Securities Caselaw Developments 2016

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William O. Fisher

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OVERVIEW

Supreme Court

Rejecting the Second Circuit’s view that, to be liable as a tipper under Rule 10b-5 insider trading law, the tipper must receive a tangible benefit, the Supreme Court held it suffices that the tipper benefited by making a gift of the material nonpublic information to a trading relative or friend.¹

Courts of Appeals

Insider Trading. The Eleventh Circuit held that an insider trading case should be sent to the jury on instructions created for Rule 10b-5(a) or (c), rather than 10b-5(b).²

16(b). The Second Circuit held that market standoff agreements (“lockups”) do not create a “group” for purposes of computing the 10% beneficial ownership triggering the section 16(b) prohibition against short-swing profits.³

SEC Rulemaking. The D.C. Circuit upheld Regulation A+ against a challenge brought by state securities regulators and ruled, in a separate case, that the district court—not the court of appeals—had jurisdiction to hear a challenge to the credit retention rule issued by the SEC jointly with federal banking regulators.⁴

Challenges to SEC Administrative Law Judges. The Second, Fourth, and Eleventh Circuits last year joined other courts of appeals in ruling that the federal courts do not have jurisdiction to hear actions that challenge the constitutionality of enforcement proceedings before

¹ See infra notes 31–57 and accompanying text.
² See infra notes 58–71 and accompanying text.
³ See infra notes 72–96 and accompanying text.
⁴ See infra notes 99–128 (Regulation A+) and 129–140 (credit risk retention) and accompanying text.
SEC Administrative Law Judges ("ALJs") when those actions are brought prior to completion of the administrative proceedings.\(^5\) In two cases in which respondents raised such challenges in petitions for court of appeals review after final SEC decisions, the D.C. Circuit ruled that the manner in which the ALJs are selected does not violate the Appointments Clause of the U.S. Constitution, while the Tenth Circuit held that ALJ appointments do violate that clause.\(^6\)

**SOX Officer Certifications and Clawback.** The Ninth Circuit held that the SEC can sue a CEO or CFO for making false statements in the certification that section 302 of the Sarbanes-Oxley Act requires and, in the same decision, held that the clawback in section 304 of that statute can apply to a CEO or CFO who does not personally commit the misconduct that leads to a restatement triggering compensation recovery.\(^7\)

**NMS Regulation and High-Frequency Trading.** The Second Circuit affirmed dismissal of an action in which a subscriber to trading data claimed breach of contract and violation of regulations because national stock exchanges provided such data microseconds faster to those who subscribed to direct data feeds from the exchanges than to the intermediaries from which the plaintiff received that data.\(^8\)

**Criminal Cases.** The Second Circuit rejected a claim that, for the government to prove a "willful violation" of the Investment Advisers Act in order to obtain a criminal conviction for transgressing that law, the government must prove that the defendant intended to harm the

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\(^5\) See infra notes 147–188 and accompanying text.  
\(^6\) See infra notes 189–219 and accompanying text.  
\(^7\) See infra notes 220–236 and accompanying text.  
\(^8\) See infra notes 237–254 and accompanying text.
victims.\textsuperscript{9} That same court affirmed a $19.7 billion forfeiture order against a challenge that it was an excessive fine prohibited by the Eighth Amendment.\textsuperscript{10}

\textit{Scienter and Scienter Pleading}. The Fifth Circuit found that plaintiffs—who alleged fraudulent failure to disclose that the issuer’s work practices were responsible for labor problems at manufacturing facilities in China—had not satisfied the special requirement for pleading scienter in private Rule 10b-5 actions.\textsuperscript{11} The Tenth Circuit affirmed dismissal for the same reason, in an action in which the plaintiffs alleged misrepresentations and omissions relating to cost overruns and delays affecting forward-loss charges.\textsuperscript{12} The First Circuit found a complaint wanting in the same respect where plaintiffs alleged fraud when a drug manufacturer misreported the results of clinical trials as showing an absolute positive effect instead of a relative positive effect.\textsuperscript{13} But the Ninth Circuit held that the complaint adequately pled scienter in a case where the defendant drug maker said that all animal studies had been concluded and carcinogenicity studies showed a drug to be safe, when the company was conducting tests on rats and data from those tests raised questions because the rats developed cancer.\textsuperscript{14}

\textit{Reliance}. The Eighth Circuit found that defendants had successfully rebutted the fraud-on-the-market reliance presumption as to statements in a conference call, which were actionable, where the call occurred within hours after a press release that contained revised earnings guidance, which was not actionable.\textsuperscript{15} The Second Circuit held that a district court had not

\textsuperscript{9} See infra notes 257–269 and accompanying text.
\textsuperscript{10} See infra notes 270–278 and accompanying text.
\textsuperscript{11} See infra notes 285–309 and accompanying text.
\textsuperscript{12} See infra notes 310–348 and accompanying text.
\textsuperscript{13} See infra notes 349–375 and accompanying text.
\textsuperscript{14} See infra notes 376–411 and accompanying text.
\textsuperscript{15} See infra notes 422–441 and accompanying text.
clearly erred in concluding, after a bench trial, that the plaintiff would not have foregone purchasing the relevant security even if the plaintiff had known the undisclosed facts.16

Loss Causation. In a case where the plaintiffs alleged failure to disclose loss of business from a significant customer, the Eighth Circuit found no further actionable loss by a stock drop following announcement of an officer resignation because the issuer had earlier disclosed unexpectedly low revenue and attributed the poor showing to reduction in work from the important customer and the stock price had declined by 50% following that earlier announcement.17 The Ninth Circuit ruled that announcement of a government investigation can constitute a corrective disclosure where the price of the relevant security drops after that announcement, market participants attribute the investigation to the circumstances that lie behind the asserted fraud, and no additional stock decline follows later disclosures providing the truth behind the fraud.18 The Sixth Circuit recognized materialization of the risk as an acceptable theory of loss causation,19 and the Second Circuit affirmed a verdict after the plaintiffs proved loss from undisclosed risk, even though that risk never fully matured.20

Rule 10b-5 Liability for Opinions. The Second Circuit applied the analytical framework from the Supreme Court’s Omnicare decision to a Rule 10b-5 case based on allegedly fraudulent opinions about the prospects for FDA approval of a drug.21

Primary Liability Under Rule 10b-5 After Janus. The Second Circuit found that plaintiffs had raised a triable issue that one of the participants in a joint venture exercised ultimate control

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16 See infra notes 442–455 and accompanying text.  
17 See infra notes 464–477 and accompanying text.  
18 See infra notes 478–492 and accompanying text.  
19 See infra notes 493–502 and accompanying text.  
20 See infra notes 503–530 and accompanying text.  
21 See infra notes 531–565 and accompanying text.
over statements by other participants because, in part, one of the defendant’s managers testified
that the defendant had to approve media responses by other participants. The Ninth Circuit
held that an attorney involved in a business deal could be sued under Rule 10b-5 for statements
that he made himself, and suggested, but did not hold, that an attorney might be liable for such
statements even if the attorney prefaced them with an introduction that the attorney was simply
relaying his client’s understanding. Addressing a case in which a plaintiff alleged that an issuer
had hired promoters to tout its stock, but had not itself disclosed that the promoters were paid for
their articles, the Eleventh Circuit affirmed dismissal because the complaint alleged no facts to
show that the issuer had ultimate authority or control over the promoters’ copy. On the other
hand, the Eighth Circuit held that plaintiffs had pled scheme liability under Rule 10b-5(a) and (c)
where the corporate defendant allegedly paid physicians to omit adverse effects from reports on
clinical trials.

**Rule 10b-5 Liability for Statements During a Merger.** The Third Circuit affirmed
dismissal of a Rule 10b-5 action based in part on alleged misstatements and omissions in (i)
representations and warranties in a merger agreement and (ii) in a proxy statement for a
shareholder vote related to the merger.

**Statutes of Limitations.** Both the Tenth and Eleventh Circuits applied the five-year
statute of limitations in 28 U.S.C. § 2462 to enforcement actions brought by the SEC, ruling on
which of the Commission’s claims that statute covers and which it does not—with the Tenth
Circuit holding that section 2462 does not apply to an SEC claim for disgorgement and the

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22 See infra notes 569–594 and accompanying text.
23 See infra notes 595–619 and accompanying text.
24 See infra notes 620–631 and accompanying text.
25 See infra notes 632–647 and accompanying text.
26 See infra notes 648–703 and accompanying text.
Eleventh Circuit holding that it does.\textsuperscript{27} The Second Circuit determined that \textit{American Pipe} tolling does not extend the three-year statute of repose in section 13 of the Securities Act or the five-year statute of repose in 28 U.S.C. § 1658(b)(2), and the Sixth and Eleventh Circuits held that \textit{American Pipe} tolling does not extend the five-year period for repose in 1658(b)(2).\textsuperscript{28} Working its way through a legal maze, the Second Circuit found that the three-year statute of limitations in Exchange Act sections 9 and 18 applies to claims under section 14(a) of that act, even though those statutes of limitations have been supplanted—as to claims under sections 9 and 18 themselves—by 28 U.S.C. § 1658.\textsuperscript{29}

\textit{Item 303.} The Second Circuit held that an issuer must have actual knowledge of a trend or uncertainty in order that an obligation to disclose it arises under Regulation S-K Item 303(a)(3)(ii), but found that plaintiffs alleged an issuer’s knowledge with respect to uncertainties created by a fraud that had been committed on a company project that might lead to a claim for recovery by the municipality for which the work was being done and the possible loss of business from other public entities.\textsuperscript{30}

\textbf{CASELAW}

\textbf{Supreme Court}

In 1983, the Supreme Court held that, in order for a tipper to violate a duty cognizable under Rule 10b-5 insider trading theory, the tipper had to “receive[] a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate

\textsuperscript{27} See infra notes 707–721 and accompanying text.  
\textsuperscript{28} See infra notes 723–731 and accompanying text.  
\textsuperscript{29} See infra notes 732–749 and accompanying text.  
\textsuperscript{30} See infra notes 750–769 and accompanying text.
into future earnings,” adding that courts had to “focus on objective criteria” to determine whether such a benefit was had.31 The Court then added that “objective facts and circumstances” possibly “justify[ing] . . . an inference” of a sufficient personal benefit included “a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient.”32 Elaborating on the last clause, the Court wrote that “[t]he elements of fiduciary duty and exploitation of nonpublic information . . . exist when an insider makes a gift of confidential information to a trading relative or friend” because “[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.”33 While this analysis governed the liability of a tipper, the Court held, as well, that a tippee could not be liable unless his or her tipper had violated a duty in passing on the information and that—since a tipper did not violate absent receiving a personal benefit—a tippee was not liable unless his or her tipper had received such a benefit.34 The Court concluded that the tippee in the case before it—who then passed the information on to others—could not be liable because his tippers obtained no personal benefit from giving the information to him.35

In 2014, the Second Circuit in U.S. v. Newman interpreted the rule that in order for a tippee to be liable, the tipper must receive some benefit for the tip.36 The court of appeals held that the required benefit must be “objective, consequential, and [must] represent[] at least a

32 Id. at 664.
33 Id.
34 Id. at 660–62.
35 Id. at 666–67.
36 U.S. v. Newman, 773 F.3d 438, 446 (2d Cir. 2014) (“The test for determining whether the corporate insider has breached his fiduciary duty ‘is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty . . . .’” (quoting Dirks, 463 U.S. at 662)), cert. denied, 136 S. Ct. 242 (2015) (No. 15-137) (mem.), abrogated by Salman v. U.S., 137 S. Ct. 420 (2016); id. at 447 (“[T]he tippee’s liability derives only from the tipper’s breach of a fiduciary duty . . . [and] the corporate insider has committed no breach of fiduciary duty unless he receives a personal benefit in exchange for the disclosure.”).
potential gain of a pecuniary or similarly valuable nature.”  

In 2015, the Ninth Circuit in *U.S. v. Salman* disagreed with *Newman* to the extent it meant that “evidence of a friendship or familial relationship between tipper and tippee, standing alone, is insufficient to demonstrate that the tipper received a benefit.”

Having granted certiorari in *Salman*, the Supreme Court resolved this circuit split in 2016. In *Salman*, an investment banker at Citigroup tipped his older brother, who tipped the defendant, who traded and made about $1.5 million. The Ninth Circuit had rejected the defendant’s argument that he could not “be held liable as a tippee because the [investment banker] did not personally receive money or property in exchange for the tips and thus did not personally benefit from them.” The evidence showed that the investment banker and his brother “enjoyed a ‘very close relationship,’” that the investment banker “‘love[d] [his] brother very much,’” that the investment banker “shared inside information with his brother to benefit him and with the expectation that his brother would trade on it,” and that—on one occasion when his brother said “that ‘he needed a favor’”—the investment banker offered his brother money but, at his brother’s request, provided inside information instead.

The Supreme Court affirmed the Ninth Circuit’s decision. The Court disapproved *Newman* to the extent that it “held that the tipper must also receive something of a ‘pecuniary or similarly valuable nature’ in exchange for a gift to family or friends,” finding “this requirement

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37 Id. at 452.
40 Id. at 424.
41 Id.; *see also* id. at 426 (characterizing the defendant’s argument as that “a tipper does not personally benefit unless the tipper’s goal in disclosing inside information is to obtain money, property, or something of tangible value”).
42 Id. at 424 (alteration in original).
43 Id. at 429.
[to be] inconsistent with Dirks."44 The Court reasoned that Dirks “ma[d]e[] clear that a tipper breaches a fiduciary duty by making a gift of confidential information to [a] ‘trading relative,’” finding “that rule . . . sufficient to resolve the case at hand.”45 Here, the investment banker, “by disclosing confidential information as a gift to his brother with the expectation that he would trade on it, . . . breached his duty of trust and confidence to Citigroup and its clients—a duty [the defendant] acquired, and breached himself, by trading on the information with full knowledge that it had been improperly disclosed.”46 Dirks was tried on the classical theory, while the Ninth Circuit characterized Salman as based on the misappropriation theory and the government said that both theories applied in Salman.47

Significance and analysis. While the Court explicitly disapproved Newman, it did not completely resolve the issue that Newman raised. The Court pointed to Dirks’s rationale “that when a tipper gives inside information to ‘a trading relative or friend,’ the jury can infer that the tipper meant to provide the equivalent of a cash gift . . . [and] the tipper benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds.”48 And there was evidence that, at least one occasion, the investment banker had, in fact, provided information as a substitute for money.49 The Court acknowledged—in response to the defendant’s argument that the Dirks standard was

44 Id. at 428 (quoting U.S. v. Newman, 773 F.3d 438, 452 (2d Cir. 2014)).
45 Id. at 427.
46 Id. at 428. In Salman, the government made interesting concessions about the elements it needed to prove to obtain a conviction. The government “observe[d] that, in order to establish a defendant’s criminal liability as a tippee, it must prove beyond a reasonable doubt that the tipper expected that the information being disclosed would be used in securities trading” and that “to establish a defendant’s criminal liability as a tippee, it must prove that the tippee knew that the tipper breached a duty—in other words, that the tippee knew that the tipper disclosed the information for a personal benefit and that the tipper expected trading to ensue.” Id. at 427.
47 Id. at 425 n.2.
48 Id. at 428.
49 See supra text accompanying note 42.
“unconstitutionally vague as applied to this case”—that “in some factual circumstances assessing liability for gift-giving will be difficult,” but found “no need . . . to address those difficult cases today, because this case involves ‘precisely the gift of confidential information to a trading relative that Dirks envisioned.’”\(^{50}\)

All of this suggests that there are instances in which a tipper, transferring information to another, is either not making a “gift” within the meaning of Dirks or making a gift of a sort that does not provide the tipper with the requisite benefit to constitute a breach of a fiduciary duty. Perhaps this occurs under circumstances where the government cannot show that the inside information constitutes a substitute for money in the sense that Dirks describes. This is more than an idle law school class question, because the government might argue that even casual friendship would provide the necessary link—as it did last year in a case where the government contended that giving information to golfing companions could provide the requisite benefit because doing so would impress his companions and make him “one of the guys.”\(^{51}\) It

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\(^{50}\) Id. at 428–29 (quoting U.S. v. Salman, 792 F.3d 1087, 1092 (9th Cir 2015) (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)) (internal quotation marks omitted)).

\(^{51}\) In U.S. v. McPhail, 831 F.3d 1, 3, 11 (1st Cir. 2016), the court affirmed the conviction of McPhail, who was a close friend of Angelo Santamaria, an executive at American Superconductor Corporation (“AMSC”). The two of them not only golfed together but vacationed together, attended the Kentucky Derby together, and gambled together at casinos. Id. at 3. Santamaria successfully lobbied golf club members to keep McPhail in the club after McPhail divorced his wife, who held a membership that anchored McPhail’s membership. Id. Santamaria provided McPhail with nonpublic information about AMSC, which McPhail passed on, largely by emails, to his golfing companions. Id. at 3–4. McPhail himself did not trade in AMSC stock, but his golfing companions did and profited by about half a million dollars. Id. The government tried its case against McPhail on the misappropriation theory—specifically that McPhail owed a duty of trust and confidentiality to Santamaria of the sort set out in Rule 10b5-2(b)(2). Id. at 4–5. Rule 10b5-2(b)(2) provides that a duty of trust or confidence, the breach of which, by trading or tipping, can lead to liability under Rule 10b-5 exists where “the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality.” 17 C.F.R. § 240.10b5-2(b)(2) (2016). The First Circuit held that evidence at the trial was sufficient to establish such a relationship, in part because Santamaria testified that he at least twice told McPhail not to repeat the information about ASMC that Santamaria provided—apparently in the context of Santamaria’s concern about his retirement investments, which consisted largely of ASMC stock, McPhail, 831 F.3d at 3, 5—and, in part, because McPhail’s emails to his golfing comrades suggested “that he had been informed, or otherwise knew, that he was not allowed by Santamaria to pass along the information from the get-go,” id. at 5. For example, McPhail took pains to avoid using Santamaria’s name, instead “refer[ing] to
seems very unlikely that the defendant there was balancing two alternatives—trading on the information and distributing thousands or tens of thousands of dollars from the trading profits to his golfing buddies, versus providing them inside information.

*Salman* also dodges the long-standing question of whether the personal benefit element is needed under both Rule 10b-5 insider trading theories. There are two principle theories: (i) the “classical theory, which applies ‘when a corporate insider’ or his tippee ‘trades in the securities of [the tipper’s] corporation on the basis of material, nonpublic information,’[and thereby] breaches a duty to, and takes advantage of, the shareholders of his corporation,” and (ii) “the misappropriation theory,” which applies when anyone—insider or not—“‘misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information’ such as an employer or client [and thereby] breaches a duty to, and defrauds, the source of the information.” The Court concluded that it “need not resolve the question” of which theory governed because “[t]he parties do not dispute that *Dirks*’s personal-benefit

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analysis applies in both classical and misappropriation cases,” leaving the Court free to “proceed on the assumption that it does.”

It is not at all clear, however, that the government will concede, or that courts will hold, that personal benefit is necessary in a misappropriation tipping case. The Dirks analysis on which the Court in Salman depends begins with the notion that “a tippee’s liability for trading on inside information hinges on whether the tipper breached a fiduciary duty by disclosing the information” and that “[a] tipper breaches such a fiduciary duty . . . when the tipper discloses the inside information for a personal benefit.” But the Securities and Exchange Commission (“SEC”) adopted Rule 10b5-2 to define, nonexclusively, the relationships of confidence or trust sufficient for the misappropriation theory in a way that does not require a fiduciary relationship. Nothing in the text of Rule 10b5-2 requires that a personal benefit be sought or obtained by a tipper in order to run afoul of insider trading proscriptions by breaching a duty imposed by any of the relationships of trust or confidence that the rule defines. Indeed, in a case decided in 2016, but before the Court rendered its Salman opinion, the First Circuit suggested that this question is still alive.

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53 Id.
54 Id. at 423 (emphasis added).
55 17 C.F.R. § 240.10b5-2 (2016); see also Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,602–03 (Dec. 28, 1999) (proposing release for Rule 10b5-2, identifying the motivation for the rule, in part, to avoid having to prove a fiduciary or fiduciary-like relationship to proceed on the misappropriation theory when one family member tips another).
56 E.g., U.S. v. McGee, 763 F.3d 304, 312–16 (3d Cir. 2014) (holding Rule 10b5-2 valid and rejecting the view that a fiduciary relationship is necessary for misappropriation liability).
57 In U.S. v. Parigian, 824 F.3d 5 (1st Cir. 2016), the court affirmed the conviction of one of McPhail’s tippees. See supra note 51 for a summary of U.S. v. McPhail. The court of appeals wrote this as to the personal benefit requirement in a misappropriation tipping context:

In Dirks, the Supreme Court ruled that under the classical conception of insider trading liability, a tippee is not liable under Rule 10b–5 unless the insider “will benefit, directly or indirectly, from his disclosure.” Dirks, 463 U.S. at 662, 103 S. Ct. 3255. We have twice considered in SEC civil enforcement actions the question whether a benefit to the misappropriator is also a necessary
Courts of Appeals

Insider trading. The difference between the two Rule 10b-5 insider trading theories produced a case last year emphasizing that lawyers trying an insider trading case must carefully craft instructions that provide all the elements of at least one of them, and that do not wander off into other parts of the vast Rule 10b-5 jurisprudence.

The plaintiff in Fried v. Stiefel Laboratories, Inc. served as the Chief Financial Officer (“CFO”) of Stiefel Laboratories (“Stiefel Labs”) from 1987 through 1997. When he retired, he owned 30,7881 shares of Stiefel common stock acquired through the company’s Employee Stock Bonus Plan. He had the right to “put” that stock to Stiefel (which was a private company) at a price determined by the most recent appraisal adopted by the plan trustee. The plaintiff exercised that right on January 6, 2009 after meeting with Charles Stiefel (“Stiefel”), the

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In Sargent, we noted that the Second Circuit in dictum appeared dubious that such a benefit need be proven in a misappropriation case. 229 F.3d at 77. We then dodged the question, in part, by concluding that if a benefit need be proven, the government’s evidence that the misappropriator and the tipper were business and social friends with reciprocal interests allowed a jury to find a benefit in the form of the misappropriator’s “reconciliation with [a] friend” and the maintenance of “a useful networking contact.” Id. In Rocklage, we then held that “[e]ven if there is a requirement that the tipper receive a personal benefit, the mere giving of a gift to a relative or friend is a sufficient personal benefit” to the giver. 470 F.3d at 7 n.4.

. . . . [T]he indictment alleges that McPhail requested—and was promised—various tangible luxury items in return for the tips. This would appear to be enough under our precedent.

. . . .

. . . . We therefore hold that the indictment’s allegations of a friendship between McPhail and Parigian plus an expectation that the tippees would treat McPhail to a golf outing and assorted luxury entertainment is enough to allege a benefit if a benefit is required.

Id. at 15–16 (emphasis added).

81 814 F.3d 1288, 1291 (11th Cir. 2016), cert. denied, 137 S. Ct. 102 (2016) (No. 15-1458).
80 Id.
80 Id.
company’s chief executive officer (“CEO”) in September 2007 and again in October 2008. The plaintiff received $16,469 per share.62

Charles Stiefel, however, had learned in November 2008 that another company was interested in buying Stiefel Labs, and he met with representatives of that company in late December 2008, putting in train a series of events culminating in a second company buying Stiefel Labs in a transaction yielding $69,705 per share to Stiefel Labs shareholders.63 Plaintiff was unaware of the negotiations to sell the company at the time he exercised his “put” and received less than one quarter of that amount.64

The plaintiff sued Stiefel and Stiefel Labs for failing to tell him about the negotiations, and a jury found against the plaintiff on that claim.65 On appeal, the plaintiff argued that Stiefel Labs was an insider when it bought back his stock through the put, that the company therefore had a duty to disclose to him all material facts before repurchasing the stock, and that the district court had improperly declined to instruct the jury on that theory.66

The Eleventh Circuit affirmed the defense judgment on the ground that the plaintiff’s proposed instruction did not properly charge on his theory.67 Rule 10b-5 includes three prohibitions—against (a) “employ[ing] any device, scheme, or artifice to defraud”; (b) making a false statement of a material fact or “omit[ting] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not

61 Id.
62 Id.
63 Id.
64 Id.
65 Id. at 1291–92.
66 Id. at 1293.
67 Id. at 1295.
misleading”; and (c) “enagag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.”68 The plaintiff proposed an instruction that modified a pattern instruction for a Rule 10b-5(b) claim, which was improper for an insider trading claim based on an insider’s duty to disclose material facts before trading in company stock because subsection (b) of rule 10b-5 “proscribes fraud only in connection with an affirmative representation” and the court had “never held that a failure to disclose material information is an omission under subsection (b) absent a statement made misleading by that failure.”69 In contrast, “[a]n insider who makes no affirmative representation but trades on nonpublic information may violate Rule 10b–5(a) or (c), not Rule 10b–5(b).”70 The court added that the plaintiff’s proposed instruction “did not adequately state the elements of a claim of insider trading,” which would have required charging on “the ‘specific insider-trading theory alleged in the particular case’—classical insider theory, misappropriation theory, tipper theory, or tippee theory.”71

69 Stiefel Labs., Inc., 814 F.3d at 1294.
70 Id. at 1294–95.
71 Id. at 1295 (quoting 11th Cir. Pattern Civ. Jury Instr. 6.3.1). The parties had submitted the following instruction to which they agreed, except for the underlined portion, which the plaintiff wanted added to support his insider trading theory:

An “omission” is a failure to disclose a material fact. The Defendants had a duty to disclose all material information to Mr. Fried. Additionally, the Defendants had a continuing duty to disclose facts that would be necessary to know in order to keep other statements from being materially misleading. That is to say that, if the Defendant has made statements regarding material facts in the past, such as in information sent out to shareholders or statements made in press releases issued by the company, there is a duty to correct statements of material fact if it is learned that the statement, though correct at the time it was made, would be misleading if left unrevised. Likewise, a Defendant has a duty to update prior statements when, though the statement was reasonable when made, subsequent events have rendered the statement materially misleading.

Id. at 1292. In addition to faulting this instruction for failing to identify an applicable theory of insider trading, the Eleventh Circuit found the words inadequate because they did not identify Stiefel Labs as a putative insider, did not “explain[] how insider trading occurs,” and “did not require the jury to find that Stiefel Labs traded ‘on the basis of’ material information.” Id. at 1295.
Section 16(b). Exchange Act section 16(b) provides that an insider is liable to an issuer for “any profit realized by [the insider] from any purchase and sale, or any sale and purchase, of any equity security [registered under section 12] . . . within any period of less than six months,” sometimes called “short swing profits.” Insiders include each “beneficial owner of more than 10 percent of any class of [such] equity security.” For purposes of determining who is a beneficial owner of more than 10% of a class of equity securities, section 16 generally adopts the rules applying section 13(d) of the Exchange Act. Under those rules, shareholders who “agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer” constitute a “group” that is “deemed to have acquired beneficial ownership” of all of

Since the instruction was deficient in so many ways, the Eleventh Circuit concluded that it did not need to decide whether it agreed with decisions that “stated or assumed that privately held corporations are insiders under Rule 10b–5 and have a duty to disclose before trading in their own stock.” Id. at 1293.

One other insider trading decision deserves note. The Second Circuit affirmed a tipper’s sentence of 78 months. U.S. v. Riley, 638 F. App’x 56, 65 (2d Cir. 2016), cert. denied, 137 S. Ct. 589 (2016) (No. 15-1511) (mem.). In calculating the “gain resulting from the offense” for purposes of section 2B1.4 of the Sentencing Guidelines, the Second Circuit found no clear error in the district court “consider[ing] . . . trading by Artis Capital Management, LP—tippee Teeple’s hedge-fund employer.” Id. The court of appeals observed that “trial evidence not only permitted the jury to find beyond a reasonable doubt that [the defendant] knew [his tippee] would trade on the communicated inside information but also permitted the sentencing judge to make a preponderance finding that [the defendant] knew [his tippee] would do so as the agent of a hedge fund.” Id. The Second Circuit further held that courts should compute the “gain”—defined by the Guidelines as “the total increase in value realized through trading in securities by the defendant and persons acting in concert with the defendant or to whom the defendant provided inside information,” U. S. Sentencing Guidelines Manual Background in Application Notes to § 2B1.4 (2015)—“by reference to the market price once the inside information has been revealed, not the profit (or loss) realized by the tippee, whose hold decisions may be informed by various factors.” Id. The Riley panel also held that (i) the “exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature” to the tipper—required by U.S. v. Newman, 773 F.3d 438, 452 (2d Cir. 2014)—could take “the form of investment advice from [the tippee,]” and could constitute the required benefit “whether or not [the defendant tipper] used or profited from it,” Riley, 638 F. App’x at 61, and (ii) venue in the Southern District of New York was proper because the defendant “could have foreseen that the trading that would result from his communication of inside information to Teeple would occur in the Southern District of New York, given that [the relevant] shares were publicly traded on NASDAQ, located in Manhattan,” id. at 62. While the Newman requirement for an actual or potential pecuniary gain is no longer law, see supra at notes 31–57, the Riley holding—that a benefit can take the form of advice that did not, in fact, produce an actual profit for the tipper—should still stand.

74 15 U.S.C. § 78p(a) (2012) (incorporated into subsection (b) by the reference there to “such beneficial owner”).
75 17 C.F.R. § 240.16a-1(a)(1) (2016).
the relevant issuer’s equity securities beneficially owned by each member of the group.76 Accordingly, a group that together owns more than 10% of the stock of an issuer that is registered under section 12 is subject to section 16(b) liability for short-swing profits.

In 2016, the Second Circuit addressed whether signatories to lockup agreements formed a “group” from which the issuer could recover short-swing profits.77 The lockup agreements were between the lead underwriters in the Facebook, Inc. (“Facebook”) Initial Public Offering (“IPO”) and pre-IPO Facebook shareholders, and “generally provided that the Shareholders would not sell or otherwise dispose of Facebook stock for periods ranging from 91 days to 211 days after the date of the Prospectus without the consent of Morgan Stanley as agent for the Lead Underwriters.”78 The lockups constituted “standard underwriting practices.”79

While the lead underwriters did not own 10% of Facebook,80 the Shareholders in aggregate did,81 and therefore the Shareholders and the underwriters, considered together, owned more than 10%.82 A shareholder sued, alleging that together, the underwriters and shareholders were a group for section 16(b) purposes because they had agreed to act together for purposes of “disposing” of their shares.83 The shareholder contended that Facebook was owed the profits

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77 Lowinger v. Morgan Stanley & Co. LLC, 841 F.3d 122, 126 (2d Cir. 2016).
78 Id. at 126–27.

As part of the IPO process, each of the Shareholders (who, in the aggregate, owned more than ten percent of Facebook’s common stock) entered into lock-up agreements with the Lead Underwriters in order to “induce the Underwriters that may participate in the Public Offering to continue their efforts in connection with the Public Offering.”

79 Id. at 127.
80 Id. at 126.
81 Id. at 126–27.
82 Id. at 130.
83 Id.
that the lead underwriters made by selling on the day of the IPO and then, after the price of Facebook stock dropped, buying shares to cover the short position that the underwriters had taken to hedge against a possible price drop should the underwriters sell more than the number of shares allotted for the IPO.\textsuperscript{84}

The Second Circuit affirmed the district court’s dismissal of the case in significant part because standard lockups serve a beneficial purpose by “lead[ing] investors reasonably to expect an orderly market free of the danger of large sales of pre-owned shares depressing the share price before the pricing of the newly offered shares has settled.”\textsuperscript{85} If section 16(b) “appl[ied] . . . to underwriters engaged in lock-up agreements as facilitators of a public offering lockup[],” the underwriters would face “tens of millions of dollars in legal exposure.”\textsuperscript{86} The court seemed to be

\textsuperscript{84} Id. at 128 (suit to recover profits “calculated under Section 16(b) by subtracting the sales prices of May 17[, the date of the IPO,] from the purchase prices during the following four days [when the underwriters were buying shares at below IPO prices to cover the short sales constituting the hedge]”). The Second Circuit explained the mechanics so:

As is common in IPOs, the Registration Statement and Prospectus alerted investors that the Underwriters might “over-allot,” i.e., sell more than the 421 million shares earmarked for the IPO. Permitting such sales allows underwriters to stabilize fluctuating share prices during an offering by increasing the supply of shares after the offering price has been determined. This ensures (and assures investors) that the entire underwritten amount is sold. Underwriters generally hedge this extra allotment by establishing a short position on oversold shares while simultaneously holding the shares long. Underwriters are thus protected against upward or downward movements in the stock’s price. The Facebook IPO permitted the Underwriters to cover this short position either by purchasing the requisite additional shares directly from Facebook and the Shareholders at a fixed price (per the terms of a so-called “over-allotment option,” or “Green Shoe”), or by purchasing shares directly from the open market once secondary trading had commenced.

\textsuperscript{85} Id. at 131.

\textsuperscript{86} Id.

\textsuperscript{Id.} at 127 (footnote omitted).

[As the price of Facebook shares declined in the early days after the Facebook offering], the Underwriters declined to exercise their Green Shoe option to cover their short positions, choosing instead to purchase the over-allotted shares directly on the secondary market, at prices lower than the Green Shoe fixed price of $38.00 per share. As a result, the Underwriters “made a profit of about $100 million with the bulk of that profit [having been] made on” May 21. J. App’x at 26 (internal citation and quotation marks omitted).
concerned that this would cause underwriters to forsake lockups, to the detriment of “orderly” offerings,\textsuperscript{87} and the Second Circuit concluded that “[l]ock-up agreements are . . . essential to the regulation of public offerings.”\textsuperscript{88} More technically, and turning to the section 13 rules that the section 16 rules adopt, the Rule 13d-5(b)(1) definition of a “group” requires that the members “act together,” while “lock-up agreements, rather than being agreements ‘to act together,’ are generally one-way streets keeping certain shareholders out of the IPO market for a specified period of time.”\textsuperscript{89}

On a section 13(d) policy level, the court reasoned that that statute “is intended to alert investors about possible changes in control and provide information about possible parties to those changes.”\textsuperscript{90} But agreements between the underwriters and the pre-IPO shareholders “create[] no need for information about potential changes in control beyond that inherent in a public offering.”\textsuperscript{91} Therefore, the court of appeals agreed with the district court “this standard form lock-up agreement is insufficient, on its own, to establish a group under Section 13(d).”\textsuperscript{92} Since there was no group, and the underwriters themselves did not hold more than 10% of the Facebook equity securities, the underwriters were not liable to Facebook under section 16(b) for their trading.\textsuperscript{93}

\textsuperscript{87} Id.
\textsuperscript{88} Id.
\textsuperscript{89} Id. at 130–31.
\textsuperscript{90} Id. at 132.
\textsuperscript{91} Id.
\textsuperscript{92} Id. at 126.
\textsuperscript{93} Id. at 126.

The court emphasized that “our analysis applies only to standard lock-up agreements like those at issue here,” so that the decision does not provide an across-the-board immunity for participants in lockups. Id. at 132 (also noting the SEC amicus brief, which stated that “[a]typical language in the lock-up agreement, or other facts and circumstances outside of the lock-up agreement,’ may trigger a Section 13(d) ‘group’ finding” (alteration in original)).
Significance and Analysis. The last part of the court’s analysis is odd. While the section 16(b) rules do indeed borrow the section 13(d) rules, the two sections serve very different purposes. As the Second Circuit notes, the purpose of section 13(d) is “to alert investors about possible changes in control.” Section 16(b), however, states that its purpose is to “prevent[] the unfair use of information which may have been obtained by” insiders. Hence, section 13(d) policies seem irrelevant to a section 16(b) case.

SEC Rulemaking. The D.C. Circuit rejected a challenge by state securities regulators to the new Regulation A+. That same court of appeals ruled that it did not have jurisdiction to hear a challenge to the credit retention rule jointly issued by the SEC and banking agencies, remanding the case to district court to begin there.

Regulation A+. Section 18(a)(1)(A) of the Securities Act provides that no state law requiring registration or qualification shall apply to a transaction in “a covered security,” with subsection (b)(4)(D)(ii) including within “covered security” a security sold to “a qualified purchaser” in a transaction that is exempt under Securities Act section 3(b)(2) from the section 5 federal registration requirement. Congress added the section 3(b)(2) exemption through the

\[\text{id} \]

\[15 \text{ U.S.C.} \ 78r(a)(1)(A), (b)(4)((D)(ii) (2012).]
JOBS Act, which ordered the SEC to adopt an exemption for issues with an aggregate offering amount not exceeding $50,000,000.\textsuperscript{100} Section 18(b)(3) provides that the SEC may, by rule, define “qualified purchasers” and may define that term “differently with respect to different categories of securities, consistent with the public interest and the protection of investors.”\textsuperscript{101} In \textit{Lindeen v. SEC}, the securities regulators in Montana and Massachusetts challenged the resulting regulation, which created what is known as Regulation A+.\textsuperscript{102}

Regulation A+ provides a two-tiered exemption from Section 5.\textsuperscript{103} Tier 1 covers offerings “in which the sum of all cash and other consideration to be received [by the issuer] for the securities being offered (‘aggregate offering price’) plus the gross proceeds for all securities sold pursuant to other offering statements within the 12 months before the start of and during the current offering of securities (‘aggregate sales’) does not exceed $20,000,000.”\textsuperscript{104} Tier 2 covers offerings “in which the sum of the aggregate offering price and aggregate sales does not exceed $50,000,000.”\textsuperscript{105} The regulation provides that a Tier 2 offering for an issuer not listed on a national securities exchange can only be made to an accredited investor, as defined in Securities Act Rule 501, or to (i) an individual where the aggregate purchase price paid “is no more than ten percent (10%) of the greater of such purchasers [a]nnual income or net worth” or (ii) an entity where the aggregate purchase price is no more than 10% of the greater of “[r]evenue or net assets for such purchaser’s most recently completed fiscal year end.”\textsuperscript{106} The regulation provides

\begin{footnotes}
\footnote{103} 17 C.F.R. § 230.251(a) (2016).
\footnote{104} 17 C.F.R. § 230.251(a)(1) (2016).
\footnote{105} 17 C.F.R. § 230.251(a)(2) (2016).
\end{footnotes}
that each person who buys in a Tier 2 offering, or to whom a security is offered in a Tier 2 offering, is a "‘qualified purchaser’" “[f]or purposes of Section 18(b)(3) of the Securities Act.”

Regulation A+ further requires that each issuer making a Tier 2 offering must file with the SEC annual and semiannual reports, as well as current reports on the occurrence of specified events.

The result is that state securities laws requiring registration or qualification of securities offering do not apply to Tier 2 offerings under Regulation A+. The Massachusetts and Montana state securities regulators alleged that this preemption was outside the permissible bounds of statutory construction under Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc. and arbitrary and capricious under the Administrative Procedure Act (“APA”). The D.C. Circuit rejected both arguments and denied the consolidated petitions to review the SEC action in adopting the regulation.

