

■ The Elusive Nine: Securities Class-Action Trials Since 1995

BY MELISSA COLÓN-BOSOLET

On January 29, 2010, after a three-month trial and three weeks of deliberation, a jury returned a verdict for the plaintiffs in one of the largest securities class actions ever tried: *In re Vivendi Universal, S.A. Securities Litigation*.¹ The *Vivendi* verdict sets the stage for what could be the largest securities class-action award ever. *Vivendi* was also the first “foreign-cubed” securities class action to be tried to a verdict.²

Interestingly, *Vivendi* was just the ninth securities class action to be tried to a verdict³ since the passage of the Private Securities Litigation Reform Act (PSLRA) in 1995. The PSLRA

raised the standard plaintiffs need to meet to file and sustain a securities fraud lawsuit.⁴ Historically, most securities class-action cases have resulted in settlement.⁵ However, a few rare cases have been tried to a verdict. The ones that have gone the distance have resulted in five wins for the defense and four wins for the plaintiffs—including the *Vivendi* verdict.

With so few securities class actions tried to a verdict, what, if anything, do these results signal to litigators? Are there similarities among these cases, or is each case an anomaly? Given the small number of cases actually tried, it may be difficult to predict trial outcomes. Perhaps practitioners should caution clients about taking their case to trial and instead encourage settlement.

There are some relevant litigation decisions and strategies that trial counsel in any securities class-action case should consider before stepping into court for opening statements.

(Continued on page 14)

■ Surprise! SEC Approves Amendments to the Custody Rule

BY JENNIFER HADLEY DIOGUARDI AND CORY L. BRADDOCK

The Securities and Exchange Commission (SEC) has acted to strengthen controls over client assets held by registered investment advisers (RIAs) or their affiliates. Specifically, on December 16, 2009, the SEC acted at an open meeting to adopt amendments to Rule 206(4)-2, commonly referred to as the Custody Rule, under the Investment Advisers Act of 1940, as well as related amendments to Form ADV Part 1 and Rule 204-2 with respect to recordkeeping.¹ The amendments were the result of a surge of SEC enforcement actions in 2009 against several RIAs and broker-dealers² alleging fraudulent conduct, including misappropriation or other misuse of investor assets, most of which arose from ponzi scheme activity.³

On December 30, 2009, the SEC issued an adopting release⁴ explaining the amendments and stating that the SEC believes the amendments will “provide for a more robust set of controls over client assets designed to prevent those assets from being lost, misused, misappropriated or subject to advisers’ financial reverses.” The changes are designed to protect investors through the strengthening of controls in order to curb potential abuses. The centerpiece of the amendments is the implementation of surprise inspections by independent public accountants of those RIAs who have custody of client funds or securities. These amendments went into effect March 12, 2010.

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Letter from the Chairs

With unprecedented shifts in the economy and groundbreaking regulation across sectors, securities issues are in the forefront of concerns for lawyers in commercial and business litigation. This publication offers a range of securities litigation articles, ranging from a broad overview for those encountering securities issues for the first time to a number of more narrowly focused pieces that provide a timely update on hot topics in this area.

The work in this publication reflects the strength of this Committee, which cuts across many subjects and benefits from the input of leaders from large and small firms throughout North America. This wide-ranging representation allows a wealth of information to be shared from the perspective of seasoned trial lawyers. This shared perspective is a strength of the Committee, and the good work of Committee members writing for this publication has made it an invaluable resource.

In addition to the good work of Committee members reflected in the articles included in this newsletter, Committee members have also been hard at work with a number of additional projects. The Committee is sponsoring a meeting, substantive seminar, and networking dinner at the ABA Annual Meeting in San Francisco, California, August 5–8. Please check the Committee webpage,

www.abanet.org/litigation/committees/commercial, for details and make plans to join us for these events.

While visiting the Committee webpage, please review the case notes and meeting news, as updates are posted frequently. Also, as we approach the new 2010-2011 ABA year, we encourage all interested Committee members to find a way to get involved in the Committee's activities. In addition to reviewing the information related to opportunities on the webpage, feel free to contact any of the Subcommittee chairs, which are listed on the webpage, or the Committee chairs if you would like to volunteer. We hope to hear from you!

Finally, as this is Barb Dawson's last publication before moving to a new Section of Litigation position—chairing a task force on the economics of litigation—she would like to express her thanks to this Committee's members for their contributions. "It is a special group committed to generously sharing insight and information," she says.

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Letter from the Editor

This issue of *Commercial & Business Litigation* focuses on securities litigation and is the product of hard work from the dedicated Securities Litigation Subcommittee and Kelly Kszywienski and Nelson Ebaugh, editorial board members. It's our hope that you find the articles informative and useful to your practice.

Upcoming issues of *Commercial & Business Litigation* will focus on construction litigation, banking and financial services litigation, and alternate dispute resolution. The schedule for these issues is as follows:

FALL 2010: Construction Litigation

Submission Deadline: September 1, 2010

WINTER 2011: Banking and Financial Services Litigation

Submission Deadline: December 1, 2010

SPRING 2011: Alternate Dispute Resolution

Submission Deadline: February 1, 2011

If you wish to contribute articles to future issues of *Commercial & Business Litigation*, please contact me at stioa@pepperlaw.com. A standard article is roughly 1,500 words, with all citations done in the body of the article. Articles should be written in MS Word format and may be submitted to my attention via email. You will be notified shortly after your submission if your article was selected for publication.

As always, thank you for your interest in the Committee on Commercial & Business Litigation.

Angelo A. Stio III

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Section of Litigation

SEC v. Goldman Sachs: The Government's Fraud Action Against a Wall Street Giant

BY JOHN R. BIELEMA AND MICHAEL P. CAREY

As widely reported, on April 16, 2010, the Securities and Exchange Commission (SEC) filed a civil fraud action against Goldman Sachs & Co. and one of its employees, claiming that Goldman made misrepresentations and omitted material facts in its marketing materials for a complex financial product it called ABACUS 2007-AC1.¹ In response, Goldman very quickly made it known to the public that it denies all wrongdoing and intends to vigorously defend itself against the charges.

The stakes are high for both sides. The SEC's complaint alleges that the fraud caused two European banks to lose a combined \$1 billion. The investors who lost money may bring their own actions, as may other investors who purchased similar products from Goldman. One of the most prominent purchasers in this area, American International Group (AIG), is reportedly evaluating potential claims. Securities regulators in the United Kingdom and Germany, home to the two banks that suffered most of the losses on the ABACUS transaction, have announced their intent to launch their own investigations into the matter. Goldman even faces suits from its own shareholders on the theory that it should have disclosed the Wells Notice it received in July 2009, which initiated the SEC investigation that led to this lawsuit.

For the SEC, *Goldman* is the most high-profile case to date involving mortgage-related securities and the subprime mortgage crisis, an area that remains somewhat uncharted territory in securities litigation. The subprime mortgage crisis led to an increase in civil actions relating to mortgage-backed securities, but as of today, there is still no tried-and-true strategy for trying such cases, and many judges and prospective jurors remain unfamiliar with these complex investments. This case could lay a foundation for future SEC activity in this area. Some commentators believe that the ABACUS case is the "tip of the iceberg," suggesting that some of the practices described in the complaint were common not only at Goldman, but elsewhere.² Assuming that there are at least some other comparable cases that have yet to be brought, this case will tell us about the SEC's ability—and its willingness—to prosecute such cases.

The SEC's Allegations

What is most striking about the SEC's case is that, notwithstanding the complicated jargon associated with the type of investment at issue, it is a simple case. The complaint runs only 22 pages and 74 paragraphs long, which is remarkably short for a securities fraud complaint alleging losses of the

magnitude alleged here. There is only one transaction at issue, and two investors who were affected by the alleged fraud. Clearly, the SEC believes that even though the investments at issue were complex and cutting edge, this is at heart a simple case involving two classic themes—conflict of interest and selective disclosure.

According to the complaint, Goldman was contacted in early 2007 by a hedge fund, Paulson & Co., Inc., which had taken a very bearish view on the U.S. housing market and was looking for ways to profit in the event of a downfall in the market.³ In particular, Paulson believed that the value of certain residential mortgage-backed securities (RMBS) would decline. RMBSs are securities closely comparable to bonds that entitle the purchaser to earn revenues from a pool of residential mortgages.⁴ The mortgages are purchased from the original lenders and pooled together in a trust. Pooling the mortgages has the effect of spreading the risk of borrower defaults among a wider set of investors. Until the subprime mortgage crisis hit, RMBSs were generally perceived to be safe investments. Like any other type of investment, however, different RMBSs have different risk characteristics. Even within a single RMBS deal, there can be multiple tranches, or classes, of bonds possessing different rights of priority to payment, meaning that some classes within the same RMBS trust are riskier than others. Paulson allegedly sought out RMBSs that were rated "Triple B," meaning that they were the riskiest kinds of RMBSs that ratings agencies such as Moody's and Standard & Poor were willing to deem investment-grade.⁵ Specifically, Paulson sought out RMBSs with high concentrations of adjustable-rate mortgages, borrowers with low FICO scores, and properties located in states such as Florida, California, and Nevada, where Paulson believed the housing downturn would hit hardest.⁶

Paulson's strategy was to take a short position on these securities. An investor can do this by purchasing a derivative investment called a credit default swap, or CDS. A CDS is similar to an insurance contract in which the buyer is seeking insurance against a reference security experiencing a default. The CDS buyer makes periodic payments to the seller, and if the reference security defaults, the buyer receives a large payoff. Though some purchasers of CDS contracts are themselves holders of the underlying security and are seeking insurance against a default, the purchaser of a CDS contract does not have to be the holder of the security. As bearish sentiment about the housing market increased, CDSs became known as a way for speculators to bet on a housing crash by effectively

taking a short position on RMBSs. The complaint alleges that Paulson purchased CDS contracts from Goldman, with the reference securities being the RMBSs that Paulson had identified to be likely candidates for default.⁷

Though the SEC's complaint is somewhat unclear on this point, it appears that Paulson and Goldman agreed to package Paulson's CDS contracts into yet another derivative security, a "synthetic CDO," which came to be known as ABACUS 2007-AC1.⁸ The purpose of creating ABACUS was to bring in other investors to serve as the counterparty to Paulson's CDS contracts. The purchasers of ABACUS would obtain the right to receive the premium payments that Paulson was making on the CDS contracts, but in exchange, the purchasers would assume the obligation to make the large payoff in the event of defaults on the underlying RMBSs. The net effect of these transactions was that Goldman would stand as the market maker for a bet on the underlying RMBSs, in which Paulson would win if the RMBSs defaulted, and the ABACUS investors would win if the RMBSs paid off without defaulting.

