The Securities Litigation Review

Third Edition

Editor
William Savitt

The LawReviews

PUBLISHER
Gideon Roberton

SENIOR BUSINESS DEVELOPMENT MANAGER
Nick Barette

BUSINESS DEVELOPMENT MANAGERS
Thomas Lee, Joel Woods

ACCOUNT MANAGERS
Pere Aspinall, Jack Bagnall,
Sophie Emberson, Laura Lynas

MARKETING AND READERSHIP COORDINATOR
Rebecca Mogridge

RESEARCHER
Arthur Hunter

EDITORIAL COORDINATOR
Gavin Jordan

HEAD OF PRODUCTION
Adam Myers

PRODUCTION EDITOR
Robbie Kelly

SUBEDITOR
Janina Godowska

CHIEF EXECUTIVE OFFICER
Paul Howarth

Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK

www.TheLawReviews.co.uk

ISBN 978-1-910813-64-5

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

PREFACE

This third edition of *The Securities Litigation Review* is a guided introduction to the international varieties of enforcing rights related to the issuance and exchange of publicly traded securities.

Unlike most of its sister international surveys, this review focuses on litigation – how rights are created and vindicated against the backdrop of courtroom proceedings. Accordingly, this volume amounts to a cross-cultural review of the disputing process. While the subject matter is limited to securities litigation, which may well be the world's most economically significant form of litigation, any survey of litigation is in great part a survey of procedure as much as substance.

As the chapters that follow make clear, there is great international variety in private litigation procedure as a tool for securities enforcement. At one extreme is the United States, with its broad access to courts, relatively permissive pleading requirements, expansive pretrial discovery rules, readily available class-action principles and generous fee incentives for plaintiffs' lawyers. At the other extreme lie jurisdictions like China, where private securities litigation is complex, expensive, seldom remunerative and accordingly quite rare. As the survey reveals, there are many intermediate points in this continuum, as each jurisdiction has evolved a private enforcement regime reflecting its underlying civil litigation system, as well as the imperatives of its securities markets.

This review reveals an equally broad variety of public enforcement regimes. Canada's highly decentralised system of provincial regulation contrasts with Brazil's Securities Commission, a powerful centralised regulator that is primarily responsible for creating and enforcing Brazil's securities rules. Every country has its own idiosyncratic mixture of securities lawmaking institutions; each provides a role for self-regulating bodies and stock exchanges but no two systems are alike. And while the European regulatory schemes have worked to harmonise national rules with Europe-wide directives – an effort now challenged by the imminent departure of the United Kingdom from the European Union – few countries outside Europe have significant institutionalised cross-border enforcement mechanisms, public or private.

We should not, however, let the more obvious dissimilarities of the world's securities disputing systems obscure the very significant convergence in the objectives and design of international securities litigation. Nearly every jurisdiction in our survey features a national securities regulatory commission, empowered both to make rules and to enforce them. Nearly every jurisdiction focuses securities regulation on the proper disclosure of investment-related information to allow investors to make informed choices, rather than prescribing investment rules. Nearly every jurisdiction provides both civil penalties that allow wronged investors to recover their losses and criminal penalties designed to punish wrongdoers in the more extreme cases.

Equally notable is the fragmented character of securities regulation in nearly every important jurisdiction. Alongside the powerful national regulators are subsidiary bodies – stock exchanges, quasi-governmental organisations, trade and professional associations – with special authority to issue rules governing the fair trade of securities and to enforce those rules in court or through regulatory proceedings. Just as the world is a patchwork of securities regulators, so too is virtually each individual jurisdiction.

The ambition of this volume is to provide readers with a point of entry to these wide varieties of regulations, regulatory authorities and enforcement mechanisms. The country-by-country treatments that follow are selective rather than comprehensive, designed to facilitate a sophisticated first look at securities regulation in comparative international perspectives, and to provide a high-level road map for lawyers and their clients confronted with a need to prosecute or defend securities litigation in a jurisdiction far from home.

A further ambition of this review is to observe and report important regulatory and litigation trends, both within and among countries. This perspective reveals several significant patterns that cut across jurisdictions. In the years since the financial crisis of 2008, nearly every jurisdiction has reported an across-the-board uptick in securities litigation activity. Many of the countries featured in this volume have seen increased public enforcement, notably including more frequent criminal prosecutions for alleged market manipulation and insider trading, often featuring prosecutors seeking heavy fines and even long prison terms.

Civil securities litigation has continued to be a growth industry as the 2008 crisis has given rise to a new normal in the private enforcement of securities laws. While class actions are a predominant feature of US securities litigation, there are signs that aggregated damages claims are making significant inroads elsewhere. Class claims are now well established as part of the regulatory landscape in Australia and Canada, and there appears to be accelerating interest around the world in securities class actions and other forms of economically significant private securities litigation. Whether and where this trend takes hold will be one of the important securities law developments to watch in coming years.

