The Evisceration of the Federal Securities Law

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I. Introduction

a. Legislative history of the Securities Act of 1933[1] ("Securities Act") and the Securities Exchange Act of 1934[2] ("Exchange Act" and collectively, the "Acts").
   i. Congress passed the Acts following the 1929 stock market crash that triggered the Great Depression.
   ii. Prior to the passage of the Securities Act, President Roosevelt stated: "This proposal adds to the ancient rule of caveat emptor the further doctrine, 'let the seller also beware.' It puts the burden of telling the whole truth on the seller."[3]
   iii. Similarly, prior to the Securities Act's passage, Senator Peter Norbeck (R-SD) urged for the passage of legislation that would "definitively fix responsibility for deception and frauds upon directors and other officials and with severe penalties for such acts."[4]

b. The Acts were intended to be clear statutes with clear violations.

c. Both Congress and the courts have weakened the acts, which is reflected in the number of cases filed.
   i. According to a SEC report issued in April of 1997 that looked at the number of federal securities class actions filed in 1996, the first full year after the Private Securities Litigation Reform Act of 1995[5] ("PSLRA") became effective, there was a 34% drop-off from the number of companies sued in federal court class actions when compared to 1995, a 52% drop-off from the number of suits when compared to 1994, and a 31% drop-off from the number of suits compared to 1993.[6]
   ii. According to data published by National Economic Research Associates, between 2009 and 2011, plaintiffs filed an average of 144 cases per year that alleged violations of the Acts. Between 2005 and 2008, the average was 173 cases per year, a decline of almost 17%.[7]

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[1] 15 U.S.C. §§ 77a *et seq*.
[2] 15 U.S.C. §§ 78a *et seq*.
[3] 77 Cong. Rec. 937 (Mar. 29, 1933), *reprinted in* 1 Federal Securities Laws Legislative History 1933-1982, at 20 (1983) .
[4] 77 Cong. Rec. 3223-33 (May 11, 1933), *reprinted in*1 Federal Securities Laws Legislative History 1933-1982, at 247.
[5] Pub. L. No. 104-67, 109 Stat. 737 (1995).
[6] U.S. Securities and Exchange Commission, REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 (April 1997), available at http://securities.stanford.edu/research/reports/19970401lreform.html.
[7] National Economic Research Associates, Dr. Renzo Comolli et al., *Recent Trends in Securities Class Action Litigation: 2012 Full-Year Review*, at 6 (Jan. 29, 2013), available at http://www.nera.com/nera-files/PUB_Year_End_Trends_01.2013.pdf.

II. Recent Court Decisions Have Made It More Difficult to Successfully Plead a Cause of Action Under the Acts.

a. The Elimination of Transnational Jurisdiction
   i. Both Section 22 of the Securities Act[8] and Section 27 of the Exchange Act[9] vest jurisdiction for violations in the United States District Courts. The Acts are "silent as to [their] extraterritorial application," which left courts to address whether transnational frauds are covered under the Acts.[10]
   ii. In matters involving fraud, the Circuit Courts had developed the "conduct" and "effects" tests that permitted jurisdiction when the defendant's conduct (or failure to act) occurred within the United States or, if the conduct occurred abroad, when that conduct caused a substantial effect within the United States.[11] These tests provided investors a remedy in cases where a company's stock traded on a foreign exchange, provided the fraudulent conduct alleged had the requisite nexus to the United States.
   iii. In 2010, however, the Supreme Court rejected the "conduct" and "effects" tests. The Court developed a bright line jurisdictional rule, holding that section 10(b) of the Exchange Act,[12] only applied to "domestic transactions" regardless of where the fraudulent conduct occurred or if the conduct caused effects in the United States.[13]
   iv. The Dodd-Frank Wall Street Reform and Consumer Protection Act[14] ("Dodd-Frank Act") amended Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act to partially restore the "conduct" and "effect" jurisdictional tests, but only for enforcement proceedings brought by the SEC or DOJ, not for action brought by private investors.
   v. As a result, investors in companies that conduct substantial business in the United States have no remedy for violations of the securities acts if a company's stock trades only on a foreign exchange.

b. Heightened Standard Under Rule 8 of the Federal Rules of Civil Procedure ("Rule 8") (for details, see section III.f, *infra*).

c. Pleading Fraud Under Rule 9 of the Federal Rules of Civil Procedure ("Rule 9").
   i. Under Rule 9(b), complaints alleging fraud must be plead with particularity.[15]

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[8] 15 U.S.C. § 77v.
[9] 15 U.S.C. § 78aa.
[10] *See Alfadda v. Fenn*, 935 F.2d 475, 478-79 (2d Cir. 1991), *cert. denied*, 502 U.S. 1005 (1991).
[11] *See id*. at 475, 478.
[12] 15 U.S.C. § 78j(b).
[13] *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869, 2883-84 (2010).
[14] Pub. L. No. 111-203, §§ 929P(b) & 929Y, 124 Stat. 1376 (2010).
[15] *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 (U.S. 2007) ("Rule 9(b) applies to 'all averments of fraud or mistake'; it requires that 'the circumstances constituting fraud . . . be stated with particularity' but provides that '[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally.'")