The crux of the SEC's fraud claim is that Goldman marketed and sold interests in ABACUS to investors as a quality investment, without disclosing Paulson's role in structuring the CDO.⁹ As a result, the SEC claims, the investors did not know that the CDO was ultimately tied to the performance of RMBSs that had been selected because of the likelihood that they would default. In layman's terms, the investment was allegedly "designed to fail." The SEC claims that had the investors known the truth about Paulson's role, they would have been scared off and avoided the investment.¹⁰

Critical to the SEC's case is the allegation that Goldman sought out and hired an insurance company, ACA Capital, to serve as a "Portfolio Selection Agent."¹¹ It appears from the complaint that ACA did indeed have a role in selecting the RMBSs that served as the underlying reference securities for ABACUS. However, all of the RMBSs chosen allegedly came from a list provided by Paulson or were ultimately approved by Paulson.¹² The SEC alleges that Goldman never told ACA about Paulson's intentions with respect to the RMBSs that were being selected, and that this was intended to (and actually did) leave ACA with the impression that Paulson was bullish about the RMBSs when that was not the case.¹³ Moreover, the SEC alleges that Goldman created marketing materials, which it gave to prospective investors, that highlighted ACA's role in selecting the portfolio, portrayed ACA as independent, and generally played up ACA's credentials as an important selling point, all the while failing to mention anything about Paulson.¹⁴

Two investors purchased the ABACUS investment. One is the German bank IKB, which allegedly lost its entire \$150 million investment.¹⁵ The other, interestingly enough, is ACA's parent company, ACA Capital Holdings, Inc.¹⁶ ACA Capital is alleged to have assumed \$909 million in credit risk in a transaction that was intermediated by the Dutch bank

ABN AMRO.¹⁷ ACA Capital was ultimately unable to pay all but a small portion of the money it owed, and ABN AMRO's successor company, Royal Bank of Scotland, paid the rest.¹⁸

Goldman's Defenses

While Goldman has yet to assert any defenses on the record, it has foreshadowed some aspects of its litigation defense strategy through the press. In the first four days after the complaint was filed, Goldman issued no less than three statements to the press describing the case as "completely unfounded," including a lengthy list of "questions and answers" about the case.¹⁹

It's clear from Goldman's statements that the company intends to contest the factual allegation that ACA (and thus, ACA's parent company) was misled into believing that Paulson held a bullish view of the RMBS portfolio and would be taking a long position. Goldman's position is bolstered by reports that a Paulson executive testified to the SEC that he personally told ACA about its intent to take a short position on the RMBS portfolio.²⁰ Doubts also exist about the extent to which Paulson had control over the selection of the portfolio. Goldman claims in a statement to the press that not only ACA but also IKB had input in the selection process, and that it was ultimately ACA's responsibility to choose the portfolio.²¹ It would seem that this factual dispute will turn largely on the credibility of witnesses for each of the players.

As for the claim that Goldman failed to inform investors about Paulson's role in its marketing materials, Goldman will argue that any such omission was not material. Questions of materiality figure to be crucial in this case. The federal standard for determining whether undisclosed information is material is whether there is "a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder."²² Not every fact that may be helpful to an investor is considered material under this standard. To be material, there must be a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available."²³

As Goldman has pointed out in its statements to the press, the investors who purchased an interest in ABACUS were highly sophisticated financial institutions with extensive experience investing in products similar to ABACUS.²⁴ Though the federal materiality standard is often stated in terms of the objective investor, in particular cases the

Not every fact that may be helpful to an investor is considered material.

investor's sophistication can be relevant.²⁵ Goldman also claims that even if it did not disclose any information about Paulson, it did disclose extensive information about each component of the RMBS portfolio itself.²⁶ Assuming that to be the case, the question that may be posed by Goldman is, "If the investors have all the information they need to arrive at their own assessment of the RMBS portfolio, why is it important to their decision that somebody else believes the portfolio is weak?" In Goldman's view, Paulson's identity and opinion of the portfolio is no more material than the opinion of anyone else. As a general matter, opinions and forward-looking statements are considered to be "soft information" that does not give rise to a duty of disclosure, though exceptions exist.²⁷

There is another level to Goldman's likely defense having to do with the distinctive characteristics of a synthetic CDO. As noted earlier, ABACUS was not literally comprised of RMBSs, but rather CDS contracts. Goldman will thus likely claim (as it has done in its press statements) that the very nature of the investment is one that requires the existence of two parties who hold opposing views about the underlying security.²⁸ In Goldman's view, transactions like ABACUS are not "designed to fail." Rather, they are understood by the parties involved to be zero-sum bets between sophisticated parties holding opposing viewpoints. Viewed in this light, Goldman may claim that it is implausible that the ABACUS investors did not know that the CDS buyer (Paulson) had a negative view of the underlying RMBS. The only thing the investors would not have known was Paulson's identity. Goldman may assert that it does not and is not required to reveal the identity of the counterparty.²⁹

The SEC's counterargument to this may be that Goldman, by voluntarily disclosing information about ACA's role as portfolio selection agent, and by prominently featuring information about ACA in its marketing materials, recognized that investors did, in fact, care about who structured the investment. Thus the proper inquiry, in the SEC's view, would be whether ACA was required to disclose information about Paulson so as to make its voluntary disclosures about ACA not misleading. Even where there is no duty to speak as to a particular subject, "upon choosing to speak, one must speak truthfully."³⁰ The SEC may also point to specific allegations—which Goldman apparently disputes—that it affirmatively represented Paulson to be interested in investing in ABACUS on the long side as an equity participant. Plainly, the inquiry into materiality will depend heavily on the facts, which is nothing unusual. Materiality is typically an issue that is resolved by juries, meaning that it will be difficult for Goldman to prevail with this defense prior to trial.³¹

Future Implications for Goldman

It's unlikely that the SEC's case will be the only action that Goldman will have to defend. On April 20, 2010, four days

after the SEC's complaint was filed, the United Kingdom's Financial Services Authority (FSA) announced that it was launching its own investigation into the SEC's allegations.³² The FSA's two-sentence statement on the matter tells us little about what the regulator plans to do except that it will be working with the SEC. Germany's bank regulator, BaFin, has contacted the SEC about the Goldman investigation, though it has made no official statement to date about any action it plans to take.³³

Goldman may also face private litigation against investors and others who suffered losses from ABACUS and similar Goldman investments. It's reasonable to expect that the ultimate losers in the ABACUS deal—IKB and RBS—will file their own actions. As these are large institutions with fiduciary duties to their own shareholders, they may, in fact, feel compelled to file suit. Another party that may be watching the SEC's case with great interest is AIG. AIG does not appear to have any direct connection to the ABACUS case, but the company's financial troubles since 2007 stemmed largely from its own exposure to similar CDOs, including CDOs it purchased from Goldman. It's believed that AIG is still insuring more than \$1 billion of Goldman's CDOs. Reportedly, AIG is now investigating its own CDO deals with Goldman and considering its own options, though at this time the company hasn't publicly stated what it intends to do.³⁴

Finally, Goldman has come under some criticism for not disclosing in July 2009 that it had received a Wells Notice from the SEC.³⁵ A Wells Notice is a notification from the SEC that it intends to recommend that enforcement proceedings be brought against the recipient. Wells Notices typically describe the charges that may be brought and give the recipient an opportunity to respond. The announcement of SEC's lawsuit on April 16 caused Goldman's stock to drop 13 percent on that day alone.³⁶ At least three shareholder suits have been filed against the company and/or its management, complaining that the company's failure to disclose its receipt of the Wells Notice caused the reduction in Goldman's stock price. Two of the cases are framed as shareholder derivative suits, while the third is a securities fraud action brought on behalf of purchasers of Goldman Sachs stock between October 15, 2009, and April 16, 2010.³⁷ Like the ABACUS case itself, the shareholder suits may come down to questions of materiality. Presently, Wells Notices are not considered to be per se material, nor are they considered to be per se immaterial. Whether this particular Wells Notice was material is likely to be a fact-specific inquiry that will depend on the perceived likelihood of an adverse result for Goldman and the perceived impact that an adverse result would have on the company.

John R. Bielema is a partner and Michael P. Carey is counsel in the Atlanta office of Bryan Cave, LLP.

Endnotes

1. SEC v. Goldman Sachs & Co., U.S. District Court for the Southern District of New York, Case No. 10-cv-03229. A copy of the complaint can be found at <http://www.sec.gov/litigation/complaints/2010/comp21489.pdf>.

2. Daniel Wagner, *Goldman Case Likely to Unleash Torrent of Lawsuits*, N.Y. TIMES, Apr. 17, 2010.

3. SEC complaint ¶¶ 11, 15-16.

4. *Id.* ¶ 14.

5. *Id.*

6. *Id.* ¶ 25.

7. *Id.* ¶¶ 14-15.

8. *Id.* ¶ 16.

9. *Id.* ¶¶ 70, 74.

10. *Id.* ¶¶ 59, 62.

11. *Id.* ¶¶ 19, 24.

12. *Id.* ¶¶ 25-35.

13. *Id.* ¶¶ 44-51.

14. *Id.* ¶¶ 36-43.

15. *Id.* ¶ 58.

16. *Id.* ¶ 61.

17. *Id.* ¶¶ 61-63.

18. *Id.* ¶¶ 64-66.

19. Michael Corkery, *Goldman Responds Again to SEC Complaint*, WALL ST. J., DEAL J. (Apr. 19, 2010), <http://blogs.wsj.com/deals/2010/04/19/goldman-responds-again-to-sec-complaint>.

20. Serena Ng, *Questions Raised About Evidence on Goldman*, WALL ST. J. (Apr. 22, 2010), at C1.

21. Corkery, *supra* note 19.

22. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

23. *Id.*

24. Corkery, *supra* note 19.

25. See, e.g., *Delta Holdings v. Nat'l Distillers & Chem. Corp.*, 945 F.2d 1226, 1242 (2d Cir. 1991); *SEC v. Happ*, 392 F.3d 12, 22 (1st Cir. 2004).

26. Corkery, *supra* note 19.

27. See *United States v. Anderson*, 533 F.3d 623, 629 (8th Cir. 2008) (“While speculative or ‘soft’ information is often immaterial, courts have been reluctant to find it *per se* immaterial.”).

