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Securities Litigation, Enforcement, and White-Collar Criminal Defense

Newsletter

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Inside

In This Issue

Crisis, scandal, and pushes for more disclosure and regulation all featured prominently in 2008, and look set to continue unfolding in 2009. So we begin this edition of the *Securities Litigation, Enforcement, and White-Collar Criminal Defense ("SLEW") Newsletter* with tips for minimizing the risks of being the target of a lawsuit or enforcement action. The Securities and Exchange Commission is now under new management, and we provide an overview of what to expect from the SEC under its new Chairman. Next, we summarize a recent large fine imposed by a United Kingdom agency enforcing the U.K.'s version of the U.S.'s Foreign Corrupt Practices Act – yet another signal of how important it is for companies doing business internationally to implement and monitor internal anti-corruption measures. We then turn to a description of the legal aftermath of the unveiling of a Ponzi scheme. This edition also features articles about disclosure issues related to climate change and "green" practices, loss causation issues that can prevent class certification in securities cases, and when "secondary actors" face liability under Section 10(b) of the Securities Exchange Act of 1934.

Our practice group, with members in the U.S., Asia, and Europe, hopes you find these articles informative. Thanks for reading. ■

Don't Get Hit by the Fallout from the Credit Crisis: Top Tips for Reducing Securities Litigation Risk

By Terri Garland and Brian L. Levine

Since early 2007, an unprecedented wave of securities litigation arising from the credit crisis has rolled through the courts. Initially, the cases focused on financial institutions, attacking them for their alleged role in creating the crisis. In late 2008, however, plaintiffs expanded their targets to include tech companies, energy companies, and other businesses. In these cases, plaintiffs typically claim that companies failed to disclose their vulnerability to the credit crisis. For example, plaintiffs have sued NextWave Wireless, a San Diego communications company, and Perrigo, a Michigan pharmaceutical manufacturer, for allegedly failing to disclose risks associated with their investment in auction rate securities. Similarly, plaintiffs have sued companies that have suffered from the turmoil in commodities markets and exchange rates, such as Pilgrim's Pride, which reported losses arising from hedging corn prices, and Aracruz Cellulose, which announced losses on currency hedges.

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Don't Get Hit by the Fallout from the Credit Crisis: Top Tips for Reducing Securities Litigation Risk

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In addition, the credit crisis has changed the regulatory environment facing all companies, not just financial institutions. Having spent the last year being flogged by lawmakers, investors, and the media, the SEC is determined to repair its reputation as a law enforcement agency. Newly appointed Chairman Mary Schapiro, quoting the SEC's first Chairman, Joe Kennedy, recently stated, "Those who break the law and take advantage of investors need to know that they will face an unrelenting law enforcement agency in the SEC — an agency that will pursue them until the full force of the law is the sure, certain, and sole reward for their wrongdoing." Structural and personnel changes at the SEC are likely to result in more investigations, faster investigations, and larger penalties.

Given the increased risk of private securities litigation and regulatory enforcement, officers and directors should be asking tough questions to assess the impact of the credit crisis on their company, such as: What are the key actions management is taking now to navigate the company through a potentially prolonged and severe recession? How much borrowing capacity do we have on our existing debt facilities? Which bank covenants are we closest to breaking? Has management evaluated all investments in light of economic conditions and SFAS 157? Has the company adequately funded its pension liabilities in light of a decline in plan assets? Has a triggering event occurred such that the value of goodwill must be examined? Has the company reviewed its accounts receivables on a customer-by-customer basis and adjusted its reserves for bad debt and returns in light of the downturn?

Companies can also reduce their risk by implementing the following tips:

Given the increased risk of private securities litigation and regulatory enforcement, officers and directors should be asking tough questions to assess the impact of the credit crisis on their company...

- **Set the Proper Tone at the Top.** Increased scrutiny by outside auditors, regulators, the plaintiffs' bar, and the media makes it especially important for management to reinforce a corporate culture of integrity and compliance. This means being open to receiving bad news as well as good, and empowering your General Counsel and internal audit department to take appropriate steps.