This suggests the final ambition for *The Securities Law Review*: to annually reflect where this important area of law has been, and where it is headed. Each chapter contains both a section summarising the year in review – a look back at important recent developments – and an outlook section, looking towards the year ahead. The narrative here, as with the book as a whole, is of both divergence and convergence and divergence, continuity and change – with divergence and change particularly predominant this year, following political upheaval in the United States and Britain that could herald a sharp break from international cooperation and forceful government regulation in the global finance capitals of New York and London.

An important example is the matter of cross-border securities litigation, treated by each of our contributors. As economies and commerce in shares become more global, every jurisdiction is confronted with the need to consider cross-border securities litigation. The chapters of this volume show jurisdictions grappling with the problem of adapting national litigation systems to a problem of increasingly international dimensions. How the competing demands of multiple jurisdictions will be satisfied, and how jurisdictions will learn to work with one another in the field of securities regulation will be a story to watch over the coming years. We look forward to documenting this development and other emerging trends in securities litigation around the world in subsequent editions.

Many thanks to all the superb lawyers who contributed to this third edition. For the editor, reviewing these chapters has been a fascinating tour of the securities litigation world, and we hope it will prove to be the same for our readers. Contact information for our contributors is included in Appendix 2. We welcome comments, suggestions and questions, both to create a community of interested practitioners and to ensure that each edition improves on the last.

William Savitt
Wachtell, Lipton, Rosen & Katz
New York
June 2017

Chapter 21

UNITED STATES

William Savitt and Noah B Yavitz[1]

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 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;

1 William Savitt is a partner and Noah B Yavitz is an associate at Wachtell, Lipton, Rosen & Katz.

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 continue to implement the statutes and the federal courts interpret their provisions. Moreover, the recent US election has led to further uncertainty, raising the likelihood that recent legislation and rulemaking may be revisited under the new presidential administration. What is certain is that the recent legislation will continue to alter 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 – although the binding power of these administrative proceedings is a hotly litigated issue, as explained further below (see Section VI, *infra*). 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 'wilfully' 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 restricting 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 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

2 15 U.S.C. Sections 77x, 78ff.
3 17 C.F.R. Section 230.405.

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.

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

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) See *In re Pfizer Sec. Litig.*, 819 F.3d 642 (2d Cir. 2016) (finding a genuine dispute of material fact over whether a defendant was the 'maker' of allegedly misleading statements by a party in privity, where defendants had final approval over the statements at issue).

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

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.

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] In a recent demonstration of how broadly this definition can sweep, the Second Circuit held that a misrepresentation as to price could be found material even in a negotiating context where such misleading statements were concededly common.[10] Some courts have held that false statements or omissions are not materially misleading as

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).

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 *United States v. Litvak*, 808 F.3d 160 (2d Cir. 2015).

long as the market possessed the correct information.[11] 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'.[12]

Under SLUSA, plaintiffs are barred from bringing class actions asserting certain securities-related claims under state law. Specifically, SLUSA bars state-law claims alleging 'a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security'.[13] This provision of SLUSA was enacted to block plaintiffs from using state law to evade the PSLRA's restrictions on federal securities class actions. To effect that purpose, the Supreme Court has interpreted the provision broadly to apply to any alleged misrepresentation that 'coincides with a securities transaction – whether by the plaintiff or by someone else'.[14] Despite this guidance, the courts have long struggled with delineating precisely which state-law class actions involving securities are precluded by SLUSA. This has resulted in a confused framework that varies somewhat from one federal circuit to the next, although in recent years, the Second and Ninth Circuits – whose courts are prime venues for federal securities litigation – have held that SLUSA precludes state-law claims that can succeed only through proof of conduct that is specified in the SLUSA preclusion statute (i.e., misrepresentations or omissions of material fact in connection with the purchase or sale of a covered security).[15]

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'.[16] 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

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

12 *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).

13 15 U.S.C. § 78bb(f)(1).

14 *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006). In 2014, the Supreme Court clarified that SLUSA preclusion does not extend to misrepresentations involving securities that are not traded on a national exchange, but that were claimed to have been backed by exchange-traded securities. See *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058 (2014).