28. Corkery, *supra* note 19.

29. *Id.*

30. *Caiola v. Citibank, N.A.*, 295 F.3d 312, 331 (2d Cir. 2002) (holding that the defendant, in choosing to discuss its trading strategy, “had a duty to be both accurate and complete”).

31. See *SEC v. Phan*, 500 F.3d 895, 908 n.19 (9th Cir. 2007) (citing *United States v. Gaudin*, 515 U.S. 506, 512 (1995)).

32. A copy of the statement can be found at http://www.fsa.gov.uk/pages/Library/Communication/Statements/2010/goldman_sachs.shtml.

33. *Bafin Ups Talks with SEC Over Goldman Fraud Probe*, REUTERS (Apr. 20, 2010), available at <http://www.reuters.com/article/idUSLDE63J1KP20100420>.

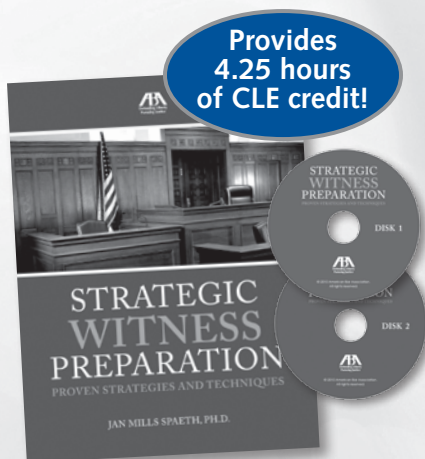
34. Francesco Guerrera, *AIG Eyes Action on Goldman Deals*, FIN. TIMES (Apr. 20, 2010).

35. Ashby Jones, *Lookout Goldman, Here Come the Shareholder Lawsuits*, WALL ST. J., LAW BLOG (Apr. 26, 2010), <http://blogs.wsj.com/law/2010/04/26/lookout-goldman-here-come-the-shareholder-lawsuits>.

36. Amir Efrati, *Plaintiffs' Attorneys 'Foaming at the Mouth' Over Goldman*, WALL ST. J., LAW BLOG (Apr. 17, 2010), <http://blogs.wsj.com/law/2010/04/17/plaintiffs-attorneys-foaming-at-the-mouth-over-goldman>.

37. A copy of the securities fraud class action is available at <http://www.rgrdlaw.com/cases/goldmansachs/complaint.pdf>.

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Preliminary Actions for Companies Facing Securities Litigation

BY N. SCOTT FLETCHER AND JEFFERSON T. MICHAEL

In the past decade, approximately 6 percent of all S&P 500 companies and nearly 2.5 percent of all companies listed on a major exchange were named as defendants in securities fraud class actions.¹ In that same period, the average securities fraud class-action settlement increased from \$11 million in 2000 to \$42 million in 2009, for an average of \$25 million per settled case during the decade.² In the past year, Securities Exchange Commission (SEC) formal orders of investigation, which often foreshadow shareholder claims, have more than doubled, increasing from an average of 246 formal orders issued annually from 2004 to 2008 to a high of 496 formal orders issued in 2009.³ In short, while the likelihood of being sued in securities litigation may be statistically low, particularly for well-run companies, the potential damages remain unacceptably high. Given these risks, the increasing volatility of the financial markets, and the desire to minimize the negative publicity associated with securities litigation, companies would be well served by preparing a list of items to discuss with litigation counsel whenever they are sued by shareholders for securities fraud, breach of fiduciary duties, or other securities claims where damages are sought.⁴

The preliminary actions listed below are neither exhaustive nor absolute, but they summarize some of the important issues to be discussed by companies and their counsel at the outset of most corporate securities cases.

Preserve potentially relevant documents and electronically stored information. While most companies recognize they have a duty to preserve potentially relevant documents whenever litigation is reasonably anticipated, many lack established procedures to do so, and many more fail to document their efforts properly. As soon as securities litigation is filed or reasonably anticipated, in-house counsel should send written notice instructing employees with potentially responsive documents to preserve them and take appropriate steps to preserve electronically stored information (ESI). With minimal effort and expense, companies can create an effective record of their preservation efforts that can be used to defend against a future spoliation claim.

Identify key company personnel, determine whether they need counsel, and review indemnification agreements and bylaws. Securities and shareholder derivative cases frequently name C-level executives, certain directors, and even employees as defendants. In most cases, the same counsel will be able to represent the company and individual defendants, but some cases require separate counsel or shadow counsel for individual defendants. Director and officer

(D&O) insurers will likely have their own views about when separate counsel is needed. In any event, companies and their counsel should review indemnification agreements and bylaws to determine whether indemnification is permissive or required, whether the company is required to advance defense costs, and under what circumstances defense costs must be repaid by individual defendants. Because public policy forbids companies from indemnifying for fraud, most companies should require their directors, officers, and employees who are indemnified to sign an agreement to repay expenses whenever fraud is alleged.

Notify insurers and make a preliminary coverage evaluation. Most companies have D&O liability policies with Side A, Side B, and/or Side C coverage that provides insurance against securities and shareholder derivative claims. Because D&O coverage is typically triggered when a claim is made, it's critical for companies to notify primary and secondary insurers promptly after litigation is filed. Because many insurers send a reservation of rights letter after being notified of claims, it's also important for companies and their counsel to review the policies and determine whether there will be serious coverage disputes.

Obtain a plaintiff-style damages estimate for the case. Securities fraud complaints rarely specify what damages they are claiming, but the damage models are fairly well established. An early estimate of how the plaintiff will likely view the case should be obtained at the outset of the litigation; it can be valuable for determining whether an early settlement might cost less than the defense.

Consider whether separate factual investigation is warranted, particularly in shareholder derivative cases. While much emphasis is placed on the sufficiency of pleadings in securities fraud cases and in shareholder derivative claims where demand futility is alleged, it may be expeditious to conduct a separate factual investigation, especially in shareholder derivative cases. If shareholders demand that the board investigate allegations of wrongdoing—or will inevitably do so—it may make sense at the outset to empower the audit committee, a committee of independent and disinterested directors, or even in-house counsel to investigate the allegations of wrongdoing first. To ensure the independence of an investigating committee and preserve privilege for its investigation, companies should consult with corporate counsel about the membership and appointment of the committee and make sure the committee has its own counsel to assist with the investigation.

Advise employees of the litigation and the need for confidentiality. Company employees will inevitably be concerned about the impact of potential litigation on them and their careers. Securities fraud actions and shareholder derivative disputes are increasingly publicized both by the media and by plaintiffs' law firms. To prevent the press or plaintiffs' counsel from learning more about the case than the company and its counsel do, current employees should be reminded early and often not to talk with others about the company's affairs.

Gather public filings and financial statements for the relevant period. When a company's stock price declines, plaintiffs frequently file a securities fraud class action and allege that the company intentionally misrepresented or omitted material facts. Defendants often get these cases dismissed by showing that the information was protected by the safe harbor for forward-looking statements, that plaintiff's allegations fail to raise a strong inference of scienter (intentional or reckless conduct), and/or that the allegedly omitted facts were actually disclosed. Although federal statutes prohibit parties from taking discovery in these cases while a motion to dismiss is pending, courts routinely examine a company's public statements to evaluate the legitimacy of the plaintiff's claims based on the information available to the market.⁵ Collecting and reviewing these materials early provides a preliminary indication of the strength of the plaintiff's case.

Gather analyst statements on the company and the industry. While analyst statements may also be useful to support a motion to dismiss, it's important to collect them to evaluate a different issue—loss causation, i.e., whether the decline in a company's stock price was caused by the alleged fraud. In many cases, analysts comment upon stock price declines and identify industry factors that provide a reason for the decline other than fraud.⁶

Evaluate stock trading by insiders. Most securities fraud class actions allege that insiders were motivated to engage in fraud to sell their own securities at artificially inflated prices. Complaints typically include a table that lists insider trades by directors, officers, and key employees of the company and identifies only the total sales price (not the net profits realized). Careful analysis of insiders' trading histories can offset these allegations by showing that insiders actually made little or no profit, sold shares pursuant to 10b5-1 trading plans, or, in some cases, were also purchasing shares when the alleged fraud occurred.⁷

Identify former employees and potentially hostile witnesses who might be contacted. Because discovery is not typically allowed in a securities fraud class action or a shareholder derivative case until after a motion to dismiss or other preliminary motion is ruled upon, plaintiffs frequently contact former

employees to obtain more information. Complaints typically use information from these confidential witnesses to allege that corporate officers and directors were aware of alleged wrongdoing and did not disclose it. While it's often difficult to obtain cooperation from former employees, some factual investigation, if properly handled, can be useful to evaluate the veracity of the plaintiff's allegations and the strength of potential evidence.

Evaluate the need for experts. Depending on the claims and the number of parties involved, it may be important to retain key experts early in a case before they are hired by others. The pool of potential experts may be particularly small when allegations involve arcane accounting rules or industry-specific requirements.⁸

Obtain a preliminary budget estimate for the litigation. Securities fraud litigation can be expensive, particularly when initial motions to dismiss are denied and extensive discovery is taken. Companies and their counsel should prepare a preliminary budget for the various phases of the case and update it periodically. It may also be useful when evaluating when and whether to settle.

Consider the likelihood of parallel SEC or other government investigations. Securities litigation is often filed on the heels of an SEC or other governmental investigation, but it sometimes arises before these investigations become public. In other situations, there may be an industry-wide investigation or even criminal proceedings that involve the client or its employees. These situations present particularly difficult timing issues because of the risk that evidence from one proceeding may be used in another proceeding. Companies and litigation counsel should consult with disclosure counsel and, if necessary, criminal defense counsel, to determine when and whether to make additional disclosures and whether litigation should be stayed or slowed until governmental proceedings are resolved.

Manage board and officer expectations for the litigation. Corporate managers should be apprised of the prospects for resolving securities litigation, the resources that will be required, and the likely timetable for resolution. Securities fraud class actions are particularly slow to get started as the parties often agree to stay proceedings until after a lead plaintiff is appointed and an amended complaint is filed.

Caution managers about their public responses to the litigation. Many executives, particularly those who have not previously been sued in securities litigation, want to go on

Prepare a preliminary budget for the case and update it periodically.

the offensive and make public statements denying the specific allegations of a complaint. While an immediate response by the company is often appropriate, it is rarely helpful to deny specific allegations before any factual investigation has been made. Indeed, a premature response could exacerbate the problem if the SEC decides to investigate the basis for the company's statement denying the allegations.

Consult with disclosure counsel about when and how to disclose the litigation in public filings. Depending on the nature and timing of the litigation and related investigations, it may be necessary or advisable to make public disclosures about litigation or an SEC investigation more quickly. Companies and their litigation counsel should work closely with disclosure counsel to ensure these matters are appropriately disclosed.

