ROUNDTABLE

Securities

EXECUTIVE SUMMARY

The recession, various stock-option backdating and honest-services cases, and growing disfavor with Sarbanes-Oxley (Pub. L. 107-204 (2002)) all make these heady times for securities litigators. The Public Company Accounting Oversight Board (PCAOB) created by Sarbanes-Oxley is being challenged for being unconstitutional while everyone is still reeling from the ramifications of the *Twombly* (*Bell Atlantic Corp. v. Twombly* (550 U.S. 544 (2007)) and *Iqbal* (*Ashcroft v. Iqbal,* 129 S.Ct. 1937 (2009)) decisions—sometimes referred to as "*Twiqbal*."

Our panel of experts discusses these topics and the changes that Robert Khuzami, director of the division of enforcement for the Securities and Exchange Commission (SEC), is making at the SEC. The panel includes David B. Bayless and Haywood S. Gilliam of Covington & Burling in San Francisco; Matthew L. Larrabee with Dechert in San Francisco; Daniel C. Girard of Girard Gibbs in San Francisco; Richard H. Zelichov with Katten Muchin Rosenman in Los Angeles; and Penelope Graboys Blair and Michael D. Torpey with Orrick, Herrington & Sutcliffe in San Francisco. *California Lawyer* moderated the roundtable, which was reported by Krishanna DeRita of Barkley Court Reporters.

MODERATOR: What's the impact of the great recession on securities litigation?

GILLIAM: On a regulatory level, which includes the SEC and DOJ, there is clearly going to be a call for action. The status quo is interpreted as a massive failure of the regulatory system. There is going to be pressure for prosecutions to be brought, regulatory actions to be opened. A Financial Fraud Task Force has been convened, replacing the prior Corporate Fraud Task Force that had many of the same functions. The SEC regulatory apparatus is talking about renewing its cooperation with other regulatory agencies, DOJ, and others. There is going to be aggressiveness because there is a political and popular push for that. Whether that will result in wiser or better enforcement is an open question. Interestingly, while regulators promise increased focus and increased aggressiveness, the courts have shown skepticism about some of the government's strategies and tactics in recent cases. The court's rejection of the proposed settlement in the *Bank of America* case (*SEC v. Bank of America Corp.*, 653 F.Supp.2d 507 (S.D.N.Y. 2009)) is one example. There's an interesting collision between aggressiveness on the part of the regulators and courts that have shown a willingness to step in and scrutinize very closely what had previously been viewed as the inner workings of how the government investigates, charges, and resolves its cases.

> **"I have trouble with the notion that our standards of conduct in the industry are good enough and can use lowering."**
> ***—Daniel C. Girard***

LARRABEE: Those collisions could increase in the sense that, as the SEC leverages new vertical expertise and they push more aggressive theories in an effort to prove to the world that they are tough—one would expect a higher rate of losses. The more aggressive theories you advance, the more edges of the envelope you push, the more likely a judge is going to disagree with you.

TORPEY: This credit crisis is changing the practice dramatically on the defense side. The cases are getting harder to settle. Ten years ago you could put an experienced defense lawyer and an experienced plaintiffs lawyer in a room with a box of documents and they would come to a mutual valuation of the case. It's very difficult to do that any more mainly because there are not just two players. Usually it's three, four, or five different players trying to come to a settlement or an agreement. The average defense cost for a case is much higher. Further, if you get past the motion to dismiss, you are going to be at trial. It's really hard to win a motion for summary judgment if you have lost the motion to dismiss. That's a change in the way this practice has evolved and there are going to be more and more individual representations.

MODERATOR: Let's talk about the Liability for Aiding and Abetting Securities Violations Act of 2009. Some folks are saying that the private suits for aiding and abetting would be the most realistic means to prevent misconduct while others say private suits would undermine the United States' international competitiveness and raise the cost of capital. Is this going to pass? If so, what will be the impact?

GILLIAM: The impetus for a proposal like this, in large part, is the perceived failure of the SEC to prevent the issues we've seen over the past couple of years. That said, the question will be whether the perceived benefit of allowing private enforcement in an aiding-and-abetting situation is worth it, when undoubtedly the cost of litigation on a system-wide basis would skyrocket. Were this to pass, a number of peripheral actors, auditors, and attorneys and others, would be pulled into nearly every case immediately. Even taking into account the heightened pleading standards that would apply, you wonder whether there are simply too few checks on the process. Even winning a motion to dismiss entails significant expense.