15 See *In re Kingate Management Ltd. Litig.*, 784 F.3d 128 (2d Cir. 2015) (to be precluded by SLUSA, allegations must by 'necessary to' or 'form the basis' of a plaintiffs' state law claims, although the allegations need not be 'essential' to the state-law claims); *Freeman Investments, L.P. v. Pacific Life Ins. Co.*, 704 F.3d 1110 (9th Cir. 2013). The Third and Seventh Circuits apply broadly similar standards, see *LaSala v. Bordier et Cie*, 519 F.3d 121, 141 (3d Cir. 2008) (dismissal is warranted where proof of a material misstatement or omission is either a necessary element of the cause of action or otherwise critical to a plaintiff's success in the case); *Holtz v. JPMorgan Chase Bank*, N.A., 846 F.3d 928 (7th Cir. 2017); however, they disagree as to the degree of similarity. See *In re Kingate*, 784 F.3d at 144-45 (distinguishing the Third Circuit's standard); *Goldberg v. Bank of America*, N.A., 846 F.3d 913, 925 (7th Cir. 2017) (Hamilton, J. dissenting) (describing a 'three- or four-way' division of authority among the Second/Ninth, Sixth, Holtz, and the Seventh Circuit's prior decision in *Brown v. Calamos*, 664 F.3d 123, 127 (7th Cir. 2011). The Sixth Circuit has adopted a different approach, precluding any complaint that features allegations of misrepresentations in connection with the purchase or sale of securities, while scrutinising other complaints for 'artful pleading' to avoid such allegations. *Segal v. Fifth Third Bank*, N.A., 581 F.3d 305, 311 (6th Cir. 2009).

16 15 U.S.C. Section 77k(a).

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'.[17] 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.[18]

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.

In *Omnicare, Inc v. Laborers District Council Construction Industry Pension Fund*,[19] the Supreme 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 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

17 *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).

18 See, e.g., *DeMaria v. Andersen*, 318 F.3d 170, 178 (2d Cir. 2003). The Third, Fifth, Eighth, Ninth and Tenth Circuits do not limit Section 11 standing to direct purchasers in the public offering. See *In re Supreme Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 274 n.7 (3d Cir. 2006); *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 871-73 (5th Cir. 2003); *Lee v. Ernst & Young, LLP*, 294 F.3d 969 (8th Cir. 2002); *Joseph v. Wiles*, 223 F.3d 1155, 1159-61 (10th Cir. 2000); *In re Century Aluminum Co. Sec. Litig.*, 729 F.3d 1104, 1106 (9th Cir. 2013).

19 135 S. Ct. 1318 (2015).

basis, or else make clear the real tentativeness of its belief'. In applying *Omnicare*, the Second Circuit has held that a securities claim may fail even where defendants are aware of significant information that undermines their public statements.[20]

Securities Act: Section 12

Under Section 12(a)(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(a)(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 or her, unless he or she can show that he or she 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(a)(1), which apply only to securities that must be registered under the Securities Act, Section 12(a)(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.[21] In addition, a defendant can avoid Section 12(a)(2) liability by showing that any claimed depreciation in a security's value was not caused by the defendant's misstatements or omissions.[22]

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 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 (1) employ any device, scheme or artifice to defraud; (2) make material misstatements or omissions; or (3) 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

---

20 See *Tongue v. Sanofi*, 816 F.3d 199 (2d Cir. 2016) (suggesting that the analysis under *Omnicare* may be more forgiving where plaintiffs are not 'sophisticated').

21 15 U.S.C. Section 77z-2(c)(1)(B).

22 15 U.S.C. Section 77l(b).

with the purchase or sale of a security (4) upon which the plaintiff justifiably relied[23] and (5), which proximately caused (6) the plaintiff's economic loss.[24] 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 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'.[25] 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*,[26] 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'.[27] This theory obviates the need for proof of individual reliance 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. 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.

More recently, in *Halliburton Co v. Erica P John Fund, Inc*,[28] the Supreme Court clarified 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 rebut the *Basic* presumption by citing news and analyst reports and other public information that shows how the supposedly undisclosed truth was already known to the market. Courts are now grappling with the application of this standard. Several decisions of the Southern District of New York have held that defendants must satisfy a heightened burden of proving by clear, definitive and compelling evidence a complete lack of price impact under *Halliburton*.[29] And

23 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.

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

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

26 485 U.S. 224 (1988).

27 Id. at 247.

28 134 S. Ct. 2398 (2014).

29 See *Carpenters Pension Trust Fund of St. Louis v. Barclays PLC*, 310 F.R.D. 69 (S.D.N.Y. 2015); *In re Goldman Sachs Grp., Inc. Sec. Litig.*, 2015 WL 5613150 (S.D.N.Y. 24 September 2015), appeal filed Case

courts across the country have struggled with plaintiffs pursuing a 'price maintenance' theory of liability – under which an alleged misstatement's lack of price impact can be overlooked so long as the misstatement 'maintained' an inflated share price by reinforcing or failing to correct a pre-existing market misapprehension. The theory has been accepted by a number of circuit courts, including most recently the Second Circuit, as discussed below.[30]

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*,[31] the Court unanimously held that 'an inflated purchase price will not itself constitute or proximately cause the relevant economic loss'.[32] 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.[33]

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.[34] More recently, the Court has clarified this standard, holding in *Wharf (Holdings) Ltd v. United Int'l Holdings, Inc*,[35] 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*,[36] 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.[37]

No. 16-250. As discussed below, pending appeals will give the Second Circuit an opportunity to interpret *Halliburton*. See below.