This checklist of preliminary actions is intended to help companies and their counsel avoid obvious mistakes and better evaluate costs and opportunities for resolving securities class actions and shareholder derivative claims. Because even the best-run companies are not immune to securities litigation, working closely with strong, experienced counsel is the best defense.

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Endnotes

1. See Stanford Law School and Cornerstone Research, Securities Class Action Clearinghouse: Litigation Activity Indices, http://securities.stanford.edu/litigation_activity.html (yearly averages from website used to calculate 2000–09 average) (last visited Apr. 8, 2010).

2. See Stephanie Plancich & Svetlana Starykh, NERA Economic Consulting, *Recent Trends in Securities Class Action Litigation: 2009 Year-End Update* 14 (Dec. 2009) (excluding settlements greater than \$1 billion and 309 IPO Litigation cases).

3. Select SEC and Market Data for fiscal years 2004–09 (available at <http://www.sec.gov/about.shtml>); see also Robert Khuzami, Director Enforcement, U.S. Sec. & Exch. Comm'n, Speech to the Society of American Business Editors and Writers (Mar. 19, 2010) (transcript available at <http://www.sec.gov/news/speech/2010/spch031910rsk.htm>).

4. The actions listed above are most applicable to securities fraud and “clone” shareholder derivative claims that seek to recover damages when a company's stock price drops precipitously. While some of the actions are also applicable when shareholders bring

claims challenging a merger or acquisition, those disputes often move at a faster pace and involve fundamentally different relief—e.g., injunctive relief to prevent a business combination from being completed absent a higher sales price or additional disclosures.

5. The Private Securities Litigation Reform Act of 1995 (PSLRA), 1934 Act § 21D(b)(3)(B), 15 U.S.C. § 78u-4(b)(3)(B) requires that “all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.” For motions to dismiss securities fraud claims, courts have routinely held that it is appropriate to consider SEC filings; press releases, transcripts of conference calls, and other documents referenced in the complaint; and stock prices. See 15 U.S.C. §§ 77z-2(e), 78u-5(e); *Lone Star Fund V (U.S.) L.P. v. Barclays Bank PLC*, 594 F.3d 383, 387 (5th Cir. 2010); *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 989 (9th Cir. 2009); *Roth v. Jennings*, 489 F.3d 499, 509 (2d Cir. 2007); *Collins v. Morgan Stanley Dean Witter*, 224 F.3d 496, 498–99 (5th Cir. 2000).

6. See, e.g., *Fener v. Operating Eng'rs Constr. Indus. & Miscellaneous Pension Fund*, 579 F.3d 401, 408–09 (5th Cir. 2009) (affirming the district court's refusal to certify a securities fraud class action where the plaintiff's expert failed to isolate the impact of a corrective disclosure of alleged fraud compared to other negative information disclosed at the same time, such as changed economic circumstances, new industry-specific or firm-specific facts, conditions, or other factors independent of the alleged fraud).

7. See *Metzler Inv. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049, 1067 & n.11 (9th Cir. 2008) (finding no inference of scienter where the defendants' trading was consistent with prior history and the bulk of trades were made pursuant to predetermined 10b5-1 trading plans); *Southland Secs. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 367–69 & n.12 (5th Cir. 2004) (analyzing insider trading allegations and considering argument that purchases by defendants during the class period negated scienter); *In re Gildan Activewear, Inc. Secs. Litig.*, 636 F. Supp. 2d 261 (S.D.N.Y. 2009) (finding no inference of scienter where only two insiders traded and did so pursuant to nondiscretionary Rule 10b5-1 trading plans).

8. See *United States v. Reyes*, 577 F.3d 1069, 1075–76 (9th Cir. 2009) (stock option backdating); *AIG Global Sec. Lending Corp. v. Banc of Am. Secs. LLC*, 646 F. Supp. 2d 385, 399 (S.D.N.Y. 2009) (loss causation related to asset-backed securities); *In re Sunbeam Secs. Litig.*, 176 F. Supp. 2d 1323, 1331 (S.D. Fla. 2001) (“[P]roof of damages in a securities fraud case is always difficult and requires expert testimony.”).



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SEC v. Tambone: First Circuit Rejects the SEC's Approach to Scope of Rule 10b-5(b)

BY JOHN R. FAHY

Brokers and other intermediaries often find themselves the last prospective defendants standing after a securities fraud collapses. However, a major new case from the First Circuit on the scope of Securities and Exchange Commission (SEC) Rule 10b-5(b) may provide brokers and intermediaries with protection against claims based on distributing someone else's statement. The First Circuit held in *SEC v. Tambone*¹ that using a statement is not the same as making a statement, and the defendant must directly or indirectly make a statement to be found primarily liable under Rule 10b-5(b) under the Securities Exchange Act of 1934.

Rule 10b-5 provides a private cause of action for securities fraud violations.² It can also be generally enforced by the SEC³ and specifically enforced by the Financial Industry Regulatory Authority (FINRA) against its members and associated persons.⁴ Rule 10b-5 makes it unlawful for "any person" "directly or indirectly" in connection with the purchase or sale of securities to employ "any device, scheme, or artifice to defraud,"⁵ "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading,"⁶ or "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."⁷

Large amounts of Rule 10b-5 caselaw focused on defining materiality⁸ and scienter.⁹ Rule 10b-5 was limited in 1994 when the Supreme Court held in *Central Bank* that there was no aiding and abetting cause of action under the Exchange Act.¹⁰ Congress then added Section 20(e) to the Exchange Act to restore the SEC's right to pursue aiding and abetting actions, but it did not provide the ability for any other party to enforce an aiding and abetting claim.¹¹ Thus, private litigants and FINRA must allege and prove primary liability under Rule 10b-5 to pursue a cause of action.

In 2008, the Supreme Court further limited claims under Rule 10b-5(a)'s scheme liability provisions by requiring that the defendants be tied to an actual fraudulent statement to have scheme liability.¹² The Supreme Court reasoned that such acts require reliance by private litigants on the defendant's statements. The Court went on to hold that a false statement to an issuer of securities that the issuer knows is false does not satisfy that requirement because investors could not have relied on that statement.¹³ The Court determined not to use the scheme approach of Rule 10b-5(a) to, in substance, resurrect aiding and abetting claims against secondary defendants.

Given this background, the scope of Rule 10b-5(b) became hugely important for secondary securities fraud defendants and those who want to sue them. On March 10, 2010, the First Circuit issued its *Tambone* en banc opinion defining the scope of

"to make" under Rule 10b-5(b).¹⁴ The *Tambone* defendants were executives of a mutual fund distributor broker-dealer affiliated with the mutual funds' sponsor. The mutual fund prospectuses made various statements hostile to short-term market timing purchases and sales. The SEC alleged that the defendants knew or recklessly ignored these statements hostile to short-term market timing and allowed certain preferred customers "to engage in market timing forays" in the funds, and made material misrepresentations and omissions in the prospectuses.¹⁵ The SEC further alleged that the defendants "made" false statements within the meaning of Rule 10b-5(b) by "using the prospectuses in their sales efforts, allowing the prospectuses to be disseminated and referring clients to them for information."¹⁶

First, the SEC argued that the defendants "made" the misrepresentations by using the prospectuses to sell mutual funds. Second, the SEC argued that the defendants impliedly made false representations to investors to the effect that they had a reasonable basis for believing that the key representations in the prospectuses were truthful and complete. This implied statement theory rested on the premise that a securities professional engaged in the offering of securities has a "special duty" to undertake an investigation that would provide him with a reasonable basis for believing that the representations in the prospectus are truthful and complete. Therefore, the theory goes, a securities professional "makes" an implied representation to investors that the prospectus is truthful and complete when he engages in an offering.¹⁷

The First Circuit rejected both SEC approaches and held that the defendants did not "make" those statements under Rule 10b-5(b) and thus have no primary liability. The court noted that Section 10(b) of the Exchange Act prohibited the "use" of manipulative and deceptive devices, but that, in writing Rule 10b-5(b), the SEC chose the term "make" instead of "use," that the SEC's choice of the more restrictive term "make" was deliberate, and that the SEC cannot now allege that "make" really means "use" under Rule 10b-5(b).¹⁸ Thus, the persons found to have primary liability under Rule 10b-5(b) actually need to make the statements, not just use them.

Further, the First Circuit was greatly concerned with how the SEC's Rule 10b-5(b) standard would affect private litigation in light of the 1994 *Central Bank* case limiting aiding and abetting liability. The court said:

Refined to bare essence, the SEC, through the instrumentality of Rule 10b-5(b), seeks to impose primary

liability on the defendants for conduct that constitutes, at most, aiding and abetting (a secondary violation). Allowing the SEC to blur the line between primary and secondary liability would be unfaithful to the taxonomy of *Central Bank*. . . . Allowing courts to imply that “X” has made a false statement with only a factual allegation that he passed along what someone else wrote would flout a core principal that underpins the *Central Bank*. We decline the SEC’s invitation to go down that road.¹⁹

The First Circuit focused on the duties owed by underwriters in the Rule 10b-5(b) context. The court said that “securities professionals working for underwriters have a duty to investigate the nature and circumstances of an offering . . . (and that) the SEC theorizes that such securities professionals impliedly ‘make’ a representation to investors that statements in a prospectus are truthful and complete.”²⁰ The First Circuit said that:

If we were to give credence to this theory, the upshot would be to impose primary liability under Rule 10b-5(b) on these securities professionals whenever they fail to disclose material information not included in a prospectus, regardless of who prepared the prospectus. That would be tantamount to imposing a free-standing and unconditional duty to disclose.²¹

The First Circuit held that the nondisclosure of information involving those other than the issuer:

[I]s actionable under Rule 10b-5 only when there is an independent duty to disclose the information arising from ‘a fiduciary or other similar relation of trust and confidence’ between the parties. . . . Fidelity to that requirement demands that we reject the SEC’s notion that a breach of duty to investigate [under Sections 11 and 12 of the Securities Act of 1933], without more, is a breach of a duty to disclose (and thus should be treated as a primary violation under Rule 10b-5(b)).²²

On March 26, 2010, the SEC’s solicitor, Jacob Stillman, told SEC Speaks conference attendees that it was too early to determine if the SEC was going to appeal the *Tambone* decision to the Supreme Court.

