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Chapter 14

UNITED STATES

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I OVERVIEW

i Sources of law

The foundation of securities law in the United States is a series of New Deal-era federal statutes enacted between 1933 and 1940. Securities regulation in the United States had traditionally been left to the individual states. But the stock market crash of 1929 and the ensuing depression persuaded Congress that federal legislation was necessary to restore investor confidence in securities markets. Congress thus enacted the Securities Act of 1933 (the Securities Act), which generally regulates the issuance of new securities, and the Securities Exchange Act of 1934 (the Exchange Act), which generally regulates secondary trading of securities after they are issued. Since their enactment, the Securities Act and the Exchange Act have constituted the twin pillars of securities regulation in the United States.

These foundational statutes were soon supplemented by additional federal laws designed to fill out the regulatory framework: the Commodity Exchange Act of 1936, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. In addition to establishing general rules governing disclosure in securities trading, these statutes created a number of federal administrative agencies, including most prominently the Securities and Exchange Commission (SEC), empowered to announce rules that interpret and provide for the enforcement of the federal securities statutes. These regulatory agencies are supplemented in turn by self-regulatory organisations, including the Financial Industry Regulatory Authority (FINRA) and the various securities exchanges, which issue their own rules and police their membership

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under the oversight of the SEC. Finally, judicial decisions interpreting the securities laws and regulations are an important source of securities law in the United States.

Over the past two decades, Congress has augmented this federal regulatory scheme through a spate of new legislation, including, most importantly:

a the Private Securities Litigation Reform Act of 1995 (PSLRA), which amended the Securities Act and the Exchange Act with the objective of reducing the incidence of meritless private securities litigation;

b the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which further amended the Securities Act and the Exchange Act to ensure that securities litigation would be channelled to the federal courts;

c the Commodity Futures Modernization Act of 2000, which revamped the Commodity Exchange Act of 1936 with a particular focus on strengthening regulation of the futures market and relaxing oversight of swap agreements;

d the Sarbanes-Oxley Act of 2002, which sought to enhance public disclosure, improve the quality and transparency of financial reporting and auditing, and strengthen penalties for securities law violations;

e the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), which increased exposure to liability under the federal securities laws of credit-ratings agencies and expanded the SEC's power to pursue enforcement actions premised on knowingly or recklessly aiding or abetting violations of the Securities Act, the Investment Company Act, and the Investment Advisers Act; and

f the Jumpstart Our Business Startups Act of 2012 (the JOBS Act), which instructed the SEC to write rules governing capital formation, disclosure and registration requirements.

The full effect of this new wave of federal securities legislation is yet to be determined, as the agencies charged with establishing regulations under Dodd-Frank and the JOBS Act continue to implement the statutes and the federal courts interpret their provisions. What is certain is that the recent legislation is altering the scope and character of securities regulation in the United States.

In addition to these federal sources of law, state law regulating the securities markets (often called 'blue sky' laws) continues to exist and state corporate law has created a fiduciary duty of candour that often imposes disclosure obligations similar to federal law.

ii Regulatory authorities

American securities law is enforced by government agencies, self-regulatory organisations, and private litigation. While the SEC is empowered to pursue civil enforcement actions, all criminal actions under the federal securities laws are prosecuted by the United States Department of Justice. Self-regulatory organisations such as FINRA and the securities exchanges have more limited enforcement powers; they can fine, suspend or bar their members from participating in certain aspects of the securities industry. Private litigants can sometimes avail themselves of state and federal statutes to seek monetary damages and occasionally injunctive relief.

Most civil enforcement actions – that is, lawsuits brought by the government to enforce the law or by investors to recover damages under the law – can be brought only in the federal courts. Government agencies such as the SEC can also bring administrative proceedings, which are presided over by administrative law judges. Criminal prosecutions proceed through the court system.

Self-regulatory organisations enforce their rules by pursuing formal complaints before internal adjudicators. For example, formal complaints filed by FINRA are presented before FINRA's Office of Hearing Officers. The determinations of this Office can be appealed before FINRA's National Adjudicatory Council, the determinations of which can in turn be reviewed by the SEC and then the federal courts.

iii Common securities claims

The most common securities claims under US law seek to enforce rights under Sections 11, 12, and 17 of the Securities Act and Sections 10, 13, and 14 of the Exchange Act. Monetary damages are available under each of these provisions for civil violations. Criminal penalties are generally available where a person or corporation 'willfully' violates the provisions of the Securities Act or the Exchange Act.[2]

Sections 11 and 12 of the Securities Act provide buyers a cause of action to recover for violations of the mandatory disclosure rules governing prospectuses and registration statements: Section 11 makes issuers responsible for a false or misleading registration statement liable in damages to any and all purchasers regardless of whom they bought from, while Section 12 allows a purchaser to rescind his or her purchase of securities, or to recover damages from the issuer if the purchaser no longer holds the stock, provided that the seller used a false or misleading prospectus or statement in making the sale. Section 17 is the general antifraud provision of the Securities Act, governing all sales by an issuer and prohibiting practices that would defraud a purchaser of securities.

Section 10 of the Exchange Act empowers the SEC to issue regulations regulating short sales, stop-loss orders and the use of manipulative or deceptive devices in the purchase or sale of securities. The SEC has promulgated a large number of rules under Section 10, the most important of which is Rule 10b-5, which is patterned closely on Section 17 of the Securities Act and generally prohibits fraud in the exchange of securities. Rule 10b-5 is by far the most important civil liability provision of the securities law. The great majority of private securities actions seek damages under Rule 10b-5 and the US regulation of insider trading is largely rooted in the application of that rule.

Section 13 of the Exchange Act imposes reporting requirements on issuers, large institutional investment managers, and shareholders who acquire a greater than 5 per cent stake in a security. Under Regulation 13D, a report must be made to the SEC within 10 days after the 5 per cent threshold has been crossed.

Section 14(a) and (b) empower the SEC to regulate the solicitation of proxies. Among the rules the SEC has issued under this authority is Rule 14a-9, which prohibits solicitation via false or misleading proxies. Section 14(d), as implemented in Regulation 14D, substantively regulates and requires disclosure in connection with tender offers by

2 15 U.S.C. Sections 77x, 78ff.

bidders seeking to own more than 5 per cent of a publicly traded security. Section 14(e) and Rule 14e-3 broadly prohibit fraud in connection with the making of tender offers.

Secondary liability for securities law violations is also possible in some circumstances. A defendant can be held answerable for another person's primary violations of the securities laws under Section 15 of the Securities Act or Section 20 of the Exchange Act, as well as by application of the common law doctrines of respondeat superior, aiding and abetting, or conspiracy. Section 15 imposes secondary liability on controlling persons for primary liability of 'controlled persons' under Sections 11 and 12 (but not 17) of the Securities Act. Section 20 imposes secondary liability on controlling persons for primary liabilities of controlled persons under any provision of the Exchange Act.