ii. Most courts have held that claims brought under the Securities Act that "sound in fraud," regardless of how the plaintiff labels the claim, require the plaintiff to satisfy Rule 9(b)'s heightened pleading requirement.[16]

d. Pleading Scienter Under the PSLRA Is More Difficult Than Pleading Fraud in Non-Securities Cases.

i. Strong inference:

1. Rule 9(b) states that "[m]alice, intent, knowledge, and other conditions of a person's mind may be alleged generally."[17] In contrast, the PSLRA provides that in private actions under the Exchange Act, where "the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[18]
2. **President Clinton vetoed the PSLRA, stating that the heightened standard for pleading scienter "impose[d] an unacceptable procedural hurdle to meritorious claims being heard in Federal courts."[19] The PLSRA passed both houses of Congress over the President's veto.**
3. In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Supreme Court noted that "[t]he strong inference standard unequivocally raised the bar for pleading scienter."[20]
    a. The Court held that "in determining whether the pleaded facts give rise to a 'strong' inference of scienter," the court must not only assume the truth of the facts alleged and all reasonable inferences, but the court must also "take into account plausible opposing inferences."[21]
    b. The Court explained: "[T]he inference of scienter must be more than merely 'reasonable' or 'permissible'--it must be cogent and compelling, thus strong in light of other explanations."[22]
    c. The Court concluded: "[a] complaint will survive . . . only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged. Therefore, a court

[16] *See, e.g., ACA Fin. Guar. Corp. v. Advest, Inc.*, 512 F.3d 46, 68 (1st Cir. 2008) ("[w]here section 12(a)(2) claims are grounded in fraud, Rule 9(b) applies"); *Rombach v. Chang*, 355 F.3d 164, 171 (2d Cir. 2004) (Rule 9(b) applies to claims brought under Sections 11 and 12(a)(2) of Securities Act when claims are grounded in fraud and not in negligence); *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 288 (3d Cir. 1992) (same).
[17] *See*, *supra* note 16.
[18] 15 U.S.C. §78u-4(b)(2).
[19] H.R. Doc. No. 104-150, 104th Cong., 1st Sess. (1995), 141 Cong. Rec. H15215 (1995).
[20] 551 U.S. at 321 (internal quotation marks and brackets omitted).
[21] *Id*. at 322-23.
[22] *Id*. at 324.

may sustain a complaint only if a reasonable person would deem the inference of scienter at least as compelling as any opposing inference."[23]

4. **Group Pleading Doctrine**
    a. "Under the group pleading presumption, a court may attribute all statements to the defendants as collective actions without considering the liability of each individual defendant."[24]
    b. Because the PLSRA refers to "the defendant," at least two United States Circuit Courts of Appeal and many United States District Courts have held that the PLSRA's "strong inference" requirement eliminated the group pleading doctrine.[25] In these jurisdictions, plaintiffs must specifically plead each individual defendant's culpable acts.
    c. *Tellabs* did not address this issue because the plaintiffs did not challenge circuit court's holding that group pleading is inapplicable under the Reform Act.[26]

ii. Recklessness
    1. Prior to the PLSRA, all Circuit Courts of Appeal that had addressed the issue had held that reckless behavior was a sufficient basis for liability under Section 10(b).[27] For example, the Second Circuit held that a plaintiff could allege facts that "give rise to a strong inference of fraudulent intent" by, *inter alia*, "alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness."[28]
    2. **The PLSRA, however, did not explicitly adopt the Second Circuit's rule that allegations constituting "strong circumstantial evidence" of recklessness are sufficient.**

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[23] *Id.*
[24] *Miss. Pub. Emples. Ret. Sys. v. Boston Sci. Corp.*, 523 F.3d 75, 93 (1st Cir. 2008).
[25] *See, e.g., Winer Family Trust v. Queen*, 503 F.3d 319, 337 (3d Cir. 2007); *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 364 (5th Cir. 2004) (collecting cases). *See also Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015, 1018 (11th Cir. Ga. 2004) (not ruling on remaining viability of group pleading, but stating "we believe that the most plausible reading in light of congressional intent is that a plaintiff, to proceed beyond the pleading stage, must allege facts sufficiently demonstrating each defendant's state of mind regarding his or her alleged violations").
[26] 551 U.S. at 326 n.6. Similarly, the issue remains unresolved in the First Circuit. *See In re Boston Sci. Corp. Sec. Litig.*, 708 F. Supp. 2d 110, 127 (D. Mass. 2010).
[27] *See Provenz v. Miller*, 102 F.3d 1478, 1490 (9th Cir. 1996); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1232-33 (10th Cir. 1996); *Van Dyke v. Coburn Enters., Inc.*, 873 F.2d 1094, 1099-1100 (8th Cir. 1989); *Rankow v. First Chicago Corp.*, 870 F.2d 356, 366-67 (7th Cir. 1989); *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 813-15 (11th Cir. 1989); *Auslender v. Energy Mgmt. Corp.*, 832 F.2d 354, 357 (6th Cir. 1987); *Warren v. Reserve Fund, Inc.*, 728 F.2d 741, 745 (5th Cir. 1984); *Dirks v. Sec. Exch. Comm'n*, 681 F.2d 824, 844-45 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983); *Healey v. Catalyst Recovery of Pa., Inc.*, 616 F.2d 641, 649 (3d Cir. 1980); *Hoffman v. Estabrook & Co.*, 587 F.2d 509, 515-17 (1st Cir. 1978); *Rolf v. Blyth, Eastman, Dillon & Co.*, 570 F.2d 38, 44 (2d Cir. 1978).
[28] *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994).