The court’s reasoning addressed both parts of the Chevron analysis. First, it held that Regulation A+ “does not conflict with the Congress’s unambiguous intent.” Since “Congress explicitly authorized the Commission to define [qualified purchaser],” Congress “intended the SEC to enjoy broad discretion to decide who may purchase which securities without the encumbrance of state registration and qualification requirements.” While the state regulators

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108 17 C.F.R. § 230.257(b)(1), (3) & (4) (2016). Subsection (4) refers to Form 1-U, which identifies eight categories of events that trigger the filing of a current report, including material modification of securityholders’ rights (Item 3), a change in the issuer’s certifying accountant (Item 4), and a change in control (Item 6). Form 1-U, General Instruction A(2).
111 Lindeen, 825 F.3d at 653.
112 Id. at 653–58.
113 Id. at 655.
114 Id. at 653.
argued that Congress could not have intended that the SEC include all Tier 2 purchasers as qualified purchasers, they could not point to any “statutory provision that bar[red] the SEC” from doing so.\textsuperscript{115} Although the state regulators contended that “any definition of qualified purchaser must advance ‘the public interest and the protection of investors,’” the court held that “the SEC, in exercising its discretion, concluded that Tier-2 investors are sufficiently protected by Tier-2’s purchase cap and reporting requirements.”\textsuperscript{116} While the state administrators complained that this left 10\% of a purchaser’s net worth at risk in transactions unregulated by either federal or state registration, the enabling law did “not amount to an unambiguous statutory mandate that the SEC protect investors as the petitioners might prefer.”\textsuperscript{117} Nor did the law “establish[] unambiguous congressional intent that a ‘qualified purchaser’ meet a certain level of wealth or sophistication.”\textsuperscript{118}

The D.C. Circuit then moved to the second prong of the \textit{Chevron} analysis, addressing the state regulators’ argument that the SEC’s interpretation of the law, as embodied in Regulation A+, was unreasonable.\textsuperscript{119} Because Congress had expressly given the SEC discretion to define “qualified purchaser,” the court concluded that it could find Regulation A+ unreasonable under \textit{Chevron}’s second step analysis only if the regulation was “‘arbitrary or capricious in substance, or manifestly contrary to the statute.’”\textsuperscript{120} Having dealt with whether the regulation was “manifestly contrary to the statute” in its analysis of the first \textit{Chevron} prong, the court did not further analyze that issue here.\textsuperscript{121} As to whether the regulation was arbitrary or capricious, the

\textsuperscript{115} \textit{Id.} at 653–54.
\textsuperscript{116} \textit{Id.} at 654.
\textsuperscript{117} \textit{Id.}
\textsuperscript{118} \textit{Id.} at 655.
\textsuperscript{119} \textit{Id.}
\textsuperscript{121} \textit{Id.}
court (i) rejected any presumption against state regulatory preemption because Congress had expressly given the SEC power to define “qualified purchasers” whose transactions would be exempt, (ii) found that the SEC explained that the reporting requirements and per-purchaser investment limitation protected investors in unregistered transactions, and (iii) held that the circumstance that the SEC’s definition of “qualified purchaser” in Regulation A+ differed from that in a 2001 Commission release for a proposal that was never adopted did not mean that the Regulation A+ definition was arbitrary or capricious because the SEC explained that the difference resulted from the particular context of Regulation A+ Tier 2 offerings authorized by the 2012 JOBS Act.\textsuperscript{122}

With \textit{Chevron} out of the way, the D.C. Circuit proceeded to the state regulators’ final argument—that Regulation A+ was “arbitrary and capricious” under the APA\textsuperscript{123} because the preemption of state regulation resulted from a notion that such registration discouraged the use of the original Regulation A, promulgated in 1936, and the SEC—when it adopted Regulation A+—“offered only a single paragraph” to explain why state regulation discouraged the use of

\textsuperscript{122} \textit{Id.} at 656–57. The 2001 SEC proposal to which the state regulators referred “would have defined ‘qualified purchaser’ universally (i.e., for \textit{any} securities purchase) to mean ‘accredited investor’ as defined by SEC Rule 501(a) of Regulation D. \textit{See} Defining the Term ‘Qualified Purchaser’ Under the Securities Act of 1933, 66 Fed. Reg. 66,839 (Dec. 27, 2001).” \textit{Id.} at 650 (emphasis by the court). As the SEC said in adopting Regulation A+, its 2001 proposed definition “contemplated that state securities review and qualification requirements would be preempted” for all securities although its “rules to implement Title IV of the JOBS Act provide for preemption in the more limited circumstances in which the requirements of [s]ection 3(b)(2) and the rules adopted thereunder are satisfied.” [Reg A+ Adopting Release, \textit{supra} note 102,] at 21,859. Given the “new and different context” outlined in Title IV, \textit{id.} at 21,860, the SEC explained that, notwithstanding it may have been appropriate “to focus on attributes of the purchaser when crafting a ‘qualified purchaser’ definition that would have applied in a broad set of possible transactions,” its Tier-2 qualified-purchaser definition “serves a different purpose because it applies only in Regulation A offerings,” \textit{id.} at 21,559–60, which, as already discussed, include additional investor safeguards.

\textsuperscript{123} 5 U.S.C. § 706(2)(A) (2012) (requiring a reviewing court to “hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law”).
that original rule. The court of appeals disagreed, finding that the SEC had “provid[ed] a reasoned analysis of how its qualified-purchaser definition strikes the ‘appropriate balance between mitigating cost and time demands on issuers and providing investor protections,’” and in doing so “considered the costs imposed on issuers by blue-sky review, relying on the Comptroller General’s conclusion that state registration and qualification requirements stymied Regulation A’s use in recent years.” To the protest, in an amicus brief filed by the North American Securities Administrators Associations, that the SEC had “rel[ied] on ‘little to no evidence’ regarding the costs of state-law compliance and state-law preemption,” the court responded that the original Regulation A had been used so infrequently “that the Commission did not have the data necessary to quantify precisely the risks of preemption for investors and the costs of state-law compliance for issuers.” The court declined to “require the Commission ‘to measure the immeasurable’ . . . [or] require it to ‘conduct a rigorous, quantitative economic analysis unless the statute explicitly directs it to do so.’” That the SEC had discussed “‘unquantifiable benefits’” and “articulated ‘. . . a rational connection between the facts found and the choice[] made,’” was enough to survive the APA challenge.

Credit retention rule. The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) amended the Securities Exchange Act (“Exchange Act”) to require the SEC, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve

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124 Lindeen, 825 F.3d at 657; id. at 649 (discussing the history of the original exemption).
125 Id. (quoting Reg A+ Adopting Release, supra note 102, at 21,888 (emphasis by the court)), id. (citing Reg A+ Adopting Release, supra note 102, at 21,868 (characterizing a GAO report as concluding that “compliance with state securities laws is one of the factors that impacts the use of existing Regulation A’)).
126 Id. at 658.
127 Id. (quoting Nat’l Ass’n of Mfrs. v. SEC, 748 F.3d 359, 369 (D.C. Cir. 2014) (quotation marks omitted), overturned on other grounds by Am. Meat Inst. v. USDA, 760 F.3d 18 (D.C. Cir. 2014) (en banc)).
128 Id. (first quoting Inv. Co. Inst. v. CFTC, 720 F.3d 370, 379 (D.C. Cir. 2013); then quoting Business Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011)).
System, and the Federal Deposit Insurance Corporation to “jointly prescribe regulations to
require any securitizer to retain an economic interest in a portion of the credit risk for any asset
that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys
to a third party.”

The agencies adopted an implementing rule. The Loan Syndications and Trading Association (“LSTA”) filed petition in the D.C. Circuit challenging the rule. The court of appeals ruled that it did not have jurisdiction.

The Exchange Act permits an “aggrieved party” to seek direct review of an SEC
“order.” But the petition challenged not an order but a “rule.” The Exchange Act only
permits direct court of appeals review of rules adopted pursuant to specifically listed sections of
that act. The section of the Exchange Act added by Dodd-Frank and mandating the credit
retention rule is not on that list. LSTA’s challenge therefore had to “begin in district court.”

LSTA could not avoid that result by pointing out that some of the sections in the
“authority, purpose and scope” provisions of the credit retention rule “contain direct-review”
rights. None of those sections gave the agencies the authority to issue the joint rule that LSTA

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131 Loan Syndications and Trading Ass’n v. SEC, 818 F.3d 716, 719 (D.C. Cir. 2016).
132 Id. at 724.
134 Loan Syndications and Trading Ass’n, 818 F.3d at 720.
135 15 U.S.C. § 78y(b)(1) (2012) (“A person adversely affected by a rule of the Commission promulgated pursuant to section 78f, 78i(h)(2), 78k, 78k-1, 78o(c)(5) or (6), 78o-3, 78q, 78q-1, or 78s of this title may obtain review of this rule in the United States Court of Appeals . . . .”). While this section refers to “the Commission,” subpart (d)(1) of 15 U.S.C. § 78y defines “Commission” for purposes of direct review to “include[] the agencies enumerated in section 78c(a)(34) of this title insofar as such agencies are acting pursuant to this chapter,” and 78c(a)(34) includes the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation. Loan Syndications and Trading Ass’n, 818 F.3d at 720.
136 Loan Syndications and Trading Ass’n, 818 F.3d at 721 (“Congress did not add section 78o–11 to the list of provisions entitled to direct review.”).
137 Id. at 720; id. at 724 (“[T]he district court has jurisdiction to review the entire regulation . . . .”).
138 Id. at 721.
challenged.\textsuperscript{139} Having no jurisdiction itself and since “[d]ismissing the petitions . . . would serve no purpose other than prolonging the litigation,” the D.C. Circuit transferred the case “in the interest of justice” to the D.C. District Court.\textsuperscript{140}

\textit{Challenges to SEC Administrative Law Judges.} When bringing an enforcement proceeding, the SEC can choose to file a lawsuit in federal court or an administrative proceeding before the Commission’s own Administrative Law Judges (“ALJs”).\textsuperscript{141} In 2015, two courts of appeals held that a respondent named in an administrative proceeding could not, while that proceeding was pending, file a lawsuit in federal court to halt the administrative proceeding on the ground that the proceeding violated the Constitution.\textsuperscript{142} In 2016, five opinions addressed the constitutionality of the SEC’s administrative proceedings.\textsuperscript{143} The Second, Fourth, and Eleventh Circuits held that a respondent or potential respondent in such a proceeding cannot stop such a proceeding by a federal lawsuit filed before the proceeding has run its course within the SEC.\textsuperscript{144} In reviewing an order issued by the SEC after the completion of a proceeding, the D.C. Circuit addressed one constitutional challenge substantively, holding that ALJs were not “Officers of the United States” within the meaning of the Appointments Clause of the U.S. Constitution and that therefore the manner of their appointment did not violate that clause.\textsuperscript{145} But the Tenth Circuit disagreed, holding that the ALJs were “inferior officers” within the meaning of the clause and,

\textsuperscript{139} \textit{Id.} at 723.

\textsuperscript{140} \textit{Id.} at 724 (quoting 28 U.S.C. § 1631 (2012)) (“Whenever a civil action is filed . . . with . . . a court and that court finds that there is a want of jurisdiction, the court shall, if it is in the interest of justice, transfer such action . . . to any other such court in which the action . . . could have been brought at the time it was filed . . . , and the action . . . shall proceed as if it had been filed in . . . the court to which it is transferred on the date upon which it was actually filed in . . . the court from which it is transferred.”).

\textsuperscript{141} 15 U.S.C. §§ 78u(d), 78u-2, 78u-3 (2012); 17 C.F.R. § 201.110 (2016).

\textsuperscript{142} Jarkesy v. SEC, 803 F.3d 9, 13, 30 (D.C. Cir. 2015); Bebo v. SEC, 799 F.3d 765, 775 (7th Cir. 2015), \textit{cert. denied}, 136 S. Ct. 1500 (2016) (No. 15-997).

\textsuperscript{143} \textit{See infra} notes 147–219 and accompanying text.

\textsuperscript{144} \textit{See infra} notes 147–188 and accompanying text.

\textsuperscript{145} \textit{See infra} notes 189–206 and accompanying text.
since they had not been appointed by the President or the Head of a Department, had been placed in their positions in violation of the Constitution.\textsuperscript{146}

Timing of constitutional challenges to ALJs. \textit{Hill v. SEC} consolidated two cases, in one of which a respondent sued in district court to stop an administrative proceeding after an ALJ denied motions for summary disposition (including one contending that the proceeding violated the Constitution) and in the other of which a party sued in district court for (i) an injunction to prevent the SEC from beginning an administrative proceeding that the SEC had threatened but not filed and (ii) a declaratory judgment—with this suit also based on asserted unconstitutionality.\textsuperscript{147} The district court, with the same judge sitting, granted the plaintiffs a temporary restraining order in the first case and a preliminary injunction in the second.\textsuperscript{148} Vacating both orders and remanding with direction to dismiss each case, the Eleventh Circuit held that the district court had no jurisdiction over the actions.\textsuperscript{149}

The court of appeals applied the “two-part framework” derived from the Supreme Court’s \textit{Thunder Basin Coal Co. v. Reich} decision.\textsuperscript{150} As to the first part—investigating congressional intent—the Eleventh Circuit concluded that Congress intended that the statutorily created review of SEC decisions by courts of appeals per 15 U.S.C. § 78y (section 25 of the Exchange Act) be

\textsuperscript{146} See infra notes 207–219 and accompanying text.
\textsuperscript{147} 825 F.3d 1236, 1239–40 (11th Cir. 2016). In the first case, the plaintiff argued “that (1) the administrative proceeding violate[d] the removal protections of Article II of the United States Constitution because ALJs are protected by two layers of tenure, (2) administrative enforcement actions before an ALJ violate[d] the non-delegation doctrine under Article I of the Constitution, . . . (3) the grant of discretion to the Commission to bring this action in an administrative forum violate[d] his Seventh Amendment right to a jury trial,” and (4) the appointment of ALJs by the SEC instead of the President, department head, or court violated the Appointments Clause. \textit{Id.} at 1239. The plaintiff in the second lawsuit made a similar Appointments Clause argument. \textit{Id.} at 1240.
\textsuperscript{148} \textit{Id.} at 1240.
\textsuperscript{149} \textit{Id.} at 1237–38.
exclusive and, concomitantly, that Congress intended to preclude district court review of such decisions.\textsuperscript{151} Section 78y provides that “[a] person aggrieved by a final order of the Commission entered pursuant to this chapter may obtain review of the order in the United States Court of Appeals for the circuit in which he resides or has his principal place of business, or for the District of Columbia Circuit by filing in such court, within sixty days after the entry of the order, a written petition requesting that the order be modified or set aside in whole or in part.”\textsuperscript{152} The statute further provides that “[o]n the filing of the petition, the court has jurisdiction, which becomes exclusive on the filing of the record, to affirm or modify and enforce or to set aside the order in whole or in part.”\textsuperscript{153} And it precludes raising arguments before the court of appeals not made to the SEC, absent a “reasonable ground” for failing to raise it to the Commission and also that the filing of a petition for review does not stay an SEC order.\textsuperscript{154} The Eleventh Circuit held that “the detail in § 78y indicates that Congress intended to deny aggrieved parties another avenue for review,” not even for “a constitutional challenge to the administrative process itself.”\textsuperscript{155}

\textsuperscript{151} Id. at 1242 (describing the test for the first part of the Thunder Basin analysis as “whether it is ‘fairly discernible’ from the ‘text, structure, and purpose’ of § 78y that Congress intended this statute to provide the exclusive means for judicial review of an SEC administrative action”); id. at 1245 (finding that “Congress’s intent to preclude district court review of the administrative proceeding is ‘fairly discernible in the statutory scheme’”).


\textsuperscript{155} Hill, 825 F.3d at 1243. The court held that the statutory process was intended to preclude district court review even before the Commission issued any order:

Here . . . the respondents . . . challenge Commission action—action which, if allowed to proceed, necessarily will result in a final Commission order. Section 78y provides that respondents must raise all objections to an order of the Commission before it becomes final or risk waiving the objection on appeal. See 15 U.S.C. § 78y(c)(1). The respondents’ constitutional challenges are essentially objections to forthcoming Commission orders; thus, they fall within the fairly discernible scope of § 78y’s review procedures.

\textit{Id.} The court rejected the argument that if “Congress wanted to preclude judicial review of his claims in the district court, it could have been clearer,” holding that “we do not require absolute clarity.” \textit{Id.} at 1245.
The court divided the second part of its *Thunder Basin* analysis—addressing “whether the specific claims the respondents raise ‘are of the type Congress intended to be reviewed within this statutory structure’”—into three parts. First, and most important of the three considerations, the court held that the respondent and potential respondent would “receive meaningful judicial review under § 78y.” While the judicial review would not occur until the administrative proceeding had run its course, and the respondent in it had suffered all the attendant costs, those litigation costs did “not amount to an irreparable injury on [their] own.” As to the sanctions that the SEC might impose, those were “speculative” since “the Commission might decide that the respondents violated no securities laws” and thus impose no sanctions, and, even if it did, “§ 78y grants the court of appeals the power to vacate a Commission order in whole, relieving the respondents of any liability.” The respondents did not suffer marginal costs to raise their constitutional issues because they were already before the SEC (or about to be) due to the Commission’s conclusion that they had violated the securities laws. The procedural rights in SEC administrative proceedings gave respondents the ability to “develop a sufficient factual record for meaningful appellate review under § 78y of their constitutional claims,” and, “to the extent the Commission fails to develop a sufficient factual record, the reviewing court not only may take judicial notice of facts relevant to the constitutional questions, . . . it may also remand to the Commission for further factfinding.”

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156 *Id.* at 1245 (quoting Thunder Basin Coal Co. v. Reich, 510 U.S. 200, 212 (1994)).
157 *Id.*
158 *Id.*
159 *Id.*
160 *Id.* at 1247.
161 *Id.* at 1248.
162 *Id.* at 1249–50 (citation omitted).
The court of appeals gave brief attention to the second and third factors relevant to the second part of the *Thunder Basin* analysis.\textsuperscript{163} The second factor was whether the SEC’s special expertise could be applied to the respondents’ argument, which the court found was true in the sense that “the Commission might decide that the [enforcement division’s] substantive claims are meritless and thus would have no need to reach the constitutional claims.”\textsuperscript{164} This possibility rendered it “of no moment that respondents’ Article II claims themselves are outside the agency’s expertise.”\textsuperscript{165} The court then dispatched the third factor—whether the constitutional claims were “wholly collateral” to the administrative proceeding—by holding that it did not matter because, “whether we characterize the respondents’ claims as wholly collateral, this factor does not convince us that Congress intended to grant the respondents a license to bypass § 78y in the face of our conclusion that the statute guarantees meaningful judicial review.”\textsuperscript{166}

Considering all three of the considerations relevant to the second part of the *Thunder Basin* framework, the court held “that the respondents’ claims are of the type Congress intended § 78y to govern.”\textsuperscript{167}

The Second Circuit’s decision in *Tilton v. SEC* is much the same.\textsuperscript{168} Two days after an administrative proceeding began, the respondents filed a federal court action to enjoin that proceeding on the ground that, in violation of Article II, the SEC “ALJs are impermissibly insulated from presidential removal, and that they were not appointed in accordance with the

\textsuperscript{163} *Id.* at 1250–52.
\textsuperscript{164} *Id.* at 1250.
\textsuperscript{165} *Id.* at 1251.
\textsuperscript{166} *Id.* at 1252.
\textsuperscript{167} *Id.*
Appointments Clause."\textsuperscript{169} The district court dismissed for lack of subject matter jurisdiction, and the Second Circuit affirmed.\textsuperscript{170}

Treating the question as whether the “scheme of administrative and judicial review” “implicitly” precludes district court jurisdiction,\textsuperscript{171} the Second Circuit employed the same two-stage \textit{Thunder Basin} paradigm as \textit{Hill}.\textsuperscript{172} The court of appeals first concluded that “the text, structure, and purpose of the securities laws make clear that Congress intended the SEC’s scheme of administrative review to permit the Commission to bring its expertise to bear in enforcing the securities laws.”\textsuperscript{173} Thus, “[g]enerally, . . . persons responding to SEC enforcement actions are precluded from initiating lawsuits in federal courts as a means to defend against them.”\textsuperscript{174}

This left the second \textit{Thunder Basin} question—“whether the scheme encompasses a respondent’s Appointments Clause challenge to a presiding ALJ”\textsuperscript{175}—a matter to be determined by (i) whether the respondents would have meaningful judicial review if they remained within the statutory administrative/judicial review scheme; (ii) whether the constitutional challenge was wholly collateral to the administrative proceeding; and (iii) whether the constitutional challenge was outside of the SEC’s expertise.\textsuperscript{176} To the argument that post-administrative court review would be meaningless “because [respondents’] exposure to the ongoing proceeding—as distinct from any adverse ruling that might result—would itself constitute a grave constitutional injury

\textsuperscript{169} \textit{Tilton}, 824 F.3d at 279–80.
\textsuperscript{170} \textit{Id.} at 279, 291.
\textsuperscript{171} \textit{Id.} at 281.
\textsuperscript{172} \textit{Id.; see supra} note 150 and accompanying text.
\textsuperscript{173} \textit{Tilton}, 824 F.3d at 281.
\textsuperscript{174} \textit{Id.} at 282.
\textsuperscript{175} \textit{Id.} at 281.
\textsuperscript{176} \textit{Id.}.
that could not be redressed after the fact,”177 the Second Circuit answered that “litigants who unsuccessfully challenge the authority of a presiding judge or jury to decide a case often must wait to appeal the issue until after the court renders a final judgment” and therefore “expend financial and emotional resources to complete a proceeding that may ultimately prove constitutionally infirm.”178 While a judicial review “cannot restore those resources,” it “can vacate the resulting judgment and remand for a new proceeding,” and “[t]hat post-proceeding relief, although imperfect, suffices to vindicate the litigant’s constitutional claim.”179 The court of appeals then held that the Appointments Clause challenge was not “wholly collateral” to the administrative proceeding because it “serves as an affirmative defense” there and, as such, will be one subject on which the Commission would render an order from which the respondents might seek judicial review.180 And even the constitutional challenge implicated the SEC’s expertise in the sense that “an agency may bring its expertise to bear on a constitutional claim indirectly, by resolving accompanying, potentially dispositive issues in the same proceeding”—in particular by ruling in the respondents’ favor and thereby rendering the constitutional question “moot.”181 Taking it all in all, the Second Circuit held “that Congress intended the appellants’ Appointments Clause claim ‘to be reviewed within’ the SEC’s exclusive ‘statutory structure’”

177 Id. at 283.
178 Id. at 285.
179 Id. The court also quoted from FTC v. Standard Oil Co. of California, 449 U.S. 232, 244–45 (1980), where the oil company sought to enjoin an agency action on the ground that the agency commenced it without sufficient evidence, and the Supreme Court “acknowledged that the company would endure ‘substantial’ expense and disruption before the administrative proceeding concluded . . . but . . . deemed that hardship to be ‘part of the social burden of living under government,’ rather than a form of irreparable injury justifying immediate judicial review.” Id. at 286.
180 Id. at 288.
181 Id. at 289–90.
and “that the appellants must await a final Commission order before raising their Appointments Clause claim in federal court.”\textsuperscript{182}

The Fourth Circuit reached the same conclusion in \textit{Bennett v. SEC}, affirming dismissal of an action brought by respondents within two months of the SEC opening an administrative enforcement proceeding against them—with the plaintiffs alleging that the proceeding was unconstitutional due to the manner in which the ALJ had been appointed.\textsuperscript{183} Employing the same two-step \textit{Thunder Basin} analysis of other courts, the Fourth Circuit first “readily discern[ed] from the text and structure of the Exchange Act Congress’s intent to channel claims first into an administrative forum and then on appeal to a U.S. Court of Appeals.”\textsuperscript{184} Turning to the second step, the court rejected the plaintiffs’ contention that they had no meaningful review by their ability to petition a court of appeals after an SEC decision because “the violation is exposure to the unconstitutional proceeding, rather than any adverse decision on the merits,” and could only be adequately addressed by an injunction because the “claim [rested on] a ‘structural,\textsuperscript{182} \textit{Id.} at 291. In a dissenting opinion, one judge complained that the majority analysis “stripped the ‘wholly collateral’ and ‘outside the agency’s expertise’ factors of any significance: in its view, as long as administrative proceedings have been initiated, those two factors are always satisfied.” \textit{Id.} at 292 (Dorney, J., dissenting). As to the collateral nature of a question, the majority view resolved this \textit{Thunder Basin} consideration in favor of proceeding administratively “as long as the claim could somehow serve to end administrative proceedings in a plaintiff’s favor.” \textit{Id.} at 295. As for agency expertise, the majority’s position “mean[es] that as long as a proceeding is ongoing, the ‘outside the agency’s expertise’ factor must weigh against jurisdiction—because any time a proceeding has commenced there is of course some possibility that a plaintiff may prevail on the merits.” \textit{Id.} at 296 (emphasis by J. Dorney). The dissenter would have found the constitutional challenge “wholly collateral” to the administrative proceeding because the respondents objected to the very existence of the proceeding. \textit{Id.} at 297. The constitutional question was outside the SEC’s expertise, in the dissent’s view, because “the SEC has no particular expertise in determining whether the system of appointing its Administrative Law Judges comports with the Appointments Clause of the Constitution.” \textit{Id.} And there was no “meaningful judicial review” because “by the time that [the respondents] access any judicial review, the proceedings will be complete, rendering the possibility of obtaining an injunction moot even if the final Commission order is vacated.” \textit{Id.} at 298. Convinced that the challenge here was not the type that Congress intended to be reviewed within the 15 U.S.C. § 78y structure—i.e., that the second prong of the \textit{Thunder Basin} test was not satisfied—the dissenting judge would have reversed and remanded for the trial court to rule on the merits of the Appointments Clause argument. \textit{Id.} at 299.

\textsuperscript{183} 844 F.3d 174, 176–77, 188 (4th Cir. 2016).

\textsuperscript{184} \textit{Id.} at 181.
prophylactic’ challenge to the constitutionality of the forum itself.” The Fourth Circuit read Supreme Court authority as “reject[ing] the drawing of jurisdictional lines between agencies and federal courts based on the nature of constitutional claims.” The Fourth Circuit further held that the plaintiffs’ constitutional challenges were not “wholly collateral” to the administrative proceeding because they “ar[o]se[ ] out of” that proceeding and “provide[d] an affirmative defense” in it. And the SEC “could bring its expertise to bear here by concluding that the Division of Enforcement’s substantive claims are meritless, thereby fully disposing of the case before reaching the constitutional question.”

Substantive challenges based on Appointments Clause. While both of the 2015 opinions and the three 2016 opinions summarized above considered only the question of when a respondent in an SEC administrative proceeding can litigate a constitutional challenge to the SEC’s administrative enforcement structure, the D.C. Circuit actually decided one such

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185 Id. at 184 (underlining by the court).
186 Id. The court of appeals similarly found unconvincing the plaintiff’s view “that an unconstitutional proceeding is, itself, the harm that she should be allowed to avoid” because “[t]he burden of defending oneself in an unlawful administrative proceeding . . . does not amount to irreparable injury.” Id. at 184–85.
187 Id. at 187.
188 Id. at 187–88. Effectively pushing this analysis back one further step, the Fourth Circuit also affirmed dismissal last year of a district court action brought by a respondent in an ongoing disciplinary decision initiated by the Financial Industry Regulatory Authority, Inc. (“FINRA”). Scottsdale Capital Advisors Corp. v. Fin. Industry Regulatory Auth., Inc., 844 F.3d 414, 417–19, 424 (4th Cir. 2016). The plaintiffs contended that FINRA had no authority to discipline them for supposed violations of the Securities Act by selling unregistered securities, id. at 417, since FINRA—registered as a national securities association under the Exchange Act, id.—at least as the plaintiffs saw it, “can only charge violations of the Exchange Act, not the Securities Act,” id. at 418–19. FINRA disciplinary decisions may be appealed by respondents in them to the SEC. 15 U.S.C. § 78s(e)(1)(A) (2012). After the SEC affirms, modifies, or sets aside the discipline, 15 U.S.C. § 78s(e)(1), the respondents can seek review of the SEC decision in a federal court of appeals, under the same statute permitting review of administrative proceedings initiated by the SEC before its ALJs—15 U.S.C. § 78y(a)(1) (2012). For that reason, and employing the Thunder Basin analysis, the district court had determined that it had no jurisdiction. Scottsdale, 844 F.3d at 419. In agreeing, the Fourth Circuit distinguished Leedom v. Kyne, 358 U.S. 184 (1958), in which the NLRB had conceded that it had exceeded its powers, and where the Supreme Court held that a district court had jurisdiction over an action to stop the NLRB. Id. at 419–21. Here, FINRA made no similar concession, id. at 420, and had “not violated a clear statutory mandate,” id. at 422. Moreover, its “interpretation of its authority to charge its members with violations of the Securities Act is plausible and the Exchange Act provides for meaningful judicial review.” Id. With that extra point out of the way, the court of appeals moved through a Thunder Basin analysis very similar to that employed in Bennett. Id. at 422–24.
challenge on the merits in *Raymond J. Lucia Companies, Inc. v. SEC*.\(^{189}\) The SEC initiated an administrative proceeding against Mr. Lucia and his company on September 5, 2012.\(^ {190}\) An ALJ issued an Initial Decision on July 8, 2013 that (i) found Mr. Lucia and his company to have violated a number of securities laws by misleading presentations of the returns a proposed investment strategy would have produced in past periods and (ii) imposed sanctions including civil penalties and a permanent bar against Mr. Lucia, preventing him from association with investment advisers, brokers, or dealers.\(^ {191}\) The Commission granted the respondents’ petition for review and, after consideration, entered its own order on September 3, 2015.\(^ {192}\) Like the ALJ, the Commission found that the respondents had made fraudulent statements and omissions in presenting so-called “backtest” information about the investment strategy, and the Commission imposed sanctions including civil penalties and a bar.\(^ {193}\) The Commission considered and rejected the respondents’ argument “that the ALJ who presided over this matter and issued the initial decision . . . was not appointed in a manner consistent with the Appointments Clause of the Constitution . . . [and] that, in light of this purported constitutional violation, the proceedings ‘are themselves invalid and any resulting orders should be vacated.’”\(^ {194}\) Agreeing with the Commission, the D.C. Circuit denied respondents’ petition for review.\(^ {195}\)

The Appointments Clause “provides that the President:”

\(^{189}\) 832 F.3d 277 (D.C. Cir. 2016).
\(^{191}\) Id. at 18–31, 45.
\(^{193}\) Id. at 17–19.
\(^{194}\) Id. at 28–33.
\(^{195}\) Raymond J. Lucia Companies, Inc. v. SEC, 832 F.3d 277, 296 (D.C. Cir. 2016).
shall nominate, and by and with the Advice and Consent of the Senate, shall
appoint . . . Officers of the United States, whose Appointments are not herein
otherwise provided for, and which shall be established by Law: but the Congress
may by Law vest the Appointment of such inferior Officers, as they think proper,
in the President alone, in the Courts of Law, or in the Heads of Departments.\footnote{Id. at 283 (quoting U.S. CONST. art. II, § 2, cl. 2).}

An “appointee is an Officer, and not an employee who falls beyond the reach of the Clause, if the
appointee exercises ‘significant authority pursuant to the laws of the United States.’”\footnote{Id. at 284 (quoting Buckley v. Valeo, 424 U.S. 1, 126 (1976)).} Whether
appointees exercise “significant authority” in this sense depends on “‘(1) the significance of the
matters resolved by the officials, (2) the discretion they exercise in reaching their decisions, and
(3) the finality of those decisions.’”\footnote{Id. at 284 (quoting Tucker v. Comm’r, Internal Revenue, 676 F.3d 1129, 1133 (D.C. Cir. 2012)).} In the circuit court argument, “the parties principally
disagree[d] about [the third of these factors—]whether . . . ALJs issue final decisions of the
Commission.”\footnote{Id. at 285 (alteration added).} The D.C. Circuit therefore focused on that single factor, saying that “[o]ur
analysis begins, and ends, there.”\footnote{Id.}

Section 4A(a) of the Exchange Act provides that the SEC “shall have the authority to
delegate, by published order or rule, any of its functions to . . . an administrative law judge . . . ,
including functions with respect to hearing, determining, [or] ordering . . . as to any work,
business, or matter.”\footnote{15 U.S.C. § 78d-1(a) (2012).} But 4A(b) states that “the Commission shall retain a discretionary right
to review the action of any . . . administrative law judge . . . upon its own initiative or upon
petition of a party to or intervenor in such action, within such time and in such manner as the
Commission by rule shall prescribe.” And 4A(c) provides that “[i]f the right to exercise such review is declined, or if no such review is sought within the time stated in the rules promulgated by the Commission, then the action of any . . . administrative law judge . . . shall, for all purposes, including appeal or review thereof, be deemed the action of the Commission.”

Thus, as the court of appeals saw it, “[u]ntil the Commission determines not to order review, within the time allowed by its rules, there is no final decision that can ‘be deemed the action of the Commission.’” Moreover, “the Commission must affirmatively act—by issuing the order—in every case,” and its “final action is either in the form of a new decision after de novo review or, by declining to grant or order review, its embrace of the ALJ’s initial decision as its own.”

The court noted that the “[p]etitioners offer neither reason to understand the finality order to be merely a rubber stamp, nor evidence that initial decisions of which the Commission does not order full review receive no substantive consideration as part of this process.”

The Tenth Circuit—also in a case brought to review a completed SEC administrative proceeding—took a broader view in Bandimere v. SEC, expressly disagreeing with the D.C. Circuit’s analysis that attributed decisive importance to whether Commission ALJs issue final decisions. Relying on Freytag v. Commissioner of Internal Revenue—where the Supreme

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204 Lucia, 832 F.3d at 286 (some citations omitted) (quoting section 4A(c)).
205 Id. The court noted that (at least since October 2013), even in the cases of default in an administrative proceeding, “ALJs must issue initial decisions as required by Commission rules,” id. at 287, presumably subject to the same protocol that they are not final until the Commission itself declines to review, at least by failing to exercise its discretionary right to review sua sponte within the time permitted by its rules of practice.
206 Id. at 287. The D.C. Circuit also denied the petition on substantive securities law grounds, holding that the substantial evidence supported the Commission’s findings of violations and that the lifetime industry bar against Mr. Lucia was neither unwarranted in law nor without justification in fact. Id. at 289–96. In reaching that last conclusion, the court rejected the argument that the SEC should have imposed a lighter sanction, similar to those in settled proceedings. Id. at 296.
207 844 F.3d 1168, 1182 (10th Cir. 2016) (stating that the Lucia decision relied on Landry v. Fed. Deposit Ins. Corp., 204 F.3d 1125 (D.C. Cir. 2000), and that “Landry place[d] undue weight on final decision-making authority”); id. at 1183–84 (stating that “[f]inal decision-making power is relevant in determining whether a public servant exercises
Court held that special trial judges ("STJs") appointed by the Tax Court were inferior officers within the meaning of the Appointments Clause and therefore subject to its strictures—

the Tenth Circuit quoted the Court as dealing with "the government’s argument that the STJs were employees because they ‘lack[ed] authority to enter a final decision’" by holding that this "argument ‘ignore[d] the significance of the duties and discretion that special trial judges possess.’"

Instead, as the Tenth Circuit saw it, Freytag found the STJs to be inferior officers (who are subject to the Appointments Clause) instead of employees (who are not) based on three characteristics, all of which "exist here: [(i)] the position of the SEC ALJ was ‘established by Law,’; [(ii)] ‘the duties, salary, and means of appointment . . . are specified by statute’; and [(iii)] SEC ALJs ‘exercise significant discretion’ in ‘carrying out . . . important functions.’"

The SEC ALJ position was established by statute because the Administrative Procedure Act ("APA") created the position of ALJ, with the Exchange Act then permitting the SEC “to delegate ‘any of its functions’ with the exception of rulemaking to ALJs,” and the Commission then adopting a rule “giv[ing] the agency’s ‘Office of Administrative Law Judges’ power to ‘conduct hearings’ and ‘proceedings.’” The APA specified the ALJs’ duties, salaries, and method of appointment. The SEC ALJs also, the Tenth Circuit held, “exercise significant discretion in performing ‘important functions’ commensurate with the STJs’ functions described in Freytag.” As examples, they “shape the administrative record by taking testimony,

significant authority [for purposes of Appointment Clause analysis, but that does not mean every inferior officer must possess final decision-making power"] (emphasis by the court).

209 Bandimere, 844 F.3d at 1175 (alterations in original) (quoting Freytag, 501 U.S. at 881).
210 Id. at 1179 (citations omitted) (quoting Freytag, 501 U.S. at 881, 882).
212 Id. (citing multiple statutes: “5 U.S.C. §§ 556-57 (duties); id. § 5372(b) (salary); id. §§ 1302, 3105 (means of appointment)).
213 Id.
regulating document production and depositions, ruling on the admissibility of evidence, receiving evidence, ruling on dispositive and procedural motions, issuing subpoenas, and presiding over trial-like hearings.”

They also “make credibility findings to which the SEC affords ‘considerable weight’ during agency review,” and “issue initial decisions that declare respondents liable and impose sanctions,” with those decisions deemed to be those of the Commission unless the Commission reviews them. The SEC ALJs also “have power to enter default judgments and otherwise steer the outcome of proceedings by holding and requiring attendance at settlement conferences.”

With all three criteria satisfied, the Tenth Circuit held “the SEC ALJs are inferior officers who must be appointed in conformity with the Appointments Clause.” Because the SEC conceded that its ALJs were not appointed in accord with that clause, the court of appeals held that “[t]he SEC ALJ held his office unconstitutionally when he presided over Mr. Bandimere’s hearing,” and therefore “grant[ed] the petition for review and set aside the SEC’s opinion.”

214 Id. at 1179–80 (footnotes with citations omitted).
215 Id. at 1180.
216 Id. (footnotes omitted). While the court of appeals acknowledged that the Commission could review initial decisions de novo, it observed that “90 percent of [the] initial decisions become final without plenary review,” and that, even when review is had, “the ALJ plays a significant role . . . in conducting proceedings and developing the record leading to the decision, and the decision publicly states whether respondents have violated securities laws and imposes penalties for violations.” Id. at 1180 n.25.
217 Id. at 1181.
218 Id. at 1171.
219 Id. at 1188. The court rejected the argument that it should defer to Congress’s “statutory framework governing the hiring of ALJs and the powers ALJs have in relation to their agencies” because such a deliberate framework “should not excuse failure to comply with the Appointments Clause.” Id. at 1185.

