The Harvard Law School Forum on Corporate Governance and Financial Regulation

Liabilities Under the Federal Securities Laws

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This post deals with certain of the liability provisions of the federal securities laws: §§ 11, 12, 15 and 17 of the Securities Act of 1933 (the "Securities Act"), and §§ 10, 18 and 20 of the Securities Exchange Act of 1934 (the "Exchange Act"). It does not address other potential sources of liability and sanction, such as federal mail and wire fraud statutes, state fraud statutes and common law remedies, RICO and the United States Securities and Exchange Commission's ("SEC") disciplinary powers.

On December 22, 1995, the Private Securities Litigation Reform Act of 1995 (the "Reform Act" or "PSLRA") became law after the Senate overrode President Clinton's veto. Pub. L. No. 104-67, 109 Stat. 737 (1995). Where relevant, this post discusses changes and additions that the PSLRA made to the liability provisions of the Securities Act and the Exchange Act.

The Securities Litigation Uniform Standards Act of 1998 ("SLUSA") amended portions of the Securities Act and the Exchange Act to preempt certain class actions that allege fraud under state law. Specifically, SLUSA precludes a private party from bringing a "covered class action" in federal or state court based on state law alleging a "misrepresentation or omission of a material fact" or the use of "any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1); *see also* § 77p(b). "Generally, a 'covered class action' involves common questions of law or fact brought on behalf of more than 50 persons or an action brought on behalf of one or more unnamed parties." *Prager* v. *Knight/Trimark Grp., Inc.*, 124 F. Supp. 2d 229, 231 (D.N.J. 2000) (citing 15 U.S.C. § 78bb(f)(5)(B)); *see also* 15 U.S.C. § 77p(f)(2)(A). SLUSA effectively makes federal court the exclusive venue for nearly all securities fraud class actions.

On December 21, 2000, Congress enacted the Commodities Futures Modernization Act (the "CFMA"), which revamped the Commodity Exchange Act and amended the securities, banking and bankruptcy laws to update the federal regulatory structure and to clarify the legal status of derivative products. Pub. L. No. 106-554, 114 Stat. 2763 (2000). The CFMA made two noteworthy changes to the securities laws. First, it lifted the ban on single stock futures and included "security future[s]" and "security futures product[s]" in the definition of "security" under the Exchange Act. *See* 15 U.S.C. §§ 78c(a)(10), (55) and (56). Because of this inclusion, security futures and security futures products are now subject to the reporting and recordkeeping, as well as the antifraud and antimanipulation, provisions of the Exchange Act. Second, the CFMA excluded swap agreements, either security-based or non-security-based, from the definition of "security" under both the Securities Act and the Exchange Act, thus excluding swap agreements from the SEC's reporting and recordkeeping requirements. *See id.* §§ 77b-1(a), (b), 78c-1(a), (b). The SEC does retain limited antifraud and antimanipulation authority over security-based swap agreements, including under § 17(a) of the Securities Act, § 9(a) of the Exchange Act and § 10(b) of the Exchange Act. *See id.* §§ 77q(a), (d), 78i(a)(2)-(5), (i), 78j(b); *see also Caiola* v. *Citibank, N.A.*, 295 F.3d 312, 327 (2d Cir. 2002); *SEC* v. *Rorech*, 673 F. Supp. 2d 217, 225 (S.D.N.Y. 2009). While this post will reflect fundamental changes made by the CFMA, the specifics of this complex law are beyond the scope of the post.

In the wake of serious accounting abuses at several large public companies, Congress passed the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), one of the most significant revisions to United States securities laws since the New Deal. Pub. L. No. 107-204, 116 Stat. 745 (2002). Sarbanes-Oxley covers a variety of areas and seeks, among other things, to enhance public disclosure, improve the quality and transparency of financial reporting and auditing, and strengthen penalties for securities law violations. Sarbanes-Oxley provides that any violation of its provisions is considered a violation of the Exchange Act, thus availing the SEC of its full range of powers, remedies and penalties under the Exchange Act. For example, Section 304 of Sarbanes-Oxley requires a CEO or CFO to pay back certain compensation when the company's misconduct requires it to restate its financial statements due to its material noncompliance with any financial requirement under the securities laws. *See SEC* v. *Jenkins*, 718 F. Supp. 2d 1070 (D. Ariz. 2010) (holding that reimbursement obligation under Section 304 does not require that a CEO or CFO have engaged in specific misconduct or even been aware of financial misconduct). Sarbanes-Oxley also expands Exchange Act remedies by providing that, in civil enforcement actions brought by the SEC, courts may grant any equitable relief that is appropriate for protection of investors, which suggests broader court oversight of (and monetary remedies against) violators of the securities laws than was the case before Sarbanes-Oxley was passed. Except with respect to recovery of profits from prohibited sales during a blackout period (*i.e.*, a period when the ability of participants in a participant-directed retirement plan to take certain actions is temporarily

suspended) and suits by “whistleblowers,” *see, e.g.*, *Lawson* v. *FMR LLC*, 134 S. Ct. 1158, 1165-68 (2014) (holding that whistleblower protection extends to employees of private contractors of publicly held companies), Sarbanes-Oxley does not expressly create new private rights of action for violations of its provisions. *See Beckett* v. *Brinx Res., Ltd*., 2014 WL 1394160, at *4 (D. Nev. Mar. 24, 2014) (discussing the limited nature of private rights of action created under Sarbanes-Oxley).

However, Sarbanes-Oxley affects existing private rights of action under the Exchange Act by (a) lengthening the general statute of limitations applicable to private securities fraud actions to the earlier of two years after discovery of the facts constituting the violation or five years after the violation (*see* discussions of individual statutes of limitations, *infra*) and (b) expanding reporting and disclosure requirements, which could potentially expand the range of actions that can be alleged to give rise to private suits under Sections 10(b) and 18 of the Exchange Act and SEC Rule 10b-5.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), Pub. L. No. 111-203, 124 Stat. 1376 (2010), enacted in response to the financial crisis of 2008-2009. While this law primarily addresses financial regulations and corporate governance issues, it does contain provisions affecting securities law liability, such as increasing exposure to liability under the federal securities laws of credit ratings agencies and establishing new incentives and protections for whistleblowers. With respect to the specific provisions of the federal securities laws covered by this post, Dodd-Frank amended § 20(e) of the Exchange Act to augment the SEC’s authority to pursue civil enforcement actions alleging aiding and abetting of Exchange Act violations by modifying the requisite state of mind to encompass “reckless,” in addition to “knowing,” acts, and adding § 15(b) to the Securities Act to empower the SEC to pursue actions premised on knowingly or recklessly aiding or abetting violations of that act (and adding similar provisions to the Investment Company Act of 1940 and the Investment Advisers Act of 1940). Dodd-Frank §§ 929M, 929N, 929O.

The complete publication is available here.