30 See *In re Vivendi, S.A. Sec. Litig.*, 838 F.3d 223, 259 (2d Cir. 2016) (endorsing a price-maintenance theory); *IBEW Local 98 Pension Fund v. Best Buy Co.*, 818 F.3d 775 (8th Cir. 2016) (holding that defendants had rebutted the *Basic* presumption in a case where plaintiffs had pursued a price-maintenance theory); *Glickenhaus & Co. v. Household Intern., Inc.*, 787 F.3d 408, 419 (7th Cir. 2015) (endorsing a price-maintenance theory); *FindWhat Investor Grp. v. FindWhat.com*, 658 F.3d 1282, 1314 (11th Cir. 2011) (same).

31 544 U.S. 336 (2005).

32 Id. at 341.

33 The courts have been relatively plaintiff-friendly in crafting a loss-causation standard. See, e.g., *Financial Guaranty Ins. Co. v. The Putnam Advisory Co.*, 783 F.3d 395 (2d Cir. 2015); *Lorely Fin. (Jersey) No. 3 Ltd. v. Wells Fargo Sec.*, LLC, 797 F.3d 160 (2d Cir. 2015) ('[It] is sufficient [for purposes of surviving a motion to dismiss] that the allegations themselves give [d]efendants "some indication" of the risk concealed by the misrepresentations that plausibly materialized in [p]laintiffs' ultimately worthless multimillion-dollar investment'); *Glickenhaus & Co. v. Household Int'l, Inc.*, 787 F.3d 408 (7th Cir. 2015) (approving of a 'leakage' loss-causation analysis that attempted to model the impact of a gradual disclosure); *Nakkhumpun v. Taylor*, 782 F.3d 1142 (10th Cir. 2015).

34 See Section II.ii, *infra*.

35 532 U.S. 588 (2001).

36 535 U.S. 813 (2002).

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

Insider trading in violation of Section 10

Since the decision of the SEC in *Cady, Roberts & Co*,[38] 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.[39] Rather, their duty is to disclose or to abstain from trading 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.[40] 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*,[41] 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 that 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*,[42] 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.[43] As

---

38 40 S.E.C. 907, 912 (1961).

39 *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).

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

41 521 U.S. 642 (1997).

42 463 U.S. 646 (1983).

43 Id. at 663.

discussed in Section V, below, the Supreme Court recently issued a decision in *United States v. Salman*[44] reaffirming its holding in *Dirks* that liability extends to circumstances where an insider gifts non-public information to a 'trading relative or friend'.[45]

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 […] which has become false or misleading'.[46] 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*.[47] 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.[48]

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 non-public 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.[49] 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.

44 137 S. Ct. 420 (2016).

45 Id. at 427–28.

46 17 C.F.R. Section 240.14a-9(a).

47 See *Dekalb County Pension Fund v. Transocean Ltd.*, 817 F.3d 393, 408 & n.90 (2d Cir. 2016).

48 See *SEC v. Das*, 723 F.3d 943, 953-54 (8th Cir. 2013). See also *Ind. State Dist. Council of Laborers & HOD Carriers Pension & Welfare Fund v. Omnicare, Inc.*, 719 F.3d 498, 507 n. 3 (6th Cir. 2013) ('In this Circuit § 14(a) does in fact require proof of scienter to state a claim.'), vacated and remanded on other grounds *sub nom. Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318 (2015).

49 17 C.F.R. 240.14e-3(a).

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, a category defined to include beneficial owners or groups of owners holding 10 per cent or more of an issuer's shares.[50] 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 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'.[51] 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*

50 Recently, the Second Circuit rejected an attempt to weaken these limitations on Section 16(b) liability, holding that a standard lock-up agreement between IPO underwriters and pre-IPO shareholders did not give rise to a 'group' owning more than 10 per cent of an issuer's shares.

51 15 U.S.C. Section 78u-4(b)(2).

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.[52]

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'.[53] 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 authorized by law or by the parties' agreement'.[54] 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.[55] 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.[56]

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.[57]

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.[58] 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

52 *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).

53 15 U.S.C. Section 78u-4(a)(6).

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

55 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).

56 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').

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

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

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. 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.[59] 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 the 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

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

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.[60]

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.[61]

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. In November 2014, for example, the former Director of the SEC Division of Enforcement indicated that the SEC will be 'considering requiring admissions in

60 In recent years, this administrative regime has been challenged as unconstitutional (see Section VI, *infra*, for additional discussion).

61 US Attorney's Manual 9-28.300, 9-28.1000, 9-28.1100.

certain types of cases where heightened accountability and acceptance of responsibility are in the public interest'.[62] It remains to be seen whether this trend will continue under the new presidential administration and new leadership at the SEC.

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, though such decisions are controversial.[63] Indeed, a recent decision from the DC Circuit Court of Appeals sharply limited the discretion of courts within that Circuit to review and reject DPAs, as well as district judges' role in monitoring compliance with DPA conditions.[64] 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'.[65]

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

62 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 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.'