3. The Circuit Courts of Appeal disagree on whether a reckless state of mind is sufficient to state a claim under the PLSRA.
    a. In the Ninth Circuit, a plaintiff must plead "facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct" and "facts showing mere recklessness or a motive to commit fraud and opportunity to do so . . . are not sufficient to establish a strong inference of deliberate recklessness."[29]
    b. In the First Circuit, scienter requires either a "conscious intent to defraud" or "a high degree of recklessness."[30]
    c. In the Third Circuit, "recklessness . . . remains a sufficient basis for liability."[31]

e. Confidential Informants
    i. **The PLSRA requires that "if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts upon which that belief is formed."**[32]
    ii. Some Circuit Courts of Appeal have ruled that, although plaintiffs are not required to name sources, they must provide a detailed description of the source.[33]
    iii. Moreover, courts may order sanctions where a confidential informant later disavows statements attributed to them in a complaint.[34]

III. Obstacles to Success Under Section 11 of the Securities Act ("Section 11").

a. Section 11 protects investors from materially untrue statements and material omissions in registration statements, but it only provides standing to a narrow class of persons who purchased stock pursuant to a registration statement.[35]
    i. Investors must be able to trace their purchase to the registration statement.[36]
    ii. Potential plaintiffs must establish standing by a preponderance of direct evidence. Proof that the security might have been issued pursuant to the

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[29] *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999).
[30] *Miss. Pub. Employees' Ret. Sys. v. Boston Scientific Corp.*, 649 F.3d 5, 20 (1st Cir. 2011) (quoting *ACA Fin. Guar. Corp. v. Advest, Inc.*, 512 F.3d at 58).
[31] *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 535 (3rd Cir. 1999).
[32] 15 U.S.C. 78u-4(b)(1).
[33] *See, e.g., Institutional Investors Group v. Avaya, Inc.*, 564 F.3d 242, 263 (3d Cir. 2009); *Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Group, Inc.*, 537 UF.3d 527, 535 (5th Cir. 2008); *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 712 (7th Cir. 2008).
[34] *See City of Livonia Emple. Ret. Sys. v. Boeing Co.*, 711 F.3d 754, 762 (7th Cir. 2013) (remanding to District Court for determination of whether sanctions to award sanction again a plaintiff's firm); *In re Sony Corp.*, 268 F.R.D. 509 (S.D.N.Y 2010). See also Max Stendahl, *Boeing Wants Robbins Geller Sanctioned In Witness Scandal*, Law360 (Nov. 25, 2013), http://www.law360.com/articles/491323/boeing-wants-robbins-geller-sanctioned-in-witness-scandal.
[35] *Demaria v. Andersen*, 318 F.3d 170, 176 (2d Cir. N.Y. 2003)
[36] *See In re Fleetboston Fin. Corp. Secs. Litig.*, 253 F.R.D. 315, 343-350 & n.29 (D.N.J. 2008)

registration statement is not enough.[37] Even evidence showing a strong likelihood that the security could be traced to the registration statement is not enough. For example, in *In re Elscint Ltd. Sec. Litig.*, the Court held that evidence showing a statistical probability of 82% that certain securities could be traced to the registration statement was not sufficient to support an inference that any one of the plaintiffs more probably than not purchased new shares of stock.[38]

b. Statute of Repose – In *Police & Fire Ret. Sys. v. IndyMac MBS, Inc.*,[39] the Court of Appeals for the Second Circuit recently held that while *American Pipe*[40] tolling applies to the one year statute of limitation under Section 13 of the Securities Act,[41] it does not apply to the three-year statute of repose.

i. The Second Circuit issues a broad holding, potentially applicable to Rule 10b-5[42] claims as well.

ii. The holding will potentially prevent institutional investors waiting to file individual actions until after the class action has progressed through discovery. It could also encourage early filings by institutional investors and push institutional investors to opt-out of class actions earlier than before.

iii. The Second Circuit's holding in *IndyMac* appears to conflict with the Tenth Circuits holding in *Joseph v. Wiles*.[43] The *IndyMac* plaintiffs have filed a Petition for a Writ of Certiorari, asking the Supreme Court to address the question: "Does the filing of a putative class action serve, under the *American Pipe* rule, to satisfy the three-year time limitation in § 13 of the Securities Act with respect to the claims of putative class members?"[44]

c. Although courts usually only dismiss on materiality grounds if misstatements were minor enough that "reasonable minds could not differ on the question of their importance,"[45] a number of doctrines still stand in a plaintiff's way.

i. "Bespeaks caution" doctrine

1. Under the "bespeaks caution" doctrine, sufficient cautionary language in a disclosure document can render an alleged omission or misrepresentation immaterial as a matter of law.[46]