The *Tambone* case is very significant to brokers and other securities intermediaries because it provides a defense against allegations that a defendant should be liable under the anti-fraud provisions of federal securities laws for statements made in prospectuses and private placement memoranda created by others through the mere act of distributing those statements. In the wake of the court’s holding in *Tambone*, distribution of someone else’s statement does not necessarily mean adopting that statement as one’s own for the purposes of Rule 10b-5 liability.

The SEC and a bankruptcy court have recently taken several actions against issuers of purported private placements sold by brokers that each involved several hundred million dollars of investor funds. Receivers²³ and a bankruptcy trustee²⁴ have been appointed. With receivers and a trustee in place of the issuers, victimized investors have been pursuing claims against brokers that sold these private placements. The *Tambone* case may provide some protection against making the brokers vicariously responsible for the issuers’ statements. However, brokers or other intermediaries may theoretically remain liable under Rule 10b-5(b) for their own statements regarding due diligence²⁵ or investor suitability.²⁶

The *Tambone* case may also be used to interpret other rules with similar language. For example, SEC Rule 10b-9 provides for liability for “any person, directly or indirectly, in connection with the offer or sale of any security, to make any representation” (emphasis added) regarding the specified units, price, and time requirements of an offering and then not follow through on those representations.²⁷ Both Rule 10b-5(b) and Rule 10b-9 were promulgated under the SEC’s authority under Section 10(b) of the Exchange Act. Additionally, both rules use precisely the same phrase: “to make” modified by “directly or indirectly.” Consequently, the same limitations should apply to both rules. Securities professionals can’t be held primarily liable under Rule 10b-5(b) and 10b-9 for statements in offering documents that they did not make and only disseminated and referred prospective investors to as part of their sales efforts.

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Endnotes

1. SEC v. Tambone, No. 07-1384, 2010 U.S. App LEXIS 5031 (1st Cir. Mar. 10, 2010).
2. Superintendent of Ins. of N.Y. v. Bankers Life Casualty Co., 404 U.S. 6, 13 n.9, 12 S. Ct. 165, 169 n.9 (1971); 15 U.S.C. § 78u-4(b).
3. 15 U.S.C. § 78u.
4. 15 U.S.C. § 78s(d) and (e).
5. 17 C.F.R. § 240.10b-5(a).
6. 17 C.F.R. § 240.10b-5(b).
7. 17 C.F.R. § 240.10b-5(c).
8. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 96 S. Ct. 2126 (1976); Basic Inc. v. Levinson, 485 U.S. 224, 231-32; 108 S. Ct. 978, 983 (1988).
9. Tellabs, Inc. v. Makor Issuers & Rights, Ltd., 551 U.S. 308, 319, 127 S. Ct. 2499, 2509 (2007); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12, 96 S. Ct. 1375 (1976).
10. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).
11. 15 U.S.C. § 78t(e).

12. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 128 S. Ct. 761 (2008).

13. *Id.*

14. *Supra* note 1.

15. *Id.* at *7.

16. *Id.* at *9.

17. *Id.* at *10-11.

18. *Id.* at *16-23.

19. *Id.* at *25, 27.

20. *Id.* at *30.

21. *Id.* at *30-31.

22. *Id.* at *31-32 (citing *Chiarella v. United States*, 445 U.S. 222, 228, 100 S. Ct. 1108 (1980); *Fortson v. Winstead, McGuire, Sechrest & Minick*, 961 F.2d 469, 472 (4th Cir. 1992); *SEC v. Cochran*, 214 F.3d 1261, 1264 (10th Cir. 2000)).

23. SEC Litigation Release No. 20901 (Feb. 17, 2009); *SEC v. Stanford Int'l Bank*, No. 3:09-CV-0298-L (N.D. Tex.); SEC Litigation Release No. 21118 (July 7, 2009); *SEC v. Provident Royalties, LLC*, No. 3:09-CV-1238-L (N.D. Tex.); SEC Litigation Release No. 21165, (Aug. 3, 2009); *SEC v. Med. Capital Holdings, Inc.*, No. 8:09-cv-00818-DOC-RNB (C.D. Cal.).

24. *In re DBSI Inc.*, 407 B.R. 159 (Bankr. D. Del. 2009).

25. *S. Cherry St., LLC v. Hennessee Group LLC*, 573 F.3d 98 (2nd Cir. 2009).

26. *Robert N. Clemens Trust v. Morgan Stanley DW, Inc.*, 485 F.3d 840 (6th Cir. 2007); *Lehman Bros. Commercial. Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 159, (S.D.N.Y. 2001).

27. 17 C.F.R. § 240.10b-9; *SEC v. Howard*, 376 F.3d 1136, 1139 (D.C. Cir. 2004).



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Securities Class Action Trials

(Continued from page 1)

Plaintiff Victory Cases

***In re Real Estate Assocs. Ltd. P'ship Litig.*, No. 98-cv-7035 DDP (C.D. Cal.).** In 1998, the plaintiffs filed a lawsuit alleging that General Partners of Real Partnerships, a series of limited partnerships created to acquire interest in affordable housing projects, violated federal securities laws and breached their common-law fiduciary duties to the plaintiffs by circulating consent solicitations that were materially false and misleading.

After a five-week trial and six days of deliberation, a jury found for the plaintiffs and awarded \$185 million in damages. Following appeal of the jury verdict, the case was settled for \$83 million. It was the first proxy law securities class action to be tried and won before a jury.⁶

***In re Clarent Corp.*, No. C-01-3361 CRB (N.D. Cal.).** On May 8, 2002, Clarent restated its revenues and earnings for fiscal year 2000 and the first two quarters of fiscal year 2001. Clarent's stock price subsequently plummeted, and shareholders brought an action alleging that the company's CEO and auditor defrauded the shareholders by materially overstating revenues for those six quarters. The plaintiffs alleged that Clarent's CEO knowingly falsified the company's financial statements during this period and that the auditors knowingly signed off on these fraudulent financial reports.⁷

After a four-week trial and three days of deliberation, a jury found the company's CEO liable for a knowing omission or misstatement in the company's SEC filing. The jury also found that the company's auditors made a false statement; however, the jury declined to assign liability to the auditors for the misstatement.⁸

***Jaffe v. Household Int'l. Inc.*, No. 02-cv-5893 (RAG) (N.D. Ill.).** On August 9, 2002, shareholders filed a lawsuit alleging that Household International and three of its former executives were engaged in a massive predatory lending scheme and reported false statistics that gave the appearance that the creditworthiness of Household's borrowers was far more favorable than it actually was. The plaintiffs alleged that, as a result, the company's financial and operational results were artificially inflated.⁹

After three-and-a-half days of deliberations, a jury in a bifurcated trial found the defendants liable for issuing 16 false and misleading statements to investors. The defendants subsequently filed a motion for judgment as a matter of law, which is currently pending before the court. If the trial judge upholds the jury verdict, a trial on damages would be scheduled.¹⁰

***In re Vivendi Universal, S.A. Sec. Litig.*, No. 02 Civ. 5571 (RJH) (S.D.N.Y.).** In 2002, the lead plaintiff, the Retirement System for the General Employees of the City of Miami Beach, brought a lawsuit alleging that Vivendi, its former CEO, and its former CFO hid the company's alleged liquidity crisis by making false and misleading statements to the U.S. Securities and Exchange Commission and in news releases.

After deliberating for three weeks on a three-month long trial, the jury found Vivendi liable for 57 false or misleading statements concerning its financial status. The jury, however, exonerated Vivendi's former CEO and former CFO and found them not liable. Lead counsel has stated that the overall damages in the case, depending on the number of shareholders who make claims and the amount of prejudgment interest, could reach an estimated \$9 billion—potentially the largest securities class-action jury verdict returned in history. Vivendi has vowed to appeal.¹¹

Counsel for Vivendi¹² recently filed a motion for judgment as a matter of law. Vivendi contends that the court lacked subject-matter jurisdiction over the claims of the “foreign-cubed” class members. Vivendi also asserts that the verdict form did not require the jury to make particularized findings as to each element, but rather asked a single up-or-down question about liability for each alleged misstatement, resulting in confusion and prejudice to the company. Vivendi further asserts that there was a failure of proof as to scienter. Specifically, Vivendi argues that a corporation can only act through its agents and there is no evidence that the company's CEO and CFO, who were both exonerated, or any other Vivendi employee had the requisite scienter.¹³

Defense Victory Cases

***In re Health Mgmt Sec. Litig.*, No. 96 Civ. 889 (ADS) (E.D.N.Y.).** In 1996, shareholders of Health Management, Inc., filed a complaint alleging that the company and its auditors made false statements regarding the company's net income and assets. In particular, the complaint alleges that the defendants included fictitious accounts receivable on its financial statements and thus overstated the company's financial health.

On October 26, 1999, the jury in the first case tried following the passage of the PSLRA returned a defense verdict.¹⁴

***Pipefitters Local 522 & 633 Pension Trust Fund v. JDS Uniphase Corp.*, No. 02-cv-01486 (CW) (N.D. Cal.).** In 2002, the lead plaintiff, Connecticut Retirement Plans and Trust Funds, accused JDS Uniphase and four key executives of defrauding investors by hiding from company shareholders advance knowledge of the company's impending downturn, which resulted in its share price plummeting. In addition, the defendants had to contend with the fact that the company had sold off nearly \$500 million in stock before the share value plunged.¹⁵

In November 2007, after just two days of deliberation in a four-week trial, a jury returned a complete defense verdict. At the time of the verdict, JDS Uniphase's chief legal officer said that a jury verdict for any one of the plaintiff's claims would have caused the company to go into bankruptcy. This was the second securities class-action case to go to trial since the PSRLA.¹⁶

***In re Am. Mut. Funds Fee Litig.*, No. 04-cv-5593 (GAF) (C.D. Cal.)**. A group of American Funds shareholders filed a lawsuit in 2004 claiming that the defendants, Capital Group Companies, Inc., Capital Research and Management Company, and American Funds Distributors (AFD), violated federal securities law by charging excessive mutual fund management fees.¹⁷

After a bench trial, the trial court held that the plaintiffs failed to meet the high burden for excessive fees established in *Gartenberg v. Merrill Lynch Asset Management*,¹⁸ which requires plaintiffs to provide proof that the fee "is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."¹⁹

***Sekuk Global Ent. v. Apollo Group Inc*, No. 04-cv-02147 (JAT) (D. Ariz.)**. In 2004, the lead plaintiff, the Policeman's Annuity and Benefit Fund of Chicago, brought a lawsuit alleging that Apollo Group, Inc., a for-profit company that runs the University of Phoenix, and two of its officers made false and misleading statements regarding a Department of Education program review of the University of Phoenix.²⁰ The lead plaintiff argued that an analyst report, which downgraded the company's stock, contained corrective disclosures that caused a stock price decline. The company argued that the lead plaintiff failed to prove loss causation because the analyst report did not introduce any new information into the market.²¹