The case split the panel. A dissent argued that the structure for Commission review of initial decisions left the SEC ALJs’ with “only a ‘purely recommendatory power,’” Landry, 204 F.3d [1125,] 1132 [(D.C. Cir. 2000)], which separates them from constitutional officers,” id. at 1197 (McKay, J., dissenting), and suggested that the majority’s decision would throw the legitimacy of federal ALJs at all agencies open to challenge, id. at 1194, 1199–1200. A concurring opinion responded on the latter point that “whether a particular federal employee or class of employees are Officers subject to the Appointments Clause requires a position-by-position analysis of the authority Congress by law and a particular executive agency by rule and practice has delegated to its personnel.” Id. at 1189 (Briscoe, J., concurring).
**Significance and Analysis.** The 2015 and 2016 cases, taken together, should sound the death knell for efforts to forestall or stop ongoing administrative proceedings by district court actions asserting constitutional challenges. Logic may have suffered in the process. In particular, it seems strained to conclude that (i) no constitutional argument that might be dispositive for a respondent can be “wholly collateral” to the underlying proceeding under *Thunder Basin* and (ii) agency expertise—for *Thunder Basin* purposes—is present in every such proceeding simply because the agency might decide for the respondent on the merits of the substantive law the agency administers.

In any event, the division of authority between courts of appeals reviewing administrative proceedings against respondents who stood the course and fought their constitutional challenges after the SEC decided against them suggests that the legitimacy of the SEC ALJs is bound for the Supreme Court.

**SOX Certifications and SOX Clawback.** Section 302 of the Sarbanes-Oxley Act of 2002 (“SOX”) ordered the SEC to adopt rules to require the CEO and the CFO of public companies to certify that, “[b]ased on such officer’s knowledge,” each Form 10-Q and Form 10-K (i) “does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading” and, (ii) “the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report.”\(^\text{220}\) The SEC issued regulations—including Rule 13a-14—prescribing the exact wording of the certifications and

requiring that the certifications be attached to the Forms 10-Q and 10-K.\textsuperscript{221} The certifications cover more than the two items listed above, but as to each of those and in accord with the statute, each executive’s statements are qualified by being “[b]ased on my knowledge.”\textsuperscript{222}

SOX section 304 created a clawback by which the CEO and the CFO owe to a public company issuer—when the issuer “is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws”—(i) “any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement” and (ii) “any profits realized from the sale of securities of the issuer during that 12-month period.”\textsuperscript{223}

In \textit{SEC v. Jensen}, the SEC sued the CEO and CFO of Basin Water, Inc., “alleging that they had participated in a scheme to defraud Basin investors by reporting millions of dollars in revenue that were never realized.”\textsuperscript{224} The district court granted partial summary judgment to the defendants on the SEC’s claim that they violated the certification requirement by filing false certifications and found after a bench trial that the clawback only operated if the defendant officers were directly involved in the “misconduct” leading to the restatement.\textsuperscript{225} Vacating the

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{221} 17 C.F.R. § 229.601(b)(31)(i) (2016) (setting out the exact words for the certifications, with the certifications required by 17 C.F.R. §§ 240.13a-14(a), 240.15d-14(a) (2016)).
\item \textsuperscript{222} 17 C.F.R. § 229.601(b)(31)(i) (certification at ¶ 2.3).
\item \textsuperscript{224} 835 F.3d 1100, 1104 (9th Cir. 2016).
\item \textsuperscript{225} \textit{Id.}
\end{itemize}
\end{footnotesize}
judgment and remanding, the Ninth Circuit rendered important holdings on both the 302 certifications and the 304 clawback.226

As to the certifications, the court of appeals rejected the district court’s conclusion that any SEC claim for violation of the implementing regulation is limited to instances in which the officers either do not sign or do not file certifications.227 Instead, the court held that the regulation “include[s] an implicit truthfulness requirement” in part because “[t]he dictionary definition of ‘certify’ is ‘1. to testify by formal declaration, often in writing; to make known or establish (a fact)’; or ‘3. to guarantee the quality or worth of; vouch for [something].’”228 The court read this definition to mean that “one cannot certify a fact about which one is ignorant or which one knows is false.”229 Accordingly, “Rule 13a–14 provides a cause of action against CEOs and CFOs who file false certifications as well as those who do not file certifications at all.”230

Turning to whether a section 304 clawback can only apply to a CEO or CFO who was himself or herself involved in the triggering “misconduct” leading to a restatement, the Ninth Circuit provided the first court of appeals decision on this hotly debated issue.231 Parsing the

226 Id. at 1111–16, 1117.
227 Id. at 1112.
228 Id. at 1113 (quoting Webster’s New Twentieth Century Dictionary of the English Language, Unabridged, 297 (Jean L. McKechnie ed., 2d ed. 1979)).
229 Id. Summarizing, the court wrote:

We . . . conclude that Rule 13a–14, . . . includes an implicit truthfulness requirement. It is not enough for CEOs and CFOs to sign their names to a document certifying that SEC filings include no material misstatements or omissions without a sufficient basis to believe that the certification is accurate. We reverse the district court’s decision to the contrary and remand the SEC’s Rule 13a–14 claim.

230 Id.
231 Compare Rachael E. Schwartz, The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean, 64 BUS. LAW. 1 (2008) (arguing that no personal misconduct by the CEO or CFO is necessary), with John P. Kelsh, Section 304 of the Sarbanes-Oxley Act of 2002: The Case for a Personal Culpability
language of SOX 304, the court held that “[t]he clause ‘as a result of misconduct’ modifies the phrase ‘the material noncompliance of the issuer,’ suggesting that it is the issuer’s misconduct that matters, and not the personal misconduct of the CEO or CFO.”

Reinforcing this view, the court read the legislative history as showing “Congress’s intent to craft a broad remedy that focused on disgorging unearned profits rather than punishing individual wrongdoing.”

**Significance and Analysis.** The notion that the 304 clawback is not punitive because it seeks to recover amounts that executives received, but to which they were not entitled, is not well founded. The 304 clawback is not limited to unearned compensation. It takes the full amount of “any bonus or other incentive-based or equity-based compensation”—not just the difference between the amount that the executive was paid and the amount that the executive

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Although it might be surprising at first glance to require CEOs and CFOs to reimburse their employers when they have not done anything illegal, there are good policy reasons why Congress may have provided for the broad scope of § 304 suggested by the SEC.

. . .

“Imagine if someone told you that they would take away half of everything you earned this year if you did not catch the misconduct of one of your employees. You would most likely be highly motivated to catch the misconduct.” [Alison] List, [The] Lax Enforcement [of Section 304 of Sarbanes-Oxley: Why is the SEC Ignoring Its Greatest Asset in the Fight Against Corporate Misconduct?, 70 OHIO ST. L.J. 195] [195 [(2009)]. “[Sarbanes-Oxley] . . . requires CEOs and CFOs to certify their companies’ financial reports, outlaws fraud and deception by managers in the auditing process, prevents CEOs and CFOs from benefitting from profits they receive as a result of misstatements of their company’s financials, and facilitates the imposition of judicial bars against officers and directors who have violated the securities laws.” S. Rep. No. 107-205, 2002 WL 1443523, at *23 (2002) (emphasis added).

Baker, 2012 WL 5499497, at *5 (some alteration by the court).

232 Jensen, 835 F.3d at 1114.

233 Id. at 1115 (quoting Committee on Rules, H.R. Rep. No. 107–418, at 31, 2002 WL 704333 (April 23, 2002)) (noting that a House version of the Senate bill that became SOX “would have provided for disgorgement of all salary, commissions, and other earnings obtained by an officer or director ‘if such officer or director engaged in misconduct resulting in, or made or caused to be made in, the filing of a financial statement’”).

The Ninth Circuit also held that the SEC had a right to a jury trial on those claims for which it sought civil penalties, but not on the 304 clawback claim, as that claim sought only equitable relief. Id. at 1106.
would have been paid had the true financial numbers determined the compensation.\(^{234}\) Similarly, 304 takes the full amount of “any profits realized from the sale of securities of the issuer” by the officer during the recovery period, not just the portion of the profit attributable to stock price inflation caused by the particular amount by which the financials were wrong.\(^{235}\) In this regard, the 304 clawback differs from the more targeted one in Dodd-Frank, which (although covering a longer period of time) is restricted to “incentive-based compensation . . . in excess of what would have been paid to the executive officer under the accounting restatement.”\(^{236}\)

\textit{NMS Regulation and Delivery of Transaction Data.} As part of the National Market System (“NMS”), national stock exchanges must collect information regarding trades made on their platforms.\(^{237}\) Each exchange must file with the SEC a plan to disseminate that information

\(^{235}\) SOX § 304(a)(2); 15 U.S.C. § 7243(a)(2).

A concurring opinion addressed two issues. \textit{Jensen}, 835 F.3d at 1117–24 (Bea, J., concurring). First, Judge Bea opined that the mental state needed to violate the certification requirement by certifying falsely is “recklessness or knowledge.” \textit{Id.} at 1121. The judge reached this conclusion by reference to the SEC adopting release for the certifications, which said that: “An officer providing a false certification potentially could be subject to Commission action for violating Section 13(a) or 15(d) of the Exchange Act and to both Commission and private actions for violating Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5.” \textit{Id.} at 1118 (quoting Certification of Disclosure in Companies’ Quarterly and Annual Reports, 67 Fed. Reg. 57,276, 57,280 (Sept. 9, 2002)). Judge Bea then reasoned that an officer could be liable for aiding and abetting a company violation of section 13(a) of the Exchange Act only if the officer had “actual knowledge or reckless disregard . . . of the wrong and of his or her role in furthering it,” \textit{id.} at 1118–19 (quoting Levine v. Diamanthuset, Inc., 950 F.2d 1478, 1483 (9th Cir. 1991)), and could only commit a primary violation of Rule 10b-5 by a false representation if the officer had actual knowledge of the falsity or recklessly disregarded the falsity, \textit{id.} at 1120. The problem with this analysis is that it does not go to primary violation of Rule 13a-14 by virtue of false statements in those paragraphs of a 302 certification that are qualified by the words “[b]ased on my knowledge.” \textit{See supra} text accompanying note 222. Violation of those paragraphs should require actual knowledge of falsity or something akin to conscious avoidance of the truth. \textit{See U.S. S.E.C. v. Big Apple Consulting USA, Inc.}, 783 F.3d 786, 801–06 (11th Cir. 2015) (explaining that a deliberate ignorance instruction can be appropriate in a civil enforcement action). Moreover, the question of mental state can be complicated by the relief that the Commission seeks. For example, civil penalties are tiered, with the second and third tiers requiring that the violation of law or rule “involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.” 15 U.S.C. § 77t(d)(2)(B) & (C) (2012). If the mental state that Judge Bea suggests is less demanding than those in the penalty statute, then imposition of second or third tier penalties would require showing a more culpable state of mind.

\(^{237}\) 17 C.F.R. § 242.602(a) (2016).
(an “NMS Plan”), and no such plan is effective until approved by the Commission. Each plan “shall provide for the dissemination of all consolidated information for an individual NMS stock through a single plan processor” (a “Plan Processor” or “Processor”). An exchange can also sell information regarding transactions on its platform to purchasers other than the Processor named in its NMS Plan.

The plaintiff in *Lanier v. Bats Exchange, Inc.* had subscriber agreements with the defendant national exchanges by which he received transaction information through Plan Processors. He sued the exchanges for breach of those agreements on the basis that the exchanges sold transaction data directly to other market participants (“Preferred Customers”), who received the information many microseconds more quickly than the Plan Processors, who then provided it to him. Affirming the district court’s dismissal of the case, the Second Circuit

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239 17 C.F.R. § 242.603(b) (2016).
240 Regulation NMS, 70 Fed. Reg. 37496 (June 29, 2005) (adopting release); *id.* at 37,503 (stating that “amendments promote the wide availability of market data by authorizing markets to distribute their own data independently (while still providing their best quotations and trades for consolidated dissemination . . .)” (emphasis added); *id.* at 37,567 n.638 (stating further that the adopted amendment “rescinds the prohibition on SROs and their members from disseminating their trade reports independently”) (“Given that members of an SRO will continue to be required to transmit their trades to the SRO (and SROs will continue to transmit trades to the Networks pursuant to the Plans), the Commission believe[s] that SROs and their members also should be free to distribute their trades independently.” (emphasis added)).
241 838 F.3d 139, 144–45 (2d Cir. 2016).
242 *Id.* at 142. The court provided these details:

Lanier’s Complaints allege, and we accept as true for purposes of this appeal, that the Exchanges disseminate the same market data they send to the Processor directly to the Preferred Customers through proprietary feeds for higher fees, which bring substantial revenue to the Exchanges. Due to the size of the connection’s capacity/bandwidth, the transfer protocol, and the physical location of the Preferred Customers’ servers near the Exchange server transmitting the data, the Preferred Customers receive data as quickly as one microsecond after data is sent. It can take 1500 microseconds for the same data to arrive at the Processor, and an even longer delay before the data reaches Subscribers. The Preferred Customers are advantaged by the speed at which they receive market data because they receive data faster than the Subscribers, who consequently trade on stale data, and the Exchanges profit by charging additional fees for the speed advantage they sell to Preferred Customers.

*Id.* at 145 (footnotes omitted).
considered three possible theories on which the plaintiff might proceed, rejecting each one as failing to state a claim.\(^{243}\)

First, to the extent the plaintiff claimed that his subscriber agreements incorporated SEC regulations and that sales by exchanges of transaction information to Preferred Customers in a manner resulting in those customers receiving that information earlier than Plan Processors violated those regulations, his claim “turn[ed] on an interpretation of the relevant regulations that conflicts with the agency’s own stated interpretation, and is thus preempted.”\(^{244}\) The applicable SEC regulation requires that an exchange must distribute information “on terms that are not unreasonably discriminatory”\(^{245}\) and that a Processor distribute information “on terms that are fair and reasonable,”\(^{246}\) and the NMS Plans contain language requiring “prompt” information service.\(^{247}\) Since the NMS Plans track the language of the SEC regulation “almost verbatim, . . . the Plans are co-extensive with that regulation with respect to the timing of the delivery of

\(^{243}\) Id. at 150–51, 158. The district court had dismissed on the ground that it did not have subject matter jurisdiction because the plaintiff had not sought SEC review before resorting to federal court. Id. at 146. The court of appeals concluded that it had jurisdiction, applying the same Thunder Basin analysis employed in determining whether district courts can hear preemptive cases to stop administrative proceedings before ALJs. Id. at 146–47; see supra text accompanying notes 150–167. The plaintiff’s “contract claims are not the type that Congress intended to be [included] within the statutory structure” governing SEC decisions and subsequent court review. Lanier, 838 F.3d at 147. His claims were “wholly collateral” to that system of decision making because they rested neither on a “final order” issued by the SEC, reviewable by a court of appeals under 15 U.S.C. § 78y(a)(1), nor a Commission rule, reviewable by a court of appeals on the petition by an aggrieved person under 15 U.S.C. § 78y(b)(1). Id. at 148. The “[q]uestions of contract interpretation and breach [were] outside the SEC’s competence and expertise” but “squarely within the core competency of the judiciary.” Id. at 149. And the plaintiff could not obtain meaningful judicial review if he were to approach the SEC because “it is at the very least unclear whether the statutory structure provides Lanier an avenue to have his contract claims heard before the SEC,” while it was crystal clear “that the damages to which he would be entitled if he prevailed under state contract law are unavailable [from the Commission] even if an agency procedure was possible.” Id. at 150. For all these reasons, the Second Circuit could not hold that “Congress implicitly precluded federal district court jurisdiction over [Lanier’s] claim prior to administrative review.” Id. at 147. Instead, the Thunder Basin factors “weigh[ed] decisively in favor of finding that the district courts have jurisdiction to hear Lanier’s claims, which are asserted as statelaw breach of contract claims.” Id. at 150.

\(^{244}\) Lanier, 838 F.3d at 151.

\(^{245}\) 17 C.F.R. § 242.603(a)(2) (2016).


\(^{247}\) Lanier, 838 F.3d at 152 & n.14.
market data.”248 But the SEC “appears to have interpreted these requirements to mean that data must be sent by the Exchanges at the same time” to Processors and to Preferred Customers, “not received simultaneously” by both Preferred Customers and Processors.249 Therefore, the plaintiff’s “interpretation of the NMS Plans, and consequently Regulation NMS[—which] would require that the Processors receive data prior to or at the same time as the receipt by the Preferred Customers . . . conflicts with the SEC interpretation and implementation of the same regulations.”250

Second, to the extent that the plaintiff based his claim “on failure to fulfill contractual obligations independent of the obligations imposed by a regulatory scheme,” the claim failed because he “identifie[d] no language in the Subscriber Agreements that makes any promise as to the timing of the receipt of unconsolidated data by the Processor, the subscribers, or the Preferred Customers.”251 Third, “to the extent that the Complaints may also be read to allege a breach of contract theory that assumes that the implementation or operation of the NMS Plans violates the Exchange Act, any such claim must first be administratively exhausted before the SEC.”252

Significance and Analysis. High-frequency trading (“HFT”) now accounts for more than half of the transactions in U.S. equity markets.253 While not all such trading depends on early

248 Id. at 153.
249 Id. (emphasis original). See the SEC release language in supra note 240, cited and to some extent quoted in Lanier, 838 F.3d at 153.
250 Lanier, 838 F.3d at 154. The court also seemed concerned that, if state courts could decide subscriber contract issues intertwined with the regulations, (i) different state courts could interpret the regulations differently, thereby frustrating “the uniformity that Congress intended to create for the National Market System” and (ii) even if all state courts interpreted the contract-implicated regulations in the same way, that result would defeat Congress’s intention that the SEC—with its special expertise—control the NMS. Id. at 155.
251 Id. at 156.
252 Id. at 157.
access to transaction information, “various HFT firms . . . employ something called slow market arbitrage wherein the firms attempt to arbitrage small price differences for stocks between various exchanges resulting from infinitesimal time differences in the trading prices that they report on the same securities, a practice described in Flash Boys, the controversial 2014 book on HFT by Michael Lewis.”\textsuperscript{254} Whether the NMS Regulation, adopted in 2005, is out of date in light of such practices or whether those practices simply reflect the market at work in our technologically advanced time was, of course, beyond the scope of Lanier. But the Second Circuit decision makes it clear that the current SEC regulation—or at least the Commission’s current interpretation of that regulation—permits such timing arbitrage.

\textit{Criminal Cases}. The Second Circuit revisited last year “willfulness” as used in criminal provisions of federal securities law.\textsuperscript{255} The same court also considered whether a $19.7 billion forfeiture order entered against defendants who participated in the Madoff fraud was an excessive fine prohibited by the Eighth Amendment.\textsuperscript{256}

\textbf{Definition of willfulness}. The defendant in \textit{U.S. v. Tagliabue} was convicted of violating section 206 of the Investment Advisers Act (“IAA”).\textsuperscript{257} IAA section 206 proscribes, among other things, both “engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client” and “engag[ing] in any act, practice, or

\begin{itemize}
\item \textsuperscript{254} \textit{Id}. at 4. The Second Circuit noted that \textit{Flash Boys} centered on the difference between the time at which the Preferred Customers receive the transaction information and the time that Plan subscribers receive it—while the plaintiff’s claims centered on the difference between the time at which the Preferred Customers receive the transaction information and the time at which the Plan Processors receive it. \textit{Lanier}, 838 F.3d at 155 n.18.
\item \textsuperscript{255} See infra notes 257–269 and accompanying text.
\item \textsuperscript{256} See infra notes 270–278 and accompanying text.
\item \textsuperscript{257} 820 F.3d 568 (2d Cir. 2016). He was also convicted of securities fraud, wire fraud, and of violating the Travel Act (18 U.S.C. § 1952). \textit{Id}. at 569.
\end{itemize}
course of business which is fraudulent, deceptive, or manipulative.”258 IAA section 217
criminalizes “willful[] violat[ion]” of the IAA.259

Tagliaferri had (i) taken kickbacks in exchange for investing client money in a company
that owned and managed racehorses; (ii) generated commissions for himself by using the money
in some clients’ accounts to buy securities held in other clients’ accounts; and (iii) sold fractional
interests (“sub-notes”) to client accounts of a nonexistent “note,” which was actually equity that
he had purchased with his own money.260 At trial, Tagliaferri testified that, while the first two
categories of actions involved conflicts of interest, he had a good faith belief that each
investment was in the best interests of the client involved.261 As to the sub-notes, he argued that
“he had always ‘believed that he would be able to work things out so that his clients would not
be harmed.’”262 The trial judge instructed the jury that the government had to prove “specific
intent to defraud,” and that “‘willfully’ means to act knowingly and purposely, with an intent to
do something the law forbids, that is to say, with bad purpose either to disobey or to disregard
the law,” but that Tagliaferri did not need to know that he was “breaking any particular law,”
rather he “need only have been aware of the generally unlawful nature of his act.”263 The court
instructed specifically that “a belief by the defendant, if such belief existed, that ultimately
everything would work out so that no investors would lose any money or that particular
investments would ultimately be financially advantageous for clients does not necessarily
constitute good faith,” and further that “[n]o amount of honest belief on the part of a defendant

260 Tagliaferri, 820 F.3d at 569–70.
261 Id. at 570.
262 Id. (quoting Appellant Brief).
263 Id. at 571 (quoting instruction).
that the scheme will ultimately make a profit for the investors will excuse fraudulent actions or false representations by him."\textsuperscript{264}

The Second Circuit affirmed the conviction,\textsuperscript{265} rejecting the argument “that, in a criminal prosecution under [IAA section 217], section 206 incorporates the common law requirement that intent to defraud includes both intent to deceive and intent to harm."\textsuperscript{266} The court held that “the wrongfulness of section 206 violations derives from their deceptiveness, proof that the defendant intended to deceive his clients suffices to establish the requisite mens rea for guilt,” and “the willfulness mental state required by [section 217] ensures that criminal penalties are limited to

\textsuperscript{264} \textit{Id.} (quoting instruction). The full set of instructions quoted by the Second Circuit said:

\begin{quote}
[T]he government must prove beyond a reasonable doubt ... that the defendant devised or participated in the alleged device, scheme, or artifice to defraud, or engaged in the allegedly fraudulent transaction, practice, or course of business, knowingly, willfully, and with the specific intent to defraud.

“Knowingly” means to act voluntarily and deliberately, rather than mistakenly or inadvertently.

“Willfully” means to act knowingly and purposely, with an intent to do something the law forbids, that is to say, with bad purpose either to disobey or to disregard the law. The defendant need not have known that he was breaking any particular law or any particular statute. A defendant need only have been aware of the generally unlawful nature of his act. “Intent to defraud” in the context of the securities laws means to act knowingly and with the intent to deceive.

“\textbf{G}ood faith,” as I will define that term, on the part of a defendant is a complete defense to a charge of investment adviser fraud.

In considering whether or not a defendant acted in good faith, however, you are instructed that a belief by the defendant, if such belief existed, that ultimately everything would work out so that no investors would lose any money or that particular investments would ultimately be financially advantageous for clients does not necessarily constitute good faith. No amount of honest belief on the part of a defendant that the scheme will ultimately make a profit for the investors will excuse fraudulent actions or false representations by him.

\textit{Id.} at 571.
\textsuperscript{265} \textit{Id.} at 575.
\textsuperscript{266} \textit{Id.} at 572.
cases in which the Government is able to prove that, at minimum, ‘the defendant acted with knowledge that his conduct was unlawful.’

Significance and Analysis. Tagliaferri echoes to some extent the Second Circuit’s holding in 2015 that the scienter required for Rule 10b-5 violation does not require an intent to harm. And Tagliaferri’s holding that willfulness requires only realization by the defendant that his or her conduct was wrong—but not necessarily an understanding of what law he or she is violating—reprises long-standing law in Rule 10b-5 cases as well.

Forfeiture and Eighth Amendment prohibition of excessive fines. The Second Circuit affirmed a $19.7 billion forfeiture order in a case against two defendants who, while working at Bernard L. Madoff Investment Securities (“BLMIS”), “designed computer programs that created books and records filled with randomly generated numbers in order to deceive regulators and clients.” The $19.7 billion represented “the total client investment” in BLMIS’s investment advisory (“IA”) business. Rejecting the argument by one defendant that the forfeiture order violated the Eighth Amendment’s prohibition against excessive fines, the court considered four factors.

First, as to “the essence of defendant’s crime and its relation to other criminal

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267 Id. at 575 (quoting Bryan v. U.S., 524 U.S. 184, 191 (1998)).
268 U.S. v. Litvak, 808 F.3d 160, 178–79 (2d Cir. 2015); id. at 179 (holding, in respect to the Rule 10b-5 counts, that, “because ‘intent to harm’ is not a component of the scienter element of securities fraud under Section 10(b), the District Court did not err in refusing to provide such an instruction to the jury”).
269 Tagliaferri, 820 F.3d at 573 (“Our Court likewise has held in contexts similar to this one that to prove willfulness, ‘the prosecution need only establish a realization on the defendant’s part that he was doing a wrongful act.’ United States v. Dixon, 536 F.2d 1388, 1395 (2d Cir. 1976) (Friendly, J.) (internal quotation marks omitted)” (with Dixon interpreting section 32(a) of the Securities Exchange Act, which criminalizes “willful violations” of provisions of that statute)); see also U.S. v. Tarallo, 380 F.3d 1174, 1188 (9th Cir. 2004) (“Under our jurisprudence . . . ‘willfully’ as it is used in [Exchange Act section 32] means intentionally undertaking an act that one knows to be wrongful . . . .”), amended by 413 F.3d 928 (9th Cir. 2005).
271 Id. at 90.
272 Id. at 91. The Eighth Amendment reads: “Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted.” U.S. CONST. amend. VIII.
activity,” the Second Circuit found no clear error in the district court’s conclusion that this
defendant’s “‘special programming’ work was ‘the essential backbone of the infrastructure
through which the IA fraud was perpetrated.’”\footnote{273} Second, as to “whether defendant fits into the
class of persons for whom the statute of conviction was principally designed,” the court of
appeals found that “the district court reasonably concluded that [the defendant] was no mere
‘technical worker,’ but a vital member of the conspiracy” because the “only purpose of [his
computer programming] was to effect [BLMIS’s] misrepresentations efficiently.”\footnote{274} Third,
considering the forfeiture in light of the “maximum sentence and fine that could have been
imposed,” the Second Circuit reasoned that “[b]ecause [the defendant] faced a maximum prison
sentence of 100 years—effectively a life sentence—the challenged forfeiture cannot be deemed
disproportional notwithstanding the statutory maximum fine of $10 million.”\footnote{275} Fourth, “the
nature of [the] harm caused by the defendant’s conduct“\footnote{276} supported the forfeiture, as the
district court committed no clear error in characterizing the damage as “‘financial devastation of
unprecedented magnitude’ resulting in confidence in securities institutions and regulatory
agencies being eroded and thousands of ‘innocent lives [being] irreversibly upended.’”\footnote{277} Taken
together, the four factors led the Second Circuit to conclude that “the ordered forfeiture, while
monumental, was not ‘grossly disproportional’ to the gravity of the crimes of conviction.”\footnote{278}

\textit{Scienter and Scienter Pleading}. The Exchange Act requires that, “in any private action
arising under this [statute] in which the plaintiff may recover money damages only on proof that

\footnote{273}{Id.}
\footnote{274}{Id.}
\footnote{275}{Id.}
\footnote{276}{Id.}
\footnote{277}{Id. at 92 (quoting district court).}
\footnote{278}{Id. at 91 (quoting U.S. v. George, 779 F.3d 113, 122 (2d Cir. 2015) (providing gross disproportionality as the test
for whether a forfeiture is proscribed by the Eighth Amendment)).}
the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this [Act], state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”

The required state of mind for a Rule 10b-5 claim is scienter, which encompasses both an “intent to deceive” and some form of recklessness. The Supreme Court has interpreted the statutory pleading requirement, in light of the state of mind necessary for Rule 10b-5 liability, to mean that a private plaintiff seeking to recover under the rule must allege specific facts that raise an inference of scienter that is “cogent and at least as compelling as any opposing inference of nonfraudulent intent.”

In 2016, the Fifth Circuit ruled that scienter allegations did not meet this standard when applied to omissions about labor problems in China. The Tenth Circuit found such allegations wanting in a case in which plaintiffs alleged misstatements about forward losses. In one case involving a pharmaceutical company report on clinical tests, the First Circuit held that the complaint failed to adequately allege scienter, while in another case involving reported test results, the Ninth Circuit found that the complaint did.

Alleged failure to disclose cause of labor problems. The CEO defendant in Local 731 I.B. v. Diodes, Inc. stated in a February 9, 2011 press release that Diodes’s production during the first quarter would be hurt by labor shortages in China, where the company manufactured semiconductors. He predicted a 5% revenue decline and a gross profit margin of 36.5%, plus

282 See infra notes 285–309 and accompanying text.
283 See infra notes 310–348 and accompanying text.
284 See infra notes 349–411 and accompanying text.
285 810 F.3d 951, 955 (5th Cir. 2016).
or minus a percentage point.\textsuperscript{286} Diodes’s May 10, 2011 press release reported the actual gross margin for the first quarter as 35.5%.\textsuperscript{287} This release also disclosed that first quarter output had been affected by a “larger than normal” number of workers not returning from the Chinese New Year holiday.\textsuperscript{288} In a conference call about the first-quarter results, the CEO stated that the second-quarter gross margin would be comparable to that in the first quarter, and at an industry conference on the same day, the CFO defendant referred to workers’ failure to return from the holiday when asked about the labor shortage in China.\textsuperscript{289} On June 9, 2011, Diodes revised its second-quarter guidance due to “‘slower than expected’ recovery from the labor shortage,” and predicted a 32.5% gross margin (plus/minus 1.5%).\textsuperscript{290} In August 2011, Diodes reported the actual gross margin for its second quarter to have been 32.8%.\textsuperscript{291}

Investors who bought Diodes’s stock from February 9 to June 9, 2011 brought a Rule 10b-5 action against the company, the CEO, and the CFO.\textsuperscript{292} They did not allege any misstatement, but claimed that the defendants misled the public by failing to disclose that the labor shortage was primarily due to the company’s labor practices—particularly doubling work hours and canceling leave before the Chinese New Year—which caused employees to quit.\textsuperscript{293} Affirming the district court’s dismissal, the Fifth Circuit held that the complaint did not plead facts raising a strong inference of scienter.\textsuperscript{294}

\textsuperscript{286} Id.  
\textsuperscript{287} Id.  
\textsuperscript{288} Id.  
\textsuperscript{289} Id.  
\textsuperscript{290} Id.  
\textsuperscript{291} Id.  
\textsuperscript{292} Id.  
\textsuperscript{293} Id. at 956, 957.  
\textsuperscript{294} Id. at 954, 961.
The court rejected the plaintiff’s argument that “[b]ecause an experienced workforce
[was] essential to Diodes’s competitive advantage . . . [the CEO] and [the CFO] must have been
aware of how [the company’s] internal labor policies exacerbated the external influences on the
company’s productivity.”\textsuperscript{295} Noting that the plaintiff did not allege any specific facts “indicating
that [the two top officers] knew that the labor shortage was principally caused by Diodes’[s]
workplace policies,” the court found that the plaintiff drew its scienter inference “simply from
the magnitude of disruption caused by the company’s labor policies, which, from their top
executive positions, [the CEO and CFO] must or should have known about.”\textsuperscript{296} While
acknowledging that “special circumstances” can support such an inference, the Fifth Circuit
found that none of the four factors exhibited in other cases in which such circumstances had been
found were present in this case.\textsuperscript{297} First, Diodes was not a small company in which executives
would know details of day-to-day operations, but an enterprise with more than 4,000 employees,
and “[i]t is not at all clear that Diodes’s top executives in Dallas would have been aware of labor
policies at the Shanghai facility, much less the chatter on the factory floor and the varying
reasons for employee attrition before and after the Chinese New Year.”\textsuperscript{298} Second, the plaintiff
did not claim “that the extent and duration of the labor shortage, whatever its cause, jeopardized
the company’s existence,” and so would have commanded top officer scrutiny.\textsuperscript{299} Third, the
effect of Diodes’s new labor policies would not have been “readily apparent” to the CEO and
CFO because the implementation of those policies close to the Chinese New Year made it
“difficult to isolate the effect of the workplace policies on the factory floor.”\textsuperscript{300} Fourth, the

\textsuperscript{295} Id. at 957–58.
\textsuperscript{296} Id. at 958.
\textsuperscript{297} Id. at 959.
\textsuperscript{298} Id.
\textsuperscript{299} Id.
\textsuperscript{300} Id.
defendants’ statements were not inconsistent; instead, the defendants correctly predicted the effect of the labor problems on company financial figures.  

The plaintiff’s argument that scienter could be inferred by “Diodes’s early shipments of orders without prior customer authorization” fared no better.  

The Fifth Circuit pointed out that early shipments are not inherently suspicious, but “may be supported by ‘any number of legitimate reasons,’ and usually ‘does not support a strong inference of scienter.’”  

Moreover, the plaintiff alleged neither that the early shipments were “fabricated” sales nor that Diodes had failed to properly account for them.  

Finally, the idea that the company would have shipped product early to customers in order to conceal a labor shortage did not make sense because such shipments would deplete inventory and expose the production problems created by the want of skilled labor.  

Since the early shipments would have been “counterproductive” in concealing the allegedly omitted facts, those shipments could not provide a “‘compelling’ []or ‘cogent’” inference that the defendants intended to fraudulently conceal company labor practices contributing to the dearth of skilled workers that in turn reduced production.

301 Id.
302 Id.
303 Id. at 959–60 (quoting Greebel v. FTP Software, Inc., 194 F.3d 185, 203 (1st Cir. 1999)).
304 Id. at 960 n.3.
305 Id. at 960.
306 Id. The Fifth Circuit also rejected the argument that executive stock sales supported a scienter inference.  

The sales represented a small portion of his investment in the company, and there are many innocent reasons why an individual would sell stock at a given time. Thus, the nonculpable inferences that may be drawn from sales of stock are more cogent and compelling than the [plaintiff’s] contrary proposition.

Id.
Significance and Analysis. The Fifth Circuit’s reasoning on the last point harkens back, in a way, to the Court’s conclusion—albeit in the very different context of reversing denial of summary judgment for defendants in an antitrust case—that “[i]t follows from . . . settled principles that if the factual context renders respondents’ claim implausible—if the claim is one that simply makes no economic sense—respondents must come forward with more persuasive evidence to support their claim than would otherwise be necessary.”\textsuperscript{307} Since Tellabs instructs that courts, in evaluating scienter allegations, “must engage in a comparative evaluation . . . consider[ing], not only inferences urged by the plaintiff . . . but also competing inferences rationally drawn from the facts alleged,”\textsuperscript{308} a plaintiff who alleges facts suggesting an explanation of events that affirmatively cuts against scienter should, other things being equal, have a harder time arguing a “strong inference” of fraud than a plaintiff who does not do so.\textsuperscript{309}

Alleged misrepresentations and omissions regarding delays and cost overruns leading to forward-loss charges. The Tenth Circuit addressed, in Anderson v. Spirit Aerosystems Holdings, Inc. last year, scienter allegations relating to a forward-loss charge, which “is an accounting term meaning that past production costs plus estimated future production costs will exceed the total revenues estimated on a given contract.”\textsuperscript{310} Investors sued Spirit Aerosystems Holdings, Inc. ("Spirit") and its CEO, CFO, senior vice president for Oklahoma operations, and a vice president overseeing one of the relevant projects (to supply Boeing), alleging that the defendants violated Rule 10b-5 by misrepresentations and omissions, during a class period from November 3, 2011 to October 24, 2012, about cost overruns and delays in three projects to supply two companies.