Administrative regulations define control, in related contexts, as 'the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise',[3] but exactly who meets this standard has never been completely clear. Controlling shareholders, directors, and even lenders can be controlling persons, where they have the power or potential power to influence the activities of the controlled person.

Up until the 1994 decision of the Supreme Court in *Central Bank of Denver*,[4] a majority of US courts had held that civil liability could be imposed on those who aided and abetted primary violations of the securities laws. *Central Bank* swept away these precedents when it held that Section 10(b) of the Exchange Act would not support a cause of action for aiding and abetting. Moreover, the Court suggested that aiding and abetting liability is unavailable under any of the liability provisions of the Acts.

Following *Central Bank*, lower federal courts grappled with whether parties, such as accountants and lawyers, traditionally subject to liability under an aiding and abetting theory may be made subject to primary liability for their role in preparing misleading information. In some federal circuits, notably the Ninth, 'preparatory liability' of this kind was held to attach even if a misstatement was made by another party. But throughout much of the country, courts have restricted this preparatory liability. The majority of courts have held that, under *Central Bank*, a third party may not be held liable by virtue of its participation in the preparation of a misrepresentation; rather, the party must actually make a false or misleading statement to be liable.

In the years since *Central Bank*, the Supreme Court has twice extended its holding. In its 2011 *Janus Capital* opinion, the Court held that Rule 10b-5 liability may only be imposed on the 'maker' of the statement alleged to be materially false or misleading.[5] Three years earlier, in *Stoneridge Investment Partners*,[6] the Court rejected a theory of 'scheme' liability under which plaintiffs brought Rule 10b-5 actions against secondary actors, such as investments banks, that had no duty to disclose and did not prepare or participate in preparing a corporation's financial misstatements.

3 17 C.F.R. Section 230.405

4 *Central Bank of Denver, NA v. First Interstate Bank of Denver, NA*, 511 U.S. 164 (1994).

5 *Janus Capital Grp, Inc. v. First Derivatives Traders*, 131 S. Ct. 2296, 2302 (2011).

6 *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc*, 552 U.S. 148 (2008).

Importantly, these restrictions on aiding-and-abetting liability do not apply to SEC civil enforcement actions. To the contrary, the PSLRA created a new Section 20(e) of the Exchange Act, which expressly authorised the SEC to seek injunctions or civil money penalties from those who knowingly aid or abet primary violations. Liability under Section 20(e) was broadened by Dodd-Frank, which also created a parallel Section 15(b) of the Securities Act. As currently written, Sections 20(e) and 15(b) allow the SEC to pursue actions against parties who knowingly or recklessly aid and abet another party's violation of the securities laws.

II PRIVATE ENFORCEMENT

i Forms of action

Nearly all private US securities enforcement is through class action litigation in the federal courts. Where a corporation is itself the entity that suffered injury under the securities laws, derivative actions can be pursued. This litigation is usually 'lawyer-driven', relying on plaintiffs' lawyers to enforce the rights of absent class members. Class action lawyers typically derive their fees from the recovery obtained at the end of the action.

Most private securities class actions are brought under Sections 11 and 12 of the Securities Act and Sections 10 and 14 of the Exchange Act. Plaintiffs' burden of proof and the defences available to a defendant will vary depending on which statutory provision is invoked. These provisions can also be civilly enforced by the public authorities, or support criminal prosecution if a violation was wilful.

One notable impediment to private claimants seeking remedies under the US securities laws is the frequent absence of a private right to sue. While the right for individual buyers and sellers to bring suit to recover actual losses is well-established for claims of fraud under Section 10 of the Exchange Act and some other statutory provisions, it should not be assumed that private plaintiffs can sue to redress conduct that violated the securities laws. In recent years, federal courts have been generally unwilling to imply new private rights of action where Congress has not explicitly provided one. As such, certain areas of enforcement are exclusively in the hands of government authorities.

An additional barrier that plaintiffs must surmount is the need to show 'standing' to sue. The contours of the standing requirement vary from one statutory provision to the next, but in general a plaintiff must show that he or she is the type of party who is authorised to sue under the statute. For example, the Supreme Court has held that to bring an action under Rule 10b-5, a plaintiff must show that he purchased or sold securities in the transaction complained of.[7] These standing requirements are reviewed where relevant in the discussion below. Note, however, that these obstacles to suit – standing and a private right of action – do not apply to the Securities and Exchange Commission, which can bring an action on behalf of the government under nearly all provisions of the securities laws.

7 *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731-32 (1975) (offerees of unconsummated offers to purchase cannot sue under Rule 10b-5).

Because the federal securities laws are generally disclosure-based (rather than contract-based), a complaining plaintiff will usually bear the burden of establishing that an issuer or seller traded securities on the basis of a material misstatement or omission. Indeed, the requirement that any misstatement be 'material' recurs throughout US securities law and applies to most private and government enforcement actions. The leading case on materiality is *TSC Industries, Inc v. Northway, Inc*,[8] in which the Supreme Court defined a material fact as one to which there is a substantial likelihood that a reasonable investor would attach importance in making a decision because the fact would significantly alter the 'total mix' of available information.[9] Some courts have held that false statements or omissions are not materially misleading as long as the market possessed the correct information.[10] Additionally, courts have held that actionable statements must be sufficiently 'concrete' and 'specific,' as opposed to 'single, vague statement[s] that are essentially mere puffery'.[11]

Securities Act: Section 11

To bring a securities claim under Section 11(a) of the Securities Act, a plaintiff must show that a registration statement 'contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading'.[12] Once a plaintiff satisfies this burden, then Section 11(a) makes liable the issuer, the directors of the issuer, anyone named in the registration statement as about to become a director of the issuer, every person who signed the registration statement, every expert (e.g., accountant or appraiser) who was named as having certified or prepared the misleading part of the registration statement, and every underwriter of the security. The plaintiff need not show that he relied upon the misstatements or that any defendant acted in bad faith.

Several courts have held that to establish standing, a Section 11 plaintiff must 'plead that [his or her] stock was issued pursuant to the public offering[s] alleged to be defective'.[13] However, most courts have held that stock purchased in a secondary market is 'issued pursuant to the public offering' if the plaintiffs can trace their securities to the challenged registration.[14]

8 426 U.S. 438 (1976).

9 Id. at 449 (defining 'material' in the context of Section 14 of the Exchange Act). The definition is now nearly universally applied under all securities liability provisions.

10 See, e.g., *Lowinger v. Pzena Inv Mgmt Inc*, 341 F. App'x 717 (2d Cir. 2009).

11 *In re N Telecom Ltd Sec Litig*, 116 F. Supp. 2d 446, 466 (S.D.N.Y. 2000) (alteration in the original and internal quotation marks omitted).

12 15 U.S.C. Section 77k(a).

13 *Bernstein v. Crazy Eddie, Inc*, 702 F. Supp. 962, 972 (E.D.N.Y. 1988), vacated on other grounds, 714 F. Supp. 1285 (E.D.N.Y. 1989).