- **Ensure that Disclosures are Current and Complete.** Many companies repeat the same or similar disclosures quarter after quarter, adjusting only for the latest financial results or other obvious changes. Given the sea change in the economy, that approach may not offer sufficient protection. Companies should take the time to consider the myriad ways in which the changed economy is affecting them, their customers, and their suppliers. The company's disclosures should reflect the results of that analysis. Take particular care when it comes to forecasts. Make sure to disclose key assumptions underlying forecasts and to identify the events most likely to affect those assumptions.

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- **Pay Attention to Compensation and Stock Sales.** Most companies are well aware of the public's heightened sensitivity to large bonuses and other forms of executive compensation. But compensation at lower levels is not immune from question. In one recent case, the court scrutinized a mortgage lender's compensation of loan officers and concluded that it encouraged them to write more loans, rather than better loans. So in addition to examining compensation at the top, companies should also evaluate incentives throughout the organization to determine whether they encourage behavior that has become riskier in the current economic environment. In addition, courts continue to scrutinize stock sales by officers, directors, and employees. Minimize your risk by establishing a pattern of regular sales in similar amounts. If you adopt a formal plan for stock sales (known as a "10b5-1 plan"), keep it simple and avoid frequent amendments.

Focus your efforts on high-risk issues, such as revenue recognition, reserves, and compliance with loan covenants.

- **Increase Vigilance For Fraud.** In an economic downturn, the temptation to commit fraud rises, as employees stretch to meet their targets, companies struggle to meet analysts' expectations, and everyone worries about losing their jobs if they fail. At the same time, staff and other resources are cut, often reducing the ability to detect fraud. Now is not the time to skimp on oversight, however. Assess and update your existing anti-fraud programs and controls to ensure they are functioning properly. Focus your efforts on high-risk issues, such as revenue recognition, reserves, and compliance with loan covenants. If needed, develop new programs to address areas under greater regulatory scrutiny, such as improper payments to foreign officials in violation of the Foreign Corrupt Practices Act.

- **Review Your D&O Coverage.** No matter how much you do to prevent fraud, the risk of a lawsuit or regulatory investigation cannot be eliminated completely, particularly in a volatile market. Review your D&O policy to ensure that you have the appropriate level of protection. For example, determine whether your policy provides coverage for responding to an informal inquiry from the SEC. Many policies do not provide coverage until the SEC launches a formal investigation or files suits, even though responding to an informal inquiry can be just as (or more) expensive. ■

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Enforcement To Be Top Priority at Schapiro's SEC

By Randall J. Fons

At this year's "SEC Speaks" Conference, held February 6–7 in Washington, D.C., newly appointed SEC Chairman Mary Schapiro stated that the Commission's highest priority in 2009 is to regain its reputation as a law enforcement agency. Consistent with this goal, on February 9 the SEC named Robert Khuzami, a former Chief of the Securities Fraud Unit at the United States Attorney's Office in Manhattan, as its new Director of Enforcement. And Senators Charles Schumer and Richard Shelby recently introduced a bill to fund the hiring of 100 new SEC enforcement officials.

At the Conference, Chairman Schapiro announced two significant policy changes intended to boost the SEC's enforcement capabilities.

The first is to end the two-year-old "Penalty Pilot" program, which required SEC enforcement attorneys to get approval from the Commissioners before negotiating civil monetary penalties with companies. The termination of this program means that the Enforcement Division will once again exercise its own discretion concerning when and how to discuss settlement of an action, and how high the penalty will be. This discretion may lead to more penalties in greater amounts.

The second change Chairman Schapiro announced was more rapid approval of formal orders of investigation. The old practice required the approval of all five commissioners, but Chairman Schapiro said she has "given direction for . . . timely approval of formal orders by seriatim approval or where appropriate, by a single Commissioner acting as a duty officer." With this faster process in place, the enforcement staff can more easily issue subpoenas to compel witness testimony and the production of documents, and is not likely to be as patient as it once was. Companies and individuals who wish to be seen as "cooperative" will thus need to react to SEC inquiries more quickly.