\textsuperscript{309} Matsushita employs just such reasoning. 475 U.S. at 588 (“Respondents in this case, in other words, must show that the inference of conspiracy is reasonable in light of the competing inferences of independent action or collusive action that could not have harmed respondents.”).
\textsuperscript{310} 827 F.3d 1229, 1237 n.5 (10th Cir. 2016).
(Gulfstream Aerospace Corporation and The Boeing Company) with parts for aircraft that those
two companies were producing.\textsuperscript{311} Spirit announced on October 25, 2012, that it expected to
suffer hundreds of millions of dollars in forward losses, and its stock dropped 30\%.\textsuperscript{312}

Affirming the district court’s dismissal for the plaintiffs’ failure to plead “facts creating a
cogent and compelling inference of scienter,”\textsuperscript{313} the court of appeals addressed each of several
types of facts in turn. First, it was unpersuaded by the argument that the defendants had a motive
to lie because they wanted “to buy time in the hope that a difficult financial situation ‘would
right itself’.”\textsuperscript{314} This “suggest[ed] a generalized corporate motive . . . that would not contribute
to an inference of scienter” because it could be inferred at any company with respect to almost
any problem.\textsuperscript{315}

Second, the court found wanting allegations based on confidential witnesses.\textsuperscript{316} Reports
by one such witness about an internal Spirit meeting in mid-2011 in which the CEO and CFO
supposedly admitted that one of the three projects was “‘behind schedule and over budget,’”
concerned events “months before the class period began,” and “plaintiffs [did] not identify any
particularized account showing that the two executives knew during the class period that their
progress reports were inaccurate.”\textsuperscript{317} While one confidential witness reported that (i) a 2011 cost
study report concluded that Spirit could not achieve cost-reduction goals and (ii) an internal
business group “regularly reported losses on the Gulfstream projects,” this did not show guilty
knowledge by the four named executives because “four levels of management hierarchy

\begin{footnotes}
\item[311] Id. at 1235–36.
\item[312] Id. at 1236, 1249.
\item[313] Id. at 1236, 1251.
\item[314] Id. at 1238–39 (quoting plaintiffs).
\item[315] Id. at 1239.
\item[316] Id. at 1239–45.
\item[317] Id. at 1239–40.
\end{footnotes}
separated [this witness] from the chief executive officer[,] and the witness’s allegations [did] not establish that the four Spirit executives actually had seen the 2011 cost-study report or were aware of the regularly reported losses on the Gulfstream projects.” 318 While a second confidential witness allegedly supplied procurement cost data to generate quarterly cost reports on the projects, “the content of the resulting quarterly cost reports is unknown because (1) they went through numerous layers of revision before reaching [the CEO] and [CFO], and (2) [the witness] did not purport to know how the procurement costs affected the cost forecasts for the Boeing 787 project.” 319 Moreover, the court reasoned that “even if [it could] assume that [the CEO] and [CFO] were aware of overruns on procurement costs, [it] ha[d] no information from [the witness] on what the internal costs were or how the overruns on procurement costs would have affected the total project costs.” 320 Although the plaintiffs also pled “general reports of delay and mismanagement of the Gulfstream projects” and contended that “these reports suggest that the Spirit executives must have long known that Spirit would need to take a substantial forward loss on the projects,” the court found that this conclusion “does not follow.” 321 Overall, “[t]hese [reports] were too far removed from the four Spirit executives and did not provide sufficiently particularized accounts of what the Spirit executives must have known.” 322 While one witness reported a confrontation with the vice president overseeing the Boeing project—during which that executive allegedly ordered the witness to lower projected costs that the

318 Id. at 1240.
319 Id. at 1241.
320 Id. at 1243.
321 Id. The court found that the only witness who “worked closely with any of the four Spirit executives . . . spoke only of general corporate mismanagement; the witness did not address whether the executives could have known that Spirit would be unable to meet long-term cost forecasts,” and that “[t]he other corroborating witnesses were further removed from the defendants . . . —four corroborating witnesses who had no alleged reporting relationship to the defendants[, and] . . . two corroborating witnesses who were separated from the chief executive officer by at least four levels of management within Spirit’s hierarchy.” Id.
322 Id. at 1244.
witness had prepared, to a level that the witness believed could not be reached—and while that executive made a presentation at an investor conference in March 2012 in which he said that Spirit’s production for Boeing was on track and that Spirit would likely be able to lower its marginal costs on additional units for Boeing, the Tenth Circuit found “two fundamental gaps” in the use of this account to support scienter.\textsuperscript{323} It “does not suggest that [the vice president] believed his cost-control efforts were unrealistic or that he wished to intentionally mislead investors,” and the witness’s failure to identify the date of the conversation made it impossible to do anything but “guess that the confrontation might have preceded [the vice president’s] remarks at the investor conference.”\textsuperscript{324}

Third, the plaintiffs argued that the top executives “must have known that the projects would not meet long-run cost forecasts” because they “‘personally monitored’ the progress of the three projects.”\textsuperscript{325} The court characterized this argument as one based on “The Executives’ Alleged Involvement in Spirit’s ‘Core Operations.’”\textsuperscript{326} Even allowing, however, that “[t]he executives’ positions at Spirit would help establish whether they should have known that particular cost projections were unrealistic,” “additional particularized facts are necessary for an inference of scienter.”\textsuperscript{327} The Tenth Circuit found that the allegations that the projects formed part of Spirit’s “core” business raised an “inference only that the four executives were overly optimistic about Spirit’s ability to achieve the forecasted production schedules and cost

\textsuperscript{323} Id. at 1244–45.
\textsuperscript{324} Id. at 1245. At another point, the court said that “[t]he factual allegations regarding [this executive] suggest that he had a culpable intent, but the plaintiffs do not tie [his] potentially culpable state of mind to any public disclosures.” Id. at 1239.
\textsuperscript{325} Id. at 1245 (quoting plaintiffs).
\textsuperscript{326} Id. The court noted the parties’ disagreement over whether the three projects were “core” since the defendants said that the three accounted for less than 20\% of Spirit’s revenue. Id. at 1245 n.14.
\textsuperscript{327} Id. at 1245.
reductions.”\textsuperscript{328} The investors provided no “reason to believe that the executives knew that the projects were unlikely to meet forecasts.”\textsuperscript{329}

Fourth, the court rejected the investors’ argument that the defendants had a “duty to disclose production delays and cost overruns” and that scienter should be inferred from their failure to fulfill that duty.\textsuperscript{330} The Tenth Circuit found in this contention no explanation of why the existence of such a duty raised an “inference that the defendants (1) knew that they needed to disclose more or (2) were reckless in failing to disclose more.”\textsuperscript{331}

Fifth and finally, the court of appeals addressed a potpourri of remaining allegations. The plaintiffs alleged that Spirit had “adopted a ‘recovery plan’ in July 2012 to put the Boeing 787 project back on schedule” and that this showed that they knew their statements between that time and the end of the class period were false or misleading.\textsuperscript{332} Even assuming that those statements were, in fact, false or misleading, the court found “little reason to question the executives’ explanation” that they held “an honest belief that Spirit’s recovery plan would reduce costs and accelerate production.”\textsuperscript{333} While “[t]he eventual announcement of a forward loss suggests that Spirit had placed too much confidence in the recovery plan,” “the same can always be said when a company delays announcement of a forward loss based on remedial efforts to increase

\textsuperscript{328} Id. at 1246.
\textsuperscript{329} Id. (emphasis original). This comment appears to apply the “actual knowledge” standard governing whether a defendant in a private lawsuit had a sufficient mental state to be liable on a forward-looking statement. 15 U.S.C. § 78u-5(c)(1)(B) (2012); see infra note 477. But the majority opinion does not discuss whether the case hinges on categorization of defendants’ statements as forward-looking. Only the dissent considers that issue. See infra note 339. At other points, the majority opinion refers not only to actual intent to deceive but also to severe recklessness as sufficient for scienter. Spirit Aerosystems, 827 F.3d at 1236–37.
\textsuperscript{330} Spirit Aerosystems, 827 F.3d at 1246.
\textsuperscript{331} Id. at 1247.
\textsuperscript{332} Id. For example, the defendants said on September 12, 2012 that “Spirit is doing reasonably well in meeting the Boeing 787 plan” and that “[t]he project plan for the Boeing 787 ‘looks okay.’” Id.
\textsuperscript{333} Id. at 1248.
profitability or production.” The investors’ citation to post-class period explanations of the loss by Spirit’s CEO did not raise a scienter inference because the CEO’s statements simply “acknowledged that Spirit had mistakenly projected Spirit’s ability to improve efficiency and that Spirit ultimately learned that it could not meet projections,” rather than “that Spirit executives had knowingly or recklessly misvalued earlier data.” While the plaintiffs pointed to Spirit’s public warnings of risks inherent in the projects, the court saw the warnings as “simply reflect[ing] an awareness of risks.” The court dismissed the investors’ allegations

334 Id.
335 Id. at 1249. The court described the CEO’s explanations so:

• the projects had progressed too slowly to meet initial cost targets,
• project costs had exceeded initial forecasts, “particularly in [the] supply chain,”
• the complexity in growth at Spirit’s Tulsa facility had contributed to increased costs,
• Spirit had delayed implementation of some measures designed to reduce costs for the Boeing 787 project, and
• cost-reduction efforts for the three projects had not met projections.

• he had underestimated the “organizational learning” necessary for Spirit to meet initial projections of the projects’ learning curves,
• Spirit could not meet cost projections for some of the projects, and
• Spirit had incurred extra costs because of production delays for required component parts on the Boeing 787 project.

Id. at 1248–49.

The plaintiffs pointed out that the CEO had stated on August 7, 2012 “that Spirit was meeting its cost estimates for the Boeing 787 project and would continue to do so,” and sought to infer an intent to mislead by that statement from the temporal proximity of the October 25, 2012 announcement of the forward loss. Id. at 1249. The Tenth Circuit disagreed because “statements were made over two months apart, and the complaint does not allege that the chief executive officer was aware in August 2012 that Spirit was not meeting its cost estimates.” Id.

336 As two of the examples, the court offered these

November 2011
• Spirit’s 10-Q for the quarter ending September 29, 2011, stated that the three projects posed a significant risk of forward-loss charges based on cost pressures throughout 2011. Spirit explained that the next twelve to eighteen months would be critical, with a significant risk of forward-loss charges.

August 2012
• Spirit’s 10-Q for the quarter ending on June 28, 2012, stated that the three projects “continue[d] to pose a risk of additional charges [or] forward-loss.”
• Spirit’s chief executive officer stated that the Gulfstream projects were “risky.”

Id. at 1249–50.

337 Id. at 1250.
that Spirit had violated generally accepted accounting principles on the ground that, even if true, that would not by itself show “fraudulent intent[ ] or recklessness.”\textsuperscript{338} Although the loss eventually announced was a large one, “[t]he size of the loss does not suggest that the four executives knew or recklessly disregarded the risks that Spirit was eventually going to lose money on the three projects.”\textsuperscript{339}

\textit{Significance and Analysis.} \textit{Spirit Aerosystems} prompts three observations. First, it may often happen that the confidential witnesses whose stories the plaintiffs recount in complaints are lower-level employees, far down the organizational chart from any executives named as defendants. Defense counsel may find useful the Tenth Circuit’s notion that accounts from such witnesses add little to an inference of scienter because several “levels of management hierarchy separated” the witnesses from the executives.\textsuperscript{340} Indeed, the \textit{Spirit Aerosystems} opinion includes an organization chart at one point to graphically show the distance between a witness and an executive.\textsuperscript{341} Second, the holding that a duty to disclose does not contribute to a scienter inference, absent facts from which a court may infer that defendants were aware of such a duty or at least reckless in their ignorance of it,\textsuperscript{342} echoes earlier authority to the same effect.\textsuperscript{343} Putting it another way, a duty to disclose is an essential element of a Rule 10b-5 action based on

\textsuperscript{338} Id. at 1251.
\textsuperscript{339} Id. One of the three judges on the panel filed an opinion in which he concurred in part and dissented in part. The dissent argued that defendants’ statements fell into two categories. While those that were forward-looking statements could not support a Rule 10b-5 action because they “reflected opinion rather than fact, and were not demonstrably false,” \textit{id.} at 1252 (Lucero, J. concurring in part and dissenting in part), this judge concluded that the plaintiffs had adequately pled scienter as to some statements of current fact regarding the Boeing project, \textit{id.} at 1256.
\textsuperscript{340} See supra text accompanying note 318.
\textsuperscript{341} \textit{Spirit Aerosystems}, 827 F.3d at 1242.
\textsuperscript{342} See supra text accompanying note 331.
\textsuperscript{343} See, e.g., First New York Sec. LLC v. United Rentals Inc., 391 F. App’x 71, 73 (2d Cir. 2010) (“URI’s failure to disclose certain information is not actionable unless it intended to defraud or mislead by withholding information that it knew it had a clear duty to disclose.”) (emphasis in original).
omissions, but scienter is also an essential element, and establishing the duty element does not necessarily create an inference that a defendant who failed to perform that duty did so with an intent to defraud or was severely reckless as to whether failing to disclose would mislead.

Third, the opinion shows the importance of winning the overall narrative battle. The court said that “Spirit’s executives knew that Spirit had encountered problems in containing costs and meeting production deadlines” and “assume[d] (without deciding) that Spirit did not adequately communicate these problems to the public.” But the court saw the scienter pleading question as deciding between the plaintiffs’ story “that the Spirit executives intentionally misrepresented or recklessly ignored economic realities,” and the defense’s story, which the court found “more probable,” “that the Spirit executives were overly optimistic and failed to give adequate weight to financial red flags.”

Misrepresentations and omissions about results from drug trials. Turn now to two decisions in the life sciences industry. Vertex Pharmaceuticals, Inc. (“Vertex”) developed and obtained FDA approval for Kalydeco, a drug to treat cystic fibrosis. Vertex then tested a combination therapy by which patients first received another drug—VX 809—before beginning Kalydeco treatment. After obtaining interim results on about half the patients in second-phase

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344 Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988) ("Silence, absent a duty to disclose, is not misleading under Rule 10b-5.").
345 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976)
346 See City of Phila. v. Fleming Cos., Inc., 264 F.3d 1245, 1260–61 (10th Cir. 2001) ("[A]llegations that the defendant possessed knowledge of facts that are later determined by a court to have been material, without more, is not sufficient to demonstrate that the defendant intentionally withheld those facts from, or recklessly disregarded the importance of those facts to, a company’s shareholders in order to deceive, manipulate, or defraud. . . . [T]o establish scienter in a securities fraud case alleging non-disclosure of potentially material facts, the plaintiff must demonstrate: (1) the defendant knew of the potentially material fact, and (2) the defendant knew that failure to reveal the potentially material fact would likely mislead investors.").
347 Spirit Aerosystems, 827 F.3d at 1238.
348 Id.
349 Local No. 8 IBEW Ret. Plan & Tr. v. Vertex Pharm., Inc., 838 F.3d 76, 78 (1st Cir. 2016).
350 Id.
trials, the company put out a May 7, 2012 press release stating that “[o]f those who received [the combination therapy], approximately 46 percent (17/37) experienced an absolute improvement from baseline to Day 56 [of the trial period] in lung function of 5 percentage points or more, and approximately 30 percent (11/37) experienced an absolute improvement from baseline to Day 56 of 10 percentage points or more.” The Chief Scientific Officer called the results “really, really fantastic,” adding that he had “never seen anything like this”; the CEO talked about “accelerating the development” of the combination therapy; and the Chief Commercial Officer said that more than 70,000 patients could benefit from the therapy, which could produce billions of dollars in revenue. Vertex stock price jumped from $37.41 (the close on Friday, May 4) to $58.12 (the close on Monday, May 7), then continued to rise to $64.85 by May 25.

On May 29, 2012, however, Vertex issued a press release stating that the May 7 release had been wrong due to a “misinterpretation” of the data that caused the company to report numbers for absolute improvement that were actually numbers for relative improvement. When corrected, the interim results revealed that only 35% of those receiving the combination treatment showed an absolute improvement of 5% or more, and only 19% showed an absolute

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351 Id. To obtain FDA approval for a drug, a company must put it through three clinical investigational phases. Id.
352 Id. The release added: “None of the patients treated with placebo (0/11) achieved a 5-percentage point or more improvement from baseline to Day 56 in lung function.” Id.
353 Id. at 79.
354 Id.
355 Id. The court of appeals provided this explanation of the two measures:

According to the complaint, a relative improvement means “a percentage change from baseline,” whereas an absolute improvement is “the numerical distance between the baseline measurement and the improved measurement.” For our purposes, it appears that we need only understand the distinction to mean that an absolute improvement is more favorable than a relative improvement of the same percentage.

Id. at 79 n.5.
improvement of 10% or more.\textsuperscript{356} Vertex stock price declined from $64.85 to $57.80.\textsuperscript{357} Investors who purchased between May 7 and May 29 brought a Rule 10b-5 claim against Vertex and several officers and directors, most of whom had sold company stock during the class period.\textsuperscript{358}

Affirming dismissal on the ground that the investors failed to plead facts raising a strong inference of scienter,\textsuperscript{359} the First Circuit rejected seven specific investors’ arguments that their allegations sufficed; as well as their contention that, when viewed holistically, their pleading passed muster.\textsuperscript{360} First, the investors claimed that Vertex should have been suspicious of the results it published on May 7 because those inside the company knew that VX-809 generally degraded Kalydeco performance instead of enhancing it—to which the First Circuit responded that this could not show scienter because the company “must have thought that positive results were possible” since it “made the investment necessary to design and perform a study testing the two drugs in combination.”\textsuperscript{361} Second, the investors claimed the results were suspicious because they did not show a reduction in sweat chloride levels—which the plaintiffs called “the ‘gold standard’ in cystic fibrosis research” and which should have accompanied the increase in lung function that the interim results purported to show—to which the court responded that since the corrected results “reflected the same phenomenon (improved [lung function] and steady sweat

\textsuperscript{356} Id. at 79.  
\textsuperscript{357} Id.  
\textsuperscript{358} Id. at 79–80. The plaintiffs also sought to recover under section 20A of the Exchange Act (15 U.S.C. § 78t-1) for insider trading by the individual defendants who had sold Vertex stock during the alleged fraud. Id.  
\textsuperscript{359} Id. at 80, 86. Once the First Circuit held that the complaint did not adequately plead Rule 10b-5 fraud, it affirmed dismissal of the insider trading claim, as well as the control person claim, on the ground that these were “derivative of [the] section 10(b) and Rule 10b–5 claim.” Id. at 86.  
\textsuperscript{360} Id. at 81–86.  
\textsuperscript{361} Id. at 81. The court added that “many studies of new pharmaceutical products result in surprises, both good and bad.” Id. at 82.
chloride levels), there is no reason given here to presume that scientists in general must view the possibility of such results as obviously wrong.”

Plaintiffs’ third and fourth arguments depended on what might be called rules of thumb used in scienter pleading analysis. The third rested on the notion that, since the clinical trial of the combined therapy was “very important to Vertex,” the top executives presumptively would be paying attention to the results. The court of appeals reasoned, however, that this notion would only help the investors if the test results the top executives would be studying under this hypothesis were themselves suspicious, and the complaint failed to plead facts showing “that the announced results, on their face, contained . . . an obvious incongruity.”

Plaintiffs’ fourth argument depended on a presumption that “key facts” known to lower-level employees “are very likely known to senior management.” Again, however, the court found that the investors failed to plead the necessary predicate to use of this rule, as they alleged neither (i) “that anybody at Vertex responsible for receiving, reviewing, and reporting the results had actually spotted the error in the interpretation of the results before the discovery that led to the second announcement”; nor (ii) that the confusion of the absolute and relative numbers in the raw data should have been apparent to the Vertex pulmonologist who received the data from the third-party statistical analysis provider; nor (iii) that the results “were themselves so obviously suspect . . . that the defendants [who allegedly had ‘access to the raw data’] were reckless in failing to consult the raw data themselves for verification.”

362 Id. at 82.
363 Id. at 82–83.
364 Id. at 83.
365 Id.
366 Id. (underlining by the court); see id. at 79 (referring to the conference call in which Vertex explained that “[t]he error . . . stemmed from a ‘misinterpretation’ . . . [of] the results Vertex had received from the third-party statistical analysis vendor”).
The investors sought to raise a scienter inference by, fifth, contending that publication of interim results during a clinical trial was suspicious—a view that the First Circuit found unconvincing because “the complaint nowhere alleges that the publication of interim results was anomalous.” 367 The investors pointed, sixth, to the defendants’ stock sales during the class period, suggesting that these supplied a motive for fraud. 368 The court of appeals was unconvinced because (i) the plaintiffs did not allege that the CEO had sold any stock; (ii) he had no incentive to publish false results that would have to be quickly corrected, thereby embarrassing the company and damaging its credibility; (iii) one director who sold during the class period did so in amounts and on a schedule consistent with his sales before and after the alleged fraud; (iv) sales by the Chief Commercial Officer were not suspicious given that that defendant “was not a scientist,” making it unlikely that that defendant “knew more than the nonsellers”; and (v) the sales were generally not suspicious because they occurred during a surge in the company’s stock price following a prolonged period of steady or falling price—exactly when insiders would be expected to sell. 369

Seventh and finally, the investors pointed to the retirement of the Chief Commercial Officer on June 8, 2012, one day after a Senator had urged the SEC to investigate whether Vertex executives had taken advantage of the stock price rise between the May 7 and May 29

367 Id. at 83–84.  
368 Id. at 84.  
369 Id. at 84–85. As to the last point, the court wrote:

The complaint’s chronology also offers a simple alternative explanation of the stock sales. After a long period of steady or dropping stock prices, the stock price suddenly jumped a large amount. Such an increase—no matter what its cause—creates a substantial incentive for holders to sell unless they believe the price will continue to rise and are willing to wait. Sales in the historical context described in the complaint carry little force in implying knowledge that the stock will drop. All in all, the presence of this perfectly understandable, innocent reason to sell, combined with the poor fit between the facts and Local No. 8’s theory, leaves us short of the scienter mark.

Id. (footnotes omitted).
press releases.\textsuperscript{370} The First Circuit did not agree that this personnel change suggested wrongdoing. While the retirement and the Senator’s letter might well have been connected, this could have occurred simply because the officer’s “very large sales” created “a major embarrassment” for the company, even “without any hint of fraud.”\textsuperscript{371}

Having rejected each of the plaintiffs’ disaggregated arguments individually, the First Circuit then rejected their scienter pleading after holistically considering the claims, picking out facts to weave a plausible alternative theory that the company may have just been negligent in viewing very good results as being even better than they in fact were.\textsuperscript{372}

\textit{Significance and Analysis.} Vertex differs from many other life sciences cases in which plaintiffs were unsuccessful against life science companies because courts concluded that the defendants’ statements reflected a difference over the interpretation of clinical results.\textsuperscript{373} In \textit{Vertex}, the company’s statements included a flat-out mistake. The company may have been saved largely by the circumstance that the mistake “stemmed from a ‘misinterpretation’ as to whether the results Vertex had received from the third-party statistical analysis vendor reflected the absolute improvement in the patients’ lung function or, rather, the improvement relative to the patients’ baseline levels of lung function.”\textsuperscript{374} It helped as well that the company found the

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\item \textsuperscript{370} \textit{Id.} at 85.
\item \textsuperscript{371} \textit{Id.} The court also reasoned that, if this executive (who was a nonscientist) had been forced out because her sales suggested wrongdoing to the company, the other sellers (some of whom were scientists and who therefore had a better chance of interpreting the reported results as suspicious on the investors’ various theories) would also have been pushed out, which did not happen. \textit{Id.} at 85–86.
\item \textsuperscript{372} \textit{Id.} at 86.
\item \textsuperscript{373} \textit{See, e.g., In re Rigel Pharm., Inc. Sec. Litig.}, 697 F.3d 869, 878 (9th Cir. 2012) (“Plaintiff’s allegations of “falsity” essentially are disagreements with the statistical methodology adopted by the doctors and scientists who designed and conducted the study, wrote the journal article, and selected the article for publication. The allegations therefore concern two different judgments about the appropriate statistical methodology to be used by Defendants. The allegations are not about false statements.”); \textit{id.} at 886 (affirming dismissal of Rule 10-5 claim based on alleged fraudulent report of clinical test results).
\item \textsuperscript{374} \textit{Vertex}, 838 F.3d at 79.
\end{itemize}
error and publicly corrected the results in about three weeks, that the CEO did not sell stock during that brief window, and that—even after correction—the clinical results showed that the drug worked.375

In a second case from the life sciences industry, Schueneman v. Arena Pharmaceuticals, Inc., the defendants did not fare so well.376 Arena Pharmaceuticals ("Arena") developed a weight-loss drug called lorcaserin.377 Arena conducted Phase III clinical trials on the drug from September 2006 to July 2009.378 During this same period, Arena tested rats to determine whether lorcaserin caused cancer (the “Rat Study”).379 By February 2007, initial results suggested that the drug did cause cancer in rats—though Arena believed this resulted from a hormone called prolactin that would not produce cancer in humans—and Arena reported these results to the FDA in May of that year.380 The FDA did not halt the ongoing Phase III clinical trials testing lorcaserin on humans, but asked Arena to conduct further rat studies and asked for a report on the prolactin levels in the test rats every other month—a combination of decisions that the Arena CEO later characterized as “highly unusual.”381 In April 2008, Arena’s Chief Scientific Officer, Chief Medical Officer, and VP of Clinical Development met with the FDA.382 The agency again decided to let the Phase III tests continue, but required Arena to provide a draft of the report on the Rat Study as quickly as possible.383 In February 2009, Arena assembled the

375 See supra text accompanying notes 355, 356, and 369.
376 840 F.3d 698 (9th Cir. 2016).
377 Id. at 701.
378 Id.
379 Id.
380 Id.
381 Id. at 701 & n.2.
382 Id. at 702.
383 Id.; id. at 700 n.1 (providing the positions of the executives).
final report, which concluded that there was a connection between lorcaserin and cancer in the rats, but that this was related to the prolactin hormone.\textsuperscript{384}

At this point—from March through November 2009—the defendants made the statements at the heart of the plaintiff’s case. On March 12, the Arena CEO advised investors that he was confident of FDA approval in part based on “all the animal studies that have been completed.”\textsuperscript{385} He signed an SEC filing in May “represent[ing] that ‘the long-term safety and efficacy’ of lorcaserin had been ‘demonstrated,’ in part, through ‘long-term preclinical toxicity and carcinogenicity studies.’”\textsuperscript{386} On September 18, the Vice President of Clinical Development stated on a call with shareholders “that Arena ‘ha[d] favorable results on everything that we’ve compiled so far.’”\textsuperscript{387} The CEO told investors on November 10 that Arena had “all of the data in hand that [would] be included” in Arena’s application to the FDA for lorcaserin, with the Chief Scientific Officer adding that “[a]s you can see from the data, we believe that lorcaserin is a game changer” and the Chief Medical Officer, William Shanahan, saying that “we’re not expecting any surprises associated with the [FDA Committee].”\textsuperscript{388}

Arena submitted its lorcaserin application to the FDA in December 2009.\textsuperscript{389} But it also retained a famed toxicologist who specialized in carcinogenicity to answer questions that an FDA Advisory Committee might have.\textsuperscript{390} To this point, Arena had said nothing to the public about the Rat Study.\textsuperscript{391}

\textsuperscript{384} Id. at 702.
\textsuperscript{385} Id. (emphasis omitted).
\textsuperscript{386} Id. (emphasis omitted).
\textsuperscript{387} Id. (emphasis omitted).
\textsuperscript{388} Id. (emphasis omitted).
\textsuperscript{389} Id.
\textsuperscript{390} Id. at 703.
\textsuperscript{391} Id.
The existence of that study became public on September 14, 2010, when the FDA published Advisory Panel briefing documents on its website. Analysts reacted with alarm, and Arena’s stock price dropped by 40%. While Arena argued to the panel that the rats had received doses of lorcaserin 82 times greater than dosages to humans and that the prolactin hormone provided the mechanism for the cancer in the rats but would not do so in humans, the Advisory Panel initially recommended against FDA approval for the drug.

The FDA then denied approval but asked Arena for an independent review of the Rat Study. The independent panel conducting that review “uniformly concluded that Arena had overreported the incidents of tumors to the FDA.” Arena submitted a new application for lorcaserin. The Advisory Committee “found that there was a high-enough safety margin for the drug and that the Prolactin Hypothesis was a ‘plausible’ explanation for the rat cancer.” The FDA approved the drug in June 2012.

The Ninth Circuit reversed the dismissal of a Rule 10b-5 case against Arena and its CEO, Chief Scientific Officer, Chief Medical Officer, and VP of Clinical Development—a dismissal based on the district court’s reasoning “that Arena and the FDA were engaged in a good-faith scientific dispute regarding the cause of the rat cancer and that, therefore, scienter was not adequately pleaded.” The court of appeals held that, while Arena was free to make no comment about animal studies, it was at least reckless in a Rule 10b-5 sense in “representing that

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392 Id.
393 Id.
394 Id.
395 Id.
396 Id.
397 Id.
398 Id.
399 Id.
400 Id. at 701.
animal studies supported lorcaserin’s safety and therefore its likelihood of being approved” without “inform[ing] the market about the risk of non-approval or delayed approval based on the FDA’s ‘concerns’ about the Rat Study.”\textsuperscript{401} As to scienter, the court cited to an FDA document stating that “[Arena] was made aware of [the FDA’s] concerns” at the time the agency and the company discussed continuation of the Phase III clinical trial in spite of the initial results from the Rat Study.\textsuperscript{402} Moreover, Arena complied with FDA requests for more data on the Rat Study at the time of the April 2008 meeting between Arena officers and the FDA.\textsuperscript{403} Further, the Arena CEO found it “highly unusual” that the FDA determined to continue with the human trials after learning that the initial results from the Rat Study showed a connection between lorcaserin and cancer.\textsuperscript{404} And all of this happened before the period from March 12, 2009 through November 10, 2009—during which Arena and its officers made the statements that misled without disclosing the Rat Study and the concerns that the FDA had developed as a result of that study.\textsuperscript{405} While “Arena had an explanation for its view of the data,” that did “not mean investors would not want to know that Arena and the FDA were at odds,” and Arena “could not represent that there was no controversy here because all the data was favorable” since that was not true.\textsuperscript{406}

\textsuperscript{401} *Id.* at 707–08; *id.* at 708 (quoting the “deliberate recklessness” standard from Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981, 991 (9th Cir. 2009)).
\textsuperscript{402} *Id.* at 708. While the court does not provide the date of the FDA document, the full passage—“FDA documents note that ‘[Arena] was made aware of [the FDA’s] concerns’ and was asked to ‘defend continuation’ of the clinical testing in light of the ‘nonclinical tumor/cancer data,’” *id.* (alteration and emphasis by the court)—links this document to the February 2007 to April 2008 period during which Arena advised the FDA of the Rat Study results, and the FDA decided to let the Phase III human trials proceed nevertheless. See supra text accompanying notes 380–383.
\textsuperscript{403} Arena Pharm., 840 F.3d at 708; see supra text accompanying notes 383–384.
\textsuperscript{404} Arena Pharm., 840 F.3d at 709; see supra text accompanying note 381.
\textsuperscript{405} See supra text accompanying notes 385–388, 391. The court added that Arena “obviously felt the need to hire a pre-eminent expert to make the case that the Prolactin Hypothesis was supported” and this “response to the issue contributes to an inference of scienter here.” *Arena Pharm.*, 840 F.3d at 708.
\textsuperscript{406} Arena Pharm., 840 F.3d at 709.
Significance and Analysis. Arena is significant in part because the drug was ultimately approved.\textsuperscript{407} The Rule 10b-5 violation lay in failing to disclose a controversy with the FDA that was ultimately resolved in the drug manufacturer’s favor. The court nevertheless accepted the plaintiff’s theory, which was “not that Defendants intentionally misled the market about the objective safety of lorcaserin’ [but] that Defendants intentionally withheld information material to the market’s assessment of whether and when the FDA would likely approve lorcaserin.”\textsuperscript{408}

The market reaction—dropping Arena’s stock price by 40% when the Rat Study was disclosed by the FDA Advisory Committee briefing documents—gives this theory some weight. Put another way, and as also suggested in the Vivendi case,\textsuperscript{409} facts that change the probability of a future event are important even though later facts may change that probability again and move it in the opposite direction—even to the point that the future event does not occur at all.

There are other decisions that suggest that a drug company need not report every disagreement with the FDA during what is often a long and somewhat contentious road to drug approval.\textsuperscript{410} While it may be hard sometimes to find the line between which disagreements

\begin{footnotes}
\item\textsuperscript{407} Id. at 701.
\item\textsuperscript{408} Id. at 709 (quoting the plaintiff).
\item\textsuperscript{409} See infra text accompanying and following note 530.
\item\textsuperscript{410} See, e.g., the summary of Tongue v. Sanofi, infra at notes 536–565, particularly notes 546–550, and accompanying text; Kuyat v. BioMimetic Therapeutics, Inc., 747 F.3d 435, 443 (6th Cir. 2014) (”[T]he more compelling inference that can be drawn from the pleadings is that BioMimetic was justified in expressing optimism about Augment’s prospects for success despite the lack of statistically significant results produced by an analysis of the ITT population. BioMimetic may have ultimately been wrong about which population would be analyzed [by the FDA] for the primary effectiveness analysis, but a reasonable person would more easily than not infer that BioMimetic believed that it had permission to use an mITT population for the analysis at the time that it spoke to investors.”); id. at 445 (affirming dismissal of complaint based on alleged misrepresentations in description of clinical test results because FDA disagreed with company’s selection of which patients within the trials counted for evaluation of drug).
\end{footnotes}
should be disclosed to investors and which should not, counsel should closely monitor proposed statements by executives that specifically discuss a matter on which the FDA is raising questions—in *Arena*, “animal studies”—to check whether those statements might mislead by omission.\footnote{In one other life sciences case, the First Circuit affirmed dismissal of a Rule 10b-5 case as to allegations that a corporate defendant’s press release fraudulently stated that “‘[i]ntial safety data show [the relevant drug] to be well tolerated’” because, although the plaintiffs alleged that an FDA report found an 8% increase in serious cardiovascular events, the complaint did not include “any specific facts about when the defendants learned of these adverse events or even when the adverse events occurred.” *In re Advanced Battery Techs., Inc.*, 781 F.3d 638, 644 (2d Cir. 2015) (internal quotation marks omitted), such as “conduct[ing] an audit so deficient as to amount to no audit at all, or disregard[ing] signs of fraud so obvious that the defendant must have been aware of them.” *id.* at 584.}

The opinion reprises the extremely auditor-friendly standard that the Second Circuit has employed in past cases:

> The standard for scienter is especially demanding where, as here, the defendant is an independent auditor. To state a claim against a non-fiduciary auditor, a plaintiff must allege with particularity conduct “approxim[ating] an actual intent to aid in the fraud being perpetrated by the audited company,” *In re Advanced Battery Techs., Inc.*, 781 F.3d 638, 644 (2d Cir. 2015) (internal quotation marks omitted), such as “conduct[ing] an audit so deficient as to amount to no audit at all, or disregard[ing] signs of fraud so obvious that the defendant must have been aware of them.” *id.* at 584.

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Reliance. In order to recover under Rule 10b-5, private plaintiffs must prove that they relied on the defendant’s deceptive action. If they bought after a public misrepresentation but before the truth came out and if they bought a security that traded in an efficient market, plaintiffs may use the rebuttable fraud-on-the-market (“FOTM”) presumption, which assumes that they relied indirectly on the misrepresentation because the price at which they bought impounded the false information that the misrepresentation spread. Such presumed reliance is critical to certification of a class under Federal Rule of Civil Procedure 23(b)(3), which requires that questions common to the class predominate over questions individual to class members. If reliance on a misrepresentation must be proved for each class member individually, that required predominance does not exist, and the class cannot be certified.

In 2014, the Supreme Court held that a plaintiff seeking to use the FOTM presumption in seeking class certification can satisfy the predicate that the security “traded in an efficient market,” by showing that the market for that security was “generally efficient” through event studies demonstrating “that the market price of the . . . [security] tends to respond to pertinent publicly reported events.” But the defendants, in opposing certification, can seek to rebut that presumption, with their own event study, by showing that neither the alleged misrepresentation nor the correction of that misrepresentation impacted the security’s price.

...
In 2016, the Eighth Circuit ruled on defense rebuttal efforts during a fight over class certification.\footnote{See infra notes 422–441 and accompanying text.} The Second Circuit ruled on rebuttal efforts in a trial on the merits.\footnote{See infra notes 442–455 and accompanying text.}

Rebutting presumption on market reliance by showing no price impact of allegedly fraudulent statements. The Eighth Circuit addressed rebuttal of the FOTM presumption in \textit{IBEW Local 98 Pension Fund v. Best Buy Co., Inc.}\footnote{818 F.3d 775 (8th Cir. 2016).} At 8:00 AM on September 14, 2010—before trading began—a Best Buy press release announced that the company was increasing its guidance range for full-fiscal year earnings per share (“eps”) to $3.55–3.70.\footnote{Id. at 777.} The stock, which had closed at $34.65 on the day before, opened at $37.25.\footnote{Id.} During a conference call with analysts that began at 10:00 AM on that same day, Best Buy’s CFO said (i) “we are pleased that our earnings are essentially in line with our original expectations for the year” and (ii) “we are pleased that we are on track to deliver and exceed our annual EPS guidance.”\footnote{Id. (emphasis by the court) (quoting CFO).} Best Buy stock closed on September 14 at $36.73.\footnote{Id.} At 8:00 AM on December 14, a Best Buy press release announced a decline in the third-quarter fiscal year sales and a reduction in the company’s guidance range for the full fiscal year to $3.20–$3.40 eps.\footnote{Id. at 778.} The company’s stock price declined from its December 13 close at $41.70 to $35.52 on December 14.\footnote{Id. at 776–77, 778.}

Investors brought a Rule 10b-5 action alleging that statements in the September 14, 2010 press release and statements in the conference call on that day were fraudulent.\footnote{Id. at 776–77, 778.} The district court dismissed the claim insofar as it was based on the press release, on the grounds that the
statements in that release were forward-looking and inactionable because accompanied by meaningful cautionary language.\textsuperscript{430} This left—after the motion to dismiss—only the two statements quoted above from the conference call.\textsuperscript{431} The district court certified a 23(b)(3) class.\textsuperscript{432}

The Eighth Circuit reversed the certification order,\textsuperscript{433} holding that the defendants had rebutted the FOTM presumption.\textsuperscript{434} The defense expert presented an event study that “found that the price increase on September 14 occurred after the press release but before the call . . . [and a]s the price before the call was almost identical to the September 14 closing price, . . . the ‘on track’ and ‘in line’ conference call statements ‘had no discernible impact on Best Buy’s stock price.’”\textsuperscript{435} The plaintiffs’ expert—who had initially offered an event study concluding that the price of Best Buy stock had increased in reaction to both the September 14, 2010 press release and the comments in the conference but did not differentiate between the impact of the release and the call\textsuperscript{436}—then provided a revised opinion.\textsuperscript{437} In that revised opinion, the plaintiffs’ expert concluded “that the ‘economic substance’ of the non-fraudulent press release statements and the alleged misrepresentations in the immediately following conference call was ‘virtually the same,’ and that the two ‘would have been expected to be interpreted similarly by investors.’”\textsuperscript{438} His “event study showed that the forward-looking EPS guidance in the press release had an immediate impact on the [Best Buy] market price, whereas the confirming

\textsuperscript{431} \textit{Best Buy Co.}, 818 F.3d at 778.
\textsuperscript{432} Id. at 777, 778–79.
\textsuperscript{433} Id. at 783.
\textsuperscript{434} Id. at 782–83.
\textsuperscript{435} Id. at 779.
\textsuperscript{436} Id.
\textsuperscript{437} Id.
\textsuperscript{438} Id. at 782.
statements in the conference call two hours later had no additional price impact.”

The court of appeals took this as “direct evidence that investors did not rely on the executives’ confirming statements two hours later.” Accordingly, the defendants—using both the opinion of their expert and the opinion of the plaintiffs’ expert—had “rebutted the [fraud-on-the-market] presumption” plaintiffs had employed “to satisfy the predominance requirement of Rule 23(b)(3), and the district court accordingly abused its discretion by certifying the class.”

Rebutting presumption of reliance by showing that plaintiff would have bought even if it had known the omitted truth allegedly rendering the challenged statements misleading. In *GAMCO v. Vivendi Universal, S.A.*, the Second Circuit also considered how to rebut the FOTM presumption, but this time during a trial on the merits. The plaintiffs (collectively “GAMCO”) were “so-called ‘value investors’ who make their own estimation of the value of a publicly-traded company’s securities and attempt to buy such securities when the market price is lower than its own valuation, betting that the market price will rise over time.” They brought a Rule 10b-5 claim against Vivendi for the latter’s failure to disclose its liquidity problems, which—when the market learned of them—drove Vivendi’s securities prices down. Vivendi won a bench trial against these plaintiffs by proving to the district court’s satisfaction “that GAMCO would have purchased Vivendi securities even had it known of Vivendi’s alleged fraud.”

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439 Id.
440 Id.
441 Id. at 783. *Best Buy* was a two-to-one decision. The dissenting judge argued that the majority had not addressed the plaintiffs’ theory that the confirming statements in the conference call “maintained Best Buy’s stock price at its inflated level.” *Id.* at 784 (Murphy, J., dissenting).
443 Id. at 216.
444 Id.
445 Id. at 216, 218. In 2014, the Supreme Court had foreclosed the argument that value investors could not rely on the FOTM presumption because they base their investment strategy on the assumption that the market price does not effectively impound available information:
Finding that the evidence was sufficient to support the district court’s findings and therefore that the district court had not clearly erred, the Second Circuit affirmed that judgment.\textsuperscript{446}

GAMCO’s investment strategy consisted of finding stocks: (i) with a Private Market Value ("PMV" or the amount “that an informed industrialist would be willing to pay for [the company], if each of its segments were valued independently in a private market sale,” also called by GAMCO the "‘intrinsic’” value of the company) below the current market price and (ii) whose issuers were likely to experience a “catalyst” event that would “cause the market to recognize th[e] discrepancy [between the intrinsic value and the market price] in the next two to five years.”\textsuperscript{447} In this case, the GAMCO analyst calculating Vivendi’s PMV “testified that, once he learned of the liquidity crisis at Vivendi (as the fraud came to light), the knowledge of the liquidity problems had no ‘impact [on his] PMV calculation,’ as he believed those problems constituted ‘a short-term issue . . . [s]omething that could be solved within a year or so.’”\textsuperscript{448} This

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Halliburton identifies a number of classes of investors for whom “price integrity” is supposedly “marginal or irrelevant.” The primary example is the value investor, who believes that certain stocks are undervalued or overvalued and attempts to “beat the market” by buying the undervalued stocks and selling the overvalued ones. . . .