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[37] *Krim v. PCOrder.com*, 402 F.3d 489, 501 (5th Cir. Tex. 2005) ("general statistics say nothing about the shares that a specific person *actually* owns and have no ability to separate those shares upon which standing can be based from those for which standing is improper") (emphasis in original).
[38] 674 F. Supp. 374 (D. Mass. 1987).
[39] 721 F.3d 95 (2d Cir. 2013).
[40] *Am. Pipe & Constr. Co. v. Utah*, 414 U.S. 538, 551 (1974).
[41] 15 U.S.C. § 77k.
[42] 17 C.F.R. § 240.10b-5.
[43] 223 F.3d 1155, 1168 (10th Cir. 2000)
[44] Petition for a Writ of Certiorari at i, *Police & Fire Ret. Sys. v. IndyMac MBS, Inc.*, No. 13-640 (Nov. 22, 2013).
[45] *See ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 197 (2d Cir. 2009).
[46] *See Halperin v. eBanker USA.com, Inc.*, 295 F.3d 352, 357 (2d Cir. 2002).

2. For example, in *Olkey v. Hyperion 1999 Term Trust*, the plaintiffs brought a class action seeking damages for fraud in issuing and using prospectuses to market mortgage-backed securities, in violation of Sections 11 and 12(2) of the Securities Act and Sections 10(b) and 20(a) of the Exchange Act.[47] The Second Circuit affirmed the dismissal by the district court of plaintiffs' claims on the grounds that, when read as a whole, the allegedly misleading materials contained in the prospectus bespoke caution.[48]
    a. In *Olkey v. Hyperion 1999 Term Trust*, the prospectuses included the following specific warnings, among others, about mortgage-backed securities:
        i. "The investment characteristics of Mortgage-Backed Securities differ from traditional debt securities. . . . These differences can result in significantly greater price and yield volatility than is the case with traditional debt securities. As a result, if the Trust purchases Mortgage-Backed Securities at a premium, a prepayment rate that is faster than expected will reduce both the market value and yield to maturity from that which was anticipated. . . ."[49]
        ii. "Because of the effect that changes in interest rates may have on prepayment rates, changes in interest rates may have a greater effect on the value of Mortgage-Backed Securities than is the case with more traditional fixed income securities."[50]
        iii. "Amounts available for reinvestment by the Trust are likely to be greater during a period of declining interest rates due to increased prepayments and, as a result, likely to be reinvested at lower interest rates than during a period of rising interest rates. Most Mortgage-Backed Securities in which the Trust may invest, like other fixed income securities, tend to decrease in value as a result of increases in interest rates but may benefit less than other fixed income securities from declining interest rates because of the risk of prepayment."[51]
    b. The prospectus in *Olkey v. Hyperion 1999 Term Trust* also included the following general warnings:

[47] 98 F.3d 2, 3 (2d Cir. N.Y. 1996)
[48] *Id.* at 5 & 9.
[49] *Id.* at 5-6.
[50] *Id.* at 6.
[51] *Id.*

i. "The market value of the Trust's portfolio . . . [is] dependent on market forces not in the control of the Adviser."[52]

ii. "A significant decline in interest rates could lead to a significant decrease in the Trust's net income and dividends while a significant rise in interest rates could lead to only a moderate increase in the Trust's net income and dividends. Changes in interest rates will also lead to changes in the Trust's net asset value."[53]

ii. Forward looking statements

1. SEC Rule 175[54]
    a. Creates a safe harbor for forward-looking statements in registration statements, and other specific documents.[55]
    b. Limits "forward-looking statements" to:
        i. "A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;
        ii. "A statement of management's plans and objectives for future operations;
        iii. "A statement of future economic performance contained in management's discussion and analysis of financial condition and results of operations included pursuant to Item 303 of Regulation S-K (§ 229.303 of this chapter) or Item 9 of Form 20-F; or Item 5 of Form 20-F.
        iv. "Disclosed statements of the assumptions underlying or relating to any of the statements described [above]."[56]
2. **The PLSRA added 15 U.S.C. § 77z-2(c), which provides a safe harbor for forward-looking statements unless the plaintiff can show that the defendant made the statement with actual knowledge of its falsity.**
3. The PLSRA contains a broad definition of "forward-looking statement." The term "forward-looking statement" means:
    a. "a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items;

[52] *Id*.
[53] *Id*.
[54] 17 C.F.R. § 230.175.
[55] *Id*. at § 230.175(b).
[56] *Id*. at §§ 230.175(c)(1)-(4).

b. "a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;
c. "a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission;
d. "any statement of the assumptions underlying or relating to any statement described in subparagraph (a), (b), or (c);
e. "any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or
f. "a statement containing a projection or estimate of such other items as may be specified by rule or regulation of the Commission."[57]

iii. Opinions are not material unless the speaker did not truly hold the opinion. "Opinions" include statements that reflect judgments or subjective thinking. For example in *Fait v. Regions Financial Corp.*,[58] the plaintiffs claimed that certain statements concerning goodwill and loan loss reserves in the defendant's registration statement gave rise to liability under Sections 11 and 12 of the Securities Act. The Second Circuit Court of Appeals held that a defendant's statements were opinions because they were based on subjective estimates by the company's management.