Deputy Director of Enforcement George Curtis echoed Chairman Schapiro's enforcement theme, adding that the Commission and its staff will be making better and faster use of the complaints, tips, and referrals it receives.

These policy changes give the enforcement staff more discretion over when and how to conduct investigations. The investigations are likely to be less "centralized" in Washington, D.C., and more decisions concerning the investigations and proposed enforcement actions will be made by the staff in each of the SEC's 11 regional offices. Expect the enforcement staff to begin flexing its muscles soon. ■

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U.K. Financial Regulator Fines Insurance Firm for Failure to Implement Anti-Corruption Policies

By Kevin Roberts

If the steady rise in U.S. actions for violations of the Foreign Corrupt Practices Act ("FCPA") were not enough to spur companies doing business overseas to increase their vigilance, a recent fine levied by a United Kingdom agency is a reminder that other countries have their own anti-corruption measures that must be heeded. On January 8, 2009, the U.K.'s Financial Services Authority (FSA) fined one of the largest insurance and reinsurance brokerage and risk management firms in the U.K. £5.25 million for failing to take reasonable care to establish and maintain effective systems and controls to counter the risks of bribery and corruption, notwithstanding the FSA's acknowledgement that the firm had not acted deliberately or recklessly.

The FSA's case was that between January 2005 and September 2007 the insurance firm had failed to assess the risks involved in its dealings with overseas firms and individuals who helped it win business and had failed to implement effective controls to mitigate those risks. The insurance firm made various suspicious payments, amounting to approximately $7 million, to a number of overseas firms and individuals, including state-owned entities or those with government connections.

While the FSA accepted that the insurance firm's failure was neither deliberate nor reckless, it concluded the firm had breached Principle 3 of the FSA's Principles for Business, which requires all regulated firms to take reasonable care to organize and control their affairs responsibly and effectively, including the use of adequate risk management systems.

In determining the fine, the FSA considered remedial measures the insurance firm had taken, which included:

- putting in place a global anti-corruption program, to ensure that relationships with overseas third parties were subject to appropriate review;
- introducing comprehensive "risk-based" training by external law firms on the risks of overseas payments, particularly for staff exposed to overseas third-party relationships; and
- introducing assessments of compliance with corporate anti-corruption policies as part of staff evaluations, and instigating disciplinary action where necessary.

The FSA noted that it had worked closely with other enforcement agencies. These included the Securities and Exchange Commission and the United States Department of Justice, which had initiated FCPA investigations.

The high level of the fine indicates not only how seriously the U.K. authorities are taking the issue of corruption, but that the U.S.'s stepped-up enforcement of its FCPA is not an isolated trend. The FSA's action is a reminder that introducing and monitoring effective anti-corruption policies is essential to any company that operates internationally. ■

Kevin Roberts is a partner in the firm's London office.

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The Legal Aftermath of a Ponzi Scheme

By Carl H. Loewenson, Jr., and Michael Gerard

The massive fraud perpetrated by Bernard L. Madoff has placed new focus on Ponzi schemes and their legal aftermath. On December 11, 2008, the Securities and Exchange Commission charged Mr. Madoff and his investment firm, Bernard L. Madoff Investment Securities LLC (BMIS), with securities fraud for a multi-billion dollar Ponzi scheme that he perpetrated on advisory clients of his firm. *SEC v. Madoff et al.*, 08 Civ. 10791 (LLS) (S.D.N.Y.). The U.S. Attorney's Office for the Southern District of New York also brought criminal charges against Mr. Madoff. On February 9, 2009, Mr. Madoff consented to a proposed partial judgment in the SEC action that, for purposes of determining his obligation to pay disgorgement, prejudgment interest, or a civil penalty, deems the facts of the SEC's complaint established and not subject to contesting by him. On March 12, 2009, Mr. Madoff pleaded guilty to all of the criminal charges, and the court accepted the plea. Mr. Madoff's bail was revoked, and he was remanded into custody. Sentencing is set for June 16.

Ponzi schemes can take many forms, but generally, the phrase is used to describe a pyramid scheme where the wrongdoer pays earlier investors from the investments of more recent investors, rather than from any underlying business concern. Once the scheme fails to attract new investors the pyramid collapses. Some operations are illegal Ponzi schemes from the first dollar, while others morph after the business suffers losses.