14 See, e.g., *DeMaria v. Andersen*, 318 F.3d 170, 178 (2d Cir. 2003). The Fifth, Eighth, Ninth, and Tenth Circuits do not limit Section 11 standing to direct purchasers in the public offering. See *Rosenzweig v. Azurix Corp*, 332 F.3d 854, 871-73 (5th Cir. 2003); *Lee v. Ernst &*

An issuer has virtually no defence under Section 11; it is effectively strictly liable for material misstatements and omissions in registration statements. Assuming a material misstatement, an issuer's only hope of avoiding liability is to prove that the plaintiff knew of the misstatements or omissions when the trade occurred. However, other defendants have a variety of defences under Section 11(b). Thus, a party named in a registration statement can avoid liability if he or she resigns and informs the SEC of the false or misleading statement before the registration statement becomes effective. In addition, under Section 11(b)(3), a non-issuer defendant can avoid liability if he or she can show reasonable grounds for believing that the alleged misstatements were true. The degree of investigation sufficient to serve as 'reasonable grounds' varies by category of defendant – while accountants are largely governed by professional standards, underwriters are subject to much stricter due diligence obligations.

Securities Act: Section 12

Under Section 12(1), any person who offers or sells a security required to be registered under the Securities Act but not registered is liable to the person purchasing the security. Under Section 12(2), any person who by the use of any means of interstate commerce offers or sells a security on the basis of a materially false or misleading prospectus or materially false or misleading oral statements is liable to the person purchasing from him, unless he can show that he did not know, and could not in the exercise of reasonable care have known, of the falsehood or omission. Unlike Section 11 and Section 12(1), which apply only to securities that must be registered under the Securities Act, Section 12(2) applies to all securities except those specifically exempted.

To succeed in a Section 12 claim, a plaintiff need not show that he or she relied on the misstatements or that the defendant acted in bad faith. However, no liability will attach in a private action based on certain statutorily defined 'forward-looking statements' unless the plaintiff proves actual knowledge of the false or misleading nature of the statement on the part of a natural person making the statement or on the part of an executive officer approving the statement made on behalf of a business entity.[15] In addition, a defendant can avoid Section 12(2) liability by showing that any claimed depreciation in a security's value was not caused by the defendant's misstatements or omissions.[16]

Exchange Act: Section 10

Section 10 authorises the SEC to prescribe rules addressing prohibited securities trading practices. Under Section 10(a), the SEC is empowered to prohibit short sales and the use of stop-loss orders for securities registered under the Exchange Act or traded on national security exchanges. Under Section 10(b), the SEC is empowered to prohibit 'the use of a manipulative or deceptive device or contrivance' in connection with the purchase or sale

Young, LLP, 294 F.3d 969 (8th Cir. 2002); *Joseph v. Wiles*, 223 F.3d 1155, 1159-61 (10th Cir. 2000); *Hertzberg v. Dignity Partners, Inc*, 191 F.3d 1076, 1080-81 (9th Cir. 1999).

15 15 U.S.C. Section 77z-2(c)(1)(B).

16 15 U.S.C. Section 77l(b).

of any securities or in connection with security-based swap agreements. While there are currently 11 SEC-promulgated rules in force under Section 10(b), the most important by far is the general anti-fraud rule, Rule 10b-5. Rule 10b-5 prohibits use of any means of interstate commerce to (a) employ any device, scheme or artifice to defraud; (b) make material misstatements or omissions; or (c) engage in any course of business that operates as a fraud against any person, in connection with the purchase or sale of any security or securities-based swap agreement. This rule is the great engine of private securities enforcement in the United States.

In general, to prevail on a Rule 10b-5 claim, a plaintiff must prove that the defendant: (1) made a false statement or an omission of material fact (2) with *scienter* (3) in connection with the purchase or sale of a security (4) upon which the plaintiff justifiably relied[17] and (5), which proximately caused (6) the plaintiff's economic loss.[18] The most important violations of Rule 10b-5 fall into three categories:

a common fraud in face-to-face transactions by sellers, purchasers, brokers and others;

b false or misleading statements of material fact by corporate insiders or others that affect the prices in which securities trade; and

c trading on material non-public information by corporate insiders and their tippees (insider trading).

There has been substantial debate and disagreement in the courts over how to construe the reliance element of Rule 10b-5 in the context of class actions. The difficulty is that in order to proceed as a class under the Federal Rules of Civil Procedure, plaintiffs must show that common questions of law or fact 'predominate over any questions affecting only individual members'.[19] But whether a particular buyer or seller relied on an alleged misstatement is typically an individualised question. Thus, if Rule 10b-5 were interpreted to require proof of individual reliance on defendants' misstatements, it would be more challenging for plaintiffs' lawyers to bring claims on a class basis.

The Supreme Court rode to the rescue of plaintiffs in *Basic Inc v. Levinson*,[20] endorsing a 'fraud-on-the-market' theory under which courts may presume that '[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price.'[21] This theory obviates the need for proof of individual reliance

17 Where a Rule 10b-5 claim is based on omissions, rather than misrepresentations, the Supreme Court has held that proof of reliance is not necessary once the materiality of the omissions is shown. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972). The lower courts have understood *Affiliated Ute* as creating a rebuttable presumption of reliance once materiality is shown. See, e.g., *Castellano v. Young & Rubicam, Inc*, 257 F.3d 171, 186 (2d Cir. 2001). In addition, there is no requirement that reliance be shown in SEC injunctive or criminal actions under Rule 10b-5.

18 See, e.g., *Dura Pharm Inc v. Broudo*, 544 U.S. 336, 341 (2005).

19 Fed. R. Civ. P. 23(b)(3).

20 485 U.S. 224 (1988).

21 Id. at 247.

and facilitates class certification. However, the fraud-on-the-market presumption is only available if a plaintiff can allege and prove that the market was 'efficient' — which is to say that market prices were responsive to new, material news. In order to establish (or refute) the claim of market efficiency, parties present economists armed with event studies analysing how the relevant market reacted to new information.

The Supreme Court has also clarified that courts should not presume that a misstatement caused an inflated purchase price in Rule 10b-5 cases. In *Dura Pharm Inc v. Broudo*,[22] the Court unanimously held that 'an inflated purchase price will not itself constitute or proximately cause the relevant economic loss.'[23] Following *Dura*, plaintiffs in fraud-on-the-market and other Rule 10b-5 cases must prove that their economic losses were actually attributable to a defendant's misrepresentations.

