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Securities Litigation and Enforcement Trends

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SEC Continues to Regulate and Claw Back Incentive-Based Compensation

Three recent events have reiterated the SEC's commitment to regulate and potentially claw back incentive-based compensation paid to executives in various industries. On March 2, 2011, the SEC released a proposed rule that would require certain financial institutions to disclose the structure of their incentive-based compensation practices and prohibit such institutions from maintaining compensation arrangements that "encourage inappropriate risks." The following day, the SEC announced yet another settlement with an "innocent" CEO to claw back all incentive-based compensation the CEO received during a restatement period. Most recently, on March 24, 2011, the SEC and former CSK Auto Corporation CEO Maynard L. Jenkins announced a tentative settlement of the SEC's clawback lawsuit against Jenkins.

Proposed Rule on Disclosure of Incentive-Based Compensation Arrangements at Financial Institutions

Pursuant to Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC recently proposed a rule to regulate the incentive-based compensation practices of certain financial institutions with $1 billion or more in assets. The covered financial institutions include broker-dealers and investment advisers. The proposed rule would: (1) require covered financial institutions to file annual disclosure reports related to incentive-based compensation; (2) prohibit incentive-based compensation arrangements that encourage inappropriate risk-taking by providing excessive compensation or that could lead to material financial loss to the firm; and (3) require covered financial institutions to develop policies and procedures to ensure and monitor compliance with the above-stated requirements related to incentive-based compensation.

In addition, for financial institutions that have $50 billion or more in assets, the SEC's proposed rule would require possible deferral of incentive-based compensation for executive officers and approval of such compensation for people whose job functions give them the ability to expose the firm to a substantial amount of risk.

The SEC's proposed rule confirms its commitment to regulate and curb incentive-based compensation paid by various financial institutions. The rule should be available in the Federal Register for public comment soon. Once the rule is published in the Federal Register, the public will have 45 days to comment.

Continued Clawback of Incentive-Based Compensation Pursuant to SOX Section 304

In addition to its regulation of the financial industry, the SEC continues to claw back incentive-based compensation from certain CEOs and CFOs in various other industries. Recently, the SEC again used Section 304 of the Sarbanes-Oxley Act as a powerful, independent cause of action in order to obtain reimbursement of bonuses and other incentive-based and equity-based compensation from an executive—without charging the executive with any personal wrongdoing.

On March 3, 2011, the SEC announced a settlement with Ian McCarthy, the CEO of Atlanta-based homebuilder Beazer Homes. The SEC brought a complaint against Mr. McCarthy under Section 304 for failure to reimburse Beazer for cash bonuses, other incentive-based or equity-based compensation, and profits from Beazer stock sales that Mr. McCarthy received during the 12-month period after Beazer filed allegedly fraudulent financial statements for fiscal year 2006.

Beazer and its chief accounting officer were previously charged for their involvement in a fraudulent earnings management scheme to artificially inflate Beazer income and earnings during its fiscal year 2006. Mr. McCarthy was not personally charged with any misconduct. Nevertheless, the SEC filed a complaint seeking to claw back any incentive-based and equity-based compensation that Mr. McCarthy received during the restated period. Mr. McCarthy chose to settle with the SEC and agreed to reimburse Beazer for

nearly $6.5 million in cash, 40,103 restricted stock units and 78,763 shares of restricted stock.

Finally, on March 24, 2011, the SEC and Maynard L. Jenkins—the former CEO of CSK Auto Corporation—announced a tentative settlement of the SEC's lawsuit against Jenkins and requested a stay of the ongoing proceedings in *SEC v. Jenkins*, 09-cv-1510, U.S. District Court, District of Arizona. In 2009, the SEC brought the clawback lawsuit against Jenkins pursuant to Section 304, seeking to claw back more than $4 million in bonuses and other incentive-based and equity-based compensation from Jenkins, without alleging that he engaged in any personal misconduct. Jenkins initially attempted to litigate the case and unsuccessfully sought to dismiss the SEC's Section 304 claims. However, according to recent court filings, the court expressed concern about the increased indemnification costs CSK Auto Corporation would incur as the *Jenkins* lawsuit continued. It now appears that the SEC and Jenkins wish to settle to avoid incurring additional legal costs in this matter. By order dated March 25, 2011, all filings in the *Jenkins* case are stayed pending approval of the settlement by the SEC Commissioners. The parties have until May 25, 2011 to file a proposed stipulation of dismissal pursuant to settlement, or to issue a joint status report if the settlement is not finalized and accepted. The terms of the tentative settlement are nonpublic until approved by the SEC Commissioners.