For some time the SEC has brought enforcement actions against the perpetrators of Ponzi schemes, but in the shadow of the Madoff scandal, the SEC appears to have placed increased emphasis on ending any ongoing "Mini-Madoffs." While the SEC does not keep an official count, according to *The Wall Street Journal*, the SEC brought actions against four Ponzi schemes in January 2009 alone, after having brought only 15 Ponzi cases in 2007 and 23 in 2008.

As in *Madoff*, when faced with a Ponzi scheme, the SEC has made a practice of seeking to freeze the wrongdoers' assets, and requesting that a district court appoint a receiver. A court-appointed receiver is generally someone who takes custody of, manages, and preserves money or property that is subject to litigation. Receivers generally wield significant authority, and may play a key role in investors' recovery of assets. Generally, the district court grants receivers the authority to pursue such assets under state and federal law, which may include payments to earlier investors. The district court may also grant receivers the power to place receivership entities into bankruptcy.

An equity receiver may also recommend to the district court a plan for distribution of frozen assets to investors. Distribution plans tend to focus on treating victims of Ponzi schemes equally, especially in light of the fact that later investors' assets are used to pay earlier investors. In *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 89 (2d Cir. 2002), the Second Circuit held that when a district court uses its equitable powers to approve a receiver's plan for distribution of assets to the victims of a Ponzi scheme, the use of a *pro rata* distribution is generally appropriate, even where tracing of a particular victim's investments is possible. Federal courts of appeals in other circuits have also followed this practice.

Where a broker involved in a Ponzi scheme is insolvent, a district court may also appoint a trustee under the Securities

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Investor Protection Act of 1970 (SIPA) to carry out a liquidation proceeding in bankruptcy court. Where there are insufficient funds, investors will be paid (subject to a cap) out of a special fund capitalized by the general brokerage community.

In *Madoff*, the district court froze the assets of Mr. Madoff and BMIS, and appointed a receiver for the assets of BMIS, including the assets of Madoff Securities International Ltd. (MSIL) and Madoff Ltd. Shortly thereafter, the district court appointed a SIPA trustee for the liquidation of BMIS, the entity primarily involved in carrying out the fraud. On December 19, 2008, an English court ordered that MSIL be placed in a provisional liquidation and appointed Joint Provisional Liquidators (JPLs) to oversee the liquidation. The court-appointed receiver in *Madoff* continues to oversee the assets of MSIL, Madoff Ltd., and any other Madoff-related broker-dealer, market-making, or investment advisory businesses outside the United States. However, on February 26, 2009, the receiver requested that the district court terminate the receivership because the investigation into Madoff's operations in the UK would be most efficiently carried out by the JPLs in participation with the UK authorities and the SEC.

Recently, the *Madoff* SIPA trustee told the bankruptcy court that nearly $950 million in cash and securities has been recovered for investors, although he said there is no evidence that Madoff purchased securities for any customers in at least the last 13 years. Unfortunately, this sum is small in comparison to what appears to be a $50 billion fraud. Several class actions have already been filed by investors seeking to recover additional funds, and more litigation is likely. ■

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Mr. Loewenson, as court-appointed receiver for the $200 million Credit Bancorp, Ltd., Ponzi scheme, has recovered and distributed to Credit Bancorp customers more than 90% of their losses.

The Green Wave and Related Disclosure Issues

By Dorothy L. Fernandez and Jina Kim

With a new president seeking billions of dollars for measures to halt or reverse climate change, it is clear there is a steady, even growing, political and social consensus that climate change is real and that people are responsible for at least some of it. At the same time, a public-relations premium, and perhaps even a pricing premium in some circumstances, has developed for companies that follow "green" practices and policies. In considering whether and how to disclose the risks of climate change (notwithstanding some continuing scientific debate on the topic), or in describing green practices and policies, public companies should take care to note recent developments and potential pitfalls.