63 See, e.g., *SEC v. Citigroup Global Markets, Inc.*, 827 F. Supp. 2d 328 (S.D.N.Y. 2011), rev'd 752 F.3d 285 (2d Cir. 2014) (rebuking the lower court for failing to accord the SEC the 'significant deference' its policy judgments are owed, and holding that '[t]he job of determining whether the proposed SEC consent decree best serves the public interest [. . .] rests squarely with the SEC.')

64 *United States v. Fokker Services B.V.,* 818 F.3d 733 (DC Cir. 2016) (reversing the rejection of a DPA outside the securities context).

65 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.

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.[66] 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'.[67] In reaching this 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'.[68] 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.[69] 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.[70] 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*.[71] However, as discussed below, a recent decision from a Utah federal court has raised the question of whether the Dodd-Frank Act allows the SEC and the Department of Justice to bring securities fraud claims against foreign parties in certain circumstances.[72]

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 300 new federal class-action securities cases in 2016, marking a 35 per cent increase over 2015 and totalling to the most since 2001. This growth was driven by a dramatic increase in merger-related lawsuits, most likely borne of developments in state law that have rendered the federal forum more attractive. In 2016, the number of these class actions doubled from 44 to 88, while traditional securities class actions rose modestly from 174 to 197. The average settlement in 2016 rose to US$72 million from US$53 million the previous year, with median settlement amounts of US$9.1 million and US$7.3 million, respectively. On

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

67 Id. at 273.

68 Id. at 266.

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

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

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

72 See *SEC v. Traffic Monsoon*, 2017 WL 1166333 (D. Utah 28 Mar 2017) (see Section VI, *infra*, for further discussion).

aggregate, securities class-action defendants paid out US$6.4 billion in 2016. Out of this total, class counsel received approximately US$1.27 billion for fees and expenses. Including filings from previous years, there were approximately 674 securities class actions pending in the federal courts at the beginning of 2017. No securities class actions proceeded to trial in 2016.[73]

In the realm of public enforcement, the SEC charged 78 people in cases involving insider trading in FY 2016 alone. Overall, the SEC filed a record 868 enforcement actions, and obtained orders totalling over US$4 billion in disgorgement and penalties.[74] 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.

Among a number of 'first-of-their-kind' enforcement actions pursued by the SEC in the past year was an investigation that yielded a consent order against a municipal bond adviser that had failed to disclose a conflict of interest to a municipal client, in violation of new fiduciary duties for municipal advisers created by the Dodd-Frank Act.[75] The SEC also pursued a novel case against two other municipal advisory firms who deceptively solicited business, in violation of a municipal adviser anti-fraud provision of that legislation.[76] Other 'firsts' from the past year included a trial victory against a municipality and one of its officers for federal securities law violations. The SEC also brought its first action against an equity adviser acting as an unregistered broker and an issuer of retail structured notes who made misrepresentations.

ii Significant decisions

Merrill Lynch, Pierce, Fenner & Smith, Inc v. Manning

In a May 2016 decision, the Supreme Court rejected an attempt to expand the reach of the federal courts' exclusive jurisdiction over securities litigation.[77] Under Section 27 of the Exchange Act, the federal courts are granted 'exclusive jurisdiction of violations of [the Exchange Act] [. . .] and all suits [. . .] brought to enforce any liability or duty created by [the Act]'. At issue in *Merrill Lynch* was whether Section 27 extends exclusive federal jurisdiction to claims under state law that are premised on federal securities law – specifically, the plaintiff brought state anti-fraud claims premised on the obligations created by an SEC regulation governing short selling. The Court rejected this broad interpretation of Section 27, holding that it does not expand federal jurisdiction. Rather Section 27 is coterminous with 18 USC Section 1331, a statute that generally provides for federal jurisdiction over state-law claims where either (1) federal law created the cause of action or (2) the claim 'necessarily raises a stated federal issue, actually disputed and substantial, which a federal forum may entertain without disturbing any congressionally approved balance of federal and state power'.[78] As reviewed in this chapter, the past three decades have marked a steady constriction of state

73 Stefan Boettrich and Svetlana Starykh, 'Recent Trends in Securities Class Action Litigation: 2016 Full-Year Review', pp. 2, 5, 26, 29, 31, 35, 40 (NERA Economic Consulting 2017), available at www.nera.com/content/dam/nera/publications/2017/PUB_2016_Securities_Year-End_Trends_Report_0117.pdf.

74 SEC, 'SEC Announces Enforcement Results for FY 2016' (11 October 2016), available at https://www.sec.gov/news/pressrelease/2016-212.html.

75 See *In the Matter of Central States Capital Markets, LLC*, Ex. Act Release No. 77369 (15 March 2016).

76 See *In the Matter of KeyGent LLC*, Ex. Act Release No. 78053 (13 June 2016).

77 *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Manning*, 136 S. Ct. 1562 (2016).