These recent actions and settlements reinforce the SEC's willingness to proceed against CEOs and CFOs under Section 304, even in the absence of any alleged misconduct by those executives. Now more than ever, corporations and executives should re-examine the benefits and drawbacks of performance-based compensation in light of the SEC's recent and repeated use of Section 304 against executives. Moreover, the SEC's use of Section 304 should be viewed as an incentive for senior executives to foster a culture of compliance and be particularly mindful of financial reporting requirements. ■

Supreme Court Determines Materiality Standard for Adverse Event Reports

On March 22, 2011 the U.S. Supreme Court ruled that reports about the adverse effects of a product may be "material" even when not statistically significant. In a unanimous opinion, the high Court affirmed the Ninth Circuit's decision and ruled that a class action securities fraud case may proceed against Matrixx Initiatives, Inc., the makers of Zicam, an over-the-counter cold remedy.

The plaintiffs brought suit against Matrixx pursuant to Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5, alleging that Matrixx committed securities fraud by failing to disclose reports that users of its Zicam product, which accounted for 70 percent of Matrixx's sales, subsequently suffered from anosmia, a condition involving the loss of the sense of smell. Such reports are referred to as adverse event reports; that is, reports that users of a drug experienced an adverse event during or after use of the drug. The district court dismissed the complaint, finding that it failed to state a claim because the undisclosed information was not statistically significant and, therefore, not material. The Ninth Circuit reversed and remanded, rejecting the lower court's application of a bright-line rule that user complaints must be statistically significant to be material and finding that the court should have engaged in a fact-specific inquiry to determine whether the information would have been significant to a reasonable investor. The Ninth Circuit's opinion was contrary to decisions in the First, Second and Third Circuits that had all held that drug companies have no duty to disclose adverse event reports unless there is statistically significant evidence linking the drug to the adverse events. The Supreme Court resolved this split among the Circuits in favor of the Ninth Circuit and the *Matrixx* plaintiffs, ruling that the materiality of adverse event reports is not subject to the application of a bright-line rule.

The plaintiffs are a class of shareholders who purchased Matrixx securities between October 22,

2003 and February 6, 2004. The plaintiffs allege that Matrixx was aware that numerous users of its Zicam product, which uses zinc gluconate applied to the nasal cavity, reported anosmia, but that Matrixx nonetheless made statements during this period that failed to disclose this information or contradicted reports of anosmia in users. When the television program *Good Morning America* did a story on Zicam and anosmia in February 2004, Matrixx's stock fell by almost 24 percent in one day.

Matrixx had numerous warnings about the possible adverse effects of its product before the start of the class period. Thereafter, Matrixx made numerous allegedly misleading statements. In an October 2003 press release and conference call, Matrixx indicated that it expected significant revenue growth due to the success of Zicam. In its 10-Q report for the third quarter of 2003, Matrixx discussed the prospect of significant costs associated with product liability claims, but did not disclose that a lawsuit claiming that Zicam had caused anosmia had already been filed. When Dow Jones Newswires reported that the FDA was investigating the possibility that Zicam may cause a loss of the sense of smell, Matrixx's stock fell from $13.55 to $11.97 per share. Matrixx immediately issued a statement stressing that no loss of sense of smell had ever been reported in a clinical trial of Zicam and that Matrixx believed that any assertions that its product caused anosmia were "completely unfounded and misleading." After the press release, Matrixx's stock price rose to $13.40 per share.

Two days later, *Good Morning America* aired a segment linking Zicam with anosmia and reporting the findings of one of the doctors who had previously contacted Matrixx regarding patients suffering from the condition after using Zicam. Matrixx's stock fell from $13.05 per share on February 5, 2004 to $9.94 per share on February 6, 2004.

In its case before the Supreme Court, Matrixx argued that the statistically significant standard should apply to prevent companies from feeling pressured to disclose all adverse event reports and thereby flood the market with unreliable and irrelevant information. Such a result, according to Matrixx and its supporters, would defeat the purpose of disclosure by making it difficult for the investing public to distinguish what information is significant in making investing decisions. Matrixx argued that reports that do not rise to the level of statistical significance do not sufficiently demonstrate a causal relationship to be material.

The Product Liability Advisory Council, Inc. ("PLAC"), which filed an amicus curiae brief in support of Matrixx, further argued that the Ninth Circuit's holding could have consequences, not only for pharmaceutical companies, but also food companies and makers of medical devices because these companies are likewise regulated by the FDA and may have obligations to report adverse events to the FDA. Furthermore, PLAC argued that the Ninth Circuit's holding could be extended to other industries such as the automobile and consumer products industries. This, according to PLAC, would overwhelm the investing public with essentially useless information.