LARRABEE: How much deterrence of aiders and abettors is enough? You can make an argument that

there hasn't been enough deterrence of financial misconduct in our system, but I haven't seen evidence that current deterrence of aiders and abettors is insufficient. There's pretty good criminal deterrence and civil enforcement by the SEC. Anybody who is in that zone also has to fear direct liability if they make affirmative misrepresentations. So I'd like to see more evidence that the problem we are facing is lack of deterrence of aiding and abetting and whether turning everybody—banks, investment advisors, lawyers, auditors, and commercial partners—into a police force for fraud is a good idea. Auditors are trained, but there are limits on what even auditors can do. Everybody else is tremendously ill equipped to find fraud except in the most extreme circumstances.

GIRARD: The original idea behind the securities laws was to raise standards of conduct in the securities industry. The message of many recent decisions including *Stoneridge* (*Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008)) is that the standards Congress set in the 1930s are too high. But as those standards have been relaxed, you have a continuing series of breakdowns, bubbles, and scandals that have undermined investor confidence. So I have trouble with the notion that our standards of conduct should continue to be lowered. The financial crisis has exposed cases where you have some very large Ponzi schemes—and it's not just Madoff—where responsibility for the fraud extends well beyond the primary actors. Restoring aiding-and-abetting liability would be a step in the right direction to improve investor confidence.

ZELICHOV: Even pre-*Stoneridge* and pre-*Central Bank* (*Central Bank of Denver N.A. v. First Interstate Bank of Denver N.A.*, 511 U.S. 164 (1994), plaintiffs lawyers did not name third-party aiders and abettors that frequently, unless the issuer had actually gone bankrupt. *Charter* (*In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006)), which was the case that ended up before the Supreme Court, is one of the few cases where the issuer wasn't bankrupt and there was a suit against defendants for aiding-and-abetting. It will, however, raise costs to allow private lawsuits against alleged aiders and abettors because while plaintiffs must still meet the scienter standard, of course, that doesn't really prevent third parties from being named in lawsuits and having to defend themselves. That's a significant cost just to bring a motion to dismiss.

BAYLESS: It's a balancing act. That is a real cost. There are situations where judges have held that aiding and abetting really should be available. There is aiding and abetting available to the SEC and of course to criminal prosecutors. So it's not like it never existed.

GRABOYS BLAIR: It is hard to imagine that there would not be a quieting effect on parties doing business, in particular, non-U.S. parties doing business with U.S. entities, if aiding-and-abetting liability was made widely applicable. For example, if *Stoneridge* had gone the other way and non-U.S. commercial partners or vendors were exposed to private suits as an aider and abettor, one would expect they would be more cautious at a minimum, and in certain circumstances be deterred from doing business.

LARRABEE: If there was liability for aiding and abetting all along, I grant you that some current litigation would include additional defendants and therefore some additional pockets to fund settlements in the cases we have. But I really haven't seen any reason to believe that situation would have changed standards of performance in a way that had any impact on the credit crisis or the number of Ponzi schemes. Dan [Girard], to shift gears slightly, have you seen a dramatic increase in the rate of dismissals post-*Twombly* and *Iqbal*?

GIRARD: What's surprising is that if you start with the backdrop of what was happening pre-"*Twiqbal*," the rate of dismissals is much higher than most people think it is. It's close to 46 percent. So you already have a very high proportion of cases being thrown out at the pleading stage. There's a thorough 90-page memo that was being prepared by a law clerk for the Civil Rules Advisory Committee that's available to anyone on the Internet, that details all the *Twombly* and *Iqbal* decisions. There's some other scholarship out there that specifically isolates cases that say they are dismissing because the complaint doesn't meet the post-*Twombly/Iqbal* standard.

MODERATOR: How much are you experiencing the new aggressiveness of the SEC enforcement division?