78 Id. at 1570 (quoting *Grable & Sons Metal Prods., Inc. v. Darue Eng'g & Mfg.*, 545 U.S. 312, 314 (2005)).

securities litigation in favour of the federal forum. While it remains to be seen how *Merrill Lynch* resonates within the legal community, the decision may open the door a crack for investors pursuing securities lawsuits under state law.

Salman v. United States

In December 2016, the Supreme Court issued a decision reaffirming that insider-trading tippee liability extends to circumstances in which the tipper provided information as a gift to a 'trading relative or friend'.[79] *Salman* resolved a division of authority in the lower courts, abrogating a Second Circuit decision that had required 'proof of a meaningfully close personal relationship [between tipper and tippee] that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature'.[80] In rejecting this approach, the Supreme Court reasoned that '[m]aking a gift of inside information to a relative [. . .] is little different from trading on the information, obtaining the profits, and doling them out to the trading relative,'[81] explicitly following the logic employed in the Court's landmark decision on tippee liability, *Dirks v. SEC*.[82]

Somers v. Digital Realty Trust

A recent Ninth Circuit decision expands a division of authority over whether the whistle-blower protections of the Dodd-Frank Act extend not only to those who disclose information to the SEC, but also to 'internal' whistle-blowers who alert their superior to securities violations.[83] The Ninth Circuit followed a recent Second Circuit decision,[84] along with an August 2015 interpretive release from the SEC,[85] in embracing a broader construction of the whistle-blower protections, further marginalising a 2013 Fifth Circuit decision that adopted the narrow interpretation.[86] This split will ultimately require resolution by the Supreme Court.

SEC v. Jensen

In an August 2016 decision, the Ninth Circuit affirmed the SEC's power to claw back performance-based compensation from CEOs and CFOs of public companies that restate previously issued financial statements 'as a result of misconduct'.[87] In reaching this result, the court issued important holdings on Rule 13a-14 of the Exchange Act, which requires principal executives to certify the accuracy of quarterly and annual financial reports, and Section 304 of the Sarbanes-Oxley Act, under which an issuer's CEO and CFO must disgorge performance-based compensation upon proof that a restatement stemmed from misconduct. First, the Ninth Circuit held that the SEC may pursue civil actions against CEOs and CFOs who certify the accuracy of incorrect financial statements, following prior decisions holding

79 *Salman v. United States*, 137 S. Ct. 420 (2016).
80 *United States v. Newman*, 773 F.3d 438, 452 (2014).
81 *Salman*, 137 S. Ct. at 428.
82 463 U.S. 646 (1983).
83 850 F.3d 1045 (9th Cir. 2017).
84 801 F.3d 145 (2d Cir. 2015).
85 SEC Release No. 34-75592, 'Interpretation of the SEC's Whistleblower Rules Under Section 21F of the Securities Exchange Act of 1934', 17 CFR Part 241 (4 August 2015).
86 See *Asadi v. G.E. Energy (USA), LLC*, 720 F.3d 620 (5th Cir. 2013).
87 835 F.3d 1100 (9th Cir. 2016).

that '[t]he affixing of a signature is not a mere formality, but rather signifies that the signer has read the document and attests to its accuracy.'[88] Second, the court held that Section 304 does not require proof of personal misconduct by a CEO or CFO, but can proceed upon proof of misconduct by any employee at the company.[89]

VI OUTLOOK AND CONCLUSIONS

While the SEC's report for FY 2016 lays out a range of goals for the coming year, the shift in presidential administrations has led to considerable uncertainty surrounding securities-related legislation, regulation, and enforcement. Most significantly, both President Trump and Republicans in the Congress have called for the repeal of the Dodd-Frank Act. While it remains to be seen whether a repeal can win passage in the sharply divided US Senate, such a repeal would touch upon many aspects of the securities law, as detailed above. An initial proposed repeal bill, the Financial CHOICE Act, also includes a range of other provisions that would impact US securities law, including: a significant reduction in the SEC's annual budget, sharper limitations on the reach of state securities law, a reduction in the SEC's use of administrative hearings, and a narrowing of SEC authority to bar individuals from participation in the securities industry.[90]

Republicans have also announced their intention to target securities regulations, which could impact the initiatives pursued by the SEC. With the departure of SEC Chair Mary Jo White in January 2017 and the appointment of new SEC Chair Jay Clayton in May 2017, the new administration is now positioned to fill two (of five) SEC Commissioner positions. In addition, the new administration will soon appoint new leadership in several SEC divisions, including the Division of Enforcement. These personnel shifts could have an immediate impact on enforcement priorities. However, the repeal or modification of any existing regulation would be subject to the extensive review that generally governs the issuance of US regulations, preventing any immediate shifts for all but a handful of regulations enacted after June 2016.[91]

Lastly, the recent appointment of Justice Gorsuch to the United States Supreme Court will have both an immediate impact on significant securities cases presently before the Court as well as the range of important securities issues that are expected to reach the Court in the coming years. While he is expected to join the bloc of conservative justices whose philosophy tends to favour limitations on securities regulations and the scope of securities liability, history has often made fools of those who attempt to pigeonhole newly appointed justices.

i Cases pending decision

Kokesh v. Securities and Exchange Commission

In April 2017, the Supreme Court heard argument on whether the SEC is subject to a five-year statute of limitations when it seeks the disgorgement of ill-gotten gains.[92] The

88 *Jensen*, 835 F.3d at 1112 (quoting *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 (9th Cir. 2000)).