d. Even though scienter is not required under Section 11, fraud must be plead with particularity.[59]

e. Although reliance and causation are not required under Section 11, "defendant[s] may, under section 11(e), reduce [their] liability by proving that the depreciation in value resulted from factors other than the material misstatement in the registration statement."[60]

f. Heightened pleading under Rule 8.

i. Rule 8 applies to claims under Section 11 that are not based on fraud.
ii. After the Supreme Court's rulings in *Bell Atlantic Corp. v. Twombly*,[61] and *Ashcroft v. Iqbal*,[62] **Rule 8 no longer only requires "a short and plain statement of the claim showing that the pleader is entitled to relief" that "gives the defendant fair notice of what the . . . claim is and the**

[57] *See* 15 U.S.C. §§ 77z-2(i)(1)(A)-(F).
[58] 655 F.3d 105, 110-13 (2d Cir. 2011).
[59] *See* note 23.
[60] *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 340 (2d Cir. 1987).
[61] 550 U.S. 544 (2007).
[62] 556 U.S. 662 (2009).

grounds upon which it rests."[63] **Now, the plaintiff's allegations, stripped of legal conclusions, must state a claim that is not merely possible, but "plausible on its face."**[64]

iii. Plaintiffs advancing claims under the Acts must now include enough facts in their complaint to allow the court to draw a reasonable inference that the defendant committed the alleged act.[65] **Historically, Section 11 was, in essence, a strict liability statute.**[66] **In order to state a claim, a plaintiff only had to show that the defendant made an untrue statement or omission in a registration statement and there was a "substantial likelihood that a reasonable investor would consider it important."**[67] **This was especially true as to claims against issuers, as others had a "due diligence" defense to Section 11 claims.**

g. For example, *In re Royal Bank of Scotland Group PLC Sec. Litig.*,[68] arguably would have turned out differently twenty years ago. In that case, the allegations included:

i. The registration statement incorporated a Royal Bank of Scotland Group ("RBS") Annual Report, which stated that RBS's "[o]verall credit quality remained strong," and that "[r]isk elements in lending and potential problem loans represented just 1.6% of gross loans and advances to customers."[69]

ii. These statements were materially false and misleading because they "failed to disclose the extent to which RBS had subprime assets in its portfolio" and "the amount of RBS's subprime assets could have influenced the economic decisions investors made on the basis of RBS's financial statements."[70]

iii. The statements were also materially false and misleading because the Annual Report "failed to disclose any concentration of credit risk arising from the billions of dollars in subprime assets in RBS's portfolio" and that international accounting standards required RBS to disclose concentrations of credit risks.

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[63] 355 U.S. 41, 47 (1957).
[64] *Bell Atlantic Corp. v. Twombly*, 550 U.S. at 570; *Ashcroft v. Iqbal*, 556 U.S. at 678.
[65] *Bell Atlantic Corp. v. Twombly*, 550 U.S. at 556; *Ashcroft v. Iqbal*, 556 U.S. at 678.
[66] *See In re Fleetboston Fin. Corp. Secs. Litig.*, 253 F.R.D. 315, 343 n.29 (D.N.J. 2008) (Section 11 "imposes virtually strict liability on offerors and sellers directly involved in a fraudulent registered transaction").
[67] *See Greenapple v. Detroit Edison Co.*, 468 F. Supp. 702, 708 (S.D.N.Y. 1979), *aff'd* 618 F.2d 198 (2d Cir. 1980).
[68] Civ. A. 1:09-cv-00300-DAB (S.D.N.Y. 2011)
[69] *In re Royal Bank of Scotland Group PLC Sec. Litig.*, Amended Complaint at ¶ 95 (S.D.N.Y. Mar. 18, 2011).
[70] *Id.* at ¶ 96.

IV. Obstacles to Success Under Section 12 of the Securities Act ("Section 12")[71]

a. Section 12(a)(1)[72]
   i. Section 12(a)(1) creates a cause of action for the offer or sale of unregistered securities. Plaintiffs are not required to prove scienter, negligence, materiality, or reliance.
   ii. Although the defense of *in pari delicto* is applicable to all private actions under federal securities laws, it is especially relevant to actions under Section 12.[73] Plaintiffs who knew about or participated in the violation are subject to a defense of *in pari delicto*, where the plaintiff's culpability is greater than, or indistinguishable from, the defendant's, and the plaintiff cooperated with or induced the defendant's actions.[74]
      1. Defense is available "only where (1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public."[75]
      2. The Supreme Court noted in *Pinter v. Dahl* that "the *in pari delicto* defense may defeat recovery in a § 12(1) action only where the plaintiff's role in the offering or sale of nonexempted, unregistered securities is more as a promoter than as an investor."[76]

b. Section 12(a)(2)[77]
   i. Section 12(a)(2) creates a cause of action against persons who offer or sell a security by means of a prospectus or oral communication, which contains material misrepresentation or omission.
   ii. Essentially, once a plaintiff-purchaser shows that a prospectus contained a material misstatement, the burden shifts to the defendant to show that the elements do not exist.[78]
   iii. **In *Gustafson v. Alloy Co.*, the Supreme Court narrowed the reach of Section 12(a)(2) by holding that buyers of stock in private transactions could not avail them of Section 12(a)(2)'s protections because private transactions do not involve a "prospectus" as that term is defined in the Securities Act**.[79]
   iv. Reform Act amended Section 12 by adding (b), which significantly lessened the extent of damages recoverable by a plaintiff.