The Securities and Exchange Commission ("SEC") has not adopted disclosure rules specific to climate change risks or green practices, and has not begun rulemaking proceedings

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on these topics. However, on October 22, 2008, responding to the SEC's request for public comments on modernizing its disclosure system, a group of asset managers and U.S. institutional investors (CalPERS, CalSTRS, and public funds or treasurers from New York City, New Jersey, and Maryland, among others) sent a letter to the SEC seeking an improved disclosure system regarding climate risks. The group sought guidance on climate risk reporting in SEC filings and the creation of "consistent, comparable standards for disclosure of climate risk information" as part of the modernization of the SEC's disclosure system. This letter was in follow-up to that group's 2007 petition asking the SEC to require publicly traded companies to evaluate and disclose financial risks from climate change. The SEC has not publicly responded to these requests.

One day after the asset managers and institutional investors sent their letter to the SEC regarding climate risk disclosures, New York Attorney General Andrew M. Cuomo announced that Dynegy Inc. ("Dynegy"), a national energy company, had agreed to include certain climate change disclosures in future SEC filings. Earlier in 2008, Attorney General Cuomo had announced a similar pact with Xcel Energy ("Xcel"). These agreements ended investigations of Dynegy and Xcel that had begun with Mr. Cuomo's office issuing subpoenas to them, and three other major energy companies, for information on whether their SEC filings appropriately described financial risks related to climate change. The subpoenas were issued pursuant to New York's Martin Act, which gives the attorney general broad powers to review financial records of companies.

The Dynegy and Xcel "Assurance of Discontinuance" agreements are substantially similar. Xcel agreed to include in its annual Form 10-K filings an analysis of material financial risks resulting from (i) legislation governing greenhouse gas emissions, including the impact of present and probable future laws; (ii) climate change-related litigation, not limited to cases in which Xcel is a party, but any court in any jurisdiction where Xcel operates; and (iii) physical impacts associated with climate change, such as extreme weather events, changes in precipitation, and changes in temperature. Xcel, to the extent that its greenhouse gas emissions materially affected its financial exposure from climate change risk, also agreed to state in the Form 10-K its current position on climate change, emission management practices (such as estimated greenhouse gas emissions for the reporting year, expected increases in emissions from new projects, and strategies to offset or reduce the emissions), and corporate governance actions concerning climate change, including whether the company's ability to meet its climate change objectives was incorporated into officer compensation.

In light of the benefits and risks associated with climate change and green practices, and the New York attorney general's foray into what disclosures about environmental issues should be in SEC filings, the prudent course is to assume the SEC, and the plaintiffs' bar, will be paying attention to this field. Companies should not assume they can wait for the adoption or issuance of rules or guidance specific to climate change and green matters before they assess how climate-related issues may materially impact their businesses, and whether to add disclosures about those issues. ■

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Using "Loss Causation" to Defeat Class Certification in a Section 10(b) Case

By Jamie A. Levitt, Michael Gerard, and Jina Kim

For many years, plaintiffs could be confident that the focus of a motion to certify a class would be on the well-known requirements of Rule 23 (typicality, predominance, etc.), with the court likely to view any sort of examination concerning the merits of the case as off-limits. Things are changing, in some circuits in a way particularly helpful to defendants, with class certification becoming a point in the case when plaintiffs have to be prepared to make a merits showing on "loss causation," or risk losing their class certification motion.

Recent circuit court decisions establish, to varying degrees, that plaintiffs will have to be prepared to offer evidence of "loss causation" – linking the decline in a company's stock price to the allegedly false or misleading statements – to justify application of the "fraud on the market" presumption. The "fraud on the market" presumption rests on the premise that, in an efficient market, a company's stock price reflects the information, or lack of information, about the company, and thus a purchaser of an efficiently traded stock can be deemed to have relied on the false or misleading public statements about the stock.

In 2007, the Fifth Circuit Court of Appeals held in *Oscar Private Equity Investments v. Allegiance Telecom Inc.*, 487 F.3d 261 (5th Cir. 2007) ("*Oscar*"), that plaintiffs asserting claims of securities fraud must establish "loss causation" at the class certification stage in order to utilize the "fraud on the market" presumption to show individual questions of reliance will not predominate, thus preventing certification of a class under Rule 23(b)(3). The Fifth Circuit held that "loss causation must be established at the class certification stage by a preponderance of all admissible evidence."