. . . .

. . . [T]here is no reason to suppose that . . . the value investor . . . is as indifferent to the integrity of market prices as Halliburton suggests. Such an investor implicitly relies on the fact that a stock’s market price will eventually reflect material information—how else could the market correction on which his profit depends occur? To be sure, the value investor “does not believe that the market price accurately reflects public information at the time he transacts.” But to indirectly rely on a misstatement in the sense relevant for the [FOTM] presumption, he need only trade stock based on the belief that the market price will incorporate public information within a reasonable period. The value investor also presumably tries to estimate how undervalued or overvalued a particular stock is, and such estimates can be skewed by a market price tainted by fraud.
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\textit{Halliburton 2014, supra} note 413, 134 S. Ct. at 2410–11 (record references omitted). While the \textit{GAMCO} district court “indeed found that GAMCO [did] not necessarily consider the market price to be an efficient reflection of the objective value of a security at any given time,” that court “explicitly disclaimed any reading of its opinion as suggesting that this fact was sufficient, on its own, to rebut the [FOTM] presumption.” \textit{GAMCO}, 838 F.3d at 218.\textsuperscript{446} \textit{GAMCO}, 838 F.3d at 223.\textsuperscript{446} \textit{Id.} at 220; \textit{id.} at 218 (explaining PMV).\textsuperscript{447} \textit{Id.} at 220.\textsuperscript{448}
supported the trial judge’s “conclusion that, if GAMCO had known of the liquidity problems and their concealment, GAMCO would still have believed Vivendi’s PMV to be ‘materially higher’ than the public market price.”\textsuperscript{449} Similarly, the liquidity problems would not have changed GAMCO’s belief that a catalyst event would occur at Vivendi, as those problems would have increased “the potential for a change in management.”\textsuperscript{450}

GAMCO nevertheless argued that, had it known of the liquidity issues at the time of its initial purchases, it would not have bought at that time, but waited until the liquidity facts surfaced and drove the price down—thereby providing GAMCO with the opportunity to purchase at a price giving it an even greater profit when the market price eventually aligned with the PMV.\textsuperscript{451} The Second Circuit held that the district court had not clearly erred in rejecting this contention on the grounds that (i) “GAMCO, [if it had been] privy to this information prior to its relevant purchases, would have believed it possible that the crisis would pass without incident or public revelation, or at minimum be[en] uncertain as to just how the market would value the crisis were it to come to light” and (ii) GAMCO might have feared that revelation of the problems would prompt the catalyst event, such as a change in management, that would bring the stock price close to the intrinsic value and therefore prevent purchasing at a discount to intrinsic value at all.\textsuperscript{452}

\textit{Significance and Analysis}. The Supreme Court’s 2014 opinion declined an invitation to jettison the FOTM presumption altogether on the ground that considerable economic analysis has

\textsuperscript{449} Id.
\textsuperscript{450} Id. at 221. In reaching this conclusion, the district court relied in part on evidence that GAMCO continued buying Vivendi stock even after the liquidity problems came out. \textit{Id.} at 220.
\textsuperscript{451} Id. at 221.
\textsuperscript{452} Id. at 222.
called it into question. But the Court’s invitation to rebut the presumption has emboldened defense counsel to do just that. We can expect many more decisions in coming years that pursue such rebuttals with invention and vigor.

453 Halliburton, supra note 413, 134 S. Ct. at 2407–13 (addressing Halliburton’s various arguments for jettisoning the FOTM, with the contention that economic thought no longer supports the FOTM addressed at 2409–11).

454 Though all in the context of class certification, the following surely suggests that a defendant can challenge the FOTM presumption in a trial on the merits:

Price impact is thus an essential precondition for any Rule 10b–5 class action. While Basic [which recognized the FOTM presumption] allows plaintiffs to establish that precondition indirectly, it does not require courts to ignore a defendant’s direct, more salient evidence showing that the alleged misrepresentation did not actually affect the stock’s market price and, consequently, that the Basic presumption does not apply.

Id. at 2416.

More than 25 years ago, we held that plaintiffs could satisfy the reliance element of the Rule 10b–5 cause of action by invoking a presumption that a public, material misrepresentation will distort the price of stock traded in an efficient market, and that anyone who purchases the stock at the market price may be considered to have done so in reliance on the misrepresentation. We adhere to that decision and decline to modify the prerequisites for invoking the presumption of reliance. But to maintain the consistency of the presumption with the class certification requirements of Federal Rule of Civil Procedure 23, defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock.

Id. at 2417.

455 The cases in the text concern presumed indirect reliance on a price in an efficient market that reflects any defendant’s misrepresentations. In a case involving direct reliance, the Second Circuit affirmed dismissal of a Rule 10b-5 claim against a broker-dealer/placement agent and affiliated individuals (the “Vista Defendants”), sued by a purchaser on a transaction involving a private offering memorandum (“POM”). Gavin/Solmonese LLC v. D’Arnaud-Taylor, 639 F. App’x 664, 665–66, 669–70 (2d Cir. 2016). Among other things, the plaintiff alleged that one of the Vista Defendants (the owner of the broker-dealer/placement agent) “told investors . . . ‘that the POM overstated the negative risks and prospects for W2E and that its technologies and know-how were even more valuable than what the POM suggested’” and that this and another Vista Defendant had, together with a founder of the issuer and its CEO, “‘represent[ed] that [the issuer] had valuable, proprietary intellectual property conservatively worth in excess of $10 million.’” Gavin/Solmonese LLC v. D’Arnaud-Taylor, 68 F. Supp. 3d 530, 541 (S.D.N.Y. 2014) [Gavin/Solmonese Dist. Ct.]. The POM stated “that [n]o dealer, salesman, or other person has been authorized to give any information or make any representation not contained in this memorandum. And, if given or made, such information or representation must not be relied upon as having been authorized by us.” Id. at 543 n.3. The Second Circuit held that any reliance by the plaintiff on the oral statements made by the Vista Defendants was unreasonable in part because of this affirmative statement that purchasers should not rely on statements outside the POM and in part because even “through minimal diligence,” the “plaintiff could have uncovered the facts relevant to [the] claims.” Gavin/Solmonese LLC, 639 F. App’x at 669 (quoting Brown v. E.F. Hutton Grp., 991 F.2d 1020, 1032 (2d Cir. 1993)). As to the latter, an 8-K filed on October 1, 2009 by the issuer, while the offering was in progress (the offering ran from “September 2009 [to] the middle of 2010,” Gavin/Solmonese Dist. Ct., 68 F. Supp. 3d at 534), stated “that W2E’s IP platform would need to be rebuilt from scratch” and had been “written down to zero” on the company’s balance sheet. Id. at 536.
Loss Causation. To recover damages in a Rule 10b-5 case, a plaintiff must plead and prove that the defendant’s fraud caused the plaintiff’s loss. A plaintiff may prove loss causation by showing a decline in the price of the relevant security when the truth becomes public (in a misrepresentation case) or when the omitted material facts become public (in an omissions case). In the patois of loss causation, the revelation of the truth or the omitted fact is accomplished by a “corrective disclosure.” Alternatively, a plaintiff may prove loss causation by some event that drops the price of the stock, does not reveal the facts of the fraud, but occurs because the risks that the fraud concealed materialized.

The court also affirmed dismissal of the plaintiff’s Rule 10b-5 claims against the issuer’s founder, its CEO, and the managing director of a subsidiary, largely on the ground that, because of the 8-K, “the debenture holders were aware or should have been aware of the key facts necessary to plead their securities fraud claims against the [issuer] defendants more than two years prior to the filing of this claim,” which was therefore untimely under the two-year prong of the statute of limitations in 28 U.S.C. § 1658(b) (stating a claim must be brought “not later than the earlier of—(1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation”). Gavin/Solmonese Dist. Ct., 68 F. Supp. 3d at 537, aff’d Gavin/Solmonese LLC, 639 F. App’x at 666, 668, 669.

Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341 (2005); 15 U.S.C. § 78u-4(b)(4) (2012). Dura, 544 U.S. at 344 (“[T]he Restatement of Torts, in setting forth the judicial consensus, says that a person who ‘misrepresents the financial condition of a corporation in order to sell its stock’ becomes liable to a relying purchaser ‘for the loss’ the purchaser sustains ‘when the facts . . . become generally known’ and ‘as a result’ share value ‘depreciate[s].’” § 548A, Comment b, at 107.” (alteration original)).

Lloyd v. CVB Fin. Corp., 811 F.3d 1200, 1209 (9th Cir. 2016) (“The burden of pleading loss causation is typically satisfied by allegations that the defendant revealed the truth through ‘corrective disclosures’ which ‘caused the company’s stock price to drop and investors to lose money.’” (quoting Halliburton 2014, supra note 413, 134 S. Ct. at 2406 (2014))).

See Nuveen Mun. High Income Opportunity Fund v. City of Alameda, Cal., 730 F.3d 1111, 1120 (9th Cir. 2013): Disclosure of the fraud is not a sine qua non of loss causation, which may be shown even where the alleged fraud is not necessarily revealed prior to the economic loss. The “materialization of the risk” approach, adopted by some circuits, recognizes loss causation where a plaintiff shows that “misstatements and omissions concealed the price-volatility risk (or some other risk) that materialized and played some part in diminishing the market value” of a security. Lentell v. Merrill Lynch & Co., Inc., 396 F.3d 161, 176–77 (2d Cir. 2005); see also Ray [v. Citigroup Global Mkts., Inc.], 482 F.3d [991,] 995 [(7th Cir. 2007)]. Although “it cannot ordinarily be said that a drop in the value of a security is ‘caused’ by the misstatements or omissions made about it, as opposed to the underlying circumstance that is concealed or misstated,” materialization of the risk recognizes that “a misstatement or omission is the ‘proximate cause’ of an investment loss if the risk that caused the loss was within the zone of risk concealed by the misrepresentations and omissions alleged by a disappointed investor.” Lentell, 396 F.3d at 173. Under this theory, the plaintiff must show that “it was the very facts about which the defendant lied which caused its injuries.” McCabe [v. Ernst & Young, LLP], 494 F.3d [418,] 431 [(3d Cir. 2007)] (internal quotation marks omitted).
In 2016, the Eighth Circuit affirmed use of loss causation analysis to narrow a class period.\(^{460}\) The Ninth Circuit held that disclosure of a government investigation can constitute a corrective disclosure—if that announcement is followed by a stock price decline and understood by the market to relate to the alleged fraud and if the issuer then makes a subsequent disclosure that relates to the alleged fraud and that subsequent disclosure is not followed by a stock price drop—because such a sequence suggests that the market discounted the stock for the fraud after the announcement of the investigation.\(^{461}\) The Sixth Circuit formally recognized materialization of risk as an acceptable theory of loss causation.\(^{462}\) And the Second Circuit affirmed a plaintiffs’ verdict in a case in which the risk never fully materialized but the defendants’ actions concealed the degree of risk.\(^{463}\)

Class period not extended by statement that does not cause further loss. In *Rand-Heart of New York, Inc. v. Dolan*, the Eighth Circuit affirmed dismissal of a Rule 10b-5 claim in part and in a way that narrowed the class period.\(^{464}\) The plaintiff alleged that a company misled investors during the period August 1, 2013 through January 2, 2014,\(^{465}\) “by concealing information about the lack of new Bank of America work[, the largest customer of the issuer’s subsidiary called DiscoverReady,\(^{466}\)] and the need to restructure.”\(^{467}\) But on August 1, 2013, the company had stated in a Form 10-Q for its second quarter that (i) it “must increase revenue and eliminate costs to achieve and maintain positive operating margins”; (ii) it was “probable that the Company will

\(^{460}\) See infra notes 464–477 and accompanying text.

\(^{461}\) See infra notes 478–492 and accompanying text.

\(^{462}\) See infra notes 493–502 and accompanying text.

\(^{463}\) See infra notes 503–530 and accompanying text.

\(^{464}\) 812 F.3d 1172, 1174, 1179–80 (8th Cir. 2016).

\(^{465}\) *Id.* at 1176.

\(^{466}\) *Id.* at 1174.

\(^{467}\) *Id.* at 1179.
be unable to comply with certain of its financial covenants in its senior secured credit facility as measured on the last day of the third quarter of 2013”; (iii) it was “currently in discussions with its lenders regarding resetting the financial covenants applicable to the third quarter and future periods”; (iv) a failure to comply with the covenants “may result in an event of default”; and (v) if it was “unable to repay [its] indebtedness, the banks could foreclose on [company] assets.”

And, on November 12, 2013, the company issued a press release and filed a Form 10-Q with its third-quarter financial results, with the 10-Q stating “that the decline in revenue ‘exceeded our expectations,’ largely due to ‘a reduction in new work from [DiscoverReady’s] largest customer, a reduction that we identified towards the end of the quarter.’” The company further stated that “the reduction ‘resulted from the customer’s evaluation of [our] financial condition’” and “reported an amended credit agreement, requiring $50 million more in cash ‘through one or more liquidity transactions separate from its operating activities, such as a sale of assets or issuance of equity or subordinated debt, by March 31, 2014.’” The company’s stock price dropped from a November 11 close at $2.08 to $1.05 on November 12 and to $0.90 on November 13.

While the stock price lost $0.14 after a January 2, 2014 press release—in which the company announced appointment of a Chief Restructuring Officer—the court held that the plaintiff failed to show that the alleged fraud caused that further decline. The Eighth Circuit observed that “[n]othing in the January 2 press release corrects previous misrepresentations.”

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468 Id. at 1175.
469 Id. (alteration in original).
470 Id.
471 Id. at 1179.
472 Id. at 1175–76.
473 Id. at 1176.
474 Id. at 1180.
475 Id.
Instead, the press release “elaborate[d] on [a] previously disclosed plan to restructure.”

Accordingly, the court of appeals held that, although the district court had mistakenly dismissed the case as a whole, it had not erred “in finding no loss- causation for the period between November 12 and January 2.”

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476 Id. The company had disclosed the plan on August 1, 2013 in a Form 10-Q that announced a net loss of $4.62/share for the second quarter and included the language quoted in the text supra accompanying note 468.

477 Id. at 1180. Rand-Heart includes two other holdings of interest. First, defendants argued that two statements made by an executive during an August 1, 2013 conference call with analysts were forward-looking:

> For 2013, we expect both DiscoverReady and the litigation support segment to grow at double-digit rates over the prior year with positive EBITDA leverage. However, we must point out that we expect DiscoverReady’s third quarter revenues to be below last year’s all time record revenue quarter.

> We make this comment not to dampen enthusiasm about our growth prospects for DiscoverReady, but to set proper expectations for a business that may experience lumpiness on a quarter-to-quarter basis.

Id. at 1175, 1177–78. A forward-looking statement enjoys two protections in private Rule 10b-5 lawsuits. First, it is not actionable unless the individual, or responsible executive officer if the defendant is an entity, had “actual knowledge . . . that the statement was false or misleading.” 15 U.S.C. § 78u-5(c)(1)(B) (2012). Second, a forward-looking statement is not actionable at all if it is accompanied by “meaningful cautionary” language. Id. § 78u-5(c)(1)(A) (2012). The Eighth Circuit held that the plaintiff adequately alleged that the executive making the statements “had actual knowledge that the statements were, at least, misleading.” Rand-Heart, 812 F.3d at 1178. Although the court did not elaborate at this point in the opinion, this ruling must have been based on the allegations that Bank of America, the company’s largest customer, had told the executive in May or June 2013 that it would not send any additional business to the company until the company resolved its financial problems, id. at 1174–75, and because the company (as of August 1) was by its own admission in a Form 10-Q, “currently in discussions with its lenders regarding resetting the financial covenants applicable to the third quarter and future periods,” id. at 1175.

The court of appeals then held that the August 1 statements during the conference call were not accompanied by “meaningful” cautionary language because the language to which the defense pointed—that “failure to comply with [financial] covenants in our debt instruments could result in an event of default that could adversely affect our financial condition and ability to operate our business as planned,” that “business revenues have traditionally been concentrated among a few customers,” and loss of these customers and failure to develop new customers could adversely affect “operating results and the ability to execute our growth strategy”—were “not ‘company-specific warnings based on a realistic description of the risks applicable to the particular circumstances [but] . . . merely a boilerplate litany of generally applicable risk factors.’” Id. at 1178–79 (quoting Julianello v. K-V Pharm. Co., 791 F.3d 915, 922 (8th Cir. 2015)).

In a second holding, the court found that the plaintiff alleged, with respect to the defendants’ failure to disclose the company’s “instability caused by the decline in Bank of America” business, the kind of severe recklessness that constitutes scienter. Id. at 1178. Since that decline was so pronounced that it had prompted the board in June 2013 to authorize marketing the company for sale, the omission of the instability from public statements “was, at the least, ‘so obvious that [the CEO] must have been aware of it.’” Id. (quoting In re K–tel Int’l, Inc. Sec. Litig., 300 F.3d 881, 893 (8th Cir. 2002)). While this language is a bit obscure, the court appears to hold that the defendants should, in August, have specifically disclosed “Bank of America had stopped sending new work . . . in May or June 2013.” Id. But the court found that the plaintiff had not pled scienter with respect to omissions “that Bank of America (1) suspended discussions of a colocation agreement and (2) demanded restructuring.” Id. at
Disclosure of government investigation as a corrective statement. In Lloyd v. CVB Financial Corp., the Ninth Circuit faced the recurring problem of whether the announcement of a government investigation, followed by an immediate stock price drop, can constitute a corrective disclosure.478 The plaintiff alleged that the defendant financial institution (“CVB”) violated Rule 10b-5 by making a variety of representations—including “that there was no basis for ‘serious doubt’ about [its largest borrower’s] ability to repay its borrowings”—that were false because that borrower had told CVB that the borrower would have to file for bankruptcy unless its loans were modified and never thereafter came current on its debt.479

1177–78. As to these, the Eighth Circuit viewed the disclosures on August 1, as inconsistent with a scienter inference. Id. at 1178; id. at 1177 (suggesting that the disclosures might have made these omissions immaterial). 478 Lloyd, supra note 458, 811 F.3d at 1209–11.

479 Id. at 1202, 1203–04. The trial court dismissed on the grounds that the complaint did not adequately allege (i) any “knowingly or recklessly false” statements by CVB or the two individual defendants, and (ii) loss causation. Id. at 1202. The text discusses loss causation.

As to scienter and falsity, the Ninth Circuit reversed as to some statements and affirmed as to the rest. The complaint alleged that the critical meeting—at which the debtor advised the defendants that the debtor would file for bankruptcy unless its debts were modified—occurred in the first part of January 2010. Id. at 1203. Thereafter, CVB filed a Form 10-K on March 4, in which it listed non-performing and past-due loans (without including the debtor on the list) and stated “that CVB was ‘not aware of any other loans as of December 31, 2009, for which known credit problems of the borrower would cause serious doubts as to the ability of such borrowers to comply with their loan repayment terms.’” Id. at 1204. CVB made substantially the same statement—following a list of bad loans on which the debtor did not appear—in its first quarter Form 10-Q, filed on May 10, 2010, with this statement as of March 10, 2010. Id. at 1204, 1208. While the district court had dismissed these representations on the ground that the most plausible inference was that CVB did not believe the debtor when it said that it would file for bankruptcy unless CVB modified the loans, the Ninth Circuit held that the debtor’s statement in January 2010 put “CVB . . . on notice of facts that would reasonably give rise to ‘serious doubts’ about [the debtor’s] ability to repay.” Id. at 1208. Allegations of the debtor’s statement at that early 2010 meeting therefore adequately pled both falsity and scienter as to the 10-Q, which by its terms covered a time period after the meeting. Id. at 1208–09. As to the 10-K, which spoke only as to the end of 2009, the Ninth Circuit allowed as to how the 10-K statement “[t]echnically . . . may have been true,” but by the time CVB filed the 10-K on March 4, 2010, it “had known for two months that there was a basis for serious doubts about the ability of [its] largest borrower . . . to repay [and t]he omission of that fact, combined with the reassurance that everything was fine as of December 31, 2009, meets the pleading standard for a material omission.” Id. at 1209.

The Ninth Circuit, however, agreed with the district court that the complaint did not allege fraud with respect to the same no “serious doubts” language in a Form 10-Q that the financial institution filed in November 2009 because, at that time, the debtor “had been current on its loans for about a year.” Id. at 1207. Moreover, CVB had extended additional loan money to the debtor in both March and September 2009, which suggested that CVB did not have “serious doubts” about its ability to collect on the loans then. Id. at 1208. And, of course, CVB filed the November 2009 10-Q before the January 2010 meeting.

The court of appeals also affirmed the district court’s dismissal of the complaint to the extent that it relied on other alleged misstatements. The court found some of those statements to constitute inactionable “puffery”—“that ‘[t]he overall credit quality of the loan portfolio is sound’; ‘CVB’s credit metrics are superior’ to those of its
The plaintiff averred that CVB’s second-quarter Form 10-Q filing on August 9, 2010 disclosed that the SEC had served a subpoena on CVB “request[ing] information regarding [its] loan underwriting guidelines, [its] allowance for credit losses and [its] allowance for loan loss calculation methodology, [its] methodology for grading loans and the process for making provisions for loan losses, and [its] provision for credit losses.” CVB’s stock price dropped 22% the following day, but the trial court ruled—in dismissing the case—“that the announcement of the subpoena could not constitute a corrective disclosure.” Reversing in part, the Ninth Circuit acknowledged that it had held in 2013 “that ‘the announcement of an investigation, ‘standing alone and without any subsequent disclosure of actual wrongdoing, does not reveal to the market the pertinent truth of anything, and therefore does not qualify as a corrective disclosure.’” The court of appeals relied on the different context here and the sequence of events to qualify that rule. Following the August 9 announcement, CVB’s stock not only declined but “various analysts perceived the subpoena to be related to CVB’s alleged misstatements about [the large borrower’s] ability to repay.” CVB then on September 9...
announced that (i) the large borrower could not pay its loans, (ii) CVB was charging off $34 million of the loans and classifying the residual $48 million as nonperforming, and (iii) discounting to zero the value of its security interest in 15 properties securing the large borrower’s debt. The circumstance that the market did not move CVB’s stock price on that disclosure “indicate[d] that the earlier 22% drop reflected, at least in part, the market’s concerns about the [large borrower’s] loans.” Taken together, this pled “a causal connection between the material misrepresentation and the loss.”

Significance and Analysis. The 2013 Ninth Circuit opinion “left open whether the announcement of an investigation can ‘form the basis for a viable loss causation theory’ if the complaint also alleges a subsequent corrective disclosure by the defendant.” In CVB, the court relied on the circumstance that the subsequent disclosure did not move the price of the defendant’s stock, while the earlier disclosure of the investigation did, to conclude that the announcement of the investigation was itself a corrective disclosure. It is worth noting that the SEC investigation produced “no formal agency proceedings . . . against CVB.”

Materialization of risk as loss causation. As an alternative to pleading loss causation by a decline in market price upon disclosure of the truth behind a misrepresentation or the facts behind an omission, “a plaintiff may allege ‘proximate cause on the ground that negative investor inferences,’ drawn from a particular event or disclosure, ‘caused the loss and were a

appeared to pertain to the adequacy of CVB’s reserves, including those for its largest borrower . . . and the adequacy of CVB’s disclosures.” Id. 487 Id. at 1205. 488 Id. The stock price declined the next day from $7.05 to a $6.99 close. Id. 489 Id. at 1211. 490 Id. (quoting Dura, supra note 456, 544 U.S. at 342). 491 Id. at 1210 (quoting Loos v. Immersion Corp., 762 F.3d 880, 890 n.3 (9th Cir. 2014)). 492 Id. at 1205.
 foreseeable materialization of the risk concealed by the fraudulent statement.””493 The Sixth Circuit recognized this alternative method last year in *Ohio Public Employees Retirement System v. Federal Home Loan Mortgage Corporation*.494

The plaintiff alleged that the Federal Home Loan Mortgage Corporation (“Freddie Mac”) and individual officers there “concealed [Freddie Mac’s] overextension in the nontraditional mortgage market—generally composed of instruments known as subprime mortgages or low credit and high risk instruments—and its materially deficient underwriting, risk management and fraud detection practices through misstatements and omissions to investors” during a class period from August 1, 2006 to November 20, 2007.495 The quality of the mortgages that Freddie Mac purchased, guaranteed, and bundled into securities declined, the plaintiff alleged, because (i) “[a]s Freddie Mac’s purchase pace outgrew its own underwriting capabilities, it increasingly relied on the underwriting systems of third parties, which routinely assigned artificially high quality designations to loans that would have been considered subprime if internally underwritten”; (ii) the exceptions Freddie Mac granted to its own underwriting standards “became so common that a Director of Credit Risk Policy inquired, ‘Why do we even have a credit risk policy if we allow more exceptions than we have compliance?’”; and (iii) its “antiquated evaluative software and fraud detection measures . . . could not keep up with the changes to Freddie Mac’s portfolio.”496

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494 *Id.* at 385 (“[W]e join our fellow circuits in recognizing the viability of alternative theories of loss causation and apply materialization of the risk in this case.”) (citing cases from the D.C. Circuit and the Third, Fourth, Fifth, Seventh, Eighth, Ninth, and Tenth Circuits).
495 *Id.* at 379.
496 *Id.* at 380–81.
Freddie Mac concealed the degradation in its loan portfolio by, for example, saying in its 2007 second-quarter report that “approximately $2 billion, or 0.1 percent . . . of loans underlying our single-family mortgage portfolio, at June 30, 2007 . . . were classified as subprime mortgage loans”—a statement based on what the plaintiff called “a ‘deceptive[ly]’ narrow definition of subprime” and one that contrasted with Freddie Mac’s internal classification of about $182 billion of its single-family credit guarantee portfolio as “Caution Loans” (loans with such high risk characteristics that they had to be approved by manual, as opposed to automated, underwriting) and “Expanded Approval” loans (either low-quality loans from Fannie Mae or loans made by “banks known for poor loan quality”).497 As another example, Freddie Mac stated in June 2007 that only 10% of its portfolio consisted of reduced documentation Alt-A loans when, according to the plaintiff, such loans comprised 29% of the single-family loans held by Freddie Mac.498

To allege loss causation, the plaintiff pointed to the 29% decline in Freddie Mac’s stock price following the company’s November 20, 2007 report of third-quarter results, which showed a $2 billion loss on mortgage investments, revealed substantial exposure to nontraditional, low-quality mortgages, and disclosed risk of loss of about $200 billion of the company’s $700 billion loan portfolio.499 The court rejected the defense arguments that (i) Freddie Mac had disclosed the risk earlier and (ii) the plaintiff needed to plead facts to show that the stock decline was not

497 Id. at 381; id. at 380 (explaining Caution Loans and Expanded Approval Loans). Individual defendant Richard Syron, the Freddie Mac CEO, also said in about May 2007 that, at the end of 2006, Freddie Mac “‘had basically no subprime exposure in our guarantee business.’” Id. at 387 (emphasis by the court) (quoting complaint). Individual defendant Patricia Cook, the Freddie Mac Chief Business Officer and Executive Vice President for Investments and Capital Markets, repeated this representation shortly thereafter at the Lehman Brothers Tenth Annual Financial Services Conference. Id.
498 Id. at 381.
499 Id. at 382, 388.
caused by the credit crisis overall. The Sixth Circuit found sufficient, for pleading loss causation, the plaintiff’s “conclusion that the 29% loss in stock price that occurred on November 20, 2007, when Freddie Mac disclosed a loss of $2 billion, is ‘directly attributable to the market’s reaction to revelations of the nature, extent, and impact of the fraud at Freddie Mac.’” Accordingly, the court of appeals reversed the district court dismissal of the complaint, which was based on failure to adequately plead loss causation.

Loss caused by failure to disclose risk that does not fully materialize. After a jury verdict for the investors who purchased Vivendi, S.A. (“Vivendi”) American depositary receipts (“ADRs”) from October 30, 2000 to August 14, 2002—with the jury specifically finding that Vivendi had violated Rule 10b-5 in making more than 50 specific misrepresentations—the Second Circuit affirmed the district court’s denial of judgment as a matter of law in an opinion that made significant holdings on both “price impact” for the purpose of applying the FOTM presumption and loss causation. The case centered on Vivendi’s statements as the company

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500 Id. at 385–86, 388. As to the first argument, the court found that the language to which the defendants pointed to show that they had disclosed risk—such as that “we have increased our participation in nontraditional mortgage market products,” that “product mix affects the credit risk profile of our Total mortgage portfolio,” and that Freddie Mac “expect[ed] [certain] . . . products to default more often than traditional products”—was insufficient to reveal the internal problems at Freddie Mac, such as that the company gave excessive exceptions to underwriting criteria in order to buy nonqualifying loans and used outdated evaluation software and fraud detection measures. Id. at 385–386. As to the second argument, the court wrote:

[The plaintiff] need only allege sufficient facts to support a plausible claim—not the most likely—at this stage. See [Bell Atl. Corp. v.] Twombly, 550 U.S. [544,] 570 [(2007)]. Having considered “the relationship between the risks allegedly concealed and the risks that subsequently materialized,” as well as the close correlation between the alleged revelation or materialization of the risk and the immediate fall in stock price, we conclude that it has done so.

Id. at 388 (alternate citation for Twombly omitted and citation at conclusion of quotation omitted).

501 Id. at 388 (quoting plaintiff).

502 Id. at 379, 388.

503 In re Vivendi, S.A. Sec. Litig., 838 F.3d 223 (2d Cir. 2016); id. at 232 (Rule 10b-5 claim); id. at 237–38 (brought against Vivendi, Jean–Marie Messier, and Guillaume Hannezo); id. at 239 (verdict against Vivendi only and on 57 statements); id. at 238 (class period); id. at 239 & n.7 (trial court awarded Vivendi judgment as a matter of law as to one of the statements, with plaintiffs not appealing that determination); In re Vivendi Universal, S.A. Sec. Litig., 765 F. Supp. 2d 512, 533–34 (S.D.N.Y. 2011) (class consisted of ADR purchasers).
transformed itself from a water supplier to an entertainment, telecommunications, and media giant. During that time, Vivendi made positive statements about its financial condition—particularly its cash and earnings before interest, tax, depreciation, and amortization (“EBITDA”)—while, in fact, its massive borrowing in order to acquire companies in new industries generated severe liquidity problems. Some of the misrepresentations referred to the

Vivendi also argues that Plaintiffs’ supposedly belated identification of a specific set of statements violated the PSLRA’s requirement that “security-fraud plaintiffs . . . ‘specify each statement alleged to have been misleading’ and ‘why the statement is misleading.’” (emphasis in quoting source) (quoting 15 U.S.C. § 78u–4(b)(1)). This argument appears to assume what it seeks to prove: that the PSLRA’s so-called “specificity requirement,” as Vivendi terms it, confines securities-fraud plaintiffs to the particular alleged misstatements identified in their complaint. We identify no such requirement in the PSLRA, which sets out certain pleading standards so as to prevent securities-fraud plaintiffs from filing costly securities class-action suits on the basis of a barely formed hunch, but nowhere binds such plaintiffs to the precise set of alleged misstatements identified in their complaint throughout the entire course of litigation.

Id. at 242 n.11 (record citations omitted). The court added that all 57 statements sent to the jury were either identified in the first amended consolidated complaint, plaintiffs’ interrogatory responses, or their expert reports. Id.

The Second Circuit describes Vivendi’s acquisition efforts, the borrowings to finance those purchases, and the cash difficulties that the resulting debt imposed. Id. at 232 (general description); id. at 235 (“With each acquisition, Vivendi ‘had to borrow some money from the banks,’ and it became ‘more and more difficult to raise the cash’ Vivendi needed to pay for its acquisitions and its accumulating debts. Vivendi’s liquidity, or its ability to pay its fixed obligations, became increasingly strained.”) (record citations omitted). The opinion provides examples of the misleading statements and the contrasting underlying facts. For instance, Vivendi stated on June 26, 2001 that it “had[d] cash available for investing,” id. at 245, even though, starting in the same month, its Treasurer “repeatedly expressed concerns over . . . the liquidity situation and discussed Vivendi’s ‘shortage in cash,’” and its CFO “comment[ed] on multiple occasions that Vivendi appeared to be ‘running out of cash’ and ‘nearing bankruptcy.’” Id. at 235. In another instance, Vivendi stated in December 2001 that then-recent acquisitions “were ‘not putting pressure on Vivendi Universal,’ and that it anticipated maintaining ‘a very comfortable . . . credit rating,’” even though shortly before this statement the CFO had “warn[ed] the CEO of the ‘danger’ of a downgrade” and described “‘painful and humiliating meetings with the ratings agencies.’” Id.

Some of the fifty-five statements praised Vivendi’s EBITDA. For example, on October 30, 2000, the “company announced its ‘objective’ to ‘grow pro forma adjusted EBITDA at an approximate 35% compound annual growth rate through 2002,’” id. at 234, and, on February 14, 2001, Vivendi said that it was “‘very confident that we will meet the very aggressive growth targets we have set for ourselves both at the revenues and EBITDA levels,’” id. at 246. But the CFO on September 15, 2000 recognized in an email “that ‘the analysts will not have it easy to track the purchase accounting benefits’ in EBITDA figures.” Id. at 248. The Second Circuit explained the misleading disconnect between EBITDA and purchase accounting in this way:

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504 Vivendi, 838 F.3d at 232.
505 Id. at 234–35. The Second Circuit rejected the company’s argument on appeal that the plaintiffs had tried the case on an impermissibly general notion that Vivendi had failed to disclose its liquidity condition. Id. at 239–42. The court sent the case to the jury with a verdict form asking that the jury determine whether the plaintiffs had proven a Rule 10b–5 claim on each of 57 statements, and the jury found against the company on all statements, with the court awarding judgment as a matter of law to the defendants regarding one statement. Id. at 238–39, 241–42. To the defense argument that the 57 statements did not map completely to the complaint, the court responded:

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company’s “high EBITDA growth,” which was “misleading for omission to disclose Vivendi’s liquidity risk” because Vivendi’s use of purchase accounting (a required technique) distorted EBITDA through “one-time paper adjustments that cannot readily translate into free cash flow.”

The plaintiffs presented an expert who testified on loss causation and damages. The jury determined, for each day of the class period, the dollar amount by which the security prices were inflated. On appeal, Vivendi challenged both the admission of the expert’s testimony

As Plaintiffs’ expert testified, high EBITDA suggests high profitability—and by implication, ample cash flow available to service debt. But Vivendi’s high EBITDA targets derived in large part from purchase accounting effects (which are just one-time paper adjustments that cannot readily translate into free cash flow) rather than profits from a company’s business operations (which reflect actual earnings that may translate into free cash flow). And although purchase accounting was the required accounting technique at the time, Plaintiffs submitted evidence that Vivendi emphasized EBITDA growth to the public because financial analysts, to say nothing of the average investor, “w[ould] not have it easy to track the purchase accounting benefits” and the degree to which they contributed to Vivendi’s EBITDA figures. [The CFO] at one point referred to purchase accounting benefits as “accounting magic” and acknowledged that Vivendi met its EBITDA growth targets thanks to purchase accounting benefits.

The Second Circuit rejected Vivendi’s argument that certain of the fifty-six odd statements were inactionable puffery, assuming without deciding that “whether a given statement was . . . puffery [w]as a fact [question.]” The jury could have “reasonably concluded” that, for example, the statement “[t]he results produced by Vivendi Universal in the second quarter are well ahead of market consensus’ . . . [was] not so general that a reasonable investor could not have relied upon [it] in evaluating whether to purchase Vivendi’s stock.” The court also held that the statutory protections for forward-looking statements, see supra note 477, did not apply to “present representations . . . embedded within statements that Vivendi deems forward-looking,” so that, for example, “there [wa]s nothing prospective” about the reference to a “very strong balance sheet” in the company’s February 14, 2001 pronouncement that it “[e]nter[ed] [2001] with strong growth prospects and a very strong balance sheet.” Vivendi, 838 F.3d at 246. The Second Circuit also held that Vivendi had not accompanied challenged forward-looking statements with sufficient cautionary language because warnings that future results could vary materially from those expressed or implied by forward-looking statements due to risks created by “success with new products and services, relationships with competitors and third parties, and marketing and advertising efforts—[did] not bear even tangentially on Vivendi’s liquidity risk,” but constituted a “kitchen-sink disclaimer, listing garden-variety business concerns that could affect any company’s financial well-being.”

506 Vivendi, 838 F.3d at 251.
507 Id. at 253.
and sufficiency of the evidence to prove loss causation. The expert used event study analysis to find days on which Vivendi’s stock experienced returns that differed, in a statistically significant way, from those predicted by a model (“residual returns”), determined on which of those dates information about Vivendi’s liquidity appeared, and found ten such dates—one of which the stock experienced a negative residual return and on one of which the stock experienced a positive residual return. The net total negative residual return constituted “the maximum loss that investors suffered due to the market’s lack of knowledge about Vivendi’s true liquidity risk, which is to say the maximum artificial inflation that entered Vivendi’s stock price and subsequently dissipated as the market found out about the truth.” Since the liquidity problem grew over time, as Vivendi acquired ever more media and communications companies and paid for the acquisitions with debt, the “liquidity-related inflation” in the stock price also grew so that “[a]scribing the full value amount of loss to the very first alleged misstatement would . . . tend to overstate the degree to which Vivendi’s stock was inflated due to the market’s lack of knowledge about Vivendi’s true liquidity risk, at least toward the beginning of the Class Period.” To adjust for this complexity, and in light of the circumstance that there was no stock market number that would untangle it, the expert used—as a proxy for the amount of the inflation over time—“the increasing degree to which purchase accounting benefits contributed to Vivendi’s EBITDA figures.”