In addition, the Supreme Court has repeatedly examined the impact that Section 10(b)'s 'in connection with' requirement has on plaintiff standing. As noted above, the Court has generally required that a Section 10 plaintiff demonstrate that he or she was misled into purchasing or selling securities.[24] More recently, the Court has clarified this standard, holding in *Wharf (Holdings) Ltd v. United Int'l Holdings, Inc*,[25] that the sale of an option to buy stock while secretly intending never to honour it also falls within the 'in connection with' language. The Court again revisited the scope of Section 10(b) in *SEC v. Zandford*,[26] holding that the provision applied to a defendant broker who, by selling a client's securities and transferring the proceeds to his own account, stole money from a discretionary account. Most recently, the Court held that not only is a Section 10 plaintiff not permitted to sue under a theory that false or misleading statements led them *not* to buy or sell shares, but that such 'holder' transactions are nevertheless preempted by SLUSA and barred in state court as well.[27]

Insider trading in violation of Section 10

Since the decision of the SEC in *Cady, Roberts & Co*,[28] insider trading – trading on material non-public information – by both corporate insiders and their tippees has been viewed by the SEC and the courts as a violation of Rule 10b-5. As such, a range of defendants can be held liable: insiders who trade on insider information; insiders who disclose material non-public information to others who may then trade (tippers); and the third-party traders who are tipped off by insiders (tippees).

This does not mean that corporate insiders have a duty to disclose all material information to the public.[29] Rather, their duty is to disclose or to abstain from trading

22 544 U.S. 336 (2005).

23 Id. at 341.

24 See subsection ii, *infra*.

25 532 U.S. 588 (2001).

26 535 U.S. 813 (2002).

27 *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006).

28 40 S.E.C. 907, 912 (1961).

29 *SEC v. Tex. Gulf Sulphur Co*, 401 F.2d 833, 848 (2d Cir. 1968), aff'd in part, rev'd in part, 446 F.2d 1301 (2d Cir. 1971).

until disclosure takes place. The duty to disclose material non-public information or abstain from trading has been held to apply not only to registered securities, but to unregistered and delisted securities as well. Since this liability is rooted in Rule 10b-5, it is subject to the purchaser–seller standing requirements discussed above.

To succeed on an insider-trading claim under Rule 10b-5, a plaintiff generally must establish five basic elements: (1) the buying or selling of a security or the tipping thereof (2) on the basis of information about the security that is (3) non-public, (4) material and (5) where trading without disclosure constitutes a breach of a fiduciary duty or other relationship of trust and confidence owed to the source of the information.

Other than materiality (discussed under 'Forms of action', *supra*), the most complex of these elements is the last – the rule that insider-trading liability can attach only if the trading constitutes a breach of a duty. This element is generally satisfied under one of two established theories. Under the 'classical' theory, a corporate insider or 'temporary insider' working for the benefit of a corporation breaches his duty to the corporation and its shareholders by using confidential corporate information to trade in the corporation's stock for his or her personal benefit.[30] Under the 'misappropriation' theory, a tipper or trader who has no duty to the issuer or to shareholders may nevertheless be liable where he or she obtains confidential information in breach of a duty owed to the source of the information. The misappropriation theory was approved by the Supreme Court in *United States v. O'Hagan*,[31] where the defendant was a lawyer who traded based on the information that one of his law firm's clients was planning a tender offer. In Rule 10b5-2, the SEC has enumerated broad categories which give rise to a duty of trust or confidence to a source of information under the misappropriation theory.

Insider-trading tippees can also be sued or prosecuted under Section 10 and Rule 10b-5. Under the standard established by the Supreme Court in *Dirks v. SEC*,[32] a tippee is liable where: (1) an insider receives a 'direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings'; and (2) the tippee knew or had reason to know of the tipper's breach of duty to an issuer.[33] As discussed in Section V, *infra*, a recent case from the Second Circuit has imposed a further requirement that the tippee be aware of both the breach of duty and the personal benefit received by the insider.

Rule 14a-9

Rule 14a-9 prohibits any proxy solicitation made pursuant to Section 14 of the Exchange Act that 'contain[s] any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication [...]

30 See *Cady, Roberts & Co*, 40 S.E.C. 907, 912 (1961); *Chiarella v. United States*, 445 U.S. 222 (1980).

31 521 U.S. 642 (1997).

32 463 U.S. 646 (1983).

33 Id. at 663.

which has become false or misleading'.[34] To succeed on a Rule 14a-9 claim, a plaintiff must establish that a proxy statement contained a material misrepresentation or omission that caused the plaintiff injury and that the proxy solicitation itself was an essential link in accomplishing the transaction.

Unlike Section 10(b), Section 14(a) does not require a showing of manipulative or deceptive conduct. As a result, most courts require proof of negligence, not *scienter*. However, some courts have adopted a more nuanced approach to the *scienter* requirement. For example, the Eighth Circuit has held that while proof of negligence suffices for corporate officer defendants, *scienter* must be shown where the defendant is an accountant or an outside director.[35]

Rule 14e-3

In the context of a tender offer, Rule 14e-3(a) prohibits any person 'who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from' the tender offeror, the issuer, or any officer, director, partner, employee, or any other person acting on behalf of the offeror to trade in the affected securities unless the information and its source are 'publicly disclosed' 'within a reasonable time' before the trade.[36] Subsection (d) of the Rule prohibits tipping in the tender-offer context, barring certain persons from communicating material non-public information relating to the tender offer where it is reasonably foreseeable that such communication is likely to result in a violation of Rule 14e-3. Rule 14e-3 has the effect of broadening the scope of insider-trading liability in the tender-offer context by dispensing with the requirement that a breach of fiduciary duty be shown.

Exchange Act: Section 16

Section 16 of the Exchange Act provides another important source of liability for insider trading. Section 16(a) requires certain insiders to report their transactions and positions in their employers' securities. Section 16(c) bars insiders from shorting their employers' equity securities. Section 16(b) permits a corporation (or derivative plaintiff) to recover short-swing profits from insider trades within a six-month period.

By its terms, the liability created under Section 16(b) is sharply circumscribed, affecting only 'short-swing' profits enjoyed by a defined class of insiders. However, where an insider runs afoul of the provision, he or she must disgorge all profits.

ii Procedure

In general, plaintiffs bringing a complaint in federal court must allege facts sufficient to render their claim plausible on its face, but must allege fraud with particularity. The PSLRA codifies a heightened pleading standard imposed for securities fraud claims brought under the Exchange Act. Under the PSLRA, a securities fraud claim must

34 17 C.F.R. Section 240.14a-9(a).

35 See *SEC v. Das*, 723 F.3d 943, 953-54 (8th Cir. 2013).

36 17 C.F.R. 240.14e-3(a).

specify each statement alleged to have been misleading, identity the speaker, state when and where the statement was made, plead with particularity the elements of the false representation, plead with particularity what the person making the representation obtained and explain the reason or reasons why the statement is misleading. In addition, where *scienter* is an element of the securities claim, plaintiffs must 'state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind'.[37] Often, a defendant will test the adequacy of a private securities complaint by bringing a motion to dismiss soon after filing.