On January 16, 2008, a jury found the defendants jointly and severally liable for \$277 million in damages for misleading investors. In an opinion dated August 4, 2008, the trial court judge overturned the jury verdict and granted the company's motion for judgment as a matter of law. Citing the loss causation requirements in *Dura Pharmaceuticals v. Broudo*, 544 U.S. 336 (2005), the trial court agreed with the company that "[t]he evidence at trial undercut all bases of which [the lead plaintiff] claimed the [analyst reports] were corrective."²² The trial court found that although the company had misled the market, the company did not cause investors to suffer any harm.²³

***Miller v. Thane Int'l, Inc.*, No. 03-cv-01031-JVS-SGL (C.D. Cal.)**. In 2002, after a merger transaction in which the shareholders of Reliant Interactive Media Corp. received shares of Thane International, Inc., a group of Reliant shareholders filed an action alleging that Thane and certain of its officers and directors made misrepresentations in connection

with the securities offering. The plaintiffs contended that the prospectus distributed to Reliant shareholders contained a material misstatement of fact because Thane did not list its stock on the NASDAQ National Market System following the merger.²⁴

Following a bench trial, the district court returned a defense verdict, which was later overturned by the Ninth Circuit Court of Appeals. The Ninth Circuit held that the district court clearly erred when it found that the company did not misrepresent that it would list the merged company's shares on the NASDAQ and that the misrepresentations were material.²⁵ Upon remand, the district court considered a series of motions and granted the defendants' motion for judgment as a matter of law on loss causation. This decision is currently on appeal before the Ninth Circuit.²⁶

Trial Lessons from the Elusive Nine

With nine cases having gone to verdict, what lessons can be learned? Do the verdicts offer any guidance to future trial counsel in securities class-action cases? Or rather, do they serve as a warning that securities litigators should encourage their clients to reach a settlement? Given the dearth of cases, it will be difficult to counsel clients on the probability of suc-

ceeding at trial. However, if the case proceeds to trial, there are several considerations counsel must take before opening statements and even after a verdict has been reached.

As an initial matter, many of these cases involve complicated financial issues. They will often require the use of several experts to calculate damages and help explain complex financial terms and accounting rules. In *Vivendi*, for example, the parties used experts on accounting principles from several countries. In *JDS Uniphase*, the testimony and subsequent cross-examination of the plaintiff's damages expert was crucial to the defense verdict. Thus, in determining your litigation strategy, the first question will inevitably become how to present your case as a cohesive and logical story. Relevant to that is who trial counsel is presenting the story to—jury or judge—as well as what part of the case is at issue—liability, damages, or both. In light of the complexity of some of these cases, it may be beneficial to try this case to a judge—particularly an experienced judge who has handled financial cases. In addition, given the post-Enron era, defense attorneys with cases that involve alleged corporate fraud may think a bench trial would be favorable. However, the nine cases that have gone to verdict haven't all resulted in plaintiff victories. More important than to whom the case is tried is how the case is presented.

It will be difficult to counsel clients on the probability of succeeding at trial.

As in any jury trial, counsel must present the necessary evidence to a jury and present the equitable considerations that warrant a finding in their favor. Given the complexity of most of these cases and the duration of the trials, trial counsel must be sure to give jurors a coherent story that they can understand and follow throughout the duration of the trial. Because jurors will be resolving issues of fact, trial counsel will need to tell the jury early on what the key facts are and keep bringing the jurors back to those facts throughout the trial. And bear in mind the cardinal rule: Keep it simple. This assumes that the discovery process revealed all of the key facts and evidence that trial counsel will need to tell their story. In a case involving both a company and its executives, it will also be impor-

At the end of the day, clients will dictate how far their cases will go.

tant to flush out for the jury exactly who did what, or, more importantly in cases involving alleged misstatements, who said what. As the *Vivendi* verdict demonstrates, just because a jury finds a company liable for misleading statements, it won't necessarily find the company's executives similarly liable.

For most of these trials, the plaintiffs' counsel will likely tap into the emotional aspects of their cases. This is particularly true for cases like *Apollo Group* and *Vivendi* that involve a sympathetic lead plaintiff such as retirement funds. While trial counsel for the plaintiff can use this as a leverage point, there are things that trial counsel for the defendants can do as well. JDS Uniphase's trial counsel, James Bennett, for example, explained the importance of personalizing the company for the jurors.²⁷ To do this, Bennett used a large chart with pictures of JDS Uniphase employees who had testified during closing statements. Although the judge required photos of each witness as an aid to jurors, Bennett said it served his other goal of making the corporation come alive for jurors. Bennett also emphasized the importance of introducing key facts early in the trial and referring back to them to "stay on message."²⁸

In addition, careful planning for cross-examination and an early determination of which witnesses' credibility could be challenged are crucial. In making these decisions, trial counsel should bear in mind that convincing a jury or judge of your preferred damages model can be just as important as trying to win the liability issue. In some cases, successful cross-examination by the defense may lead to a reduced damages calculation that, for clients facing billions in damages, may be considered a semi-victory. For example, after the *Vivendi* verdict, trial counsel for the company stated that the verdict was a partial victory because the jury gave the plaintiffs only half of the rate per share that they were requesting.²⁹ In total, jurors found that Vivendi inflated its stock by as much as \$11.³⁰

Even when the trial is over, trial counsel should consider moving for judgment as a matter of law. Your case may present a situation like *Apollo Group, Inc.*, where the jury simply got it wrong, and a judge may overturn the verdict.

As in any service industry, we as attorneys represent our clients in their wishes. One can give advice to a client about the benefits or risks of going to trial; however, at the end of the day, clients will dictate how far their cases will go. Given the current economic climate, client concerns may push toward settlement if the number is right. This is particularly true in light of the exorbitant amount of money required to try such a case. However, for some clients facing prohibitive damages that could reach into the billions, the risk of being vindicated at trial may be worth it. If you find yourself litigating the 10th securities class-action trial, remember to present a coherent story and take advantage of each and every direct- and cross-examination.

Melissa Colón-Bosolet is a law clerk to the Honorable George B. Daniels in the Southern District of New York.

Endnotes

1. No. 02-cv-05571-RJH-HBP (S.D.N.Y.).
2. "Foreign-cubed" or "f-cubed" cases involve foreign plaintiffs suing a foreign company for violations of American securities laws based on transactions on foreign exchanges. The Supreme Court is considering the reach of U.S. securities laws over these cases and the extent to which U.S. courts have jurisdiction over claims that involve transnational securities fraud in *Morrison v. National Australia Bank Ltd.*, No. 08-1191. In oral arguments on March 29, 2010, the Supreme Court seemed to oppose the idea of extending jurisdiction to such cases. See Tony Mauro, *Supreme Court Justices Hostile to 'Foreign-Cubed' Cases*, NAT'L L.J. (Mar. 30, 2010), available at <http://www.law.com/jsp/article.jsp?id=1202447043326>. Attorneys who represent foreign companies should pay particular attention to this case because the Court's ruling will define the limits of U.S. securities laws over private actions with foreign components. In addition, Congress is considering Proposed Bill H.R. 3817, the Investor Protection Act of 2009, which, if passed, could make it easier for investors to sue foreign companies in U.S. courts even if they are based abroad and listed on foreign exchanges. This act could also open the doors to U.S. courts and result in a surge of securities class-action cases involving foreign litigants.
3. Other securities class-action cases have gone to trial but not gone all the way to a verdict. In addition, seven securities class-action cases have been tried involving conduct that occurred prior to the passage of the PSLRA. See Adam T. Savett, RiskMetrics Group—Securities Class Action Services, *Securities Class Action Trials in the Post-PSLRA Era* (Jan. 2010), <http://blog.riskmetrics.com/slw/SCAS%20Trials.pdf>.
4. In 1995, Congress sought to reduce the number of "frivolous" securities lawsuits filed in federal courts and enacted the PSLRA.

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Section of Litigation

The PSLRA enacted various procedural and substantive changes related to, among other things, pleading, discovery, and liability. First, the PSLRA heightened the pleading standard by requiring that a plaintiff allege each misleading statement, as well as the reason or reasons why the statement is misleading. In addition, if an allegation regarding the statement or omission is made on information and belief, the complaint must state with particularity all the facts on which that belief is formed. See 15 U.S.C. § 78u-4(b)(1). The PSLRA also requires a plaintiff to allege that the defendant acted with scienter. In alleging scienter, a plaintiff must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” *Id.* In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), the Supreme Court interpreted the PSLRA’s “strong inference” requirement and held that the “inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.” 551 U.S. at 324. The *Tellabs* decision makes clear that courts must now engage in a comparative analysis where they weigh the fraudulent factual allegations with plausible innocent explanations. The PSLRA also makes clear that a plaintiff in a Rule 10b-5 case “shall have the burden of proving that the act or omission of the defendant . . . caused the loss for which the plaintiff seeks to recover damages.” 15 U.S.C. § 78u-4(b)(4). After the Supreme Court’s decision in *Dura Pharmaceuticals v. Broudo*, 544 U.S. 336 (2005), a plaintiff must also allege loss causation in its complaint. Finally, the PSLRA included an automatic stay of discovery “during the pendency of any motion to dismiss.” 15 U.S.C. § 78u-4(b)(3)(B).

5. In 1996, the average settlement was \$8 million and reached a high of \$80 million in 2006. However, outlier settlements in 2006 were responsible for this high figure. The average settlement in 2009 was \$12 million. See Stephanie Planchich, Ph.D. & Svetlana Starykh, Nera Economic Consulting, Recent Trends in Securities Class Action Litigation: 2009 Year-End Update, (December 2009), http://www.securitieslitigationtrends.com/Recent_Trends_Report_01.10.pdf.

6. See Labaton Sucharow, In re Real Estate Associates Limited Partnership Litigation, <http://lsr.nisgroup.com/en/cases/In-re-Real-Estate-Associates-Limited-Partnership-Litigation.cfm>.

7. See Bernstein Litowitz Berger & Grossmann, LLP, In re Clarent Corporation Securities Litigation, <http://www.blbglaw.com/cases/00102>.