509 Vivendi, 838 F.3d at 253, 260.
510 Id. at 253–54. The opinion refers to the difference between the return predicted by the expert’s model and the actual return as the “residual return.” Id. at 254. But it is also called the “abnormal” return. See Ludlow v. BP, P.L.C., 800 F.3d 674, 683 n.37 (5th Cir. 2015).
511 Vivendi, 838 F.3d at 254.
512 Id. at 255.
513 Id.
Vivendi challenged this technique because it failed to relate residual price changes to the specific statements on which the plaintiffs sued; indeed, on the great majority of the days when the challenged statements were made, the expert’s event study did not show any residual return.\textsuperscript{514} Vivendi contended that, without proof that the challenged statements had a “price impact,” the expert could not show loss causation or damages and must have relied on a legally untenable theory that the statements maintained price inflation instead of causing it.\textsuperscript{515} The Second Circuit responded that the “far more coherent” way to view the expert’s theory was that the statements prevented the dissipation of the ever-growing stock price inflation.\textsuperscript{516} And the amount to be dissipated—i.e., “the amount of inflation due to investors not knowing the truth”—was measured by the expert’s work.\textsuperscript{517} As to how this fit into the loss causation analysis, the Second Circuit saw its opinion as “join[ing] in the Seventh and Eleventh Circuits’ conclusion that ‘theories of “inflation maintenance” and “inflation introduction” are not separate legal categories.’”\textsuperscript{518} And as to the expert, the Second Circuit found his testimony “relevant as to loss causation because the total amount of actual inflation that [he] identified is the maximum amount of loss potentially caused by Vivendi’s alleged misstatements” and “relevant as to damages because [his] model of inflation over the course of the Class Period provides a means for calculating each Plaintiff’s damages.”\textsuperscript{519}

\textsuperscript{514} Id. at 256.
\textsuperscript{515} Id.
\textsuperscript{516} Id. at 258.
\textsuperscript{517} Id. at 259.
\textsuperscript{518} Id. (quoting Glickenhaus & Co. v. Household Int’l, Inc., 787 F.3d 408, 418 (7th Cir. 2015)) (citing FindWhat Inv’r Grp. v. FindWhat.com, 658 F.3d 1282, 1316 (11th Cir. 2011)). Adding a rhetorical flourish, the Second Circuit “agree[d] with the Seventh and Eleventh Circuits that securities-fraud defendants cannot avoid liability for an alleged misstatement merely because the misstatement is not associated with an uptick in inflation.” Id.
\textsuperscript{519} Id. at 260. Technically, the court of appeals held that the district court had not abused its discretion in admitting the expert’s testimony on loss causation and damages over Vivendi’s objection that doing so would violate Rule of Evidence 702. Id. at 233, 253, 260.
Vivendi had one more loss causation argument—that there was insufficient evidence to establish loss causation because “no specific corrective disclosure ever exposed the precise extent of Vivendi’s alleged fraud.” In the language of loss causation, there was no materialization of the risk because “the risk . . . allegedly concealed (i.e., the risk of a liquidity crisis) . . . ‘never materialized’ into ‘an objective event such as bankruptcy, default, or insolvency.’” The Second Circuit rejected this argument because the misrepresentations misled by concealing Vivendi’s liquidity risk, which existed and when revealed drove the stock price down, even though the risk never fully matured.

Significance and Analysis. The Vivendi opinion deserves three comments. First, it is somewhat disturbing that the company could be found to have misled by reporting or even emphasizing EBITDA numbers on the basis that those numbers did not reflect cash flow because the company derived EBITDA from numbers generated by purchase accounting that the company was required to employ. Perhaps this only emphasizes the long-standing principle that companies can comply with accounting principles and still violate Rule 10b-5. Or perhaps it emphasizes that a company deriving and publicizing a non-GAAP number like EBITDA must be especially cautious, even when computing the non-GAAP number from

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520 Id. at 262.
521 Id. at 261.
522 Id. at 262. Although not articulated in this way, this view fits the facts pretty well. Three of the nine events that the plaintiffs’ expert identified as revealing the truth about Vivendi were (i) “May 3, 2002 news that Moody’s downgraded Vivendi’s long-term senior debt to a notch above junk status; [(ii)] . . . July 2, 2002 news that Moody’s downgraded Vivendi’s long-term senior debt to junk status, followed by S&P’s downgrade of Vivendi’s short-term senior debt; [and (iii)] July 10, 2002 news that rating agencies cautioned that further downgrades were possible,” with news on this day also including a French raid on Vivendi offices as part of a securities fraud investigation. Id. at 262–63. In trading on July 2 after the July 2 downgrade, the price of Vivendi stock fell by 26%. Id. at 237. A credit rating reflects the risk of default, and a credit rating can decline when that risk increases, even though no default has taken place and even in instances in which no default ever occurs.
523 See supra notes 505 and 506 and accompanying text.
524 See U.S. v. Simon, 425 F.2d 796, 805–06 (2d Cir. 1969); U.S. v. Rigas, 490 F.3d 208, 220 (2d Cir. 2007).
GAAP-compliant figures.\(^{525}\) Or maybe it shows that the problem arose only because the Vivendi executives understood that the effect of purchase accounting on the EBITDA numbers would be hard to unearth, even for analysts, and consciously declined to clarify the relationship between the two.\(^{526}\) Still, \textit{Vivendi} suggests the possibility that a company must consider how investors might interpret a non-GAAP measure, expressly caution against unwarranted interpretations, and take care to avoid any language that might, in hindsight, be considered as encouraging such interpretations.\(^{527}\)

Second, while the \textit{Vivendi} plaintiffs tried their case on misrepresentations, those misrepresentations misled because of omissions—since “the evidence introduced at trial [was] sufficient to support the jury’s conclusion that a reasonable investor could find Vivendi’s statements about high EBITDA growth misleading for omission to disclose Vivendi’s liquidity risk.”\(^{528}\) The “price maintenance” theory of loss causation endorsed by the Second Circuit may

\begin{footnotesize}
\begin{enumerate}
\item See supra note 505.
\item The Second Circuit included this odd passage in its opinion:

\begin{quote}
In Vivendi’s October 30, 2000 Form F–4 registration statement filing with the SEC, Vivendi stated that it “considers operating income to be the key indicator of the operational strength and performance of its business.” J.A. 4681. Vivendi continued to state, however, that while “[a]djusted EBITDA should not be considered an alternative to operating or net income as an indicator of Vivendi’s performance,” or “an alternative to cash flows from operating activities as a measure of liquidity,” adjusted EBITDA was nevertheless a “pertinent comparative measure” to “operating income.” \textit{Id.} (emphasis added). Given the arguable endorsement of the EBITDA measure inherent in this language, sufficient evidence supported the jury’s conclusion that such language did not meaningfully caution against reliance on EBITDA figures as a measure of Vivendi’s performance.

\textit{Vivendi}, 838 F.3d at 247. While the court wrote these words in the context of evaluating the sufficiency of evidence to support a jury conclusion that Vivendi had not accompanied forward-looking statements about EBITDA with sufficient cautionary language to invoke the PSLRA safe harbor for forward-looking statements, 15 U.S.C. § 78u-5(c)(1)(A)(i) and see supra note 477, the reference to the “arguable endorsement of the EBITDA measure inherent in [the] language” Vivendi used is worrisome. Almost any reference to a non-GAAP number, unless actively attacking the importance or utility of the number, might “arguabl[y] endorse[ ]” it in some “inherent” way.
\end{quote}
\end{enumerate}
\end{footnotesize}
be particularly apropos in omissions cases.\textsuperscript{529} In such cases, it may be likely that repeating assurances does not boost a stock price, so much as failing to disclose prevents the price from falling.

Third, \textit{Vivendi’s} conclusion that a concealed \textit{risk} may produce loss when revealed even if the risk is never fully realized, echoes the probability/magnitude analysis that the Court long ago held should inform the materiality analysis of facts bearing on a possible merger or acquisition.\textsuperscript{530} Investors look forward, trying to predict future returns. As the magnitude of a risk or reward changes, or as the probability of that risk or return changes, investors’ real time estimate of the return will change and their buy/sell decisions based on that real time estimate will affect price. Hence, if a previously unanticipated risk that could hurt an issuer is disclosed at date X, the price of that issuer’s stock will decline at date X—even if the risk never matures.

\textit{Liability for Opinions Under Rule 10b-5.} The Supreme Court’s \textit{Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund} decision in 2015\textsuperscript{531} held that an opinion can be false or misleading in any of three ways. First, it is false if the speaker does not

\textsuperscript{529} See U.S. v. Schiff, 602 F.3d 152, 162 (3d Cir. 2010) (some alteration by the court):

We explained in \textit{Oran v. Stafford} that a duty to disclose under Rule 10b–5 may arise in three circumstances: “when there is [1] insider trading, [2] a statute requiring disclosure, or [3] an inaccurate, incomplete or misleading prior disclosure.” 226 F.3d [275,] 285–86 [(3d Cir. 2000)] (citations omitted). To support this proposition, the \textit{Oran} Court cited to (i) a First Circuit Court of Appeals en banc opinion, \textit{Backman v. Polaroid Corp.}, 910 F.2d 10, 12 (1st Cir.1990) (en banc), explaining that a duty to disclose arises in the same three circumstances listed in \textit{Oran}, (ii) a Second Circuit Court of Appeals opinion, \textit{Glazer v. Formica Corp.}, 964 F.2d 149, 157 (2d Cir.1992), noting that, absent the same three circumstances, there is no duty to speak, and (iii) a District of Delaware Court opinion, \textit{In re General Motors Class E Stock Buyout Sec. Litig.}, 694 F. Supp. 1119, 1129 (D. Del.1988). \textit{Oran}, 226 F.3d at 286.

\textsuperscript{530} Basic Inc. v. Levinson, 485 U.S. 224, 238–39 (1988) (“[M]ateriality ‘will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.’” (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968))).

\textsuperscript{531} 135 S. Ct. 1318 (2015).
believe the opinion because an opinion “‘explicitly affirms one fact: that the speaker actually holds the stated belief,’” and would therefore “subject the [speaker] to liability (assuming the misrepresentation [is] material)” if it “falsely describe[d the speaker’s] state of mind.”

Second, it is false if it “contain[s] embedded statements of fact,” and the embedded facts are false. Third, an opinion is misleading if, in stating it, the speaker does not disclose “particular (and material) facts going to the basis for the issuer’s opinion—facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have—whose omission makes the opinion . . . misleading to a reasonable person reading the statement fairly and in context.”

The context encompasses “surrounding text, including hedges, disclaimers, and apparently conflicting information,” and “customs and practices of the relevant industry.”

The last of these three promised to be the most difficult to apply. Last year, the Second Circuit did so in *Tongue v. Sanofi*. The decision affirmed dismissal of two actions brought by purchasers of contingent value rights (“CVRs”) that paid cash upon the achievement of milestones in the development and sale of Lemtrada, a drug for treating multiple sclerosis (“MS”). Plaintiffs in both cases asserted Rule 10b-5 claims, and the plaintiffs in one of the

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532 *Id.* at 1326.
533 *Id.* at 1327.
534 *Id.* at 1332.
535 *Id.* at 1330.
536 816 F.3d 199 (2d Cir. 2016).
537 *Id.* at 203 (lower court dismissed); *id.* at 214 (affirmed); *id.* at 202, 204 (CVRs defined and explained); *id.* at 207 (appeal included two consolidated cases).
cases also brought claims under sections 11 and 12(a)(2) of the Securities Act. The Second Circuit repeatedly characterized the plaintiffs as “sophisticated.”

“The first milestone, called the ‘Approval Milestone,’ entitled CVR holders to $1 per CVR if the FDA approved Lemtrada for treatment of MS by March 31, 2014.” The FDA denied approval in December 2013, but granted approval in November 2014—after the March milestone pay date had passed. The plaintiffs built their cases largely around concerns that the FDA expressed to the defendants, beginning in 2002 and continuing over many years, that clinical tests of Lemtrada employed single-blind (in which only those administering the treatment are unaware which drug is provided), as opposed to double-blind (in which both the patients and those administering the treatment are unaware of which drug is provided), protocols. Lemtrada’s competitive advantage derived in part from the circumstance that it

538 Id. at 207–08. Genzyme Corporation owned the rights to Lemtrada before 2011. Id. at 203. The CVRs were issued as part of the consideration in Sanofi’s acquisition of Genzyme in April 2011 through a tender offer followed by a short-form merger. Id. at 204. The CVRs then apparently traded in the secondary market, because one of the consolidated cases was brought by a class that bought CVRs between March 6, 2012 and November 7, 2013, alleging a claim under Rule 10b-5. Id. at 207. The plaintiffs in the second case included those who had opted out of the class action and those who acquired CVRs outside of the class period. Id. They brought claims under both Rule 10b-5 and sections 11 and 12(a)(2). Id.
539 Id. at 211, 212–13, 214.
540 Id. at 204.
541 Id. at 207.
542 Id. at 203 (explaining single- and double-blind testing). The FDA provided these concerns to two of the companies that, as time passed, owned the rights to the drug—ILEX, id. at 203, and Genzyme, id. In 2002, the FDA told ILEX “that the use of single-blind studies in Lemtrada’s early clinical trials would ‘not provide substantial support for a BLA [Biologics License Application].’” Id. at 203. In 2004, the agency told ILEX again that the “‘open-label’” protocol, together with a small sample size, rendered a clinical trial “‘unlikely to provide substantial support’” for such an application. Id. In 2007, the FDA sent a letter to Genzyme “‘strongly recommend[ing]’ Genzyme ‘use a double-dummy placebo control in [its] pivotal trials,’ adding that ‘[t]he acceptability of [its] rater-blinded study will be a matter of review.’” Id. at 203–04 (some alteration by the court). In March 2010, the FDA stated in a meeting with Genzyme “that it ‘was concerned by the potential bias introduced by the absence of blinding of patients,’ and that ‘the bias introduced by unblinding physicians and patients remains a significant problem which will cause serious difficulties in interpreting the results of the trial.’” Id. at 204 (quoting agency minutes of the meeting). In 2011, the FDA told Genzyme in a meeting “that ‘the lack of doubleblinding has consistently concerned us. The lack of blinding remains a major concern.’” Id. Sanofi bought Genzyme in 2011. See supra note 538.

The materials that the FDA released shortly before its advisory committee met to consider Lemtrada showed that two of the doctors reviewing the drug harbored concerns based on the trials’ failure to double blind. Id. at 206. The FDA released this information on November 8, 2013, id., drawing the class period to an end on November 7, id. at 207.
required only two annual treatment courses, whereas other MS drugs required daily or weekly
dosing.\textsuperscript{543} This vast difference in dosage schedule “precluded the use of double-blind studies, as
patients would realize they were being required to undergo treatment far less frequently than
under their normal drug.”\textsuperscript{544}

The plaintiffs attacked three sets of statements by the defendants, allegedly misleading
for failure to disclose the FDA concern over the single-blind protocol used in Lemtrada tests,\textsuperscript{545}
a concern that affected the likelihood that the March 31, 2014 milestone-payment deadline would
be achieved.\textsuperscript{546} First, Sanofi estimated in the CVR offering material a 90\% probability that the
FDA would approve Lemtrada by the first milestone deadline and, indeed, projected FDA
approval in late 2012.\textsuperscript{547} Rejecting the argument that these statements misled “by failing to
disclose the FDA’s repeated statements of concern about the use of single-blind studies,”\textsuperscript{548} the
Second Circuit concluded that the FDA comments could not—by “any reasonable
interpretation”—be interpreted as “conflict[ing] with” the predictions because (i) the agency had
said, in a 2007 letter, that the “‘acceptability’” of the single-blinded studies “‘will be a matter of
review’” and that “‘[i]f your study results reveal an extremely large effect, then FDA may
potentially accept this rater-blinded design for the pivotal trials’” and (ii) “the parties do not
dispute, that Lemtrada’s treatment effect was, in fact, large.”\textsuperscript{549} Turning to “context,” the

\textsuperscript{543} Id. at 203.
\textsuperscript{544} Id.
\textsuperscript{545} Id. at 210–11.
\textsuperscript{546} Id. at 208 (“Both complaints allege, among other things, that by failing to disclose the feedback from the FDA
regarding the use of single-blind studies, Defendants misled investors as to the likelihood of meeting the Approval
Milestone, upon which the CVRs’ value partially depended, thereby artificially inflating the value of the CVRs.”).
\textsuperscript{547} Id. at 204–05 (noting that the statements originated in Genzyme SEC filings, incorporated by reference into the
Form F-4 Registration Statement and the 424B3 Prospectus for the Sanofi tender offer and short-form merger, see
\textit{supra} note 538).
\textsuperscript{548} Id. at 211.
\textsuperscript{549} Id. at 203–04, 211.
Second Circuit found important that (i) the “sophisticated investors” buying the CVRs (a) were “no doubt aware that projections provided by issuers are synthesized from a wide variety of information, and that some of the underlying facts may be in tension with the ultimate projection set forth by the issuer,” (b) understood “that ‘continuous dialogue between the FDA and the proponent of a new drug is the essence of the product license application process,’” and (c) “that inherent in the nature of a dialogue are differing views”; (ii) the offering materials included “numerous caveats to the reliability of the projections”; and (iii) “nowhere in the complaints do Plaintiffs allege that the risks arising out of the FDA feedback were out of the ordinary, or presented a special challenge not of the kind normally confronted by pharmaceutical companies seeking FDA approval.”

In the second set of challenged statements, the defendants—in the course of discussing the time at which Lemtrada would launch—professed themselves “very satisfied with where the progress is going,” said “they ‘expect[ed] a decision on Lemtrada by the end of the year,’” and declared that they “were ‘feeling pretty, pretty relaxed.’” Declining to find misleading the “subjective optimism” inhering in feeling “relaxed” or “satisfied” about progress towards a product launch, the court of appeals reasoned that “no reasonable investor would have inferred that mere statements of confidence suggested that the FDA had not engaged in industry-standard dialogue with Defendants about potential deficiencies in either the testing methodology or the drug itself.” As to the prediction that the FDA would make a decision by the end of the year,

550 Id. at 211–12 (quoting from In re Medimmune, Inc. Sec. Litig., 873 F. Supp. 953, 966 (D. Md. 1995)).
551 Id. at 211 (alteration by the court).
552 Id. at 213.
the court read this as projecting an agency decision by the end of 2013, then observed that the
FDA had decided by that date—albeit a decision, at that time, to reject the drug.553

Third and finally, the plaintiffs challenged as misleading defendants’ characterizations of
clinical test results as “demonstrat[ing] a ‘strong and robust treatment effect,’” with the “‘data
[being] nothing short of stunning.’”554 The Second Circuit here observed that “statements
lauding the effectiveness of Lemtrada” had to be considered “in the context of a global rollout
plan” that had, by early 2014, featured approval of the drug for use in 30 countries other than the
U.S. “based on Lemtrada’s exceptional clinical results.”555 There was, accordingly, no “rational
connection between Defendants’ statements about the general effectiveness of Lemtrada and the
FDA’s methodological feedback.”556 Even narrowing the focus to the U.S., “Plaintiffs’
allegations regarding Defendants’ stated opinion about the Lemtrada trial results are little more
than a dispute about the proper interpretation of data” and “Defendants’ statements were not
misleading simply because the FDA disagreed with Defendants’ interpretation of the data.”557

Significance and Analysis. Sanofi is important for three reasons. First, while Omnicare
dealt only with claims under section 11558—which does not require scienter559—Sanofi applies
the same analysis in all the claims before it, including Rule 10b-5 claims, that do require
scienter.560 Second, Sanofi applies Omnicare’s analysis of opinions to predictions.561 This
extension is sound, since a prediction is simply one kind of opinion. Third, Sanofi centers on the

553 Id.
554 Id.
555 Id.
556 Id. at 214.
557 Id.
559 Sanofi, 816 F.3d at 209.
560 Id.
561 Id. at 210–11. Omnicare centered on opinions that contracts in the health care industry complied with legal
restrictions. Omnicare, 135 S. Ct. at 1323.
third manner in which *Omnicare* held an opinion may be false or misleading—by omitting some material fact—such as one suggesting that the opinion might not be sound because of some undisclosed fact that is known to the speaker and that a “reasonable investor” would conclude the speaker would disclose in order that the opinion not mislead. When it identified this third basis on which an opinion might be false or misleading, the Supreme Court observed that the rule would *not* render an opinion “necessarily misleading when an issuer knows, but fails to disclose, some fact cutting the other way.” Instead, “context” would be important, and “reasonable investors understand that opinions sometimes rest on a weighing of competing facts; indeed, the presence of such facts is one reason why an issuer may frame a statement as an opinion, thus conveying uncertainty.” *Sanofi* employs this idea in the context of FDA approval, in which differing views of clinical results are not uncommon. But the same could be true of other projections—including financial projections, which can emerge from top executive judgments after considering different forecasts from different departments or different individuals in the company.

**Primary Rule 10b-5 Liability After Janus.** Rule 10b-5 prohibits three categories of wrongdoing in connection with the purchase or sale of securities, one of which—in the rule’s subpart (b)—is “mak[ing] any untrue statement of a material fact or . . . omit[ting] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.” In *Janus Capital Group, Inc. v. First*

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562 See supra note 534 and accompanying text.
563 *Omnicare*, 135 S. Ct. at 1329.
564 Id. at 1330.
565 Id. at 1329.
566 17 C.F.R. § 240.10b-5 (2016). The other two prohibitions are against (a) “employ[ing] any device, scheme, or artifice to defraud,” and (c) “engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.” Id.
Derivative Traders, the Supreme Court held that “[f]or purposes of Rule 10b–5[(b)], the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.”567 The Court also wrote that “in the ordinary case,” express attribution of a statement to a party provides “strong evidence that a statement was made by—and only by—the party to whom it is attributed.”568

The Second Circuit applied these principles last year to statements made by participants in a joint venture.569 The Ninth Circuit applied them to statements made by a lawyer working on a deal.570 The Eleventh Circuit did so for statements made by stock promoters hired by a company to raise its profile in the investment community,571 and the Eighth Circuit ruled that even though a drug company could not be liable under subpart (b) of Rule 10b-5 for statements made by physicians who reported on drug test results, the drug manufacturer might be liable under subparts (a) and (c) for paying those physicians to omit information about adverse side effects.572

Joint venture statements. G.D. Searle (“Searle”) developed a drug called Celebrex.573 In early 1998, Searle and Pfizer, Inc. (“Pfizer”) entered into agreements by which they would both market Celebrex.574 A merger in early 2000 transferred ownership of Celebrex and Searle’s rights under the agreements to Pharmacia Corporation (“Pharmacia”).575 Pharmacia developed a drug similar to Celebrex, called Bextra.576 Pharmacia and Pfizer entered into co-promotion

568 Id. at 142–43.
569 See infra notes 573–594 and accompanying text.
570 See infra notes 595–619 and accompanying text.
571 See infra notes 620–631 and accompanying text.
572 See infra notes 632–647 and accompanying text.
573 In re Pfizer Inc. Sec. Litig., 819 F.3d 642, 645–46, 655–58 (2d Cir. 2016).
574 Id. at 646.
575 Id.
576 Id. at 646 n.3.
agreements as to that drug as well (all such agreements collectively the “Co-Promotion Agreement”).

Pfizer acquired exclusive rights to Celebrex and Bextra—including promotional rights—in April 2003 when Pfizer bought Pharmacia.

Investors who purchased Pfizer stock between October 31, 2000 and October 19, 2005 brought a Rule 10b-5 claim alleging that statements made during that class period by Searle, Pharmacia, and Pfizer “concealed the safety risks of Celebrex and Bextra.” The plaintiffs contended that Pfizer was liable for 10 statements made by Searle or Pharmacia. In deciding a motion for summary judgment, the district court ruled that Pfizer could be liable for one of those statements—a press release—because the Co-Promotion Agreement raised a triable issue as to whether Pfizer had “ultimate control” over press releases. Pfizer did not contest that ruling on appeal. Rejecting the plaintiffs’ argument that they had raised a triable issue as to Pfizer’s control over a second statement—made in a Pharmacia Form 8-K—the Second Circuit found nothing in the record to suggest that Pfizer controlled that “regulatory disclosure,” and noted that the Co-Promotion Agreement specifically provided “that Searle (later Pharmacia) would have ‘sole responsibility for communicating with . . . regulatory authorities’ about Celebrex.”

But the court of appeals held that the plaintiffs had raised a triable issue as to Pfizer’s control over the other eight statements, which were statements by Searle or Pharmacia employees to the media or in journal articles. A fax from a public relations firm to Searle and

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577 Id.
578 Id. at 647.
579 Id.
580 Id. at 652.
581 Id. at 652, 656.
582 Id. at 656.
583 Id.
584 Id. at 656–57.
Pfizer employees transmitting a “‘Q & A document’ containing questions the press might pose regarding cardiovascular risks associated with Celebrex, along with scripted answers” said that the questions and answers “would be ‘reviewed and finalized during a . . . conference call’ between Pfizer and Searle, before being ‘distributed . . . to the appropriate parties at Searle and Pfizer for final sign-off.’” A Pfizer manager testified in deposition “that ‘senior management’ at Pfizer ‘would . . . need to . . . approve[ ]’ of ‘media responses [related to the category of drugs into which Celebrex and Betra fell], both to reporters and to publications in the forms of letters to the editors’ in order to ‘get [them] out the door.’” Although “not abundant,” the Second Circuit was “unable to conclude that no reasonable jury could find from this evidence that Pfizer had ‘ultimate authority’ over the eight statements to the press.” The Second Circuit therefore vacated the summary judgment in favor of defendants on those eight statements.

Significance and Analysis. In Janus, the Supreme Court held that the assets manager of mutual funds did not have “ultimate control” over, and therefore did not “make” within the meaning of Rule 10b-5(b), the statements in the funds’ prospectuses. The Court emphasized

585 Id. at 657 (emphasis by the court).
586 Id.
587 Id.
588 Id. at 658, 667. The district court had also granted a motion to exclude the report of the plaintiffs’ expert on loss causation and damages. Id. at 653–54. As this left the plaintiffs without any proof on these essential elements, the district court entered judgment for the defendants on the entire case. Id. at 654. Although declining to rule on the plaintiffs’ loss causation theory—that Pfizer’s statements maintained an artificially high stock price instead of creating it and Pfizer was therefore liable for the entire loss, id. at 648, 655, 659, 664—the Second Circuit held that the trial court should not have excluded the expert’s report altogether simply because it did not disaggregate the price effect of Pfizer’s statements as opposed to the price effect of statements made by Searle or Pharmacia, id. at 660–61. And, even if the expert employed flawed methodology to adjust for price declines attributable to two disclosures that the district court ruled were not corrective of the alleged fraud, the trial court should not have excluded the study overall. Id. at 661–67. Relying on the rule that “when the unreliable portion of an opinion can easily be distinguished from testimony that could help the jury, it may be an abuse of discretion to throw the good out with the bad,” id. at 665, the court of appeals concluded that “eliminating [the expert’s] Proportional Reduction [to adjust his original calculations in light of the holding that two disclosures were not corrective] does not render . . . his analysis useless; instead, it merely ensures the adoption of the most conservative estimate of the losses Pfizer allegedly caused,” id. at 666–67. Excluding the report was therefore an abuse of discretion, id. at 667, and the Second Circuit vacated the judgment for defendants on the case overall, id.
formalities—that the business trust in which the funds were organized was a separate legal entity from the asset manager and that the law imposed on the business trust, rather than the asset manager, the obligation to file the prospectuses with the SEC.\textsuperscript{590} In \textit{Pfizer}, however, the Second Circuit held that the one legal formality in the case—the Co-Promotion Agreement—was not dispositive; even “[a]ssuming . . . that the Co–Promotion Agreement unambiguously fails to provide Pfizer the power to approve or disapprove of Searle’s and, later, Pharmacia’s statements to the press, other evidence still creates a question of fact as to whether, notwithstanding any procedures articulated in the contract, Pfizer in fact had ‘ultimate authority’ over these statements.”\textsuperscript{591} The court added that “[t]he meaning of the Co–Promotion Agreement is thus but one factor in the factual determination whether Pfizer indeed had ‘ultimate authority’ over the eight statements to the media.”\textsuperscript{592} This suggests that the question of who had sufficient control over a statement to be liable under \textit{Janus} for a Rule 10b-5(b) violation cannot necessarily be foreclosed by a contract stating that only one person or party had such authority. Similarly, while the language of \textit{Janus} indicated that it would be difficult to impose liability on a party or person to whom a statement was not “attributed,”\textsuperscript{593} the Second Circuit found a triable issue of fact as to Pfizer’s ultimate control “[n]otwithstanding that the eight statements to the press were attributed to Searle and Pharmacia employees” rather than to Pfizer.\textsuperscript{594} Accordingly, a potential defendant may not necessarily be protected from primary liability on a statement simply because

\textsuperscript{590} Id. at 138 (stating that business trust was “a separate legal entity” from the asset manager); id. at 147 (“Only [the business trust] bears the statutory obligation to file the prospectuses with the SEC.”); id. (stating that the business trust was “a legally independent entity with its own board of trustees”).

\textsuperscript{591} \textit{Pfizer}, 819 F.3d. at 657.

\textsuperscript{592} Id.

\textsuperscript{593} See supra note 568 and accompanying text.

\textsuperscript{594} \textit{Pfizer}, 819 F.3d at 657.
it is not attributed to him or her or it. This, of course, does not suggest that such formalities are unimportant, just that they are not always dispositive.

Attorney statements. In a 2008 decision, the Ninth Circuit reversed dismissal where the plaintiff alleged that she agreed to accept stock in a settlement after attorneys for the issuer falsely told her that the issuer’s CEO was not targeted in a criminal investigation.\textsuperscript{595} The court of appeals held that “[a]n attorney who undertakes to make representations to prospective purchasers of securities is under an obligation, imposed by Section 10(b), to tell the truth about those securities.”\textsuperscript{596} In 2016, the same court of appeals held that an attorney can be liable for misstatements about the attorney’s client who claims to have securities to sell.

The plaintiff in \textit{ESG Capital Partners, LP v. Stratos} was organized to buy shares of Facebook, Inc. (“Facebook”) before Facebook went public.\textsuperscript{597} ESG negotiated for purchase of those shares with a man known to ESG as “Ken Dennis,” the CEO of Soumaya Securities, LLC (“Soumaya Securities”).\textsuperscript{598} ESG transferred money on three occasions—in aggregate $11.25 million—to purchase the Facebook stock.\textsuperscript{599} In fact, Mr. “Dennis” was actually Troy Stratos, and Soumaya had no Facebook shares to sell.\textsuperscript{600}

Venable LLP (“Venable”), acting principally through a partner named David Meyer, had represented Stratos.\textsuperscript{601} ESG sued Venable and Meyer, claiming under Rule 10b-5 and various state law theories.\textsuperscript{602} In reversing dismissal of the case, except as to one state law claim barred

\begin{footnotesize}
\begin{enumerate}
\itemThompson v. Paul, 547 F.3d 1055, 1057–58, 1065 (9th Cir. 2008).
\item\textit{Id.} at 1063.
\item828 F.3d 1023, 1029 (9th Cir. 2016).
\item\textit{Id.} at 1029–30.
\item\textit{Id.} at 1030–31.
\item\textit{Id.} at 1029, 1034 (“[T]here was no Facebook deal . . . .”).
\item\textit{Id.} at 1029.
\item\textit{Id.} at 1031.
\end{enumerate}
\end{footnotesize}
by a California statute of limitations relating specifically to certain claims against attorneys, the Ninth Circuit considered the liability of an attorney under Rule 10b-5(b).

Venable argued that the complaint failed to plead that Meyer “made” misrepresentations to ESG, and the district court had ruled that Meyer had “simply communicated Soumaya[’s] . . . understanding of the deal, not his own.” Although the court of appeals acknowledged that “Meyer prefaced many of his emails with: ‘It is Soumaya’s understanding . . . ,’” it added that “we are not convinced that such a short, easy preface could shield a messenger from liability in all circumstances.” The Ninth Circuit, however, did not need to decide this issue because it found that the plaintiff pled misstatements that Meyer had unquestionably made as his own.

In particular, the complaint alleged that, on April 18, 2011, Meyer spoke by telephone with ESG’s managing agent and (i) “informed [the] managing agent . . . that ‘Dennis’ was in contact with Facebook executives and had access to millions of Facebook shares”; (ii) “told [the] managing agent . . . that ‘Dennis’ ‘is who he says he is’”; (iii) “assured [the] managing agent . . . that ‘Dennis’ and Soumaya . . . were . . . affiliates” of Mexican billionaire Carlos Slim; (iv) said “that the sale [of Facebook shares] was legitimate”; and (v) advised that Venable represented “Dennis” and Soumaya in the deal and that Meyer would provide the deal documentation.

603 Id. at 1040; see Cal. Civ. Proc. Code § 340.6(a) (“An action against an attorney for a wrongful act or omission, other than for actual fraud, arising in the performance of professional services shall be commenced within one year after the plaintiff discovers, or through the use of reasonable diligence should have discovered, the facts constituting the wrongful act or omission, or four years from the date of the wrongful act or omission, whichever occurs first.”); ESG, 828 F.3d at 1036–37 (discussing the one-year limitation in this statute and concluding that it barred EST’s breach of fiduciary duty claim).
604 ESG, 828 F.3d at 1032–36.
605 Id. at 1033 (quoting district court).
606 Id.
607 Id. at 1033–34 (“Even assuming that this disclaimer was sufficient to indicate that Soumaya Securities or Stratos was the ‘maker’ of the statements in attorney Meyer’s emails, attorney Meyer made other false statements directly to ESG Capital.”).
608 Id. at 1030, 1033–34.
The next day, ESG wired $2.8 million into Venable’s trust account for the Facebook deal, and ESG alleged that it would not have done so without these assurances.\(^{609}\) Notably, after Meyer confirmed receipt of the money to ESG, the entire $2.8 million was placed in Stratos’s personal client account at Venable rather than in any account for Soumaya.\(^{610}\)

The Ninth Circuit held that ESG pled that such statements—made by Meyer himself—were false because, for example, Dennis was not who he said he was but was really Troy Stratos and neither “Dennis” nor Soumaya was affiliated with billionaire Slim.\(^{611}\) Moreover, Meyer “made material omissions when he failed to reveal that there was no Facebook deal; that Stratos, not Soumaya . . ., was Venable[’s] . . . client; and that ESG[’s] . . . $2.8 million deposit would be immediately dispersed to Stratos.”\(^{612}\)

The court of appeals held that the complaint pled Meyer’s scienter because he had been copied on emails between “Dennis” and ESG that showed “Dennis” using an email address at which Meyer emailed Stratos.\(^{613}\) And a strong inference that Meyer knew Stratos’s scheme arose from allegations that (i) Meyer and Stratos had more than 100 telephone calls and 25 meetings between February and November 2011; (ii) Meyer and Stratos “held an all-day conference with Stratos after ESG . . . wired its $2.8 million”; and (iii) “Venable LLP opened

\(^{609}\) Id. at 1030.

\(^{610}\) Id.

\(^{611}\) Id. at 1029–30.

\(^{612}\) Id. at 1034. The court did not identify the basis for Meyer’s duty to disclose, but presumably it was that the statements he made to ESG misled without the disclosure of these other material facts. 17 C.F.R. § 240.10b-5(b) (2016).

Venable argued that Meyer’s statements were not actionable because Meyer did not represent the seller of the shares—i.e., Facebook. ESG, 828 F.3d at 1034. The Ninth Circuit held that section 10(b) applies to an attorney whether he or she represents a seller or not, id. (“That [the attorney] may have an attorney–client relationship with the seller of the securities is irrelevant under Section 10(b).”) (alteration by the court) (quoting Thompson v. Paul, 547 F.3d 1055, 1063 (9th Cir. 2008)), and noted that, in any event, ESG—even acting as a middleman—“was the seller [of the Facebook shares] for ESG[’s] . . . purposes.” Id. at 1034–35.

\(^{613}\) ESG, 828 F.3d at 1035.
bank accounts for Stratos, since he was ‘black listed’ and unable to open bank accounts in his own name.”  

While “no single factual allegation substantiates an inference of attorney Meyer’s scienter,” the Ninth Circuit held that “ESG . . . has provided a narrative that strongly points to the existence of scienter.”  

As to reliance, ESG pled expressly that it would not have wired the $2.8 million to Venable on April 19 without Meyer’s assurances to the ESG managing agent the day before, and, more generally, that it transferred all $11.25 million “in direct reliance on . . . Meyer’s assurances and involvement.”

614 Id. In addition, Attorney Meyer then consistently authorized payments from Stratos’s client trust account between April 20, 2011, through July 2011. . . . Venable LLP also performed thousands of dollars’ worth of nonlegal services for Stratos, such as buying office supplies and car insurance.

615 Id. These further facts are hard to relate to scienter. They seem simply to show that Meyer knew a good deal about Stratos and had a close relationship with him. Perhaps more pertinent, but not relied upon by the court of appeals for scienter, was that “[a]t the time Venable LLP was representing ‘Dennis’ in the Facebook deal, Venable LLP, but not attorney Meyer, also represented Stratos in an unrelated suit for the theft of $7 million.”  Id. at 1029.

616 Id. at 1035.  Id. at 1030, 1036.  As to ESG’s state law claims, the Ninth Circuit held: The agent’s immunity rule did not shield the defendants because an attorney has a duty—indeed of the duty owed by his or her principal—“to refrain from defrauding nonclients.’”  Id. at 1037 (quoting Rickley v. Goodfriend, 212 Cal. App. 4th 1136, 1151 (2013), reh’g denied (Feb. 5, 2013), review denied (Apr. 10, 2013)).  Moreover, “Meyer had an independent legal duty to ESG Capital when he accepted and disbursed ESG Capital’s funds.”  Id.  ESG adequately pled conversion by alleging the unauthorized transfer of funds paid by ESG to Stratos’s personal client trust account and the transfer of money out of that account to Stratos and to Venable.  Id. at 1038.  The transfer of those funds to Venable also supported ESG’s claim for unjust enrichment.  Id. at 1038–39.  The transfer of ESG funds in Stratos’s personal client account out to Stratos and to Venable itself supported a claim under the California statute proscribing unfair business practices.  Id. at 1039.

ESG pled a claim for aiding and abetting fraud because “it alleged that . . . Meyer knew Stratos’s real identity and helped him create Soumaya . . . as part of the fraudulent Facebook deal,” thereby alleging both “actual knowledge of fraud and substantial assistance” to the fraud.  Id. at 1039.  ESG adequately pled a conspiracy to commit fraud against Meyer by (i) alleging formation of the conspiracy by Meyer’s assistance in forming Soumaya “knowing it was unaffiliated with Slim and was instead an empty shell unable to conduct business” and (ii) alleging “wrongful conduct” by “Meyer’s participation in creating Soumaya Securities, vouching for ‘Dennis,’ accepting and dispersing ESG Capital’s deposit, and facilitating the fraudulent deal.”  Id.  ESG satisfied the additional requirement of damage from the wrongful conduct by pleading that Venable transferred the $2.8 million as a result of the conspiracy.  Id.  None of these claims were barred by the one-year statute limiting claims against attorneys from wrongful actions “arising in the performance of professional services” because none of them depended on a violation of professional obligations distinct from the obligations owed by non-attorneys.  Id. at 1036–37.