Federal discovery procedures are liberal, coupling broad mandatory disclosures with invasive depositions, subpoenas, and interrogatories. Under the PSLRA, however, in any private action brought under the Exchange Act, all discovery is stayed while a motion to dismiss is pending unless the court finds that particularised discovery is necessary to preserve evidence or prevent prejudice.

iii Settlements

Far more often than not, securities suits are settled rather than litigated to trial. Since securities lawsuits are typically brought as class actions, their settlement can bind absent class members and judicial review of such settlements must comply with Federal Rule of Civil Procedure 23 (Rule 23). Rule 23 requires the court to conduct a hearing and to approve a settlement only after a finding that it is 'fair, reasonable, and adequate'. In applying this standard, the courts look to a range of factors, including:

> *1) the complexity, expense and likely duration of the litigation; (2) the reaction of the class to the settlement; (3) the stage of the proceedings and the amount of discovery completed; (4) the risks of establishing liability; (5) the risks of establishing damages; (6) the risks of maintaining the class action through trial; (7) the ability of the defendants to withstand a greater judgment; (8) the range of reasonableness of the settlement fund in light of the best possible recovery; (9) the range of reasonableness of the settlement fund to a possible recovery in light of all the attendant risks of litigation.*[38]

Under Federal Rule of Civil Procedure 23(e)(5), '[a]ny class member may object to [a proposed settlement subject to judicial review].'

Attorneys' fees are also subject to some degree of judicial review in the securities class action context. Under the PSLRA, '[t]otal attorneys' fees and expenses awarded by the court to counsel for the plaintiff class' in an Exchange Act lawsuit cannot 'exceed a reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class'.[39] More generally, Federal Rule of Civil Procedure 23(h) permits a court to award class counsel 'reasonable attorney's fees and non-taxable costs that are

37 15 U.S.C. Section 78u-4(b)(2).

38 *In re Prudential*, 148 F.3d 283, 317 (3d Cir. 1998) (reviewing the settlement of claims brought under Sections 10(b) and 20(b) of the Exchange Act).

39 15 U.S.C. Section 78u-4(a)(6).

authorized by law or by the parties' agreement'.[40] This 'reasonableness' determination can be guided by retainer agreements, fee stipulations embodied in settlement agreements, and other fee agreements entered into between lead plaintiffs and class counsel.[41] A 2013 study examining judicial review of attorneys' fees in securities class actions found that the existence of an arm's-length fee agreement correlates negatively with judicial reductions of fee requests and awards.[42]

iv Damages and remedies

Different remedies are available for the common securities claims described above. For claims brought under Section 11 of the Securities Act, the measure of a plaintiff's damages is the decline in the value of his or her securities, quantified as the difference between purchase price and sale price. For Section 12 of the Securities Act, the remedy is rescission – the plaintiff tenders his securities to the defendant and receives his purchase price with interest. Where appropriate, a court can also order injunctive relief for a Securities Act plaintiff.[43]

Remedies available under Section 10, Rule 14a-9, Rule 14e-3, and Rule 10b-5 include both injunctive relief and damages. However, the measure of damages in all Exchange Act claims is limited to 'actual damages'. In the context of a Rule 10b-5 claim, the Supreme Court has held that this imposes an 'out-of-pocket' measure, which is the difference between the price paid or received for the security and its true value at the time of purchase.[44] In insider-trading cases brought under Rule 10b-5, a disgorgement remedy is often available, under which defendants are liable for the profits that they and their tippees obtained. Finally, at least where the plaintiff dealt face-to-face with the defendant and the securities purchased or sold have not been re-transferred, the plaintiff may elect to sue for rescission rather than damages. In a Rule 14a-9 claim, courts have allowed both out-of-pocket and disgorgement damages, as well as fashioning damages designed to give the plaintiff the benefit of the bargain they would have received had the misrepresentations been true.

III PUBLIC ENFORCEMENT

i Forms of action and procedure

The agencies charged with enforcing the securities statutes can proceed through a civil proceeding in court, an internal administrative proceeding, or a criminal prosecution.

40 Fed. R. Civ. P. 23(h).

41 See Lynn A Baker, Michael A Perino and Charles Silver, 'Setting Attorneys' Fees in Securities Class Actions: An Empirical Assessment', 66 *Vand. L. Rev.* pp.1677 and 1683–91 (2013).

42 Id., pp.1681–82 (finding that 'the court awarded a lower fee than the class counsel requested in about 18% of the cases we reviewed', but that 'evidence of an *ex ante* fee agreement [is] correlated with statistically and economically significant reductions in fee requests and awards, as well as with greater judicial deference to the requested fee').

43 *Deckert v. Independence Shares Corp*, 311 U.S. 282, 287-90 (1940).

44 *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972).

Notably, while the SEC is empowered to civilly prosecute securities law violators under any of the provisions discussed above, it can also call upon a range of other statutory provisions, including most importantly Section 17 of the Securities Act. Unlike private litigants, government enforcement agencies generally have standing to enforce all aspects of the federal securities laws.

Section 17 contains a range of proscriptions that collectively endow the SEC with substantial authority to punish fraudulent trading in securities. Sections 17(a)(1), (2), and (3), respectively, prohibit the use of any means of interstate commerce: (1) to employ any device, scheme or artifice to defraud; (2) to obtain money or property by means of material misstatements or omissions; or (3) to engage in any course of business that would operate as a fraud upon a purchaser. In keeping with the general scheme of the Securities Act, Section 17 protects only purchasers and operates only against sellers, unlike Section 10(b) of the Exchange Act, which operates against both purchasers and sellers. The Supreme Court has emphasised that each of Sections 17(a)(1), (2) and (3) contains different prohibitions, to be interpreted separately.[45] Most importantly, a defendant's bad faith need only be shown in a prosecution under Section 17(a)(1), not (2) or (3). Section 17's other liability provision, 17(b), prohibits publishing any description of any security without disclosing consideration received from any issuer, underwriter, or dealer of such security.

Regardless of the statutory provision that the SEC is enforcing, its investigations generally commence with an informal inquiry, requesting that the subject of an investigation voluntarily provide information or documents. The next step is the entry of a formal order of investigation, permitting SEC staff to issue investigative subpoenas. These orders are typically non-public. At the close of such an investigation, the SEC staff will issue a 'Wells notice' to the subject of the investigation, informing that person of the SEC's preliminary determination of whether securities laws were violated. Where the SEC has determined that no enforcement action will be brought, a termination notice can be sent.

If the SEC determines that there has been a violation of the securities laws, it can commence either a civil proceeding before a court or an internal administrative proceeding. In a civil proceeding, the SEC often seeks an injunction barring further violations of the securities laws and remedies to cure past violations. Remedies can include disgorgement of ill-gotten gains or civil monetary penalties. Damages can be placed in a 'fair fund' for disbursements to victims of a defendant's illegal practices. In an administrative proceeding, the SEC pursues an accelerated 'trial' before an administrative law judge (ALJ). The remedies available in this tribunal are much the same as in an ordinary court, though in an administrative proceeding the SEC can request a permanent cease-and-desist order rather than an injunction. In addition, the ALJ in an administrative proceeding can order that a defendant be barred from appearing or practising before the SEC, effectively debarring them from employment in the securities industries.