GRABOYS BLAIR: I think we can expect to see an increased focus on individuals in enforcement proceedings. Additionally, certain changes have been made to streamline and expedite how the Enforcement Division pursues matters. The power to issue formal orders of investigation and thus have subpoena power has been delegated from the commission to the supervising staff. Currently, an SEC staff attorney need only get permission from a supervisor to issue a subpoena. The Enforcement Division also removed a layer of management vesting more power with the staff attorneys at the front line.

ZELICHOV: We've definitely seen an increased pace with respect to the investigations, especially coming out of D.C. The branch offices have been a little more understanding, with respect to requests for time to figure out what's going on before meeting with them, but D.C. has pushed and has not been really willing to allow us to have those delays. What we haven't seen yet, and I assume we will see, is some more aggression with respect to the substance of the claims that the SEC is going to want to bring and enforce.

BAYLESS: The SEC's Robert Khuzami is the first former federal criminal prosecutor that's ever been the head of the division of enforcement. If you look at his predecessors, they have been people from within the SEC. So he brings a perspective on cases, and also on techniques. The idea of flipping individuals is, of course, common in the criminal context. But it's something that the SEC has never done.

TORPEY: Khuzami explicitly said in a speech, "I want to change the practice." He thinks that flipping individuals is going to make their cases stronger, and the way you flip them is you have everybody separately represented. That is going to change the practice on the defense side enormously.

BAYLESS: Let's face it. The SEC took a big hit in terms of publicity, whether that was warranted or not. They feel like they've got to be aggressive and change things, change people, change processes, change procedures. And they are doing it. I agree that this is really going to change the way that we in the defense bar practice. Right now defense lawyers basically cooperate with each other. You are not worrying about one guy going in first and getting a better deal than your guy. But if you have to worry about that, the way you interact with defense counsel is different.

TORPEY: If you are representing the company, you get a letter from the SEC saying, "We want to look at this issue." The very first thing that we have to do is say, "OK. Do we spin out the individuals or not?" The minute you do that, there are consequences. Your internal investigation gets trickier, harder, less productive, and way more expensive.

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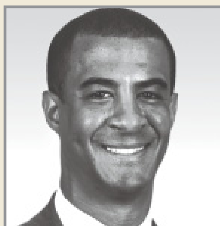

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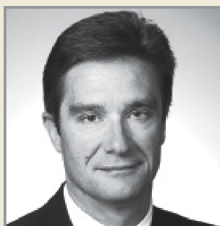

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GILLIAM: Joint representation can also be problematic from the perspective of how the government views the case. In his speech, Khuzami offered his view that the new cooperation policy will increase the risk of conflicts of interest in joint representations. So you can expect the SEC to scrutinize those representations closely. It was a shot across the bow that was somewhat unexpected.

GIRARD: From the investor perspective, Khuzami is an exciting appointment. We are looking to him to bring a lot of new energy to the position. The concern is resources. The number of regulated entities that the SEC has to be concerned with is so high, from the investor perspective, you have to hope that he gets the support he needs from the start.

LARRABEE: The SEC cannot meet all of their objectives with its current staff. Since the SEC is devoting more intensity, more document review, and more resources to individual investigations, the fascinating part of this change will be picking and choosing which cases to pursue.

TORPEY: I'd be interested to know what you think, Dan [Girard], about the changes in the SEC process. How is it going to change the way the plaintiffs bar looks at matters? Will there be a tendency to wait until the SEC is done? Is it still in the interest of the investors to jump out in front and be the first to file before the SEC? How is all that timing going to change, and how is it going to change the practice, if at all?

GIRARD: There's an element of entrepreneurship in the plaintiffs bar. But you can't file a case without a client. The cases that have been filed in the past couple of years reflect people having suffered very serious losses, often on retirement funds, and investors are going to pursue their rights even if there are parallel regulatory proceedings. Lawyers on the plaintiffs' side are very mindful of the need to plead in compliance with the stringent pleading standard, but if the SEC uncovers evidence of fraud, that evidence should be available to private litigants, as Judge Chin recently allowed in the *Bank of America* case (*In re Bank of America Corp. Sec., Derivative, and ERISA Litig.*, 2009 WL 4796169 (S.D.N.Y. Nov. 16, 2009)).