Last fall, the Second Circuit Court of Appeals decided *In re: Salomon Analyst Metromedia Litigation*, 544 F.3d 474 (2d Cir. 2008) ("*Salomon*"), which did not go as far as *Oscar*, but nonetheless made it clear that loss causation is not off-limits at class certification. In *Salomon*, plaintiffs brought a putative class action claiming that research analysts issued and disseminated reports allegedly containing materially false and misleading statements and omissions. The Second Circuit held that plaintiffs did not have to satisfy an evidentiary burden to establish they could utilize the "fraud on the market" presumption. However, the Second Circuit held it was error for the district court not to allow defendants the opportunity to rebut the applicability of the presumption.

While the Second Circuit's opinion appears to be inconsistent with the Fifth Circuit's requirement that the plaintiff bear the initial burden of establishing loss causation at the class certification stage, it cites the Fifth Circuit's decision in *Oscar* to support the proposition that district courts must permit defendants to rebut the "fraud on the market" presumption at that stage. Thus, even the Second Circuit is clear that the defense has the opportunity to seek and present evidence to show no loss causation, thereby barring the use of the "fraud on the market" presumption and preventing class certification. Plaintiffs will have to be prepared to meet the defendant's challenge.

Class certification has emerged as a promising opportunity for defendants. The extent of this opportunity may vary among the circuits, but the trend line is clear, and we can expect to see more judicial scrutiny of loss causation when plaintiffs move for class certification. ■

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Section 10(b) and Rule 10b-5: The U.S. Courts of Appeals Apply Different Legal Tests for Assessing the Primary Liability of Secondary Actors

By Ketanji Brown Jackson and Karen Escalante

In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, the Supreme Court reaffirmed its prior holding that, while secondary actors in securities markets (e.g., attorneys, accountants, and underwriters) cannot be held liable in a private action for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934, such actors *can* be subject to liability for their own primary violations of the Act. *See* 128 S. Ct. 761, 773-774 (2008). The Court has recognized such secondary actor liability for primary violations of Section 10(b) and Rule 10b-5 for the past 15 years. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994).

No single standard for determining the scope of conduct for which a secondary actor may be held primarily liable, however, has emerged among the lower courts. The federal courts of appeals have established distinctly different tests, including a new standard that the Tenth Circuit has applied in the context of an SEC enforcement action.

Counsel for secondary actors in securities fraud cases should be aware of the federal courts' different legal tests of secondary actor liability under Section 10(b). The different tests increase the potential that liability for secondary actors will vary based on where the securities fraud action is litigated and whether the action brought is a private suit or an SEC enforcement action.

THE "BRIGHT-LINE" AND "SUBSTANTIAL PARTICIPATION" TESTS

The different tests that the circuits employ are primarily based on different views as to whether the secondary actor

Counsel for secondary actors in securities fraud cases should be aware of the federal courts' different legal tests of secondary actor liability under Section 10(b).

"must *make* the material misstatement or omission in order to be a primary violator." *Wright v. Ernst & Young,* 152 F.3d 169, 174 (2d Cir. 1998).

The "bright-line" test adopted by the Second and Eleventh Circuits requires that, "in order for the defendant to be primarily liable under [Section] 10(b) and Rule 10b-5, the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at the time that the plaintiff's investment decision was made." *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001); *see also Wright*, 152 F.3d at 175 (finding that accounting firm was not primarily liable because it merely reviewed and approved material misstatements and did not communicate a misstatement to investors).

In essence, the bright-line test requires a plaintiff to demonstrate that (1) the secondary actor actually made a false or misleading statement or omission, and (2) the statement or omission has been publicly attributed to that specific actor. Public attribution is a key component of the "bright-line" test because a plaintiff in a private Section 10(b) action can claim detrimental reliance on a material misstatement made

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by a secondary actor only if such a statement was known to have been made by that actor when the investment was made. *Wright*, 152 F.3d at 175.