89 *Jensen*, 835 F.3d at 1115-16.

90 H.R. 5983, available at https://www.congress.gov/bill/114th-congress/house-bill/5983.

91 One such regulation, which mandated, pursuant to the Dodd-Frank Act, that energy companies were required to disclose payments made to overseas governments, was summarily repealed on 14 February 2017.

92 No. 16-529.

Court determined in 2013 that the limitations period applies to civil monetary penalties sought by the agency,[93] but the lower courts have split on the scope of that decision. In the August 2016 decision under appeal, the Tenth Circuit held that disgorgement is 'remedial', and accordingly not subject to the limitations period.[94] That decision created a division of authority with the Eleventh Circuit, which held in May 2016 that disgorgement is equivalent to a forfeiture under a civil monetary penalty, and thus is governed by the same limitations period.[95] The Court's decision in *Kokesh* will have a significant impact for long-running frauds, potentially hampering the SEC's efforts to claw back a portion of defendants' gains.

California Public Employees' Retirement System v. ANZ Securities, Inc

The Supreme Court also recently heard argument on whether the filing of a putative class action extends the period during which a putative class member can file a claim under the Securities Act.[96] It has long been established that such tolling applies to the one-year 'statute of limitations' on such claims;[97] at issue in *ANZ Securities* is whether this rule extends to the Securities Act's three-year 'statute of repose'.[98] The Tenth Circuit held in 2000 that the statute of repose may be tolled;[99] more recent decisions of the Second, Sixth, and Eleventh Circuits have reached the contrary conclusion.[100] The Court's decision will also have an immediate impact on the time limitations imposed by the Exchange Act, which similarly couples a short statute of limitations with a lengthier statute of repose.

Leidos v. Indiana Public Retirement System

In a significant securities case scheduled for the October 2017 term,[101] the Supreme Court will resolve a circuit split over whether a company can face liability under Section 10(b) for a failure to disclose 'known trends and uncertainties' in compliance with Item 303 of Regulation S-K. The Ninth Circuit has held that the Item 303 duty to disclose does not necessarily translate into a Section 10(b) duty, noting differences between the SEC's definition

93 *Gabelli v. SEC*, 133 S. Ct. 1216 (2013).

94 *SEC v. Kokesh*, 834 F.3d 1158 (10th Cir. 2016) (also holding that the limitations period does not apply to injunctions), cert granted, Case No. 16-529. The Tenth Circuit decision followed prior decisions of the DC Circuit and the First Circuit, which predated the Supreme Court's decision in Gabelli. See *Riordan v. SEC*, 627 F.3d 1230, 1234 (D.C. Cir. 2010); *SEC v. Tambone*, 550 F.3d 106, 148 (1st Cir. 2008), withdrawn, 573 F.3d 54 (1st Cir. 2009), reinstated in relevant part, 597 F.3d 436, 450 (1st Cir. 2010).

95 *SEC v. Graham*, 823 F.3d 1357 (11th Cir. 2016). Notably, *Graham* and *Kokesh* agree that the limitations period does not apply to injunctive relief, which is a prospective remedy distinguishable from civil monetary penalties.

96 No. 16-373.

97 See *American Pipe v. Utah*, 414 U.S. 538 (1974).

98 While the distinction between statutes of limitations and repose is fairly abstruse, typically a statute of limitations runs from the time when a reasonable plaintiff would have discovered that they have a right to sue, while a statute of repose runs from the time when the plaintiff suffered harm. The Supreme Court recently has repeatedly held that statutes of repose represent an 'unqualified bar' on late-filed actions, 'giving defendants total repose'. *Merck & Co. v. Reynolds*, 559 U.S. 633, 650 (2010).

99 *Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000).

100 *Police & Fire Retirement System of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95 (2d Cir. 2013); *Stein v. Regions Morgan Keegan Select High Income Fund, Inc.*, 821 F.3d 780, 793-94 (6th Cir. 2016); *Dusek v. JPMorgan Chase & Co.*, 832 F.3d 1243, 1247-49 (11th Cir. 2016), petition for cert. filed, No. 16-389 (26 September 2016).