MODERATOR: What about the new disclosure requirements? How are they changing?

TORPEY: The disclosure changes so far are mostly about executive compensation. In the old days, derivative actions were not particularly lucrative things for the plaintiffs bar to invest in. Options backdating changed that, and what we saw was the rise of the derivative action. On the other hand, plaintiffs have the potential to create huge defense fees, because the minute you file a derivative action, particularly in this day and age, most of those people are going to have to be separately represented—especially if it's an executive compensation issue. That will change the way in which the defense bar gets aligned and it will cost the company more money.

ZELICHOV: It's going to be very difficult to actually bring derivative claims related to executive compensation because unlike options back-dating where some of the directors themselves received options that were allegedly back-dated, when it comes to executive compensation, it's usually the independent directors approving someone else's compensation. So you do not have any claims about self-dealing, it will be difficult to challenge in litigation. Changes, if any, are going to have to come from regulators or legislators.

GRABOYS BLAIR: The primary addition in the latest round of executive compensation requirements is to disclose all employee-compensation policies that are reasonably likely to have a material adverse consequence to a company. That is a broad definition that leaves a large amount of discretion to companies as to what to disclose. In addition, companies are allowed to consider mitigating factors in determining the materiality of the adverse impact. A number of the other changes focus on disclosure of board composition processes. This latest round of requirements is unlikely to lead to additional litigation or a change in the way executive compensation suits are brought.

TORPEY: Why do you guys bring those in Delaware? Aren't you way better off in California?

GIRARD: With a California court interpreting Delaware law, a California judge is going to defer to his or her sense of what he or she thinks a Delaware court would do. Your only real shot is to get a Delaware court to decide to take another look at it. The argument that needs to be made on executive compensation is that it should be treated like any other purchasing decision by a corporation. It's a contracting decision, and you need to be able to justify what you've done in an arm's-length sense. Like if you pay someone $100 million dollars a year, you ought to be able to prove that you have some reasonable belief that a person couldn't do that job just as well for $5 or $10 million. If you applied the truly market-driven standard to these decisions, I don't think that they would hold up.

MODERATOR: How are courts reacting to the fraud by hindsight in the loss-causation defense premised on the credit crunch?

BAYLESS: I have many of these cases. Like most things, it depends on the judge, and certainly depends on the district. I find loss causation the better argument in many ways—something that judges inexperienced in federal securities litigation don't often think of. There's got to be the revelation of the truth, which has to then result in the loss being suffered. And I have found that to be a very effective argument. The fraud by hindsight is something everybody knows. You can't say somebody committed fraud in hindsight. Unfortunately, it's very difficult to overcome that psychologically. The loss causation argument has so far been effective for me with courts.

GRABOYS BLAIR: And the extreme nature of the credit crisis may have made it more difficult for certain judges to get their arms around deciding on fraud by hindsight at the motion-to-dismiss stage. Loss causation at the end of the day should be a very effective defense, if not the best, but it will play out downstream in these cases, post-motion to dismiss.

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LARRABEE: We are just now starting to see credit crisis opinions on loss causation. The motions on some of the biggest cases are still being briefed as we speak.

ZELICHOV: There's a really interesting loss-causation question: normally when we think about loss causation, you have to isolate company-specific drops [in stock prices] and company-specific information from market-wide or industry-wide drops. But the plaintiff's view with respect to companies affected by the credit crisis is essentially that the entire market was fraudulent, so when you try to isolate a market wide-drop from a company-specific drop, you are going to have a hard time isolating any loss related to the fraud and show the loss caused to a particular company.

GIRARD: There's some experience with that with the telecom bubble and the litigation that was brought in the wake of that bubble. A damages expert should filter out market-wide decline from issuer-specific decline. But, as the *Countrywide* (*In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132 (C.D. Cal. 2008)) case held, that's a matter for a trier of fact, not a motion to dismiss. A case should survive a post-*Dura* (*Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336 (2005)) loss-causation analysis, if you show some movement in the share price in response to particular corrective disclosures.

"This credit crisis is changing the practice dramatically on the defense side." *— Michael D. Torpey*

MODERATOR: How about the current cases on securities issues, such as whether or not PCAOB is unconstitutional?