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[71] 15 U.S.C. § 77l.
[72] 15 U.S.C. § 77l(a)(1)
[73] *See Pinter v. Dahl*, 486 U.S. 622, 635 (1988).
[74] *Id.* at 637 (1988).
[75] *Id.* at 633
[76] *Id.* at 639.
[77] 15 U.S.C. § 77l(a)(2)
[78] *Id.*
[79] 513 U.S. 561, 569-71 (1995)

1. Prior to the Reform Act, Section 12(2)[80] established that "any person" who violates the section "shall be liable to the person purchasing such security from him . . . to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."
2. **Section 12(b) establishes a loss causation requirement <u>not present</u> in the original text of Section 12(2), allowing defendants to minimize damages by proving that "any portion or all of the amount recoverable under subsection (a)(2) represents other than the depreciation in value of the subject security resulting from" the Section 12 violation**.

V. Other Obstacles to Success Under Section 10(b) of the Exchange Act and SEC Rule 10b-5

a. Plaintiffs "did not rely on the integrity of the market."
   i. After trial in *Gamco v. Vivendi*, the United States District Court for the Southern District of New York held that the plaintiffs traded without relying on the integrity of the market because, while they alleged that the defendant failed to disclose its liquidity position, the metric that the plaintiffs used to determine the intrinsic value of their potential purchase was "completely independent of liquidity concerns and market price."[81]
   ii. In *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.*, the defendants challenged all claims to see if investors relied on the integrity of the market and to see if investors' claims were properly authorized. The defendants appear to have reduced their exposure by millions of dollars.[82]
      1. After the jury found the defendants made false or misleading statements, each class member was required to respond "yes" or "no" to the following inquiry: "If you had known at the time of your purchase of Household stock that defendants' false and misleading statements had the effect of inflating the price of Household stock and thereby caused you to pay more for Household stock than you should have paid, would you have still purchased the stock at the inflated price that you paid?"[83]
      2. The Court dismissed the claims of any class member who failed to answer the question.[84]
      3. For class members who answered "yes," the Court determined that the defendant had successfully rebutted the presumption of reliance

[80] The Reform Act added subsection (b) to Section 12 and renumbered Section 12(2) as 12(a)(2).
[81] 927 F. Supp. 2d 88, 101 (S.D.N.Y. 2013).
[82] *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.*, 2012 U.S. Dist. LEXIS 135135 (N.D. Ill. Sept. 21, 2012)
[83] *Id.* at *5.
[84] *Id.* at *22-23.

on the market and ordered those claims proceed to trial on the issue of reliance.[85]

4. The Court ruled that those class members who answered "no" were entitled to judgment as to liability because the defendant did not adequately rebut the presumption of reliance on the market price.[86]

iii. The Supreme Court recently granted certiorari in *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (to be argued Mar. 5, 2014) (see section V.f.iv, *infra*).

b. The Second Circuit's ruling in *Police & Fire Ret. Sys. V. IndyMac MBS, Inc.*, could easily be extended to eliminate tolling of the five-year statute of repose applicable to actions under Section 10(b) (see section III.b, *supra*).

c. Duty to Disclose in Omission Cases –

i. In *Basic v. Levinson*, the Supreme Court held that "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5." [87]

ii. Duty must specifically run to shareholder from the defendant and cannot arise from a general duty to disclose truthful and accurate information.[88]

d. Statements protected from liability

i. Forward-Looking Statements (see above, Section III.c.ii)

1. In 1979 the SEC created safe harbor for forward-looking statements in specific documents.[89]

2. PLSRA Safe Harbor –

a. Contains a broad definition of forward-looking statements (see above).

b. Once a statement has been identified as forward-looking and material, in order to be protected it must be accompanied by "meaningful" cautionary statements or the defendant must have made the statement without actual knowledge of its falsity (i.e., statements made recklessly or without a reasonable basis are protected).

ii. As mentioned above, the bespeaks caution doctrine dictates that sufficient cautionary language in a disclosure document can render alleged omission or misrepresentation immaterial as a matter of law.[90] This doctrine applies to forward-looking statements outside of a document specifically protected by the SEC safe harbor.

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[85] *Id.* at *17.
[86] *Id.* at *6-7.
[87] 485 U.S. 224, 239 n. 17 (1988)
[88] *See Badger v. S. Farm Bureau Life Ins. Co.*, 612 F.3d 1334, 1343-44 (11th Cir. 2010).
[89] 17 C.F.R. §§ 230.175 & 240.3b-6
[90] *See Halperin v. eBanker USA.com, Inc.*, 295 F.3d 352, 357 (2d Cir. 2002).