In another case brought against an attorney for his own statements, although this one not generating a Janus argument, the Second Circuit affirmed summary judgement against the lawyer on SEC claims under section 17(a), section 5, and Rule 10b-5.  SEC v. Frohling, No. 13–3191–cv, 2016 WL 6602426 (Nov. 8, 2016).  The lawyer wrote, or approved, opinion letters concluding that shares were unrestricted securities because the owners had held them for two years within the meaning of Rule 144(k), as that rule was phrased at the time of the transfers.  Id. at *2;
Significance and Analysis. ESG’s holding does not surprise. It is unremarkable that a lawyer should be liable to a deal counterparty when the lawyer confirms to the counterparty that the lawyer’s client is who he said he is, while the lawyer knows that the client is, in fact, misrepresenting his identity to the counterparty. But the opinion may cause heartburn with its comment that a lawyer might not be able to “shield” himself or herself from Rule 10b-5 liability—when retransmitting information from the lawyer’s client to a counterparty and specifically attributing the information to the client.617 This suggestion is contrary to at least some authority.618 And the problem for an attorney sued by a counterparty for passing on client

17 C.F.R. § 230.144(k) (2005) (“[The restrictions] shall not apply to restricted securities sold for the account of a person who is not an affiliate of the issuer at the time of the sale and has not been an affiliate during the preceding three months, provided a period of at least two years has elapsed since the later of the date the securities were acquired from the issuer or from an affiliate of the issuer.”). In calculating the two-year holding period with respect to a security acquired from the issuer “for a consideration consisting solely of other securities of the same issuer surrendered for conversion,” the rule provided that “the securities so acquired [were] deemed to have been acquired at the same time as the securities surrendered for conversion.” 17 C.F.R. § 230.144(d)(3)(ii). It was undisputed that (i) the attorney “wrote, approved, or concurred in 11 opinion letters relying explicitly or implicitly on the Rule 144(k) exemption, stating that the shares could lawfully be transferred to the recipients as unrestricted shares on the ground that they were acquired by persons unaffiliated with [the issuer] solely in exchange for other [issuer] securities they had received more than two years earlier” and (ii) “that those statements were untrue.” Frohling, 2016 WL 6602426, at *2. “For example, certain owners—the ‘Morelli Group’—which purported to be receiving the to-be-offered shares from [the issuer] in exchange for old convertible promissory notes agreed that at least half of the proceeds from the sale of the shares would be paid to [issuer], thus making it false to represent that the Morelli Group was acquiring the to-be-offered shares ‘solely’ in exchange for the promissory notes.” Id. The defendent attorney “admitted at his deposition that he knew of the Morelli Group’s commitment to transfer to [the issuer] at least half of the proceeds of the public sale of the unregistered shares.” Id. at *3 (quoting SEC v. Greenstone Holdings, Inc., No. 10 Civ. 1302, 2012 WL 1038570, at *6 (S.D.N.Y. Mar. 28, 2012) [hereinafter Greenstone Dist. Ct. Dec.]). As another example, the attorney wrote two opinion letters “to receive unrestricted shares himself, in exchange for a promissory note” even though “he had received the note less than the required two years earlier.” Id. In another instance, the attorney wrote a letter concluding that the two-year period was satisfied because the holder acquired securities in exchange for convertible notes even though the notes did not exist and the attorney knew the true facts. Id. The Second Circuit concluded “that the record was ample to support the district court’s determination that there was no genuine issue to be tried as to [the attorney’s] knowledge that the representations as to the applicability of the Rule 144(k) exemption were false, and to support its conclusion that [the lawyer] violated § 17(a) of the Securities Act, § 10(b) of the Exchange Act, and Rule 10b–5 because the opinion letters he wrote, approved, or concurred in ‘all falsely claimed registration exemptions under Rule 144(k).’” Id. at *4 (quoting Greenstone Dist. Ct. Dec., at *6). The appellate court found no abuse of discretion in the lower court ordering relief that included a permanent injunction against the lawyer participating in penny stock offerings, in part because of the attorney’s explanation “that he was ‘simply relying on the opinions of other people’; and his continued insistence that he was entitled to give, approve, and concur in the opinions he gave without knowing, and without investigating to find out, whether they were true or false.” Id. at *1, *4 (quoting hearing transcript).

617 See supra text accompanying note 606.
618 The Supreme Court said in Janus that, “[i]n the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is
information that turns out to be false is that the counterparty might survive a motion to dismiss simply by showing that the attorney was working diligently on the relevant deal and therefore knew or was reckless in not knowing that the information was not true.619 

Stock promoters’ statements. The corporate defendant in the Galectin Therapeutics, Inc. Securities Litigation—a pharmaceutical company that was developing drugs not yet approved by the FDA—“allegedly retained [four] promoters to ‘recommend or “tout”’ Galectin’s stock and raise the stock price.”620 The promoters published articles about Galectin and its drug development.621 During this time, Galectin sold stock to the public, pricing the stock “at the

attributed.” See supra note 568 and accompanying text. This language may preclude private 10b-5 actions against lawyers who simply transmit false information from a client to investors, where the lawyers do not expressly vouch for the information themselves. See Thomas H. Lee Equity Fund V, L.P. v. Mayer Brown, Rowe & Maw LLP, 612 F. Supp. 2d 267, 276 (S.D.N.Y. 2009) (holding, in a pre-Janus case, that the law firm representing a seller could not be liable on private Rule 10b-5 claim for “simply repeating [to representatives of buyer conducting due diligence for a stock purchase] information provided by others without any endorsement or representation that [the law firm] had, itself, verified or adopted the information”—e.g., could not be liable where its partner stated that he was “advised by” the client’s management or had “confirmed [a fact] with” the client’s CEO—even when the lawyer allegedly knew that the information that he passed along from the client was false); id. at 277 (finding the firm’s “mere association with statements made by others”—here, by relaying a statement that is attributed to the authority of another—is insufficient to make a secondary actor liable under § 10(b)). See also Schaffer Family Investors, LLC v. Sonnier, 120 F. Supp. 3d 1028, 1042 (C.D. Cal. 2015) (holding the agent for sellers, who forwarded to buyers emails from sellers—some of which the agent altered before forwarding and some of which he did not—was “properly charged as the ‘maker’ of statements that he altered in the forwarded emails and falsely attributed to the [sellers]”); id. at 1043 (but holding that the agent was not the maker of statements in unaltered emails that he forwarded because, “[g]iven that [he] was allegedly the [sellers’] agent acting within the scope of his agency, it does not appear that [he] had control over the statement[s’] contents or whether or how to communicate them. He thus was not their maker.”); id. at 1044 (granting in part and denying in part the agent’s motion to dismiss Rule 10b-5 claims).

619 In one other case applying Janus, the Second Circuit affirmed dismissal of a claim against a broker-dealer/placement agent and affiliated individuals (the “Vista Defendants”) insofar as the Rule 10b-5 claim rested on alleged misrepresentations in a private offering memorandum (“POM”). Gavin/Solmonese LLC v. D’Arnaud-Taylor, 639 F. App’x 664, 665, 669–70 (2d Cir. 2016). While the plaintiff alleged “that the POM was drafted with the approval and input of some Vista Defendants,” those facts were “not sufficient to demonstrate the control essential to maker liability.” Id. at 669.

620 843 F.3d 1257, 1262, 1263 (11th Cir. 2016). The court proceeded on “the premise that nothing in the securities laws prohibits Galectin as a company (issuing a regulated security) from hiring analysts to promote Galectin, circulating positive articles about its drug development, or recommending the purchase of Galectin’s stock.” Id. at 1272. The opinion added: “Under § 17(b) of the Securities Act, the duty to disclose promotional payments lies with the parties that receive the payments for promotional activities. 15 U.S.C. § 77q(b). There is no statutory duty to disclose imposed on the issuer—here defendant Galectin—which paid for the promotional articles or activities.” Id. at 1272–73.

621 Id. at 1263–65. The promoters, and the number of the articles each wrote, were: The Dream Team (7), Patrick Cox (23), TDM (6), and Acorn (2). Id. at 1264–65.
The company (i) stated in two offerings “that it had not taken any action that caused or resulted in the ‘manipulation’ of its stock price” and (ii) did not disclose either in the offerings or in its other SEC filings that it had paid the promoters. The plaintiff alleged that the reports published by the paid promoters inflated the price of Galectin stock causing those who bought it to pay too much, and that the price of the stock dropped precipitously after the relationship between the company and the promoters came to light.

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622 Id. at 1263. The opinion states that the company “announced two issuances of common stock,” that it sold more than 2.7 million shares in the first offering, and that the complaint did not allege the “sales figures” from the second offering. Id. An “at the market” offering prices the securities at their current market price. 2 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 6:19 (2016).

623 Galectin, 843 F.3d at 1266.

624 Id. at 1264–65 (recounting allegations that Galectin did not disclose any payments to The Dream Team, Patrick Cox, or TDM and that it disclosed that it had paid Acorn with stock but not what Acorn had done to earn that stock); Id. at 1266–67 (recounting allegations that Galectin did not disclose the payments in a Form 10-K or in Forms 10-Q in which the company reported the results of the first offering). While two of the promoters themselves disclosed payments from Galectin, the other two did not. Id. at 1264–65.

625 Id. at 1265.

626 Id. at 1265–66. The court stated:

Whether due to the articles or not, Galectin’s stock price increased during the drug’s development cycle. When Galectin announced the beginning of its drug development program in January 2013, Galectin stock was trading at roughly $2 per share. By the time Galectin made its first ATM [(at the market)] offering in October 2013, Galectin’s stock had risen to “an all-time high of $12.45 per share.” This price continued to climb to $15.31 per share by the time of Galectin’s second ATM offering in March 2014.

... In late July 2014, several months after Galectin’s second ATM offering, investment commentators began publishing articles and messages regarding suspected ties between Galectin and the stock promoters. The messages charged promotional touting; some included language such as, “[Galectin] paying penny stock promoters to issue misleading PRs” and “[o]nly someone being paid to shill would claim Galectin is ‘nipping at Intercept’s [(a company developing a drug similar to Galectin’s)] heels.”’ On July 28, 2014, after the investment commentators published these articles and messages, Galectin’s stock price began to fall. Over a one-day period from July 28, 2014 to July 29, 2014, Galectin’s stock price fell from $15.91 per share to $7.10 per share, generating a loss of $8.81 per share (a 55% loss in the stock price).

Id.
The plaintiff sued the company and five officers and directors, making a Rule 10b-5 claim. In affirming dismissal, the Eleventh Circuit reasoned that, “[i]n part, [the plaintiff] claims that the defendants committed securities laws violations not by virtue of their own statements, but rather based upon the statements of the third-party stock promoters in their articles.” The court rejected this theory because, although the plaintiff alleged “that the defendants worked in conjunction with stock promoters to promote Galectin’s stock, particularly with respect to the timing of articles by the stock promoters and company press releases, [he] has not included sufficient allegations to support a finding that Galectin had ‘ultimate authority’ or ‘control’ over the stock promoters’ statements.” The court then specifically held that the company’s payment “for the promotional articles does not mean that Galectin is the maker of the statements in the articles” and that therefore the payment was “not sufficient to support a claim under Rule 10b-5(b).”

627 Id. at 1268.
628 Id. at 1261, 1276.
629 Id. at 1270. For example, about two weeks after Galectin filed a Form 8-K discussing its competition with another drug maker, Intercept, “TDM published an article which stated that, ‘if conclusions are to be drawn so early in the game, it’s arguable that Intercept’s peer Galectin Therapeutics may actually have a better NASH/fibrosis drug in GR-MD-02.’” Id. at 1265 (underlining by the court). Within a week of Galectin making its second offering, TDM published, another article “which described Galectin as ‘only a clinical data set away from a potential leap forward with GR-MD-02.’” Id. (underlining by the court).
630 Id. at 1272.
631 Id. The court further held that Galectin had made no misrepresentation itself when it stated that it had not manipulated its stock because (i) its “engagement of third parties to promote awareness of its stock and to encourage investment in its business was legal and did not constitute stock-price manipulation,” with the defendants having no duty to disclose the payments to the promoters since 15 U.S.C. § 77q(b) places that disclosure obligation on the promoters rather than the issuer, id. at 1267, 1272–73, and (ii) “manipulation” as used in Rule 10b-5 cases refers to purchases and sales that create an artificial appearance of market activity, with the plaintiff alleging no such “simulated market activity” by any defendant, id. at 1273–74. The court also rejected the argument “that Galectin’s 10-K and 10-Q reports of the results of its October 25, 2013 ATM offering were misleading because Galectin omitted that it had paid third parties to write articles promoting its stock.” Id. at 1274–75. Relying on the principle that an issuer does not violate Rule 10b-5 by omission unless it has a duty to disclose the omitted fact, the court found no such duty here:
Articles written by physicians receiving money from companies producing drugs that the articles discuss. Even in a case relying essentially on alleged misstatements, a plaintiff might name a defendant and argue that the defendant took actions sufficiently independent of the statements, yet sufficiently proximate to them, to incur liability not under subpart (b) of Rule 10b-5 (which prohibits “mak[ing]” untrue or misleading statements) but under subpart (a) (which prohibits “employ[ing] any device, scheme, or artifice to defraud”) and under subpart (c) (which prohibits “engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person”). In this way, the plaintiff might avoid the strictures of Janus, yet claim that those who prompted the misstatement were nevertheless primary Rule 10b-5 violators and therefore liable in private actions. West Virginia Pipe Trades Health & Welfare Fund v. Medtronic, Inc. reversed summary judgment for defendants in an action in which the plaintiffs alleged just such a claim.

Medtronic manufactured INFUSE, a protein inducing the human body to grow new bone tissue. The FDA approved INFUSE for specific and limited uses in 2002, but some 85% of its

in the ATM offerings that it had paid third parties to write articles about Galectin, there was no duty on Galectin to disclose in the 10-K and 10-Q reports that it had paid the same third parties to write the same articles.

. . . Commercial analysts are routinely paid to promote stocks. It cannot be said that the reasonable securities investor would conclude, based on Galectin’s reporting of the number of shares sold, price per share, and net proceeds of its October 25, 2013 ATM offering, without more, that Galectin was in some way certifying or representing that it had not paid promoters to tout its stock to potential investors. It follows that Galectin’s silence on this separate payment issue in its 10-K and 10-Q reports did not render the true facts in those reports misleading within the meaning of Rule 10b-5(b).

Id. at 1275–76 (footnote omitted). The court added—without extended analysis—that, as an “alternative and independent ground,” the complaint failed to adequately plead scienter. Id. at 1275 n.10.

633 845 F.3d 384, 391–94 (8th Cir. 2016).
634 Id. at 387.
use was for other purposes.\textsuperscript{635} The FDA publicly warned in 2008 that such off-label uses of the drug were associated with life-threatening side effects.\textsuperscript{636}

In 2010, newspaper articles and a clinical study reported in a medical journal suggested that physicians who had authored Medtronic-sponsored reports of earlier clinical tests had undisclosed financial ties with the company and might have omitted adverse side effects from their reports as a result.\textsuperscript{637} This led to a congressional hearing in 2012 and a Senate committee report saying “that Medtronic ‘was heavily involved in drafting, editing, and shaping the content of medical journal articles authored by its physician consultants who received significant amounts of money through royalties and consulting fees from Medtronic.’”\textsuperscript{638} The committee further reported “that Medtronic employees added language designed to exaggerate the disadvantages of standard spinal fusion techniques and recommended against publishing a complete list of adverse events associated with INFUSE.”\textsuperscript{639}

In defending in the court of appeals the summary judgment it had won below, Medtronic argued that the case rested on the statements and omissions of the authors of the reports that supposedly omitted side effects and favorably compared INFUSE with spinal fusion and that therefore, under \textit{Janus}, Medtronic could not be sued in a private lawsuit based on statements in those reports, which Medtronic did not “make” under Rule 10b-5(b).\textsuperscript{640} The Eighth Circuit recognized that “[t]he broader scope of scheme liability under Rule 10b-5(a) and (c) potentially offers plaintiffs a means to circumvent \textit{Janus},” but also recognized that such efforts to avoid the

\textsuperscript{635} Id.
\textsuperscript{636} Id.
\textsuperscript{637} Id. at 387–88.
\textsuperscript{638} Id. at 388.
\textsuperscript{639} Id.
\textsuperscript{640} Id. at 388 (characterizing Medtronic’s as contending that plaintiffs were trying “to hold Medtronic secondarily liable for the fraudulent statements of others”).
effect of the Supreme Court’s decision were restricted under circuit authority. A plaintiff “cannot support a scheme liability claim by simply repackaging a fraudulent misrepresentation as a scheme to defraud,” but a plaintiff can avoid Janus and move the case from Rule 10b-5’s subpart (b) to subparts (a) and (c) by “alleg[ing] some deceptive act other than the fraudulent misrepresentation.”

The Eighth Circuit held that the plaintiffs had done so here by a “scheme liability claim . . . that Medtronic shaped the content of medical journals by ‘pay[ing] physicians . . . to induce their complicity in concealing adverse events and side effects associated with the use of INFUSE and overstating the disadvantages of alternative bone graft procedures.’” While “the scheme liability claim also includes allegations that Medtronic edited language in the clinical studies that the physicians ultimately published, the act of paying physicians to induce their complicity is the allegation at the heart of the scheme liability claim,” and “[p]aying someone else to make a misrepresentation is not itself a misrepresentation.”

This, however, left the plaintiffs with a further problem, created by the Supreme Court’s decision in Stoneridge Investment Partners, LLC v. Scientific–Atlanta, Inc., where the Court held that two suppliers that had entered into round-trip transactions with a public company could not be sued by the purchasers of the public company’s stock because the deceptive acts that the suppliers had committed (e.g., misdating contracts to prevent the auditor of the public company from discovering that the transactions were economically meaningless) did not bear a sufficiently causal relationship to the resulting false financial statements that the public company published

641 Id. at 392.
642 Id. (emphasis added).
643 Id. at 393.
644 Id.
and on which the plaintiffs could claim reliance.\textsuperscript{645} As the Eighth Circuit read \textit{Stoneridge}, “a scheme liability claim must demonstrate that the causal connection between the defendants’ alleged deceptive act and the information on which the market relied is not too remote to support a finding of reliance.”\textsuperscript{646} The court found a sufficient “causal connection” here that was “not too remote to support a finding of reliance” because “paying the physician-authors to conceal adverse effects and to overstate the disadvantages of alternative procedures . . . directly caused the production of the information on which the market relied.”\textsuperscript{647}

\textit{Significance and Analysis.} The facts in \textit{Galectin} and \textit{Medtronic} are quite close. One difference seems to be that, in addition to alleging that the defendant paid a third party for reports or articles that were complimentary, the defendant in \textit{Medtronic} exercised actual control over the third party’s content and caused the third party to omit facts harmful to the defendant’s business. But if the defendant exercised such control, why would it not be liable under the \textit{Janus} analysis

\textsuperscript{645} 552 U.S. 148, 154–55 (describing round-trip transactions and backdating contracts to create the impression of chronological separation, thereby rendering the round tripping more difficult for an auditor to detect); \textit{id.} at 155 (observing that the suppliers “had no role in preparing or disseminating the public company’s financial statements”); \textit{id.} at 160–61 (recognizing that a private plaintiff suing under Rule 10b-5 must rely on the deceptive actions of the defendant and that the deceptive actions here, such as backdating the contracts, “were not disclosed to the investing public”); \textit{id.} at 161 (explaining that those deceptive acts were “too remote” from the public company’s financial statements, on which the plaintiffs could have relied at least indirectly through the market’s incorporation into security prices of the false numbers those statements contained—in part because “nothing [the suppliers] did made it necessary or inevitable for [the public company] to record the transactions as it did” and thereby produce the false financials that distorted the market price).

\textsuperscript{646} \textit{Medtronic}, 845 F.3d at 394.

\textsuperscript{647} \textit{id.} (adding that “[a] company cannot instruct individuals to take a certain action, pay to induce them to do it, and then claim any causal connection is too remote when they follow through”). The Eighth Circuit also rejected Medtronic’s argument that the Rule 10b-5 action was barred by requirement that such a claim must be filed within “2 years after the discovery of the facts constituting the violation.” \textit{id.} at 389 (citing and quoting 28 U.S.C. § 1658(b)(1)). Under \textit{Merck & Co., Inc. v. Reynolds}, 559 U.S. 633, 648 (2010), facts that a reasonably diligent plaintiff would have known are deemed to have been discovered for purposes of applying this rule. \textit{Medtronic}, 845 F.3d at 389. However, the facts that must have been discovered or deemed discovered in order to start the two-year limitations period include facts with which a plaintiff could plead scienter with the specificity and strength of inference required in private Rule 10b-5 actions. See \textit{supra} notes 279–281 and accompanying text. Since the plaintiffs could not have discovered such facts here “until October 2012 when the Senate Finance Committee released its findings that Medtronic had intentionally edited the studies to omit unfavorable results,” their June 27, 2013 complaint was timely. \textit{Medtronic}, 845 F.3d at 388, 390–91.
of Rule 10b-5(b)? Medtronic suggests that a plaintiff can pursue a defendant as a primary Rule 10b-5 violator under subparts (a) and (c) if the defendant has some control over misstatements but not “ultimate” control simply by alleging that there was a mechanism by which the defendant wielded that lesser degree of control and labeling the mechanism “deceptive” because the statement over which the control was wielded was false. Wouldn’t there always be some such mechanism, and if so, wouldn’t this reasoning very substantially erode Janus?

Rule 10b-5 Liability for Statements Made During an Attempted Merger. During a merger, the target company, if public, typically will file a Form 8-K announcing the merger agreement, with the agreement attached.648 That agreement will contain representations and warranties that the target company has made to the acquiring company and that must be true both when the agreement is signed and on the merger’s closing date.649 Where sufficient time elapses between the signing of the merger agreement and closing, the target company will file one or more Form 10-Qs or a Form 10-K,650 and the target company will also file a proxy statement by which it will seek approval of its shareholders for the merger.651

648 17 C.F.R. §§ 240.13a-1, 13a-11 (2016) (companies with a class of securities registered under section 12 of the Exchange Act must file Form 8-K); 15 U.S.C. § 78(d)(1) (2012), 17 C.F.R. §§ 240.15d-1, 15d-11 (2016) (companies that have filed registration statements under the Securities Act that have become effective must file Form 8-K); Form 8-K, Item 1.01(a) (Form 8-K must be filed when company “has entered into a material definitive agreement not made in the ordinary course of business”). Subsection (a)(2) of Item 1.01 requires the Form 8-K to include “a brief description of the terms and conditions of the agreement . . . that are material.” It is typical to attach the entire merger agreement to the 8-K. See, e.g., The Chubb Corp., Current Report (Form 8-K), Exh. 2.1 (filed July 7, 2015), https://www.sec.gov/Archives/edgar/data/20171/000119312515246790/d40501d8k.htm, with the exhibit at https://www.sec.gov/Archives/edgar/data/20171/000119312515246790/d40501dex21.htm.


650 Public companies with securities registered under the Exchange Act and companies that have filed a registration statement under the Securities Act that has become effective must file Form 10-Q and Form 10-K. 17 C.F.R. § 240.13a-1 (2016); 17 C.F.R. § 249.310(a) (2016); 17 C.F.R. § 240.13a-13 (2016); 15 U.S.C. § 78o(d)(1) (2012), 17 C.F.R. §§ 240.15d-1, 15d-13 (2016); Form 10-K, General Instruction A(2) (form to be filed after completion of fiscal year); Form 10-Q, General Instruction A(1) (form to be filed after each of the first three fiscal quarters).

651 For example, under Delaware Law, the shareholders in the target company will vote on the merger. DEL. CODE ANN. tit. 8, § 251(c) (West 2016).
Cooper Tire & Rubber, the Third Circuit addressed a Rule 10b-5 case, based on all such documents, filed after a merger broke down.652

On June, 12, 2013, Cooper Tire & Rubber Company ("Cooper") and Apollo Tyres Ltd. ("Apollo") announced a merger by which Apollo would acquire Cooper at a 40% premium over Cooper’s recent trading price.653 Cooper filed an 8-K and attached the merger agreement.654 In chronological order thereafter, Cooper filed a 10-Q on August 9 for the quarter ending June 30,655 an August 30 proxy statement,656 a September 19 8-K,657 and a September 30 8-K.658

Two labor issues arose while the merger agreement was in force. First, during the period from June 21 to August 17, workers at Cooper Chengshan Tire Company, Ltd. ("CCT") in China—owned 65% by Cooper and 35% by the Chengshan Group ("Chengshan"), headed by Chairman Che Hongzhi ("Che")—went on strike, returned to work, went out on strike again, and finally returned for work through the rest of the events.659 CCT accounted for about 25% of Cooper’s revenue and profits.660 Second, on August 1, the United Steelworkers Union ("USW") filed a grievance on the basis that the merger violated its collective bargaining agreement, which led to an arbitration and a finding in favor of the USW that "barred Cooper from selling two of its plants to Apollo, ‘unless and until the [USW] ha[s] entered into agreements with’ Apollo,” which in turn led Apollo to ask on September 25 for a price reduction,661 which—when Cooper

652 834 F.3d 481 (3d Cir. 2016).
653 Id. at 486.
654 Id. at 487.
655 Id. at 497.
656 Id. at 500.
657 Id. at 504.
658 Id.
659 Id. at 486 (identifying companies and Che); id. at 487 (detailing that strike began on June 21; workers returned on June 28; strike resumed on July 13; and ended on August 17).
660 Id. at 486.
661 Id. at 487 (alteration by court) (quoting joint appendix).
denied that request—led Apollo to decline to close.\textsuperscript{662} In a Delaware Chancery Court action that Cooper then brought against Apollo, the state court denied specific performance, but concluded “that ‘Apollo lacked the contractual right to demand renegotiation of the merger agreement based on the necessity to renegotiate USW contracts,’” and instructed Apollo to continue negotiating with the USW to try to reach an agreement.\textsuperscript{663} On December 30, 2013, Cooper terminated the merger agreement.\textsuperscript{664}

While the merger agreement was between Cooper and Apollo, another possible suitor—“Party C,” allegedly “a consortium including Chengshan”—had contacted Cooper on April 10.\textsuperscript{665} While Party C never made a definitive proposal to Cooper, it did communicate many times with Cooper—with Party C saying that it intended to make a proposal—before Cooper signed the agreement with Apollo.\textsuperscript{666}

The complaint in a class action on behalf of those who bought Cooper stock between June 12, 2013 and November 8, 2013 made a Rule 10b-5 claim against Cooper, its CEO, and its CFO.\textsuperscript{667} After the district court dismissed on the basis that the complaint failed to identify any misrepresentation as to which it adequately pled falsity and scienter, the Third Circuit

\textsuperscript{662} Id. at 487–88.
\textsuperscript{663} Id. at 488, 505.
\textsuperscript{664} Id. at 488–89.
\textsuperscript{665} Id. at 486.
\textsuperscript{666} Id.
\textsuperscript{667} Id. at 489; Compl. ¶¶ 1, 109–17, OFI Asset Management v. Cooper Tire & Rubber, 834 F.3d 481 (3d Cir. 2016) (No. 1:14CV00068), 2014 WL 358674.
affirmed. The opinion addressed the alleged misstatements in each of Cooper’s SEC filings separately.

The merger agreement attached as an exhibit to the June 12 8-K included three challenged representations and warranties. Per the agreement, each one had to be true on the date of the agreement, June 12, and the date of the closing, which never occurred—so that only the June 12 date was germane. First, Cooper represented in the merger agreement that Cooper or a subsidiary “‘ha[d] exclusive possession of each Owned Real Property and Leased Real Property,’ including the CCT facilities.” The court took this to be limited to “possession of real property,” and so concluded that allegations that CCT had its own “independent computer systems to which Cooper . . . had limited access” did not show that the representation was false. That left—as the only fact pled to show this representation false—that Cooper personnel had at some point been locked out of the CCT premises, but this allegation “lack[ed] any detail as to when the incident occurred, who was kept out, and what transpired during the incident and afterward.” Thus, it did not “support the assertion that OFI would ultimately need to prove—that Cooper lacked ‘exclusive possession’ of the CCT facility on June 12,

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668 Cooper Tire, 834 F.3d at 489, 505. The amended class action complaint covered almost 100 pages and included 245 paragraphs. Id. at 491. The district court found it so rambling and unorganized that it required the plaintiff’s counsel “to submit a letter ‘identifying and verbatim quoting’ the five most compelling examples it could muster of false or fraudulent statements by Cooper, with three factual allegations demonstrating the falsity of each statement and three factual allegations supporting a finding of scienter as to the making of the statements,” then focusing oral argument on those alleged misrepresentations. Id. at 489. Responding to the contention on appeal that this procedure deprived the plaintiff of consideration of all the alleged misstatements and a holistic review of scienter-relevant facts, the Third Circuit noted that the plaintiff’s “kitchen-sink pleading has been a hindrance at every stage of these proceedings,” and concluded that there was no error because “[a] District Court enjoys substantial discretion in managing complex disputes, particularly when, as in this case, the claims become unwieldy.” Id. at 491–92; see also id. at 493 n.9 (“[T]he District Court did nothing to abuse its broad case management discretion in this instance.”).
669 Id. at 494–505.
670 Id. at 494–97.
671 Id. at 494.
672 Id. at 494–95 (alteration by the court) (quoting the plaintiff that, in turn, quoted the merger agreement).
673 Id. at 495.
674 Id.
Second, Cooper represented that it “maintained internal control over financial reporting [that was] effective in providing reasonable assurance regarding . . . prevention or timely detection of unauthorized acquisition, use or disposition of the Company’s assets that could have a material effect on its financial statements.” The Third Circuit found that the plaintiff did not plead this false by alleging that CCT had an “independent” financial system that collected information then transferred on to Cooper, as the plaintiff failed to “allege that Cooper had experienced any difficulty with that arrangement in the past, let alone anything that would call into question its efficacy in detecting fraud that could materially affect Cooper’s financial statements.”

Third, Cooper represented in the merger agreement that there “was not ‘pending or . . . threatened, nor has there been for the past five years, any labor strike or lockout or any material dispute, walk-out, work stoppage or slowdown involving [Cooper] or any of its Subsidiaries.’” While the plaintiff alleged that Cooper knew that Che and Chengshan would oppose the merger and that Chengshan had in fact orchestrated the post-June 12 strike at CCT, the specifically pled facts led the court to conclude that Che’s probable reaction to the merger was unknown, and that Cooper thought that Che might actually support the merger if he was compensated. As to possible labor problems with USW if a merger were announced, the complaint pled only that Cooper appreciated this risk and was preparing for it, but no facts to

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675 Id.
676 Id. at 496 (quoting merger agreement).
677 Id. The additional allegation that Cooper’s control over CCT was “illusory” was insufficiently particular to satisfy the PSLRA pleading rules. Id.
678 Id. (alterations by the court) (quoting merger agreement).
679 Id.
680 Id. at 499. That strike began after June 12. See supra note 659.
681 Id. at 496–97.
show that Cooper knew “that a material dispute with the USW was either pending or threatened as of June 12, 2013.”682

The plaintiffs contended that Cooper’s August 9 Form 10-Q was false for two reasons, the first of which was that the company stated “that there were ‘no other changes in the Company’s internal controls over financial reporting during the quarter ended June 30, 2013 that have materially affected, or are reasonably likely to materially affect, the Company’s internal controls over financial reporting.’”683 While the plaintiff alleged that, in fact, Cooper lost its ability to collect financial information from CCT on August 19, that date was “ten days after the filing, and over a month after the reporting period closed [on June 30].”684 Second, the plaintiff asserted that the 10-Q misled by characterizing the strike at CCT, which started during the second quarter, as “implemented” by CCT’s “unionized workforce,” when in fact it was Chengshan behind the work stoppage, and also misled by characterizing the strike as “temporary.”685 As to the suggestion that the workers initiated the strike, the court held that even if Che had been the motivating force, nothing suggested a strong inference that the defendants had scienter about any falsity, as the characterization “was a single phrase buried within a filing that encompassed dozens of pages,” and nothing indicated that any of the defendants “stood to gain from this relatively minor misrepresentation, if that’s what it was.”686 As to calling the strike “temporary,” the Third Circuit recognized that adjective to be forward-looking, and concluded that the language in the 10-Q warning that “if there were ‘[a]n extended work

682 Id. at 497.
683 Id.
684 Id. at 497–98; see Cooper Tire & Rubber Co., Quarterly Report (Form 10-Q), cover page (filed August 9, 2013) (stating that the report was “[f]or the quarterly period ended June 30, 2013”).
685 Cooper Tire, 834 F.3d at 498–500.
686 Id. at 499. The court was also skeptical of the materiality of this alleged misstatement, as the plaintiff “did not plead any facts demonstrating that the extra information about Che’s support for the strike would have materially affected the closing of the merger.” Id.
stoppage at [CCT, it] could negatively affect the Company’s future financial performance””
brought the “temporary” characterization within the PSLRA safe-harbor.687

Turning to the August 30 proxy statement, the plaintiff contended, first, that it included projections that were false because they were above projections that Cooper provided to Apollo between July 21 and August 9.688 But the proxy statement said only that the projections it included had been provided to Apollo during the negotiations leading up to the June 12 merger agreement, and specifically advised that readers should not rely on the projections and that they were outdated.689 They therefore were not “false.”690 As to the plaintiff’s second claim that the proxy statement was false when it said that the strike at CCT was not “expected to have an effect on the consummation of the merger,” the court found this statement to be forward-looking and protected from a private lawsuit by meaningful cautionary language (i) warning that “labor problems” and “disruptions” and “changes in [Cooper’s] relationship with joint-venture partners” “could cause . . . actual results . . . to differ materially from those . . . implied by forward-looking statements” and (ii) disclosing that “the strike was underway, that CCT’s employees were ‘demanding termination of the merger,’ that the strike had started and stopped before, and that CCT was then denying Cooper access to the facility and withholding financial information.”691

Third and finally as to the proxy statement, the plaintiff contended that Cooper misled by stating that Party C had been a potential purchaser without disclosing that Party C was a group headed

687 Id. at 500 (“[A]cknowledgement of the business effects of the then-active strike, and its reference to the implications of that stoppage persisting or later being renewed, provided sufficient notice to the reader about the specific risks attached to the forward-looking statement”); see 15 U.S.C. § 78u-5(c)(1)(A)(i) (2012). Supra note 477 explains the Exchange Act protections for forward-looking statements in private actions brought under that statute.
688 Cooper Tire, 834 F.3d at 500.
689 Id. at 501.
690 Id.
691 Id. at 501–02.
by Chengshan. The Third Circuit held that Cooper was not obligated to make such a disclosure because the failure to do so did not render any statement in the proxy solicitation either false or misleading.

Turning last to the two 8-Ks in September, the plaintiff alleged them misleading because they did not say that the USW arbitration decision, and Apollo’s reaction to that decision, imperiled the merger’s closing. But Cooper filed the first of these 8-Ks on September 19, before Apollo requested a price reduction on September 25, or indicated that the deal was contingent on such a reduction. Although Cooper filed the second 8-K on September 30—after the requested price reduction—the court held that the failure to disclose that development created no cause of action because Cooper “believed Apollo had no contractual right to demand such a reduction”—a view that the Delaware Chancery court confirmed.

Significance and Analysis. While the court addressed each of the allegedly false representations and warranties in the merger agreement with a standard Rule 10b-5 analysis, it introduced its discussion by quoting an extensive passage from the June 12, 2013 8-K that attached the agreement. That passage said, among other things, that investors “should not rely on the representations and warranties in the Merger Agreement as characterizations of the actual state of facts about the Company.” Similarly, in discussing the projections included in the

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692 Id. at 503.
693 Id. ([Section] 10(b) and Rule 10b–5 do not impose liability for ‘statements that are simply incomplete,’ only those that are ‘misleading or untrue.’” (quoting Winer Family Tr. v. Queen, 503 F.3d 319, 330 (3d Cir. 2007))).
694 Id. at 504.
695 Id.
696 Id. at 505 (“Cooper’s choice not to disclose a request by Apollo that it was not entitled to make thus does not constitute an actionable material misrepresentation.”).
697 Id. at 494.
698 Id. Here is the full passage:

The Merger Agreement contains representations and warranties made by the Company and the Apollo Parties to, and solely for the benefit of, each other. The assertions embodied in the

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proxy statement, the court noted that that filing said that readers “should not rely on the projections.” In neither case did the Third Circuit hold that the plaintiff could not recover for want of reliance. But the circumstance that the court quoted the language suggests that this careful lawyering paid off in setting the stage for a defense victory, and the language could have been relevant on scienter, as it seems inconsistent with an intent to defraud for the defendant to explicitly tell investors that they should not rely on statements that the plaintiff later claims to be wrong.

As set out above, the court concluded that the plaintiff could not successfully sue on two statements about the strike at CCT because the alleged misrepresentations were accompanied with meaningful cautionary language that shielded them from private lawsuits under the statutory representations and warranties contained in the Merger Agreement are qualified by information in confidential disclosure letters provided by the parties to each other in connection with the signing of the Merger Agreement. While the Company does not believe that these disclosure letters contain information that the securities laws require the parties to publicly disclose, other than information that has already been so disclosed, they do contain information that modifies, qualifies and creates exceptions to the representations and warranties of the parties set forth in the Merger Agreement. You should not rely on the representations and warranties in the Merger Agreement as characterizations of the actual state of facts about the Company or the Apollo Parties, since they were only made as of the date of the Merger Agreement and are modified in important part by the underlying disclosure letters. Moreover, certain representations and warranties in the Merger Agreement were used for the purpose of allocating risk between the Company and the Apollo Parties rather than establishing matters as facts. Finally, information concerning the subject matter of the representations and warranties may have changed since the date of the Merger Agreement, which subsequent information may or may not be fully reflected in the companies’ public disclosures.

Cooper Tire & Rubber Co., Current Report (Form 8-K), 3 (June 12, 2013) (emphasis by the court added), https://www.sec.gov/Archives/edgar/data/24491/000119312513256252/d555217d8k.htm; see Cooper Tire, 834 F.3d at 494. 699

699 Cooper Tire, 834 F.3d at 501. The full passage read:

[The] financial projections set forth below are included in this proxy statement only because this information was provided to the Apollo Parties . . . in connection with a potential transaction involving Cooper Tire . . . You should not regard the inclusion of these projections in this proxy statement as an indication that Cooper Tire, the Apollo Parties, [or other relevant parties] considered or consider the projections to be necessarily predictive of actual future events, and you should not rely on the projections as such.

Id. (emphasis by the court).