101 Case No. 16-581.

of materiality under Item 303 and that applied in the context of the Exchange Act.[102] However, in the case on appeal before the Court, the Second Circuit held that a defendant could be held liable under the Exchange Act for a failure to make a supplemental disclosure required by Item 303.[103] This holding potentially conflicts with a landmark feature of the securities law: an omission may be fraudulent only if the omitted information is necessary to make an affirmative statement not misleading.[104] If the Court endorses the Second Circuit's interpretation and departs from this long-standing feature of securities law, it could considerably expand the scope of Section 10(b) liability.

Strougo v. Barclays and In re Goldman Sachs

In two closely watched appeals,[105] the Second Circuit is expected to address what measure of evidence is required of defendants seeking to defeat class certification through a demonstration that their alleged misstatements had no impact on share price.[106] While the circuit recently endorsed a 'price maintenance' theory in *In re Vivendi, SA Sec Litig*,[107] it remains to be seen how the panel will apply that theory in the class-certification context following the Supreme Court's 2014 decision in *Halliburton*. Observers will closely scrutinise the Second Circuit's analysis for any contrast with a decision recently issued by a divided panel of the Eight Circuit,[108] which dismissed a securities class action after holding that the defendants had successfully demonstrated a lack of price impact, prompting a dissenting opinion that accused the majority of giving short shrift to the plaintiff class's price-maintenance theory.

Raymond J Lucia Cos, Inc v. SEC and Bandimere v. SEC

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. While many of these challenges have either failed on procedural grounds or been mooted by settlements,[109] recent decisions from the Tenth Circuit and the DC Circuit have created a potential division of authority over whether the appointment process for

102 See *In re Nvidia Corp Sec. Litig.*, 768 F.3d 1046 (9th Cir. 2014).

103 *Indiana Public Retirement System v. SAIC, Inc.*, 818 F.3d 85 (2d Cir. 2016).

104 *Basic v. Levinson*, 485 U.S. 224 (1988) ('silence, absent a duty to disclose, is not misleading under Rule 10b-5').

105 Case Nos. 16-450, 16-0250 (2d Cir).

106 See *In re Goldman Sachs Group, Inc. Sec. Litig.*, No. 16-250 (2d Cir.); *Strougo v. Barclays PLC*, No. 16-1912 (2d Cir.).

107 838 F.3d 223 (2d Cir. 2016) (affirming a jury verdict, reasoning that lack of price impact can be overlooked so long as the misstatement 'maintained' an inflated share price by reinforcing or failing to correct a pre-existing market misapprehension). See also *Gamco Investors v. Vivendi Universal, S.A.*, 838 F.3d 214 (2d Cir. 2016) (affirming dismissal securities fraud claims on a showing that the plaintiffs were indifferent to any fraud on the market).

108 *In IBEW Local 98 Pension Fund v. Best Buy Co.*, 818 F.3d 775 (8th Cir. 2016).

109 See, e.g., *Jarkesy v. SEC*, 803 F.3d 9 (D.C. Cir. 2015) (federal courts lack jurisdiction to consider constitutional challenge to the SEC's ALJ system); *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015) (same), cert. denied No. 15-997 (28 March 2015); *SEC v. Tilton*, 824 F.3d 276 (2d Cir. 2016) (same); *Hill v. Gray Financial Group*, 825 F.3d 126 (11th Cir. 2016).

administrative law judges passes muster under the US Constitution. In August 2016, the DC Circuit dismissed a constitutional challenge to the SEC's adjudicatory system, holding that administrative law judges are not subject to constitutional restrictions on the appointment of federal 'officers'.[110] A divided panel of the Tenth Circuit subsequently held otherwise in a December 2016 decision, concluding that the SEC's use of an administrative forum does not comply with these constitutional limitations on appointments.[111] The DC Circuit decision has now been vacated pending a rehearing *en banc*, adding to the uncertainty over the continued validity of the SEC's hearing procedures.

SEC v. Traffic Monsoon

Following a March 2017 decision by a Utah district court endorsing extraterritorial prosecutions by the SEC and the Department of Justice, a significant appeal is now pending before the Tenth Circuit. At issue is the impact of Section 929P(b) of the Dodd-Frank Act, under which the government may bring securities fraud claims under the Securities Act or Exchange Act if an alleged violation involves either conduct that occurred in the United States, or actions outside the United States that had a substantial domestic effect. Days before this statutory language was enacted, the Supreme Court's decision in *Morrison* rejected the 'conduct and effects' test enshrined in Section 929P(b), raising questions over how to reconcile the conflicting authorities. The district court held that *Morrison* cannot constrain the authority granted by Congress. If confirmed on appeal, this decision could mark a significant expansion of the government's authority to prosecute international securities fraud.

110 *Raymond J. Lucia Companies v. SEC*, 832 F.3d 277, 289 (D.C. Cir. 2016), rehearing *en banc* granted (16 February 2017).

111 *Bandimere v. SEC*, 844 F.3d 1168 (10th Cir. 2016).