8. *Id.*

9. See generally Amended Consol. Compl., 02-cv-5893 (RAG) (N.D. Ill.); see also Kevin LaCroix, Rare Securities Lawsuit Jury Trial Commences in Case with Predatory Lending Issues (Mar. 30, 2009), <http://www.dandodiary.com/2009/03/articles/securities-litigation/rare-securities-lawsuit-jury-trial-commences-in-case-with-predatory-lending-issues>.

10. See *id.*

11. Larry Neumeister, Jury Rules for Shareholders in Vivendi Suit; Plaintiffs Predict \$9.3 Billion Payout: New York Jury Finds Company Liable, But Not Its Executives (Feb. 1, 2010), <http://www.law.com/>

[jsp/article.jsp?id=1202439681253](http://article.jsp?id=1202439681253); Nathan Koppel, Viva Vivendi! New York Plaintiffs’ Firms Score Huge Verdict (Jan. 29, 2010), <http://blogs.wsj.com/law/2010/01/29/viva-vivendi-new-york-plaintiffs-firms-score-huge-verdict/>; see also Vivendi Will Appeal to Overturn Jury Verdict (Jan. 29, 2010), <http://www.vivendi.com/vivendi/Vivendi-Will-Appeal-to-Overtturn>.

12. Vivendi was represented by Weil, Gotshal & Manges, LLP and Cravath, Swaine & Moore, LLP. Although Colón-Bosolet formerly worked at Weil, Gotshal & Manges, LLP, she did not work on the *Vivendi* case during its trial.

13. See Def. Mem. of Law in Support of Its Motion for Judgment as a Matter of Law.

14. See NERA Economic Consulting Information on Securities and Finance Client Experience at http://www.nera.com/PracticeArea.asp?PA_ID=44&more=ClientExp&c_ID=212; see also Zwerling, Schachter & Zwerling, LLP, The Practice: Securities Litigation, <http://www.zsz.com/practice-sec.htm>.

15. See Pamela A. MacLean, *Hammer the Experts*, NAT’L L.J. (June 16, 2008), <http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1202422212187>.

16. *Id.*

17. See Analysis Group, In re American Funds Fee Litig., <http://www.analysisgroup.com/cases.aspx?id=9736>.

18. The outcome of future cases based on excessive fees will be governed by the Supreme Court’s decision in *Jones v. Harris Associates L.P.*, 130 S. Ct. 1418 (2010). In *Jones*, the Seventh Circuit applied an alternative standard to *Gartenberg*. The issue before the Court was whether a shareholder’s claim that the fund’s investment adviser charged an excessive fee is not cognizable under § 36(b) of the Investment Company Act of 1940, unless the shareholder can show that the adviser misled the fund’s directors who approved the fee. On March 30, 2010, the Supreme Court issued an opinion vacating the Seventh Circuit’s opinion, finding that the *Gartenberg* standard “may lack sharp analytical clarity . . . it accurately reflects the compromise that is embodied in § 36(b), and it has provided a workable standard for nearly three decades.” *Id.* at 1430.

19. See In re Am. Mut. Funds Fee Litig., No. CV 04-5593 GAF (RNBx), 2009 U.S. Dist. LEXIS 120597, at *8-9 (C.D. Cal. Dec. 28, 2009).

20. In re Apollo Group, Inc. Securities Litig., CV 04-2147-PHX-JAT, 2008 U.S. Dist. LEXIS 61995, at *6-7 (D. Az. Aug. 4, 2008).

21. *Id.* at *10-12.

22. *Id.* at *15-16.

23. *Id.*

24. See *Miller v. Thane Int’l, Inc.*, 519 F.3d 879 (9th Cir. 2008).

25. *Id.* at 888-93.

26. *Miller v. Thane Int’l, Inc.*, No. 09-55474 (9th Cir. 2009).

27. *Supra* note 15.

28. *Id.*

29. *Supra* note 11.

30. *Id.*



Amendments to the Custody Rule

(Continued from page 1)

Surprise Examinations

Under the newly adopted amendments, RIAs who have custody of client assets or whose client assets are held by a related person are required to engage an independent public accountant to conduct a surprise examination of the client assets held by the adviser.⁵ The RIAs required to obtain a surprise examination must enter into a written agreement with an independent public accountant stating that the first examination will take place by December 31, 2010, or, for advisers that become subject to the rule after the effective date, within six months of becoming subject to the requirement.⁶ While the amendments require the RIA to arrange for the engagement of the independent public accountant, the inspection must be unannounced and at a time selected by the accountant.⁷ Further, the inspection must occur annually and irregularly from year to year.⁸ In other words, the inspection cannot happen at or around the same time each year. The SEC expects the inspection to truly be a surprise.

With respect to RIAs who are acting as qualified custodians because they maintain clients' assets or because a related person maintains client funds or securities, then the independent public accountant retained to perform the surprise inspection must be registered with and subject to regular inspection by the Public Company Accounting Oversight Board (PCAOB) as of the commencement of the professional engagement period and as of the end of each calendar year.⁹ In this circumstance, RIAs must also obtain (or receive from their related person), a written internal control report within six months of becoming subject to the regulation and then at least once each following calendar year.¹⁰ The internal control report must include an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date and whether they are suitably designed and operating efficiently to meet control objectives related to custodial services, including the safeguarding of client funds and securities,¹¹ and a verification by the accountant that the funds and securities are reconciled to a custodian other than the RIA or a related person.¹² The SEC noted that the internal control report can "significantly strengthen the utility of the surprise examination" to the extent it "provides a basis for the independent public accountant performing the surprise examination to obtain additional comfort that the confirmations received from the related custodian are reliable" and serves to "inform the surprise examination process."¹³ The agreement with the independent public accountant for the surprise inspection must provide for the first examination to occur no later than six months after obtaining the internal control report.¹⁴

There are three significant exceptions to the new surprise annual examination requirement.

Fee Deduction Exception

RIAs who have custody of client assets solely for the purpose of withdrawing their advisory fees from client accounts are exempt from independent verification requirements.¹⁵ The amendments provide increased controls over the account statements delivered to the client (discussed later in this article) that the SEC reasoned sufficiently enable the client to monitor the propriety of the amount of advisory fees deducted.¹⁶ This exception, however, is not available to an RIA that serves as trustee for its clients, despite the fact that many trustees do not charge a separate fee or charge only a minimal fee for this service.¹⁷ The SEC reasoned that the level of authority that a trustee exercises over the trust assets makes these assets susceptible to misuse and thus in need of the protections afforded by the surprise examination.¹⁸

The SEC amended the proposed rule to recognize an acceptable alternative to the surprise examination requirement for pooled investment vehicles.

Advisers to Pooled Investment Vehicles

The SEC had originally also proposed requiring the surprise examination of advisers to a pooled investment vehicle, even though pooled investment vehicles are also subject to an annual financial statement audit by an independent public accountant.¹⁹ In response to comment that surprise examinations would be duplicative of the annual financial statement audit, the SEC amended the proposed rule to recognize an acceptable alternative to the surprise examination requirement for pooled investment vehicles.²⁰ Specifically, if a pooled investment vehicle is subject to an annual financial statement audit by an independent public accountant and distributes audited financial statements prepared in accordance with GAAP to the pool's investors, it has satisfied the annual surprise examination requirement.²¹ In order for the audit to serve as an alternative to the surprise examination requirement, the independent public accountant conducting the audit must be registered with and subject to regular inspection by the PCAOB as of the commencement of the professional engagement period and as of the end of each calendar year, and the audited financial statements must be provided to pool

investors within 120 days of the end of the pool's fiscal year.²² If, however, the pooled investment vehicle does not distribute audited financial statements to its investors, the adviser must obtain an annual surprise examination and have a reasonable basis, after "due inquiry," for believing that the qualified custodian sends an account statement of the pooled investment vehicle to its investors.²³

In addition to obtaining an annual audit, advisers of pooled investment vehicles with custody of pool assets must also obtain a final financial statement audit upon liquidation of

the pool and distribute the audited financial statements, prepared in accordance with GAAP, to the pool investors promptly after the completion of the audit.²⁴

On a related note, the SEC recognized that investors in pooled investment vehicles will not receive the benefit of the controls discussed later in this article with respect to receiving regular reports that the assets underlying their investments are properly held.²⁵

However, the SEC has directed its staff to "explore ways in which we could remedy this potential shortcoming while respecting the confidential nature of proprietary information."²⁶

Advisers with Custody Through Related Persons

The amendments provide that an RIA has "custody" of any client's securities or funds that are directly or indirectly held by a "related person" in connection with advisory services provided by the adviser to its clients.²⁷ Further, a "related person" is defined by the rule as any "person, directly or indirectly, controlling or controlled by you, and any person that is under common control with you."²⁸ The SEC indicated that several commentators had urged it to adopt the position that staff had taken in previous "no-action letters expressing the view that custody of client assets by a related person would not be attributed to the adviser if the related person was operationally separate."²⁹ The SEC noted, however, that it viewed advisers as having sufficient authority or influence over related persons to prevent risks resulting from the related person's ability to obtain client assets, so the adviser itself should be treated as having custody of the assets.³⁰

As a result, the SEC adopted the amendment as proposed but provided for a limited exemption from the surprise

examination requirements for RIAs that are deemed to have custody solely as a result of certain of their related persons holding client assets and to be "operationally independent" of the custodian.³¹ The amendments include a detailed definition of "operationally independent" that provides that a related person is "presumed not to be operationally independent unless each of the following conditions is met and no other circumstances can reasonably be expected to compromise the operational independence of the related person":

- client assets in the custody of the related person are not subject to claims of the adviser's creditors;
- advisory personnel do not have custody or possession of, or direct or indirect access to, client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the adviser or its related persons or otherwise have the opportunity to misappropriate such client assets;
- advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and
- advisory personnel do not hold any position with the related person or share premises with the related person.³²

An adviser that is able to satisfy these requirements can overcome the presumption that it is not operationally independent of its related person and, as a result, would not have to obtain a surprise examination of client assets held by that related person. As noted by the SEC, however, the adviser would still "have to comply with the other provisions of the rule (unless an exception is available), including notifying the client where the assets are maintained, forming a reasonable belief after due inquiry that the qualified custodian sends the client account statements, and obtaining an internal control report from a related person that is a qualified custodian."³³

SEC Reporting

The amendments provide that the written agreement with the independent public accountant must require, among other things, that the accountant notify the SEC within one business day of finding any material discrepancy during the course of the examination³⁴ and that the accountant submit Form ADV-E to the SEC with the accountant's certificate within 120 days of the time chosen by the accountant for the surprise examination, stating that the accountant has examined the funds and securities and describing the nature and extent of the examination.³⁵