45 *Aaron v. SEC*, 446 U.S. 680, 695-97 (1980); *United States v. Naftalin*, 441 U.S. 768, 773-74 (1979).

Parallel SEC civil and criminal proceedings are not uncommon. Moreover, the SEC and other agencies sometimes refer matters to other agencies for enforcement action. Where the SEC has determined that a violation of securities laws is potentially criminal, it can refer the matter to the Department of Justice for criminal enforcement. In a criminal enforcement, the defendant is entitled to trial before a jury and conviction turns on whether the government can prove guilt beyond a reasonable doubt. Referrals can also be made to self-regulatory authorities (such as FINRA), other agencies (such as the Public Company Accounting Oversight Board) or state agencies.

Because the government authorities have the power to conduct extensive investigations before bringing action, they effectively enjoy discovery rights that greatly exceed even the liberal discovery provisions available in private civil litigation. For example, a criminal investigation can draw upon warrants, wiretaps and other investigative tools that are unavailable to both the SEC and private litigants.

ii Settlements

In negotiating settlements to securities claims, the public authorities have a number of tools at their disposal. In criminal investigations of corporate wrongdoers, the Department of Justice will often negotiate a deferred prosecution agreement (DPA) or non-prosecution agreement (NPA). In a DPA, the Department of Justice files a criminal case but defers prosecuting it, subject to the defendant's agreement to comply with established conditions. In an NPA, the government does not file a complaint, but the result is otherwise much the same. Under either agreement, the defendant typically admits to wrongdoing, waives applicable statutes of limitations, agrees to no longer violate the law, agrees to help the government prosecute other securities-law violators, and agrees that it will not disclaim the terms of the agreement. To secure such an agreement, the defendant often must also pay a substantial fine. In weighing whether to prosecute a corporation or negotiate a plea agreement, the Department of Justice looks to a range of factors, including: collateral consequences for a corporation's employees, investors and customers; collateral non-penal sanctions; the pervasiveness of criminal conduct; and the adequacy of the corporation's compliance programmes.[46]

Settlements are also a common conclusion for civil and administrative proceedings initiated by the SEC. Such agreements can impose many of the same conditions as DPAs and NPAs, including stipulated facts and assurances of remedial action to improve compliance and prevent future securities violations. While SEC settlements traditionally did not require the corporate defendant to admit wrongdoing, over the past five years the SEC has shifted to a more aggressive posture. Most recently, in November 2014, the Director of the SEC Division of Enforcement indicated that the SEC will be 'considering requiring admissions in certain types of cases where heightened accountability and acceptance of responsibility are in the public interest'.[47]

46 US Attorney's Manual 9-28.1000.

47 Remarks to the American Bar Association's Business Law Section Fall Meeting (Speech, Washington, DC, 21 November 2014), available at www.sec.gov/News/Speech/Detail/Speech/1370543515297. The SEC official went on to explain that '[a]dmissions will be

Both DPAs and SEC settlements must be filed with and approved by a federal judge. Historically, this review has been very lenient, but on occasion, judges will scrutinise proposed settlements critically and sometimes reject them outright.[48] NPAs are not filed with the courts, and are thus not subject to judicial review.

iii Sentencing and liability

Criminal convictions under the securities laws can result in both fines and, for natural persons, imprisonment. The maximum fines and terms of imprisonment are established by statute, with sentencing guidance provided by the US Federal Sentencing Guidelines. Fines for certain security frauds default to the actual loss associated with the fraud, while in other cases penalties are committed more liberally to the discretion of the sentencing authority.

Where the SEC assesses a civil money penalty for a corporation's violations of the securities laws, it principally looks to two considerations: 'the presence or absence of a direct benefit to the corporation as a result of the violation' and 'the degree to which the penalty will recompense or further harm the injured shareholders'. The SEC also considers seven additional factors: (1) 'the need to deter the particular type of offense'; (2) 'the extent of the injury to innocent parties'; (3) 'whether complicity in the violation is widespread throughout the corporation'; (4) 'the level of intent on the part of the perpetrators'; (5) 'the degree of difficulty in detecting the particular type of offense'; (6) the 'presence or lack of remedial steps by the corporation'; and (7) the 'extent of cooperation with [the] Commission and other law enforcement'.[49]

IV CROSS-BORDER ISSUES

For many years, American courts held that securities claims could be pursued against foreign entities where there was sufficient domestic 'conduct' or 'effects' to warrant extraterritorial application. In 2010, the Supreme Court overturned this line of precedent and held that Section 10(b) of the Exchange Act does not apply to securities transactions that take place wholly outside the United States.[50] The Court held that Section 10(b) 'reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States'.[51] In reaching this

considered in certain types of cases, including those involving egregious conduct, where large numbers of investors were harmed, where the markets or investors were placed at significant risk, where the wrongdoer posed a particular future threat to investors or the markets, where the defendant engaged in unlawful obstruction of the Commission's processes, or where admissions would significantly enhance the deterrence message of the action.'

48 See, e.g., *SEC v. Citigroup Global Markets, Inc*, 827 F. Supp. 2d 328 (S.D.N.Y. 2011).

49 SEC, 'Statement of the Securities and Exchange Commission Concerning Financial Penalties' (4 January 2006), available at https://www.sec.gov/news/press/2006-4.htm.

50 *Morrison v. Nat'l Austl Bank, Ltd*, 561 U.S. 247 (2010).

51 Id. at 273.

determination, the Court looked to the 'focus' of the statute's text, and concluded that 'the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases or sales of securities in the United States'.[52] This decision has been interpreted to apply to the Securities Act as well.

Since *Morrison*, plaintiffs have unsuccessfully advanced two arguments for allowing at least some foreign transaction claims to proceed under Section 10(b). First, some plaintiffs have contended that a security transaction takes place 'in the United States' if the purchase or sale order is made from the United States. Courts have not allowed civil actions relating to foreign issuers to proceed on that ground.[53] Second, some plaintiffs have argued that if a foreign issuer lists any portion of its securities on an American stock exchange, all foreign transactions in all foreign shares would be fair game. This theory has also been rejected as contrary to *Morrison*.[54]

In applying *Morrison*'s transactional analysis, the focus is on where the purchase or sale actually occurs. Transactions on an exchange presumptively take place where the exchange is located, but for other types of securities the answer is less clear. Notably, *Morrison*'s restriction has been interpreted not to bar the extraterritorial application of equitable relief provided by Section 21 of the Exchange Act, including by repatriating and freezing offshore assets.