iii. Most Courts conclude that "vague and general statements of optimism constitute no more than 'puffery' and are understood by reasonable investors as such."[91]

iv. Opinions –

1. Opinion statements are only actionable if the statement was not honestly held by the speaker at the time the statement was made.[92]
2. Any statement that reflects judgment or subjective thinking could be viewed as an opinion.[93]

v. Characterizations – as long as material facts are disclosed, a failure to characterize facts in a negative manner is not actionable.[94]

vi. **Firm Specific Information – the Acts "only require" issuers to disclose firm-specific information and there is no duty to disclose industry- or nation-wide economic information**.[95]

vii. Claims alleging mismanagement are not actionable absent specific misstatements or omissions.[96] Similarly, a board's failure to disclose its own mismanagement usually is not actionable.[97]

e. Scienter (discussed further at section II.d, *supra*)

i. The PSLRA requires "strong inference" of scienter and it is an open question whether recklessness still suffices.

ii. Insider stock sales – unusual insider stock sales may support an inference of scienter, but a plaintiff must show that trading involved substantial amounts and occurred during the relevant period.[98]

f. Causation

i. The PSLRA codified the requirement that the plaintiff must plead and prove loss causation in an action under Section 10(b).[99]

ii. Plaintiffs must directly connect misstatements to the decline in stock value. Plaintiffs must specifically allege that the misstatement or omission, when disclosed, caused a drop in stock value.[100]

iii. *Dura Pharmaceuticals, Inc., v. Broudo*,[101] requires plaintiffs to "provide the defendant with some indication of the loss and the causal connection that [they have] in mind."

iv. Reliance – the "fraud-on-the-market" theory is under scrutiny.

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[91] See, e.g., *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 538-39 (3d Cir. 1999) (citing cases).
[92] *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1095-96 (1991).
[93] *See Fait v. Regions Fin'l Corp.*, 655 F.3d 105, 110-12 (2d Cir. 2011).
[94] *See, e.g., Ley v. Visteon Corp.*, 543 F.3d 801, 808 (6th Cir. 2008).
[95] *See Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 515 (7th Cir. 1989) ("Issuers need not 'disclose' Murphy's Law or the Peter Principle, even though these have substantial effects on business").
[96] *Winer Family Trust v. Queen*, 503 F.3d 319, 333 (3d Cir. 2007).
[97] *Werner v. Werner*, 267 F.3d 288, 299 (3d Cir. 2001).
[98] *See, e.g., City of Dearborn Heights v. Waters Corp.*, 632 F.3d 751, 761-62 (1st Cir. 2011).
[99] 15 U.S.C. § 78u-4(b)(4).
[100] *See, e.g., Emergent Capital Inv. Mgmt. LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197-98 (2d Cir. 2003)
[101] 544 U.S. 336, 347 (2005).

1. In *Basic Inc. v. Levinson*,[102] the Supreme Court recognized a presumption of reliance based on a fraud-on-the-market theory. Courts "may presume that investors trading in efficient markets indirectly rely on public, material misrepresentations through their 'reliance on the integrity of the price set by the market.'"[103] Therefore, as the law currently stands, investors need not show that they actually relied on alleged misstatements to state a claim under Rule 10b-5 and it is the defendant's burden to rebut the presumption of reliance.
2. **The Court recently granted certiorari in *Halliburton Co. v. Erica P. John Fund, Inc.***
    a. The issues will be:
        i. Whether the Court should overrule or substantially modify the holding of *Basic Inc. v. Levinson*, to the extent that it recognizes a presumption of class-wide reliance derived from the fraud-on-the-market theory; and
        ii. 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.
    b. Halliburton argued in its Petition for Certiorari that:
        i. The fraud-on-the-market theory is premised on an economic theory that is now "roundly rejected."[104]
        ii. The fraud on the market presumption is at odds with the Court's recent class action jurisprudence that "plaintiffs must 'affirmatively demonstrate . . . compliance' with Rule 23 [of the Federal Rules of Civil Procedure], and thereby 'prove . . . *in fact*' that common issues predominate before a district court may certify a class."[105]
        iii. Because the court below found no evidence that Halliburton's alleged misrepresentation actually moved the market price, "*Basic* should be modified to require plaintiffs to prove price impact in order to invoke the presumption in the first instance."[106]

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[102] 485 U.S. 224 (1988).
[103] *Amgen Inc., v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1192 (2013) (quoting *Basic Inc. v. Levinson*, 485 U.S. at 245).
[104] Petition for Writ of Certiorari at 13, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (filed Sept. 9, 2013).
[105] *Id.* at 21 (quoting *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2551 (2011)).
[106] *Id.* at 24.

g. Automatic Stay of Discovery

i. The PSLRA established that in any action arising under the Securities Act or Exchange Act, "all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds, upon the motion of any party, that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party."[107]

ii. Under this regime, courts decide motions to dismiss based on the facts alleged and the inferences drawn from those facts. Defendants' input as to what inferences the court may draw comes from the briefs filed by their counsel.

h. Limitations on Who Can Be Sued

i. There is no private right of action for aiding and abetting under Section 10(b).[108] Additionally, as discussed above (see section II.d.4), the PSLRA essentially eliminated the group pleading presumption. However, the PSLRA granted the SEC authority to bring actions under the Exchange Act against "any person that knowingly provides substantial assistance to another person" who violates the Exchange Act or SEC regulations.[109]

ii. The Supreme Court has also held that there is no scheme liability under the Exchange Act.[110]

iii. ***Janus Capital Group v. First Derivative Traders*[111] held that a defendant "makes" a statement only if that person "is the person or entity with <u>ultimate authority</u> over that statement, including its content and whether and how to communicate it."**