GILLIAM: The interesting thing about that issue is that you really have two levels: the doctrinal level and the underlying debate about the relative merits of Sarbanes-Oxley. The case now before the Supreme Court regarding whether the PCAOB violates the Appointments Clause (*Free Enterprise Fund v. Public Company Accounting Oversight Board,* 537 F.3d 667 (D.C. Cir. 2008), cert. granted 129 S.Ct. 2378 (2009)) is interesting, and you can tell from the oral argument that the justices were intrigued and engaged. But ultimately, it's hard to see the likelihood that this issue pulls Sarbanes-Oxley down entirely. Because Sarbanes-Oxley has no severability clause, finding the PCAOB unconstitutional would invalidate the statute altogether. In terms of the debate over Sarbanes-Oxley, that's one where there really are colliding forces in the public mood. Obviously, there's been lots of analysis about the cost of Sarbanes-Oxley as to whether it's accomplishing what it intends to in terms of a cost-benefit balance. But in an environment like this one, coming off not just the credit crisis and those collapses, but Enron before and WorldCom, it's hard to imagine that there would be a political drive sufficient to wipe this statute out.

TORPEY: If you are Sarbanes or if you are Oxley, aren't you embarrassed that there's no severability provision in your act? Don't you think you are sitting there thinking "What staff person let that get through and who am I going to chop?"

BAYLESS: I was astonished to learn that. It just is hard to imagine.

GRABOYS BLAIR: The procedural posture of this case is interesting because there is no circuit [court] dispute. It is a stand-alone appeal on a constitutional question that the Court has taken on. The Court has also signaled a willingness to consider the constitutionality of the honest-services fraud law, though those cases are of a different flavor than the PCAOB question.

MODERATOR: What can we infer from the Supreme Court's obvious skepticism towards the two honest-services cases that they recently heard, and from recent findings of prosecutorial misconduct in securities cases?

BAYLESS: Courts are getting less deferential and more skeptical of the government in its regulatory role and are saying, "Well, look. Are you guys just making this up as you go along or is this really called for by the statute?" It puts the burden on the government, as it should, to show that this is truly criminal behavior and the people were on notice. It's part of a larger trend of federal courts being more skeptical of law enforcement.

LARRABEE: It's a broader societal trend than that. If you are in front of a jury today, the level of skepticism about the government and regulators and financial institutions is very near an all-time high, at least in our lifetime, and that leads to a level of distrust and cynicism. That's very damaging for everybody. At some point, the federal courts have to get back to restoring faith in the regulators because we need the public to have faith in them.

GILLIAM: In the Brocade case (*United States v. Reyes* (577 F.3d 1069 (9th Cir. 2009)), Reyes's conviction was overturned based on closing-argument misconduct, but his co-defendant's conviction was upheld, and there was a pretty straightforward analysis of the criminality of concealed options backdating under the laws requiring the keeping of accurate books and records. So to the extent the argument had been "This doesn't rise to the level of crime," I think the court found otherwise there.

GRABOYS BLAIR: On one hand the Brocade and Broadcom decisions (see *United States v. Ruehle,* 583 F.3d 600 (9th Cir. 2009); cases dismissed by district court (C.D. Cal. Nos. 08-138 & 139) on Dec. 15, 2009) had very distinct bases for being overturned. On the other hand, maybe it is not a coincidence that the convictions of two individuals in separate stock-option backdating cases were vacated or overturned back to back. Perhaps it signals a particular view, at least from those two courts, about how the options cases were developed and brought as criminal actions.

GILLIAM: On the honest-services issue, there's a perception in the courts that the prosecution is overreaching in its expansive use of that theory. The premise is if this is criminal, you've got a whole federal code filled with specific statutes. There's got to be something in there that covers the particular crime, and often there is. But we've seen a belt-and-suspenders approach from the government. In the *Skilling* case, for example, (*United States v. Skilling,* 554 F.3d 529 (5th Cir.), cert granted, 130 S.Ct. 393 (2009)), he was charged with insider trading and securities fraud, but also with conspiracy to defraud his employer of honest services. The root of the backlash is that this theory is so malleable. The Supreme Court looks ready to impose limits, and may even invalidate the statute entirely as too vague. ■