V YEAR IN REVIEW

i Public and private enforcement

According to statistics compiled by NERA Economic Consulting, private plaintiffs filed 221 new federal class action securities cases in 2014, just one less than in 2013. The bulk of these, 76 per cent, alleged violations of Rule 10b-5, Section 11, or Section 12. The average settlement in 2014 dipped to US$34 million from US$86 million the previous year, with median settlement amounts of US$6.5 million and US$9.1 million, respectively. In aggregate, securities class action defendants paid out US$2.6 billion in 2014. Out of this total, class counsel received approximately US$619 million for fees and expenses. Including filings from previous years, there were approximately 653 securities class actions pending in the federal courts at the beginning of 2015.[55]

As for public enforcement, the SEC charged 80 people in cases involving insider trading in FY 2014 alone. Overall, the SEC filed a record 755 enforcement actions,

52 Id. at 266.

53 See, e.g., *Cornwell v. Credit Suisse Grp*, 729 F. Supp. 2d 620, 624 (S.D.N.Y. 2010).

54 See, e.g., *City of Pontiac Policemen's & Firemen's Ret Sys v. UBS AG*, 752 F.3d 173, 176 (2d Cir. 2014).

55 Renzo Comolli and Svetlana Starykh, 'Recent Trends in Securities Class Action Litigation: 2014 Full-Year Review' pp. 5, 23, 27, 28, 31 and 35 (NERA Economic Consulting 2015), available at www.nera.com/content/dam/nera/publications/2015/Full_Year_Trends_2014_0115.pdf.

and obtained orders totalling US$4.16 billion in disgorgement and penalties.[56] The government continues to pursue and sometimes achieve long prison sentences for targeted defendants.[57] Regulators continue to pursue novel investigations, including the SEC's recent complaint against a large bank for failing to maintain adequate controls to prevent insider trading (an offence that does not even require proof of any insider trading) and claims based on political intelligence (that is, trading in advance of a public disclosure of a change in government policy or the announcement of a revised interpretation of an agency rule, for example). And of course, the mere fact of an investigation – no matter whether it proves grounded in law or fact – can cause extreme injury to target companies and individuals.

The SEC has not been shy in broadcasting its aggressive posture. According to SEC Chair Mary Jo White, the commission's goal is 'to create an environment where you think we are everywhere—using collaborative efforts, whistleblowers and computer technology to expand our reach, focusing on gatekeepers to make them think twice about shirking responsibilities, and ensuring that even the small violations face consequences'.[58] White has stated that her goal is 'all-encompassing enforcement', which includes 'vigorous use of criminal, civil, and regulatory tools to enforce the securities laws'.[59]

ii Supreme Court decisions

Over the past year, the Supreme Court has issued several important securities law decisions, most of which avoid broad interpretive strokes in favour of incremental judicial lawmaking.

Omnicare, Inc v. Laborers District Council Construction Industry Pension Fund

In *Omnicare, Inc v. Laborers District Council Construction Industry Pension Fund*,[60] the Court rejected a lower court holding that an issuer's sincerely held opinion could constitute an 'untrue statement of a material fact' under Section 11 of the Securities Act. The Court reasoned that accurately disclosing a belief cannot amount to an untrue statement. But the Court also held that some genuinely held opinions could still be actionable, because Section 11 also proscribes statements that have 'omitted to state a

56 SEC, 'SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases' (16 October 2014), available at www.sec.gov/News/PressRelease/Detail/PressRelease/1370543184660.

57 For example, Matthew Martoma, a former trader for a high-profile hedge fund, received a nine-year sentence after his conviction for using inside information about the results of a clinical trial to trade in shares of two drug companies.

58 Mary Jo White, Remarks at the Securities Enforcement Forum (speech, Washington, DC, 9 October 2013), available at www.sec.gov/News/Speech/Detail/Speech/1370539872100#.UqB6cmTk9eE.

59 Mary Jo White, 'All-Encompassing Enforcement: The Robust Use of Civil and Criminal Actions to Police the Markets' (speech, 31 March 2014), available at www.sec.gov/News/Speech/Detail/Speech/1370541342996#.VG5Kh_Pnbug.

60 No. 13-435 (U.S. 24 March 2015).

material fact [...] necessary to make statements not misleading'. Omitted facts could render a genuinely held opinion misleading where investors expect that the opinion 'fairly aligns with the information in the issuer's possession at the time.' Accordingly, 'if a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from [the issuer's statement of opinion], then Section 11's omissions clause creates liability.' The Court counselled that 'to avoid exposure for omissions under Section 11, an issuer need only divulge an opinion's basis, or else make clear the real tentativeness of its belief.'

Halliburton Co v. Erica P John Fund, Inc

In *Halliburton Co v. Erica P John Fund, Inc*,[61] the Supreme Court declined the opportunity to limit or discard the fraud-on-the-market presumption of reliance that underlies many Rule 10b-5 class actions. But *Halliburton* did hold that Rule 10b-5 defendants can defeat class certification by demonstrating that alleged misstatements had no effect on price. Based on this holding, defendants can now cite news and analyst reports and other public information that shows how the supposedly undisclosed truth was already known to the market.

Chadbourne & Parke LLP v. Troice

In *Chadbourne & Parke LLP v. Troice*,[62] the Supreme Court held that SLUSA does not preclude state-law class actions where misrepresentations involve securities that are not traded on a national exchange, but that were claimed to have been backed by exchange-traded securities. The Court expressed concern that the broader interpretation of SLUSA would infringe on state efforts to combat non-securities fraud. By narrowing the application of SLUSA, the *Troice* decision throws a lifeline to plaintiffs hoping to bring securities-related fraud class actions in state courts.

iii The Second Circuit Court of Appeals

At the close of 2014, the Second Circuit Court of Appeals handed down an important insider trading decision in *United States v. Newman*.[63] The Court held that to be liable under Section 10(b) of the Exchange Act and Rule 10b-5, it must be proven (in a criminal case, beyond a reasonable doubt) that the tippee–defendant accused of insider trading 'knew of the tipper's breach, that is, he knew the information was confidential and divulged for "personal benefit"'. As in *Newman* itself, in future cases involving remote tippees, there may be 'no evidence that [the defendant] was aware of the source of the inside information', making it difficult for the government to prove that the ultimate tippee knew the information was divulged for a 'personal benefit'.

61 No. 13-317 (U.S. 23 June 2014).

62 No. 12-79 (U.S. 26 February 2014).

63 *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

The Second Circuit also contributed to important developments in the judicial review of SEC settlements.[64] In 2011, the Southern District of New York refused to approve a negotiated consent agreement between the SEC and Citigroup, faulting the settlement for failing to require that Citigroup admit wrongdoing. The Second Circuit stayed this decision in 2012 and, in June 2014, it issued a strongly worded opinion reversing the district court decision and reaffirming the bedrock principle that the parties to a controversy are in the best position to evaluate the competing considerations that inform the decision to settle. The Court of Appeals also rebuked the district court for failing to accord the SEC the 'significant deference' its policy judgements are owed, including with respect to whether, when and how to resolve enforcement proceedings. In reversing the district court ruling, the Second Circuit observed that '[t]he job of determining whether the proposed SEC consent decree best serves the public interest [...] rests squarely with the SEC.'