VI. Obstacles to Class Certification

a. The Supreme Court has held that class certification is proper only if "the trial court is satisfied, after a rigorous analysis, that the prerequisites of Rule 23(a) have been satisfied," and that this rigorous analysis may require a court to "probe behind the pleadings" into the merits of the plaintiff's case at the class certification stage.[112]

b. In *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, the plaintiffs invoked the "fraud-on-the-market" presumption.[113] As the Court noted, the "fraud-on-the-market" presumption "facilitates class certification by recognizing a rebuttable

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[107] *See* 15 U.S.C. §§ 77z-1(b)(1) & 78u-4(b)(3)(B).
[108] *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver NA.*, 511 U.S. 164 (1994).
[109] 15 U.S.C. s. 78t(e).
[110] *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).
[111] 131 S. Ct. 2296, 2302 (2011) (emphasis added).
[112] *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2551 (2011) (quoting *General Telephone Co. of Southwest v. Falcon*, 457 U.S. 147, 157 (1982)). *See Comcast Corp. v. Behrend*, 133 S. Ct. 1426, 1432 (2013).
[113] 133 S. Ct. 1184, 1190 (2013).

presumption of classwide reliance on public, material misrepresentations."[114] The defendant conceded the efficiency of the market for the securities at issue, but argued that the plaintiffs had not adequately shown that the alleged misstatements were material enough to affect the market price.[115] The question was whether, at the class certification stage, the plaintiffs must do more than merely plead that the defendant's alleged misrepresentations materially affected the market price of the securities at issue.[116] The Court held that plaintiffs need not prove materiality at the class certification stage because, in an efficient market, materiality is an objective question that is common to the class.[117]

c. Therefore, at the class certification stage, the inquiry focuses on whether the plaintiff has established the prerequisites for the fraud-on-the-market presumption:
    i. The alleged misrepresentations were publicly known,
    ii. The stock traded in an efficient market, and
    iii. The relevant transactions took place "between the time the misrepresentations were made and the time the truth was revealed."[118]

d. In *Comcast Corp. v. Behrend*, the Supreme Court ruled that a trial court, when ruling on class certification, could not decline to evaluate the methodology of the plaintiff's expert witness's testimony about damages, even if that evaluation might ultimately affect the ability of the plaintiff to establish damages at trial. [119] Further, the Court held that, at the class certification stage, plaintiffs must provide a classwide damages model **that is consistent with their theory of liability**.[120]

e. *In Re BP p.l.c. Sec. Litig.*,[121] provides a good example of how these decisions have created obstacles to successful securities class action claims. In that case, the United States District Court for the Southern District of Texas denied class certification because the lead plaintiffs had failed to demonstrate that the alleged misrepresentations were publicly known.[122] Additionally, the Court refused to certify the class because the plaintiffs had not met their burden under *Comcast Corp. v. Behrend* of "showing that damages can be measured on a classwide basis consistent with their theories of liability."[123]

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[114] *Id.* at 1193.
[115] *Id*. at 1190.
[116] *Id.* at 1191
[117] *Id.* at 1195-1196.
[118] *Erica P. John Fund Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2185 (2011) (quoting *Basic, Inc. v. Levinson*, 485 U.S. at 248 n. 27).
[119] 133 S. Ct. at 1433-35.
[120] *Id.* at 1433.
[121] Memorandum and Order, 4:10-md-02185, Docket #709 (S.D.TX decided Dec. 6, 2013).
[122] *Id.*, slip op. at 24-26.
[123] *Id.*, slip op. at 30-31.

f. As mentioned above, Halliburton argued in its Petition for a Writ of Certiorari that the fraud-on-the-market presumption is at odds with the Supreme Court's recent class action jurisprudence, citing *Wal-Mart Stores, Inc. v. Dukes* and *Comcast Corp. v. Behrend*, that "plaintiffs must 'affirmatively demonstrate . . . compliance' with Rule 23 [of the Federal Rules of Civil Procedure], and thereby 'prove . . . **in fact**' that common issues predominate before a district court may certify a class."[124]

VII. Other Problems

a. No extensive SEC enforcement of public company disclosures
b. Plaintiff's lawyers end up policing the public company markets. However, some of the plaintiffs' attorneys most involved in prosecuting mega-frauds are no longer practicing.

VIII. Some Closing Thoughts on Overcoming the Obstacles

a. Institutional investor private actions
b. Favorable precedents in foreign jurisdictions.
    i. The Australian stock exchange has a "continuous disclosure" regime.[125]
    ii. Additionally, Canada is more plaintiff friendly, in some part due to schemes involving investing in such matters as timberlands and gold mines.
c. Emergence of new plaintiff's attorneys and firms.
    i. Deminor Group (Europe).
    ii. Dimitri Lascaris (Siskinds, LLP – Toronto).
    iii. Alexander Reus (DRRT – US and Europe).
    iv. Slater & Gordon (Australia)
    v. Maurice Blackburn (Australia)

[124] Petition for Writ of Certiorari at 21-23, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (filed Sept. 9, 2013).
[125] *See* ASX Rule 3.1.