In contrast to the "bright-line" test applied in the Second and Eleventh Circuits, the Ninth Circuit permits secondary actor liability even if the secondary actor did not make the statement. Under the Ninth Circuit's "substantial participation" test, a plaintiff must demonstrate only that the secondary actor substantially participated or was intricately involved in the making of the fraudulent statement. *See Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000) ("[W]e have held that substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statements."); *accord In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994) (holding that an accounting firm may be primarily liable for its "significant role in drafting and editing" a fraudulent letter sent to the SEC).

To the extent that the "substantial participation" test permits a secondary actor, who has not actually made a fraudulent statement or omission, to be held liable as a primary violator of Section 10(b) based solely on his assistance with the preparation of such a statement, "the substantial participation test has been criticized as inconsistent with [the Supreme Court's] prohibition of private aiding and abetting." *SEC v. Tambone*, 550 F.3d 106, 139 (1st Cir. 2008).

THE "CAUSATION" STANDARD FOR SEC ENFORCEMENT ACTIONS

The Tenth Circuit recently rejected both the "bright-line" and "substantial participation" tests in the context of an SEC enforcement action. *See SEC v. Wolfson*, 539 F.3d 1249, 1259 (10th Cir. 2008). The First Circuit, too, has rejected both the "bright-line" test and the "substantial participation" test when a Section 10(b) action is brought by the government. *See Tambone*, 550 F.3d at 138-140 (critiquing the tests as "irrelevant" in the SEC enforcement context). In private Section 10(b) actions, the Tenth Circuit has required a plaintiff to demonstrate that the secondary actor actually made a false or misleading statement that he or she knew or should have known would reach potential investors, *see Anixter v. Home-Stake Prod. Co.,* 77 F.3d 1215, 1227 (10th Cir. 1996), but that court has promulgated a different standard for establishing the primary liability of secondary actors under Section 10(b) in government suits.

Under the Tenth Circuit's new test, a secondary actor is primarily liable in an SEC enforcement action when it "can fairly be said" that he or she "*caused*" the company "to make the relevant statements, and . . . knew or should have known that the statements would reach investors." *Wolfson*, 539 F.3d at 1261 (emphasis added). The Tenth Circuit reasoned that a consultant who had drafted the relevant filings on behalf of the company "made" the statements for Section 10(b) purposes, and thus should be treated as a primary violator of the securities laws, despite the fact that the misstatements appeared without attribution to the consultant in documents filed by the company.

The Tenth Circuit rejected the conclusion that the "bright-line" test should be applied in the SEC enforcement context because, in its view, the requirement that the statement be publicly attributed to the secondary actor was derived from

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the reliance element that must be proved only in private actions. *Id.* at 1259-1260. The Tenth Circuit also distinguished its new rule from the Ninth Circuit's "substantial participation" test by making clear that, "[u]nder the rule articulated today, a defendant must do more than substantially participate in creating an actionable misstatement (or omission)"; rather, he or she must "be so involved in creating or communicating the offending misstatement (or omission) that he or she can fairly be said to have caused it to be made." *Id.* at 1261 n.18.

The Tenth Circuit's "causation" test expands secondary actor liability beyond what is allowed in the Second, Ninth, and Eleventh Circuits. While it appears to hinge primarily on the distinction between private actions and civil actions brought by the SEC, the Tenth Circuit's standard for government enforcement actions is nonetheless important to consider when an action for violations of Section 10(b) is brought against a secondary actor. ■

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About Morrison & Foerster's Securities Litigation, Enforcement, and White-Collar Criminal Defense Practice Group

Morrison & Foerster is a recognized leader in all aspects of securities litigation, enforcement, and white-collar criminal defense. The Securities Litigation, Enforcement, and White-Collar Criminal Defense Practice Group includes more than 150 attorneys in our 17 offices around the world. Along with a deep bench of experienced civil and criminal defense lawyers, the Group includes in-house accounting experts. The Group has represented companies located in the United States and abroad in a wide range of industries, including financial services, consumer products, energy, software, life sciences, and telecommunications.

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