This decision from the Second Circuit does not prevent the SEC itself from seeking admissions of wrongdoing from defendants. In March 2014, the United States Attorney for the Southern District of New York announced that 'you can expect before long a significant financial institution will be charged with a felony or made to plead guilty to a felony, where the conduct warrants it.' Soon afterwards, two large international banking institutions pleaded guilty to conspiracy to aid tax evasion and conspiracy to violate US economic sanctions, respectively. As discussed above, the SEC has also begun requiring admissions in settlements of certain securities investigations.[65]

VI OUTLOOK AND CONCLUSIONS

In its report for FY 2014, the SEC has laid out a range of goals for the coming year. In continuing to implement Dodd-Frank, the agency intends to issue new regulations on the over-the-counter derivatives market and executive compensation. Under the JOBS Act, the SEC plans to adopt final rules to implement exemptions under the Securities Act for certain crowdfunded offerings.[66] More generally, the SEC plans to explore new rules governing: 'destabilizing trading strategies in vulnerable market conditions'; 'pre-trade transparency in the fixed income markets'; and conflicts of interest at credit-rating agencies. For enforcement, the agency has flagged 'complex financial products, gatekeepers, financial reporting, market structure, insider trading, investment advisers and private funds, and municipal securities' as priorities. The Enforcement Division's Microcap Fraud Task Force 'will continue its efforts to root out microcap fraud through the use of strategies like trading suspensions and efforts to target repeat players and gatekeepers'.

Looking beyond the SEC's announced priorities: the past year has seen considerable debate and outcry over activist investors' increasing practice of sharing information

64 *SEC v. Citigroup Global Markets, Inc*, 752 F.3d 285 (2d Cir. 2014).

65 See Section III.ii, *supra*.

66 SEC, Agency Financial Report: Fiscal Year 2014 at p. 39 (2014), available at www.sec.gov/about/secpar/secafr2014.pdf.

about their trading with other investors. This debate has been stoked by the joint efforts of hedge fund Pershing Square Capital Management and Valeant Pharmaceuticals to take over another pharmaceutical company, Allergan. Before publicly announcing its tender offer, Valeant informed Pershing Square of its plans. This allowed Pershing Square to acquire a large position before the tender offer was publicly disclosed, circumventing Regulation 13D's requirement that an SEC report be made within 10 days following the accumulation of a securities position that exceeds 5 per cent of outstanding shares. In addition, though Pershing Square and Valeant took steps to sidestep liability under Rule 14e-3, which generally bars insider trading in the context of a tender offer, a federal judge in California determined that there were 'serious questions' as to whether Pershing Square and Valent had violated the Rule.[67]

In light of the tactics pursued by Pershing Square and Valeant and other activist investors, moreover, there have been increasing public calls for an amendment to shorten the 10-day reporting window imposed by Section 13 and Regulation 13D. Petitions have been made for the SEC to reduce the reporting time to one day, to account for the increased pace of the modern marketplace and to bring US law into line with an emerging international consensus that more prompt notification of rapid accumulations of stock is necessary to protect market fairness and investor confidence.

The Second Circuit's holding in *Newman* is expected to spark a broader discussion on the limits of insider-trading laws. Recently, Supreme Court Justices Scalia and Thomas openly questioned the extent to which the courts should afford deference to the SEC's expansive insider-trading theories, calling for a case in which the issue can be squarely addressed.[68] Unless the Supreme Court or Congress speaks, it is impossible to have full confidence in the rule established by *Newman*. And even if *Newman* is universally followed, it leaves important questions open, for example, as to the elements of the misappropriation theory of insider trading.

As noted above, the SEC has increasingly begun bringing enforcement actions as administrative proceedings rather than civil suits in federal court. Critics of this trend have noted that, in the administrative forum, the hearing officer is an SEC administrative law judge and certain procedural protections for defendants are weaker. There have been several recent attempts to challenge the SEC's use of the administrative forum in particular cases on constitutional and other grounds. So far, these challenges have either failed on procedural grounds or been mooted by settlements. As the SEC continues to bring more cases administratively, a litigated decision on the merits becomes more likely.

The SEC has also been expanding its reliance on whistle-blower reports.[69] In 2014, the agency received 3,620 whistle-blower reports, the highest total since the

67 *Allergan, Inc., et al v. Valeant Pharmaceuticals Int'l, Inc, et al*, No. SACV 14-1214 DOC (C.D. Cal. Nov. 4, 2014).

68 *Whitman v. United States*, 574 U.S. __ (2014) (No. 14-29, Nov. 10, 2014) (Scalia, J and Thomas, J, concurring).

69 'Whistle-blowers' in this context are individuals who voluntarily provide the government with information related to a possible violation of the federal securities laws that has occurred, is ongoing, or is about to occur. Under the SEC's Whistleblower Program, the SEC will give

2011 creation of a bounty programme pursuant to Dodd-Frank. In an effort to give teeth to whistle-blower protections, the SEC recently brought its first enforcement action against a corporation that had required its employees to sign confidentiality agreements at the outset of interviews in internal investigations.[70] The SEC found that this practice violated rules under which corporations are barred from impeding whistle-blowing. This move could signal the beginning of a broader effort to ensure that corporate insiders are free to report securities violations to the SEC.

Lastly, the impact of the Supreme Court decision in *Morrison* on the extraterritorial application of US securities laws will continue to develop over the coming year. Courts continue to expand the reach of *Morrison*. Though *Morrison* dealt with civil liability, the Second Circuit Court of Appeals has held that *Morrison*'s holding applies equally to criminal prosecutions under Section 10(b) and Rule 10b-5.[71]

Dodd-Frank apparently intended to partially overrule *Morrison* by restoring a version of the 'conduct' and 'effects' test in cases brought by the United States and the SEC. However, the legislation sought to accomplish this by providing that federal courts have 'jurisdiction' to hear such cases. Since *Morrison* addressed the substantive reach of Section 10(b) and not the federal courts' jurisdiction, there is considerable debate as to Dodd-Frank's effect in this area. At this point, a number of courts have opined that Dodd-Frank reversed *Morrison* in the context of SEC enforcement actions, but it remains to be seen whether this trend will be widely adopted.

eligible whistle-blowers cash awards of between 10 and 30 per cent of the monetary sanctions that the government is able to collect on the basis of original information. See 17 C.F.R. Sections 240.21F-1 – 240.21F-17. Once this information has been made public, it can also provide the foundation for follow-on private lawsuits.

70 *In the Matter of Paradigm Capital Management, Inc. & Candace King Weir*, Exchange Act Rel. No. 72,393 (16 June 2014).

71 *United States v. Vilar*, 729 F.3d 62, 67, 70 (2d Cir. 2013).