The agreement with the accountant must also require the accountant, upon resignation or dismissal, to file a

An independent public accountant must notify the SEC within one business day of finding any material discrepancy during an examination.

statement regarding the termination with Form ADV-E within four business days.³⁶ This statement must include the date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant; and an explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination.³⁷ Likewise, the RIA is required on its Form ADV Part I to disclose, among other things, the identity of the accountant that performs its surprise examinations and to amend its Form ADV in the event it changes accountants. Despite comments suggesting that the accountant termination filings should not be made public, the SEC noted that it believed it is “important that the public have access to the termination statements” and that “identifying frequent changes in accountants could put clients and prospective clients on notice to inquire about the reasons for these events.”³⁸

Delivering Account Statements and Notice to Clients

The amended rule eliminates the option for RIAs to deliver account statements themselves; all account statements must be delivered directly by the custodian.³⁹ The SEC indicated that this amendment was motivated by the belief that, “direct delivery of account statements by qualified custodians will provide greater assurance of the integrity of account statements received by clients.”⁴⁰ All custodians holding advisory client assets, subject to applicable consumer privacy laws, must deliver custodial statements directly to the advisory clients rather than through the RIA. The RIA may still elect to send account statements to clients in addition to the statements sent by the custodian, but if the RIA does send additional statements, it must instruct those clients to compare the account statements they receive directly from the custodian with the statements they receive from the RIA.⁴¹ This instruction must be communicated to the client by way of a legend included in the notification to clients upon opening an account with a qualified custodian on their behalf, upon changes to their account information, and in any subsequent account statements.⁴²

If the RIA elects not to send separate account statements to the client, the RIA is not absolved from all responsibility with respect to sending the statements. The amended rule requires that the RIA must have a reasonable basis, after “due inquiry,” for believing that the qualified custodian is, in fact, sending account statements to clients on at least a quarterly basis, detailing the assets and transactions in the clients’ accounts, directly to each client for which it maintains custody.⁴³ The SEC has not provided extensive guidance as to what will constitute “due inquiry” and instead is “providing advisers with flexibility to determine how best to meet this requirement.”⁴⁴ However, in the adopting release, the SEC provided limited guidance by indicating that the “due inquiry” requirement is satisfied “if the qualified custodian provides the adviser with a copy of the account statement

that was delivered to the client” but not if the RIA accesses “qualified custodian account statements through the custodian’s website.”⁴⁵ The SEC advised that accessing the statements through the custodian’s website “merely confirms that they are available” and that the RIA must take “additional steps to determine whether account statements were sent to clients.”⁴⁶

Compliance Policy and Procedures

Rule 206(4)-7 of the Advisers Act requires RIAs to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.⁴⁷ In its adopting release, the SEC noted its belief that “an adviser’s maintenance of strong policies and procedures” in addition to the new rule amendments “is an essential component of a comprehensive approach to addressing the potential risks raised by an adviser’s custody of client assets.”⁴⁸ Further, the SEC provided guidance regarding the specific types of policies and procedures relating to the safekeeping of client assets that RIAs should consider including in their compliance programs:⁴⁹

- conducting background and credit checks on employees of the investment adviser who will have access (or could acquire access) to client assets to determine whether it would be appropriate for those employees to have such access;
- requiring the authorization of more than one employee before the movement of assets within, and withdrawals or transfers from, a client’s account, as well as before changes to account ownership information;
- limiting the number of employees who are permitted to interact with custodians with respect to client assets and rotating them on a periodic basis;
- if the adviser also serves as a qualified custodian for client assets, segregating the duties of its advisory personnel from those of custodial personnel to make it difficult for any one person to misuse client assets without being detected;
- requiring that any problems be brought to the immediate attention of the management of the adviser;
- developing policies regarding the ability of individual employees to acquire custody of client assets, because their custody may be attributable to the firm, which will thereby acquire responsibility for those assets under the custody rule;
- consider developing procedures by which the chief compliance officer (CCO) periodically tests the effectiveness of the firm’s controls over the safekeeping of client assets; and
- advisers that have custody as a result of their

authority to deduct advisory fees from client accounts held at a qualified custodian should have policies and procedures in place that address the risk that the adviser or its personnel could deduct fees to which the adviser is not entitled under the advisory contract, which could violate the contract and constitute fraud under the Advisers Act including:

- periodic testing on a sample basis of fee calculations for client accounts to determine their accuracy;
- testing of the overall reasonableness of the

amount of fees deducted from all client accounts for a period of time based on the adviser's aggregate assets under management; and

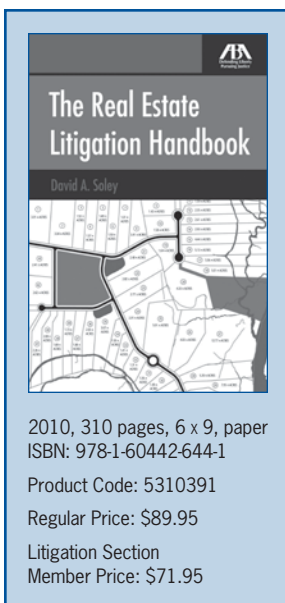
- segregating duties between those personnel responsible for processing billing invoices or listing of fees due from clients that are provided to and used by custodians to deduct fees from clients' accounts and those personnel responsible for reviewing the invoices and listings for accuracy, as well as the employees responsible for reconciling those invoices and listings with deposits of advisory fees by the custodians into

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the adviser's proprietary bank account to confirm that accurate fee amounts were deducted.⁵⁰

The SEC noted, however, that the propriety of certain policies and procedures is dependent upon variances in the operations and size of each adviser. The foregoing guidance is "primarily in the form of examples," and the SEC "expects advisers to tailor their custody policies and procedures to fit both the size and the particular risks that are raised by their business model."⁵¹

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Endnotes

1. The recordkeeping amendments may be found at 17 C.F.R. § 275.204-2 (2010).
2. The SEC indicated that the amendments impacting RIAs are the "first step in the effort to enhance custody protections, with consideration of additional enhancements of the rules governing custody of assets by broker-dealers to follow." See *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2968, at 4 (Dec. 30, 2009), available at <http://www.sec.gov/rules/final/2009/ia-2968.pdf>.
3. *Id.* at 3 n.1 (listing multiple SEC enforcement actions).
4. *Id.*
5. See 17 C.F.R. § 275.206(4)-2(a)(4) (2010). Additionally, the SEC acknowledged the concerns raised regarding the impact the cost of the surprise examinations will have on smaller advisers that have authority to obtain possession of client funds or securities and whose client assets are maintained by an independent qualified custodian. The SEC indicated that, after the first round of surprise examinations, the SEC staff will conduct a review with respect to these smaller RIAs and make recommendations to the SEC for amendments to improve the effectiveness of this rule or address any unnecessary burdens it may impose upon these RIAs. See adopting release, *supra* note 2, at 13-14.
6. See *id.* at 13 n.37; 17 C.F.R. § 275.206(4)-2(a)(4) (2010).
7. *Id.*
8. *Id.*
9. 17 C.F.R. § 275.206(4)-2(a)(6)(i) (2010).
10. 17 C.F.R. § 275.206(4)-2(a)(6)(ii) (2010).
11. The SEC indicated that in order to form this opinion, the internal control report should address "control objectives and associated controls related to the areas of client account setup and maintenance, authorization and processing of client transactions, security maintenance and setup, processing of income and corporate action transactions, reconciliation of funds and security positions to depositories and other unaffiliated custodians, and client reporting." See adopting release, *supra* note 2, at 29.
12. 17 C.F.R. § 275.206(4)-2(a)(6)(ii)(A) & (B) (2010).
13. See adopting release, *supra* note 2, at 27-28.
14. 17 C.F.R. § 275.206(4)-2(a)(4) (2010).
15. 17 C.F.R. § 275.206(4)-2(b)(3) (2010).
16. See adopting release, *supra* note 2, at 14-15.
17. *Id.* at 14 n.38.
18. *Id.*
19. *Id.* at 15.
20. *Id.* at 15-16.
21. See 17 C.F.R. § 275.206(4)-2(b)(4) (2010).
22. See 17 C.F.R. § 275.206(4)-2(b)(4)(ii) (2010).
23. See 17 C.F.R. § 275.206(4)-2(b)(4) (2010).
24. See 17 C.F.R. § 275.206(4)-2(b)(4)(iii) (2010).
25. Adopting release, *supra* note 2, at 18.
26. *Id.*
27. See 17 C.F.R. § 275.206(4)-2(d)(2) (2010) (defining "custody").
28. See 17 C.F.R. § 275.206(4)-2(d)(7) (2010) (defining "related person").
29. Adopting release, *supra* note 2, at 32 & n.104.
30. *Id.* at 33.
31. See 17 C.F.R. § 275.206(4)-2(b)(6)(i) & (ii) (2010).
32. See 17 C.F.R. § 275.207(4)-2(d)(5) (2010) (defining "operationally independent").
33. Adopting release, *supra* note 2, at 35.
34. The notification to the SEC must be transmitted by "means of a facsimile transmission or electronic mail, followed by first-class mail, directed to the attention of the Director of the Office of Compliance Inspections and Examinations." 17 C.F.R. § 275.206(4)-2(a)(4)(ii) (2010).
35. See 17 C.F.R. § 275.206(4)-2(a)(4)(i) & (ii) (2010). Further, the SEC has issued a companion release to provide guidance for accountants with respect to the surprise examination and internal control report required under 17 C.F.R. § 275.206(4)-2(a)(6)(ii)(A) (2010) Rule 106(4)-2. See *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 2969 (Dec. 30, 2009), available at <http://www.sec.gov/rules/interp/2009/ia-2969.pdf>.
36. See 17 C.F.R. § 275.206(4)-2(a)(4)(iii) (2010).
37. See 17 C.F.R. § 275.206(4)-2(a)(4)(iii)(A) & (B) (2010).
38. Adopting release, *supra* note 2, at 20.
39. 17 C.F.R. § 275.206(4)-2(a)(3) (2010).
40. Adopting release, *supra* note 2, at 7.
41. 17 C.F.R. § 275.206(4)-2(a)(2) (2010).
42. *Id.*
43. 17 C.F.R. § 275.206(4)-2(a)(3) (2010).
44. Adopting release, *supra* note 2, at 8.
45. *Id.* at 9 n.21.
46. *Id.*
47. 17 C.F.R. § 275.206(4)-7 (2010).
48. Adopting release, *supra* note 2, at 42.
49. *Id.*
50. *Id.* at 43-46.
51. *Id.* at 46-47.

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