700 See id. at 493 (listing reliance as an element of a Rule 10b-5 claim).
protection for forward-looking statements. 701 In the second instance, the court rejected the plaintiff’s argument that, even if a defendant accompanies a forward-looking statement with language warning of risks, the statement is still actionable if the defendant could not have believed the statement to be true. 702 The Third Circuit joined other circuits in holding that “whether [the defendants] believed th[e] statement to be true at the time is irrelevant, as long as there was sufficient ‘meaningful cautionary language.’ ”

Statutes of Limitation. Two courts of appeals applied the five-year statute of limitations in 28 U.S.C. § 2462 in SEC actions, reaching different conclusions as to whether that statute governs Commission claims for disgorgement. 704 Three courts of appeals held that the pendency of a class action does not toll the repose periods applicable to either (i) claims under sections 11 and 12 of the Securities Act or (ii) claims under Rule 10b-5 and the related control person statute. 705 The Second Circuit held that the statute of limitations in sections 9 and 18 of the Exchange Act governs claims for violation of section 14(a). 706

Limitations in an SEC enforcement action. Unless some other law imposes another limitations period, Section 2462 of Title 28 governs “an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise,” and provides that a claim for any such relief “shall not be entertained unless commenced within five years from the date when the claim first accrued.” 707 The district court in SEC v. Graham applied this statute to

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701 See supra text accompanying notes 687 and 691.
702 Cooper Tire, 834 F.3d at 502–03.
703 Id. at 503; see also In re Cutera Sec. Litig., 610 F.3d 1103, 1112 (9th Cir. 2010); Miller v. Champion Enter., Inc., 346 F.3d 660, 672 (6th Cir. 2003); Edward J. Goodman Life Income Tr. v. Jabil Circuit, Inc., 594 F.3d 783, 795 (11th Cir. 2010) (quoting Harris v. Ivax Corp., 182 F.3d 799, 803 (11th Cir. 1999)).
704 See infra notes 707–721 and accompanying text.
705 See infra notes 723–731 and accompanying text.
706 See infra notes 732–749 and accompanying text.
dismiss the Commission’s entire action, which sought (i) an injunction forbidding the defendants from violating federal securities laws, (ii) a declaration that the defendants had violated such laws, (iii) disgorgement of all profits from defendants’ illegal business, and (iv) civil penalties.\footnote{823 F.3d 1357, 1359 (11th Cir. 2016).}

The district court did so because the alleged securities violations occurred more than five years before the SEC filed its lawsuit.\footnote{Id.} On appeal, the SEC conceded that section 2462 barred the civil penalties.\footnote{Id. at 1360.}

The Eleventh Circuit held that 2462 did not apply to bar the suit insofar as it sought an injunction because an injunction “typically look[s] forward in time” and is not a “penalty,” which “addresses a wrong done in the past.”\footnote{Id. at 1361.} In contrast, a declaration that the defendants had violated the securities law was “backward-looking” and “intended to punish because it serves neither a remedial nor a preventative purpose.”\footnote{Id. at 1362.} Accordingly, it “fit[] the definition of a penalty,” and was therefore “subject to § 2462’s five-year statute of limitations.”\footnote{Id. at 1363.} And disgorgement of ill-gotten gains was “a subset of forfeiture,” subject to section 2462’s five-year limitation because that statute applies to forfeitures.\footnote{Id. at 1363–64 (finding “no meaningful difference in the definitions of disgorgement and forfeiture”).} Affirming insofar as the judgment dismissed the claims for civil penalties, declaratory relief, and disgorgement, the court reversed insofar as the SEC sought an injunction.\footnote{Id. at 1364. As it had done in the past, the Eleventh Circuit condemned the form of the injunction that the SEC requested, as it would forbid, in a blanket way, the defendants from violating federal securities laws. \textit{Id.} at 1359, 1362 n.2. In the court’s view, such “obey-the-law” injunctions fail the Federal Rule of Civil Procedure Rule 65(d) standard that requires that every injunction “describe in reasonable detail—and not by referring to the complaint or other document—the act or acts restrained or required.” \textit{Id.} at 1362 n.2; \textit{Fed. R. Civ. P.} 65(d). But the Eleventh Circuit agreed with the SEC that it was “premature” to consider this question as the district court had not yet issued any injunction in the case. \textit{Graham}, 823 F.3d at 1362 n.2.}

\footnote{823 F.3d 1357, 1359 (11th Cir. 2016).}
In SEC v. Kokesh, the Tenth Circuit likewise held that section 2462 does not apply to an SEC claim for an injunction, on much the same reasoning as the Eleventh: an injunction’s “purpose is not to penalize,” but to “give[ the d]efendant an added incentive to conduct himself in accordance with the securities laws.” An injunction “is ‘purely remedial and preventative,’ and not a penalty or forfeiture.” But the Tenth Circuit explicitly disagreed with the Eleventh on disgorgement, holding that disgorgement “is not a penalty under § 2462 because it is remedial”—merely “depriving the wrongdoer of the benefits of wrongdoing,” and not a forfeiture because, at the time section 2462 was enacted, forfeitures were a species of in rem proceeding. Accordingly, the Tenth Circuit affirmed an injunction and disgorgement judgment, ruling that the five-year limitations period in section 2462 did not apply to either. The Court has granted certiorari in Kokesh to address whether 2462 applies to disgorgement.

In an unreported case, the Second Circuit affirmed a judgment that included civil penalties, finding that “[t]he district court . . . correctly limited civil penalties to ‘gains only from frauds occurring within the five-year statute of limitations for civil penalties.’” SEC v. Amerindo Inv. Advisors, 639 F. App’x 752, 754 (2d Cir. 2016) (quoting district court), cert. denied, 136 S. Ct. 2429 (2016) (mem.).

Under 28 U.S.C. § 2462, any “action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued.” The question presented is: Does the five-year statute of limitations in 28 U.S.C. § 2462 apply to claims for “disgorgement”? https://www.supremecourt.gov/qp/16-00529qp.pdf.
American Pipe tolling and repose in actions under sections 11 and 12 and actions under Rule 10b-5. Securities Act section 13 provides that “[n]o action shall be maintained to enforce any liability created under section [11] or [12](a)(2) of this title unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, . . . [and that i]n no event shall any such action be brought to enforce a liability created under section [11] . . . of this title more than three years after the security was bona fide offered to the public, or under section [12](a)(2) of this title more than three years after the sale.”

Title 28, section 1658(b) of the U.S. Code provides that “a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, . . . may be brought not later than the earlier of—(1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation.” This latter statute applies to claims brought for violations of Rule 10b-5.

In American Pipe & Construction Co. v. Utah, the Supreme Court held that a case that is filed as a class action but in which no class is certified tolls statutes of limitation from the time the case is commenced until the class certification motion is denied. By its 2013 opinion in Police and Fire Retirement System of City of Detroit v. IndyMac MBS, Inc., the Second Circuit held that the three-year period in section 13 constitutes a statute of repose—“creat[ing] a substantive right, extinguishing claims after a three-year period”—and that “[p]ermitting a

726 414 U.S. 538, 554 (1974) (“[T]he commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class who would have been parties had the suit been permitted to continue as a class action”); id. at 561 (“[T]he commencement of the class action in this case suspended the running of the limitation period only during the pendency of the motion to strip the suit of its class action character.”).
plaintiff to file a complaint or intervene after the repose period set forth in Section 13 of the Securities Act has run would therefore necessarily enlarge or modify a substantive right and violate the Rules Enabling Act.”**727** “Accordingly, . . . American Pipe’s tolling rule, whether grounded in equitable authority or on Rule 23, does not extend to the statute of repose in Section 13.”**728**

In 2016, the Sixth Circuit reached the same conclusion with respect to section 13 in *Stein v. Regions Morgan Keegan Select High Income Fund, Inc.*, and extended that reasoning to the five-year period in 28 U.S.C. § 1658(b)(2).**729** The court therefore affirmed dismissal of claims under sections 11 and 12 of the Securities Act because the actions were filed more than three years after the violations, and dismissed claims under section 10(b) of the Exchange Act and Rule 10b-5 because the actions were filed more than five years after the violations.**730** On the same reasoning, the Second Circuit (via a ruling on a control person claim) and the Eleventh

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**727** 721 F.3d 95, 107, 109 (2d Cir. 2013) (emphasis by the court).

**728** Id. at 109.

**729** 821 F.3d 780, 793 (6th Cir. 2016) (finding *Police & Fire Ret. Sys. of City of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95 (2d Cir. 2013), “cogent and persuasive”); id. at 793–94 (holding both the three-year period in section 13 and the five-year period in 1658(b)(2) are periods of repose); id. at 794–95 (holding statutes of repose “vest a substantive right” and “regardless of whether American Pipe tolling is derived from courts’ equity powers or from Rule 23, it does not apply to statutes of repose”).

**730** Id. at 795. The plaintiffs bought interests in five investment funds and sued the funds’ investment adviser and two corporate parents. Id. at 783. The funds replaced the defendant investment adviser in July 2008. Id. The court concluded:

> Plaintiffs filed the instant actions on October 25, 2013, asserting claims with repose periods of three and five years. If the repose periods began to run before October 25, 2010 for the Securities Act claims and October 25, 2008 for the Securities Exchange Act claims, Plaintiffs’ claims are barred . . . in their entirety. Unquestionably, they did—the non-fund Defendants turned over management of the closed-end funds at some point in July 2008, and the complaints allege no misconduct whatsoever by any Defendant after that date. Plaintiffs’ claims are thus time-barred by the statutes of repose.

Id. at 795.
Circuits also held, in 2016, that *American Pipe* tolling is inapplicable to toll the five years in section 1658(b).\(^{731}\)

**Limitations period for proxy violation claim.** Section 14(a) of the Exchange Act prohibits solicitation of proxies to vote any security registered under section 12 of that act “in contravention of such rules and regulations as the Commission may prescribe.”\(^{732}\) Rule 14a-9, in turn, prohibits such solicitation “by means of any proxy statement . . . containing any statement which . . . is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading . . . .”\(^{733}\)

In *DeKalb County Pension Fund v. Transocean Ltd.*, the Second Circuit affirmed dismissal of a Rule 14a-9 claim by the DeKalb Fund (“DeKalb”) against Transocean, a claim alleging that a proxy statement Transocean disseminated on October 2, 2007, to seek authority to vote

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\(^{731}\) SRM Global Master Fund Ltd. P’ship v. Bear Sterns Cos., 829 F.3d 173, 177 (2d Cir. 2016) (“For the reasons we provided in *IndyMac*, we hold that *American Pipe* tolling does not apply to § 1658(b)(2)’s five-year statute of repose . . . . Because the complaint fails to allege that the defendants made any misrepresentations within five years of the filing of SRM’s complaint, SRM’s Section 10(b) and Rule 10b–5 claims are time-barred under § 1658(b)(2)’s five-year statute of repose.”), *petition for cert. filed* (U.S. Sept. 22, 2016) (No. 16-372); Dusek v. JPMorgan Chase & Co., 832 F.3d 1243, 1245–46 & n.4 (11th Cir. 2016) (A class of investors in Bernard L. Madoff Investment Securities LLC (“BLMIS”) filed an action against JPMorgan Chase and two executives on March 28, 2014, seeking to recover the value of securities listed on their BLMIS account statements and alleging, among other claims, that the defendants were liable as control persons of BLMIS and Mr. Madoff, and that Madoff and BLMIS had violated Rule 10b-5), *petition for cert. filed* (U.S. Sept. 26, 2016) (No. 16-389); *id.* at 1246–47 (28 U.S.C. § 1658(b) provided the applicable periods of limitation and repose, with the five-year period in (b)(2) one of repose); *id.* at 1249 (affirming dismissal of securities law claim and “hold[ing] that *American Pipe* tolling does not apply to the statute of repose at issue in this case”).

The *Dusek* plaintiffs also alleged a RICO claim, dismissed below on the ground it violated the prohibition that “no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of section 1962 [of the federal RICO Act].” *Id.* (alteration in original) (quoting 18 U.S.C. § 1964(c) (2014)). The Eleventh Circuit affirmed that ruling, holding that the plaintiffs could not avoid the prohibition by pleading mail and wire fraud as predicate acts where the “conduct . . . would have been actionable as securities fraud”—here “the fraudulent conduct of Madoff and BLMIS relating to securities investments.” *Id.* The plaintiffs also included state law claims, which the district court dismissed without prejudice after declining to exercise supplementary jurisdiction. *Id.* at 1246.


\(^{733}\) 17 C.F.R. § 240.14a-9(a) (2016).
Transocean stock in connection with a merger, included false and material statements concerning Transocean’s safety protocols and blowout preventer technology.”

The decision turned on which limitations period applied. While another plaintiff filed a class action on September 30, 2010, DeKalb first appeared in the action on December 3, 2010, when it filed a motion to be appointed lead plaintiff—a motion resulting in both the first plaintiff and DeKalb proceeding as co-lead plaintiffs. After the district court dismissed the first plaintiff because it did not have standing, DeKalb continued as the only lead plaintiff, filing a second amended complaint on April 18, 2012.

Congress had enacted 28 U.S.C. § 1658(b) since the last time the Second Circuit had considered which limitations period applied to a section 14(a) case. As set out above, section 1658(b) provides two-year and five-year periods for “a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws,” with the five-year period constituting a statute of repose. If section 1658(b) applied, and assuming that the repose period began to run on October 2, 2007, DeKalb’s appearance in the litigation on December 3, 2010 would fall within the five-year repose period. The Second Circuit, however, held that section 1658(b) did not apply because its coverage extends only to claims for “fraud, deceit, manipulation, or contrivance,” which the

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734 817 F.3d 393, 398–400, 415 (2d Cir. 2016), petition for cert. filed (U.S. Aug. 12, 2016) (No. 16-206).
735 Id. at 399.
736 Id. at 400.
737 Id. at 397–98. The Second Circuit had considered the limitations periods applicable to a section 14(a) in Ceres Partners v. GEL Associates, 918 F.2d 349 (2d Cir. 1990). Id. at 397. Congress added 28 U.S.C. § 1658 in 2002, as part of the Sarbanes Oxley Act (“SOX”). Id. at 398.
738 28 U.S.C. § 1658(b) (2012); DeKalb, 817 F.3d at 398; see supra notes 729 and 731 and accompanying text.
court held must be “claims requiring proof of fraudulent intent,” and a plaintiff making a section 14(a) claim can prevail simply by showing negligence.

Conducting a rather labyrinthine analysis, the court concluded that the limitations statute applicable to a 14(a) claim is the statute that governs claims under Exchange Act sections 9 and 18, each of which provides that “[n]o action shall be maintained to enforce any liability created under this section, unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation.” The Second Circuit reasoned that it had previously held that these limitations periods on express causes of action in the Exchange Act applied to the implied action under section 14(a). Even though 28 U.S.C. § 1658(b) now provides the statute of limitations for section 9 claims and 18 claims because actions under both 9 and 18 rest on fraud, the limitations periods in sections 9 and 18 remain

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739 DeKalb, 817 F.3d at 403 (first quoting 28 U.S.C. § 1658(b); then quoting and agreeing with In re Exxon Mobil Corp. Sec. Litig., 500 F.3d 189, 197 (3d Cir. 2007)) (citing and agreeing with Jones v. Southpeak Interactive Corp. of Del., 777 F.3d 658, 667–68 (4th Cir. 2015)).
740 Id. at 409. The court observed that—at the time it enacted SOX—Congress must have known of the “myriad decisions” holding that section 14(a) liability required naught more than negligence and therefore understood that section 1658, with its application limited to claims for “fraud, deceit, manipulation, or contrivance,” would not change the limitations period for section 14(a) claims. Id. at 409–10.
741 Id. at 401, 408–10.
742 15 U.S.C. §§ 78i(f), 78r(c) (2012).
743 DeKalb, 817 F.3d at 401–02.
744 As to section 9, the Second Circuit wrote: Congress clearly intended [28 U.S.C. § 1658(b)] to apply to “claims requiring proof of fraudulent intent.” A claim arising under Section 9(f), “the statutory provision that governs securities price manipulation claims,” is exactly that, as it “contain[s] requirements of both manipulative motive and willfulness.”

Id. at 403 (footnotes omitted).

As to section 18, the Second Circuit noted the Supreme Court’s “statement that Section 18(a) requires ‘scienter.’” Id. at 406 (quoting Musicik, Peeler & Garrett v. Emp'rs Ins. of Wausau, 508 U.S. 286, 296–97 (1993)). But the court cautioned that a plaintiff need not plead or prove scienter in a section 18(a) case, id. at 405, with fraud coming into such an action through the statute’s provision that a defendant can escape if the defendant “prove[s] that he [or she] 'acted in good faith and had no knowledge that [the challenged] statement was false or misleading,'” id. at 407 (quoting 15 U.S.C. § 78r(a) (2012)), so that “[a] plaintiff asserting a Section 18(a) claim is, in essence, asserting a fraud claim—a fraud claim with respect to which the defendant, and not the plaintiff, uncharacteristically bears the burden of proof regarding the defendant’s state of mind, but a fraud claim no less,” id. (footnote omitted).
applicable to section 14(a) as Congress—being aware that the courts had borrowed the section 9 and 18 limitations periods for 14(a) claims—could not have intended to displace application of those borrowed statutes by a new limitations period governing only claims based on “fraud, deceit, manipulation, or contrivance,” which Congress knew the courts did not require for a section 14(a) claim.\footnote{Id. at 409–10.}

The three-year periods in sections 9 and 18 were periods of repose, meaning that any claim filed more than three years after the section 14(a) violation was barred.\footnote{Id. at 410.} Because the violation occurred on October 2, 2007, DeKalb “had until October 2, 2010 to file its Section 14(a) claim.”\footnote{Id. at 411–12.} Because DeKalb “did not appear in the action until December 3, 2010,” its claim was barred.\footnote{Id. at 412.}

_Significance and Analysis._ DeKalb is a true oddity. After holding that the limitation provisions written into both section 9 and section 18 have been superseded—in application to claims under _those_ statutes—by 28 U.S.C. § 1658(b),\footnote{Id. at 398, 415.} the Second Circuit held that those

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\footnote{Id. at 409–10.}
\footnote{Id. at 410.}
\footnote{Id. at 411–12.}
\footnote{Id. at 412. The court rejected DeKalb’s argument that, under the relation back doctrine encompassed in Federal Rule of Civil Procedure 17(a)(3), “the consolidated complaint naming DeKalb as a lead plaintiff should be deemed timely filed on September 30, 2010[, when the initial plaintiff first filed,] because DeKalb was substituted in as the real party in interest.” _Id._ (internal quotation marks omitted). The Second Circuit found that DeKalb had failed to even suggest that its failure to file earlier resulted from an understandable and honest mistake with a reasonable basis—prerequisites for its argument. _Id._ In any event, the court concluded, the initial complaint, having been filed by a party without standing, was a nullity to which no later pleading could relate back. _Id._ at 412–13. DeKalb’s contention that the 60-day period provided for class members to move for appointment as lead plaintiff, 15 U.S.C. § 78u–4(a)(3)(A)(i), tolled the three-year period fared no better. _Id._ at 413. The court of appeals saw nothing in the statute that “even remotely suggests that [it] was intended to toll the applicable statutes of repose for the 60 days.” _Id._ at 413. And the Second Circuit rejected DeKalb’s argument that its claim survived under the tolling rule announced in _Am. Pipe & Constr. Co. v. Utah_, 414 U.S. 538 (1974). _Id._ at 413–14. If considered an equitable principle, it could not apply to vary a statute of repose because equitable tolling is inapplicable to repose. _Id._ at 414. If considered “legal in nature,” _American Pipe_ tolling could not, under the Rules Enabling Act, vary the substantive right created by the three-year period of repose. _Id._}
\footnote{Id. at 398, 415.}
superseded limitations provisions live a kind of legal afterlife, as they are still appropriately borrowed for the implied right of action under another statute, section 14(a).

*Item 303.* Regulation S-K Item 303(a)(3)(ii) requires a company subject to it to “[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.” The Second Circuit interpreted that rule last year in *Indiana Public Retirement System v. SAIC, Inc.* The plaintiff alleged that SAIC hired Gerard Denault to manage a contract SAIC had won to develop and provide to New York City (“NYC”) an automated timekeeping program called CityTime. Denault arranged for Technodyne to staff the project, then entered into a scheme by which Technodyne paid Denault (and SAIC’s Chief Systems Engineer) an illegal kickback for each hour that a Technodyne consultant or subcontractor worked on CityTime. The plaintiff charged that the scheme began to fall apart in late December 2010, and that subsequent events included an internal SAIC investigation, administrative leave for Denault followed by his resignation, a criminal investigation and criminal complaint filed against him, and an announcement by the NYC Mayor that he was reevaluating SAIC’s role in the CityTime project and reviewing payments to SAIC with a view to recovering them.

On June 2, 2011, SAIC filed a Form 8-K disclosing a joint criminal investigation of the CityTime work by the U.S. Attorney’s Office for the Southern District of New York and the NYC Department of Investigation, Denault’s arrest for fraud, the Mayor’s intention to recover

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751 818 F.3d 85 (2d Cir. 2016).
752 Id. at 89.
753 Id.
754 Id. at 89–90.
payments to SAIC for the CityTime project, and SAIC’s offer to refund $2.5 million to NYC.755 On July 1, 2011, SAIC filed an 8-K including a letter from the Mayor demanding reimbursement of $600 million, and in March 2012, SAIC entered into a deferred prosecution agreement by which it agreed to reimburse NYC $500.4 million and forego receivables of $40 million.756 SAIC stock price declined during these events.757

The plaintiffs brought a Rule 10b-5 action against SAIC and its CEO and CFO.758 Partially vacating a judgment that the district court entered after dismissing the case,759 the Second Circuit held that the lower court had improperly denied the plaintiffs’ motion to amend their complaint insofar as it alleged a Rule 10b-5 claim resting on SAIC’s failure to comply with Item 303, and an accounting rule, in a Form 10-K that the company filed on March 25, 2011.760 Specifically, the plaintiffs contended that the 10-K violated Item 303(a)(3)(ii) “by failing to disclose: ‘(i) that SAIC had overbilled [the City] hundreds of millions of dollars on CityTime over a multi-year period; and (ii) that SAIC’s overbilling practices subjected it to numerous undisclosed risks, including monetary risks and reputational risks, particularly because government agencies are SAIC’s primary customers and any harm to its reputation and/or

755 Id.
756 Id. at 90.
757 Id. (with the price falling from $17.21 on June 2, 2011 to $12.97 on September 1, 2011). By the time the case arrived in the Second Circuit, the plaintiff alleged a class period from March 23, 2011 to September 1, 2011. Id. at 93.
758 Id. at 88.
759 Id. at 98.
760 Id. at 88, 89 (providing the date of the 10-K filing). Form 10-K requires a company to “[f]urnish the information required by Item 303 of Regulation S-K.” 10-K, Item 7.

The case came to the court of appeals after the plaintiffs “moved to vacate or to obtain relief from the judgment pursuant to Rules 59(e) and 60(b) of the Federal Rules of Civil Procedure and moved under Rule 15(a) for leave to file a proposed amended complaint.” SAIC, Inc., 818 F.3d at 91. Since “the District Court denied leave to amend under Rule 60(b)(6) solely on the ground that amendment . . . would be futile,” the Second Circuit “assess[ed] futility as [it] would a motion to dismiss, determining whether the proposed complaint contains ‘enough facts to state a claim to relief that is plausible on its face.’” Id. at 92 (quoting Bell Atl. Corp. v. Twombly, 550 U.S. 544, 570 (2007)).
relationships with such agencies would adversely affect its current business, as well as its future revenues and growth prospects.”

The court read the “plain language of Item 303 [as] confirm[ing its] previous assumption that [item 303] requires the [company’s] actual knowledge of the relevant trend or uncertainty.” But the court held that the proposed amended complaint alleged facts “support[ing] a strong inference that SAIC actually knew (1) about the CityTime fraud before filing its Form 10–K on March 25, 2011, and (2) that it could be implicated in the fraud and required to repay the City the revenue generated by the CityTime contract.” The court reached this conclusion on a plethora of allegations, including that (i) SAIC knew by the end of December 2010 that the authorities were investigating Denault for criminal violations (with SAIC advancing Denault’s legal fees related to that investigation); (ii) a December 2010 criminal complaint suggested SAIC’s involvement in the wrongdoing; (iii) SAIC had initiated its own internal investigation by December 19, 2010; (iv) the Mayor had issued a press release reported in NYC newspapers, saying that the city was looking into recovering money paid to SAIC on the CityTime project; (v) SAIC had interviewed its Chief Engineer on the project on January 24, 2011, and had agreed by February 11, 2011 to pay his legal fees in connection with the criminal matter; and (vi) SAIC’s internal auditors had provided on March 9, 2011 a memorandum about Denault’s improper practices.

Of course, knowledge of a trend or uncertainty is not enough to require an Item 303 disclosure. The trend or uncertainty must be one that the issuer “reasonably expects will have a

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761 SAIC, Inc., 818 F.3d at 94 (alteration by the court) (quoting plaintiffs).
762 Id. at 95.
763 Id.
764 Id. at 91–92.
material favorable or unfavorable impact on net sales or revenues or income from continuing operations.” 765 And the Second Circuit had ruled in 2015 that Item 303 could provide the duty to disclose, violation of which would support a Rule 10b-5 claim, provided that the omission was material, and provided that all the other elements of a Rule 10b-5 claim are also present. 766 Despite the company’s argument that the CityTime contract for $635 million was insignificant because its annual revenues totaled $10 billion, the court of appeals found that it could not conclude at the pleading stage that the Item 303 omissions were “‘so obviously unimportant’ either quantitatively or qualitatively that they could not be material.” 767 The Second Circuit could not do so because the plaintiffs alleged that the CityTime fraud (i) threatened SAIC’s “anticipated . . . potential sale of CityTime’s timekeeping software to other municipalities [which] presented a ‘market opportunity valued [internally] at approximately $2 billion’—twenty percent of its yearly revenue”; and (ii) threatened “possible exposure to significant civil and even criminal liability arising from the submission of fraudulent time and billing records to the City and the resulting risk of loss of revenue from future contracts for CityTime projects or debarment from other government contracts altogether.” 768 Indeed, the plaintiffs alleged that “in December 2010, as a result of the CityTime fraud, both the City and New York State rejected pending contract awards to SAIC valued at more than $150 million.” 769

767 SAIC, Inc., 818 F.3d at 96 (quoting ECA & Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 197 (2d Cir. 2009) (quoting Ganino v. Citizens Utils. Co., 228 F.3d 154, 162 (2d Cir.2000) (explaining the standard to dismiss on the basis that alleged misrepresentations or omissions are immaterial))).
768 Id. at 95–96.
769 Id. at 95.

The Second Circuit also held that the proposed amended complaint adequately alleged a Rule 10b-5 claim based on the claim that SAIC “violated GAAP by failing to comply with FAS 5, which requires the issuer to disclose a loss contingency when a loss is a ‘reasonable possibility,’ meaning that it is ‘more than remote but less than likely.’ Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5, Accounting for Contingencies ¶¶ 3, 10 (1975).” Id. at 93. In particular, the plaintiffs “assert[ed] that SAIC failed to disclose the loss contingency related to the CityTime fraud in SAIC’s March 2011 Form 10–K.” Id. Factual
Miscellaneous. The Eleventh Circuit held that misrepresentations made to the Government National Mortgage Association ("Ginnie Mae") were "in connection with the purchase or sale" of securities and "in the offer or sale of any securities" within the meaning of Rule 10b-5 and section 17(a), respectively, where defendants made the misstatements for the purpose of obtaining Ginnie Mae guarantees for securities that the defendants were selling.\footnote{See infra notes 774–778 and accompanying text.}

The Tenth Circuit found that interests in a limited liability company ("LLC") were not "investment contracts" and therefore not securities under federal law where the purchasers held 80\% of the total interests in the LLC, had the right to choose eight out of nine LLC managers and were sophisticated investors receiving LLC financial statements, with access to other company records.\footnote{See infra notes 779–787 and accompanying text.} The First Circuit affirmed summary judgment in favor of a bank holding company on a control person claim, while reversing summary judgment in favor of the holding company’s allegations supported the conclusion that there was a "reasonable possibility" of a loss because, "by March 2011 [NYC] had manifested an awareness of a possible, sizeable claim against SAIC," \textit{id.}, through the Mayor’s announcement that the city was reviewing payments to SAIC with the goal of seeking reimbursement, \textit{id.} at 91, 94. SAIC also knew by the time it filed the 10-K of the criminal investigation focusing on Denault and the company’s Chief Systems Engineer and had "received the results of its internal investigation about possible fraud, [making the company] aware not only of Denault’s wrongdoing but also its own potential liability to [NYC]." \textit{id.} at 93–94.

The court of appeals rejected SAIC’s argument that the proposed complaint failed to adequately plead scienter with respect to the FAS 5 and Item 303 violations, finding allegations—that "by March 9, 2011, when SAIC received the results of its internal investigation but before it filed its 10–K, SAIC knew about Denault’s kickback scheme, the extent of the CityTime fraud, and, . . . that it risked civil and criminal fines and penalties, [as well as] losing a significant number of current and future government contracts”—"support the inference that SAIC acted with at least a reckless disregard of a known or obvious duty to disclose when, as alleged, it omitted this material information from its March 2011 10–K in violation of FAS 5 and Item 303." \textit{id.} at 96.

On the other hand, the Second Circuit affirmed the district court’s judgment in two respects. First, it agreed that the plaintiffs had not alleged a Rule 10b-5 claim based on an asserted failure to comply with FAS 5 in the June 11, 2011 8-K. \textit{Id.} at 97. That filing had, in addition to the disclosures set out in the text accompanying \textit{supra} note 755, advised that “there is a reasonable possibility of additional exposure to loss [beyond the $2.5 million that the company had offered to refund to NYC] that is not currently estimable if there is an adverse outcome.” \textit{Id.} at 90 (quoting 8-K). The plaintiffs “failed to identify in their complaint any additional disclosures SAIC should have made in the 8–K to more accurately portray the extent of SAIC’s exposure to liability from the project.” \textit{Id.} at 97. Second, the court agreed with the district court that SAIC had not made \textit{material} misrepresentations in its 2011 annual report by including references to “SAIC’s ‘culture of high ethical standards, integrity, operational excellence, and customer satisfaction’ and its ‘reputation for upholding the highest standards of personal integrity and business conduct.’” \textit{Id.} (quoting annual report). The Second Circuit saw such language as “puffery,” so general that an investor would not rely on it as any kind of warranty that no company employee would ever take actions contrary to these assurances. \textit{Id.} at 97–98.
wholly-owned broker-dealer, in a case involving alleged fraud in selling auction rate securities. The Ninth Circuit also held that the Securities Litigation and Uniform Standards Act (“SLUSA”) carve-out for claims based on an issuer’s repurchase of its own securities does not create an independent basis for federal jurisdiction.

In connection with. Section 10(b) of the Exchange Act and Rule 10b-5 proscribe certain practices “in connection with the purchase or sale” of securities. Section 17(a) of the Securities Act proscribes certain practices “in the offer or sale of any securities.” In SEC v. Radius Capital Corp., the Eleventh Circuit affirmed a judgment based on both these statutes, and the rule, after a jury trial. The section 10(b)/Rule 10b-5 claim rested on misrepresentations that the defendant made to Ginnie Mae in order to obtain Ginnie Mae guarantees for mortgage-backed securities (“MBS”) that he and his company sold, and the section 17(a) claim was based on those representations to Ginnie Mae and, as well, on representations in the prospectuses for the MBS saying that the loans underlying the MBS were federally insured. The court of

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772 See infra notes 788–792 and accompanying text.
773 See infra notes 793–795 and accompanying text.
776 653 F. App’x 744, 747–48, 754 (11th Cir. 2016).
777 To obtain the Ginnie Mae guarantee for an MBS, the defendants had to represent to Ginnie Mae that the loans within the MBS were either insured by the Federal Housing Administration (“FHA”) or eligible for FHA insurance. Id. at 748. The SEC alleged that the defendants made that representation, even though they knew that most of the loans were neither FHA insured nor met the standards for such insurance. Id. The prospectuses for the MBS, then, stated that the corporate defendant had certified that the underlying loans were FHA insurance eligible. Id. The SEC included two counts in its complaint—one under section 17(a) and one under Rule 10b-5. SEC v. Radius Capital Corp., No. 2:11–cv–116–PtM–29DNF, 2012 WL 6956668 at *3 (M.D. Fla. Mar. 1, 2012). The trial court denied the defendants’ motion to dismiss the 17(a) claim both insofar as it was based on representations to Ginnie Mae and insofar as it was based on representations in the prospectuses. Id. at *6–8. The trial court denied the motion to dismiss the Rule 10b-5 claim insofar as it was based on the representations to Ginnie Mae, but granted the motion to dismiss the Rule 10b-5 claim to the extent it rested on the prospectuses because the Commission did not plead that an individual defendant had “made” the statements in in the sense required by Janus—“that he had ‘ultimate authority over the statement[s], including [their] content and whether and how to communicate [them].’” Id. at *7–8. In affirming, the Eleventh Circuit agreed with the district court and held “that the requirement that a defendant ‘make’ the misrepresentations is limited to Rule 10b–5(b) claims,” and rejected the argument that Janus limits the reach of section 17(a). Radius Capital, 653 F. App’x at 751.
appeals held that the representations to Ginnie Mae were actionable under both Rule 10b-5 and section 17(a)—rejecting the defense contention that neither applied because Ginnie Mae “was not involved in any security transaction” and holding instead “that the misrepresentations themselves need not be explicitly directed at the investing public or occur during the transaction to be ‘in connection with the purchase or sale of’ or ‘in the offer or sale of’ any security.”

**LLC interest as an investment contract.** Both the Securities Act and the Exchange Act include “investment contracts” within the definition of “security.” The Supreme Court held in *SEC v. W.J. Howey Company* that “an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person [1] invests his money in [2] a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party.” Lower courts have relaxed the last of these four elements to some extent. The Tenth Circuit held that two members of a manager-managed LLC operating Quiznos had not acquired an investment contract and therefore had not acquired a security by exchanging Quiznos debt for their LLC interests. The court found the fourth element missing because the two members “controlled the profitability of their investments.” They had such control because (i) by their combined 80% ownership, the two members could “make the company member-managed, which would allow direct control over Quiznos, or allow dissolution of the

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778 *Radius Capital*, 653 F. App’x at 749, 751.
780 328 U.S. 293, 298–99 (1946).
781 *See* Williamson v. Tucker, 645 F.2d 404, 418 (5th Cir. 1981) (“Although the Court used the word ‘solely’ in the *Howey* decision, it should not be interpreted in the most literal sense. The Supreme Court has repeatedly emphasized that economic reality is to govern over form and that the definitions of the various types of securities should not hinge on exact and literal tests.”; “[W]e adopt a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.” (quoting *SEC v. Glenn W. Turner Enters.*, Inc., 474 F.2d 476, 482 (9th Cir. 1973))).
783 *Id.* at 882.
company through a majority vote of the members”\textsuperscript{784}; (ii) they had the right to (a) “[c]hoose eight of the nine managers, including the chairperson of the board, and [(b)] remove the eight managers without cause”\textsuperscript{785}; and (iii) they were “sophisticated and informed investors” who “receive[d] audited and unaudited financial statements from Quiznos and designate[d] non-voting members to attend board meetings” and had the right to “inspect, examine, and copy Quiznos’s books.”\textsuperscript{786} The Tenth Circuit rejected the argument that the interests were investment contracts, nonetheless, because the two members had not intended to exercise their power, holding that for the fourth element of the \textit{Howey} test, “we analyze the measure of control that [the members] \textit{could} exercise over Quiznos, not the control that they \textit{intended} to exercise.”\textsuperscript{787}

Control person liability. Exchange Act Section 20(a) provides that “[e]very person who, directly or indirectly, controls any person liable under any provision of this [act] or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable (including to the Commission . . . ), unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.”\textsuperscript{788} In 2016, the First Circuit affirmed summary judgment in favor of Bank of America, N.A. (“BANA”) in a Rule 10b-5 case brought against BANA and its wholly-owned broker-dealer subsidiary, Banc of America Securities LLC (“BAS”).\textsuperscript{789} The case centered on allegations that the defendants had

\textsuperscript{784} Id. at 883 (formatting removed).
\textsuperscript{785} Id.; and see id. at 883 n.4 (explaining that the LLC was governed by a board of managers).
\textsuperscript{786} Id. at 883 (formatting removed).
\textsuperscript{787} Id. at 884 (emphasis added). The court acknowledged that “[t]he interests could constitute investment contracts . . . if Quiznos’s managers and officers were irreplaceable or otherwise insulated from [the two members’] ultimate control,” but found “no suggestion that Quiznos’s managers or officers were irreplaceable or otherwise beyond . . . the ultimate control” of the two plaintiffs. Id.
\textsuperscript{789} Tutor Perini Corp. v. Banc of Am. Sec. LLC, 842 F.3d 71, 75, 83–86, 96 (1st Cir. 2016).
failed to disclose facts pointing toward the failure of auctions for auction-rate securities, failures that left the plaintiff holding an illiquid investment. The First Circuit concluded that the plaintiff “alleged zero facts indicating that BANA actually exercised control over BAS.”

Thus, the parent was out of the case even though the court of appeals reversed the summary judgment against the subsidiary broker-dealer on, among other claims, the omissions claim under Rule 10b-5.

Federal jurisdiction and SLUSA. The Securities Litigation Uniform Standards Act precludes an action in federal court based on misrepresentations or omissions in connection with the purchase or sale of covered securities (including those traded on national exchanges), where the action is brought by more than 50 plaintiffs and is based on state statutory or common law. The statute carves out from this preclusion actions involving “the purchase or sale of securities by the issuer . . . exclusively from or to holders of equity securities of the issuer.” In a breach of contract action where the plaintiff claimed the issuer had paid too little in redeeming

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790 Id. at 75, 81–82, 83.
791 Id. at 84 (citing Aldridge v. A.T. Cross Corp., 284 F.3d 72, 85 (1st Cir. 2002)) (characterizing Aldridge as “emphasizing that ‘the alleged controlling person must not only have the general power to control the company, but must also actually exercise control over the company’”). Although the case came to the court of appeals after summary judgment, much of the opinion—written in a disturbingly breezy style—reads like a review of a dismissal.
792 Id. at 93–94. See also Curry v. TD Ameritrade, Inc., No. 16–12041, 2016 WL 6135469 (11th Cir. Oct. 21, 2016) (affirming dismissal of control person claim against defendant that was “not alleged to have participated in the actual sales” but once the decisions to invest had been made, [plaintiffs] invested in the fraudulent funds using [the defendant] as a custodian to complete the transaction and then to hold the securities on behalf of the purchasers” (at *1); plaintiffs failed to plead facts tending to show that the defendant had either “the power to control the general business affairs of [the violator]” or “the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in primary liability” (at *2) (quoting Mizzaro v. Home Depot, Inc., 544 F.3d 1230, 1237 (11th Cir. 2008) (internal quotation marks omitted)).
Exchangeable Redeemable Preferred Stock, the Ninth Circuit held last year that this carve-out “does not provide an independent basis for federal question jurisdiction.” \(^{795}\)

\(^{795}\) Rainero v. Archon Corp., 844 F.3d 832, 838 (9th Cir. 2016). The court of appeals affirmed dismissal. Id. at 841. The district court had no jurisdiction under 28 U.S.C. § 1332(d)(2) (actions by classes of more than 100 members and minimal diversity) because § 1332(d)(9)(C) excepts such class actions if they “involve[e] a claim . . . that relates to the rights, duties (including fiduciary duties), and obligations . . . created by or pursuant to any security.” While the plaintiff contended this exception did not apply because the Exchangeable Redeemable Preferred Stock was no longer in existence by the time he filed the complaint, his claim nevertheless fell within the exception because he sought to enforce rights created by that security. Rainero, 844 F.3d at 839. And he could not rest jurisdiction on 28 U.S.C. § 1332(a) (diversity jurisdiction in controversies exceeding $75,000) because he failed to plead, as to his individual claim, either diversity of citizenship or the dollar amount he sought. Id. at 839–40. Finally, “[g]ranting leave to amend would have been futile because Rainero’s proposed amended complaint also failed to allege a sufficient amount in controversy, and the district court did not abuse its discretion by failing to afford Rainero yet another opportunity to cure the jurisdictional defect rather than dismissing the complaint without prejudice.” Id. at 840–41.