.

BAYLESS: My view in advising a company is to forget about the 120 days and the whistleblower. If something comes to your attention, look into it. It takes as long as it takes. When it gets near 120 days, even though you are not done, tell the SEC because you want them to hear it from you first. Obviously if the whistleblower goes to the SEC without your knowledge, there's nothing you can do.

TORPEY: Why wouldn't a whistleblower go to the SEC first?

RESLEY: That is the issue that drew considerable comment during the drafting and comment period. A number of commenters sought a requirement that the whistleblower first report to the company in order to benefit from any bounty. That was rejected.

LARRABEE: The SEC decides upon the size of the bounty, from 10 to 30 percent of the ultimate recovery. One factor they could use in exercising their discretion to pick the 30 percent is the extent to which the whistleblower used internal procedures. It's really uncertain at this point whether the SEC will actually use that criteria.

LEVINE: We have heard from a number of potential whistleblowers over the past six months. These individuals appear to have meritorious complaints about potentially illegal and improper practices and, for the most part, already have gone to the company before they've come to us, but the company has not taken any action. So, our experience is that potential whistleblowers have already exhausted the internal processes before they go to the SEC.

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DAVIS: A lot of these whistleblowers are motivated by the reward, but they are also motivated by other slights, real or perceived, or feel stymied in the organization, or they would not typically take the reputational risk to become one. A robust compliance program and encouraging, noisily, the aggrieved to come forward internally is required to meet their need for vindication.

LARRABEE: What percentage of the time would you say that those people also have an individual gripe with the company?

LEVINE: So far, not very often. Sometimes they have personal issues, but they usually arise from the practices they are whistle blowing about. We spoke with a potential whistleblower who was not being given as much work as before, but it turned out that was because he had complained to the company about the improper practices and told them that they violated his professional obligations.

BAYLESS: This does create an incentive under the statute to go in immediately because then the anti-retaliation provisions kick in. The SEC says they will handle the anti-retaliation claims. I'm not sure the SEC really has the expertise for that. The Sarbanes-Oxley Act had similar anti-retaliation provisions, but they were assigned to the Department of Labor and OSHA.

RESLEY: The SEC realistically does not have the resources to prosecute retaliation actions. It is already stretched to the limit investigating violations of the securities laws so it is hard to fathom how the SEC can spend time and manpower enforcing employment laws.

LARRABEE: There's an office of the whistleblower and they are spending money. They couldn't be acting like they are more serious if they wanted to.

LEVINE: We sense that the SEC is looking at the complaints as they come in and reacting quickly if a strong whistleblower complaint is filed. We spoke to a whistleblower who the SEC contacted within days of filing. Somebody at the SEC got that complaint relatively quickly even though it was by an individual and not a law firm.

DAVIS: If the commission that's relying on and benefiting from the whistleblower, can in turn give thumbs up for the retaliation claim and reward them, it would be as if the DOJ could lower the taxes of the confidential informant. It gives them all the power to reward the whistleblowers that they deem worthy.

BAYLESS: People don't know what the procedure would be. Do you go to an administrative law judge? Does the SEC decide this internally?

DAVIS: I have an audit committee investigation where every individual officer and several mid-level people, instead of having pool counsel, got their own lawyer. Everybody was looking at everybody else and trying to see if somebody might run to the commission. If you had pool counsel, that wouldn't necessarily happen. It requires very open and credible channels among the various individuals' counsel to prevent the escalation of those sorts of situations.

LEVINE: This is going to create issues in the future, because it does not appear that the amount of D&O insurances being maintained by many corporate directors and officers has kept up with the need for everyone to have separate representation in these cases. The existing policies are going to waste at an awfully fast clip if that is the new standard.

DAVIS: I'm not sure the companies taking on D&O insurance have thought about that. It's going to need to go way up.

BAYLESS: That's a good thought for counseling corporations. We've talked about three different incentives—Robert Khuzami in his capacity as the SEC's Director of Enforcement, Delaware courts, and Dodd-Frank rules—that create reasons for individuals to get separate counsel, and that impacts the amount of D&O insurance that a company should have.

TORPEY: But let's assume that there are five or ten individuals who know there's been some violation. Assume they all have lawyers and are thinking of going to the SEC. The question is what makes you go in or not?

DAVIS: The executives who want to have a long career don't go in because of the reputational consequences. A major factor in the reporting person's calculus is whether you are 49 or 51 percent culpable, and whether you have made a statement.

RESLEY: There are individuals who approach the SEC early, not because they are looking for a bounty, but because they are seeking some cooperation credit. Under the SEC's Cooperation Initiative, the SEC can impose reduced penalties to individuals with some culpability if they go in early and provide the SEC with substantial assistance in prosecuting an action.

DAVIS: It used to be that the commission leveraged itself with the internal investigations. It was a finished product. But as an outgrowth of Khuzami having been a former Assistant U.S. Attorney, they now want to create divisiveness, to get everybody lawyered up and looking at each other.

BAYLESS: There's been a change in tone at the top of the SEC. It's been hammered by Congress, the media, their own Inspector General. It's not pleasant.

LARRABEE: Talking to a credible whistleblower who actually knows something went wrong and is telling you the truth is one thing. The SEC benefitted from having cases put together for them. While they may get some benefit from a bunch of credible stories, they've taken on the burden of turning those stories into cases. That's a big burden. I predict they are going to lose a number of them. ■