The plaintiffs countered that reasonable investors are sophisticated enough to consider information that is not statistically significant and decide whether it should impact their investing decisions. The United States, filing an amicus curiae brief in support of the plaintiffs, also noted that reports of adverse effects may signal potential regulatory activity, impact product sales and increase the likelihood of litigation, all of which may be material to investors. Additionally, the government argued that companies would need to disclose reports of negative effects of products only where the company also makes positive statements about the products' success and safety.

The Supreme Court, agreeing with the arguments advanced by the plaintiffs and the United States, unanimously affirmed the Ninth Circuit's decision. The Court, referencing its previous decision in *Basic Inc. v. Levinson*, began its analysis by noting that the standard for materiality is whether the reasonable investor would regard the omitted information as substantially likely to alter the "total mix" of information. Matrixx had attempted to argue that evidence that failed to rise to the level of statistical significance was not a reliable indicator of causation. The Court, however, found fault with this premise, observing that "medical professionals and regulators

[like the FDA] act on the basis of evidence of causation that is not statistically significant" and consequently, "it stands to reason that in certain cases reasonable investors would as well." The determination of whether adverse event reports are material, according to the Court, requires a fact-intensive inquiry that considers "the source, content, and context of the reports." Applying this framework to *Matrixx*, the Court determined that "the allegations of the complaint as a whole . . . allege[d] facts suggesting a significant risk to the commercial viability of Matrixx's leading product," and were, therefore, sufficient to allow the plaintiffs to go forward with their case.

Despite its apparently pro-plaintiff decision, the Court was quick to point out that its ruling did not create a requirement for pharmaceutical manufacturers to disclose all adverse event reports. The mere existence of adverse event reports alone does not require disclosure. Rather, disclosure is necessary only where the failure to disclose renders statements made by the company misleading. As the Court pointed out, "companies can control what they have to disclose under these provisions by controlling what they say to the market."

Important to the Court's decision was the fact that Matrixx had made several affirmative statements about its expected revenues and about the safety of its leading product. Given these affirmative statements, the failure to disclose reports of adverse events made these statements misleading. While the *Matrixx* decision clearly applies to pharmaceutical companies, it should prompt SEC-reporting companies to exercise caution in making affirmative statements where they have received reports of adverse events in connection with their products. ■

SEC Aggressively Targets Insider Trading and Expert Networks

As part of its widespread ongoing investigation focusing on expert networks, on February 8, 2011, the SEC charged a New York-based hedge fund and four hedge fund portfolio managers and analysts with trading on illegal tips received from expert network consultants in *SEC v. Longoria et al.*, brought in the Southern District of New York.

Focus on Insider Trading

The case involves insider trading by ten individuals and one investment adviser entity, all of whom are consultants, employees or clients of the California-based expert network firm Primary Global Research LLC (PGR). The complaint alleges that PGR's employees sought experts who had access to and were willing to share inside information in exchange for fees of $150 to $1,000 per hour. In some cases, the so-called experts willingly shared sales forecasts, earnings, performance data, revenues and other detailed information about their own companies with clients of PGR.

The complaint further alleges that managers and analysts at the hedge fund Barai Capital Management illegally traded in securities of AMD, Seagate Technology, Western Digital, Fairchild Semiconductor and Marvell, among others, on the basis of material, nonpublic information obtained from employees moonlighting as expert network consultants for PGR, netting more than $30 million in illicit gains.

This case is an example of joint criminal and civil investigations by the SEC, the FBI and the U.S. Attorney's Office for the Southern District of New York targeting allegedly pervasive practices of financial industry professionals eliciting material, nonpublic information from firms that match industry specialists with money managers, and trading on such information. The fallout from PGR's conduct has resulted in criminal charges against a number of technology company employees, traders (including former employees of SAC Capital, a $12 billion hedge fund group) and consultants for PGR.

Widespread Investigations; Civil and Criminal Charges Pending

These charges come on the heels of other investigations into insider trading and at least two SEC enforcement actions, *SEC v. Galleon Management, LP et al*. and *SEC v. Cutillo et al*. According to the SEC, the insider trading rings

identified in these enforcement actions include several prominent hedge funds and high-profile hedge fund managers, as well as Wall Street professionals such as attorneys, professional traders and senior corporate executives.

Most recently, the SEC announced civil insider trading charges against Rajat K. Gupta, a former member of the Boards of Directors of Goldman Sachs and Procter & Gamble, for allegedly disclosing material, nonpublic information about these companies to Raj Rajaratnam, who is the founder and managing partner of Galleon Management, LP. Among other things, Gupta, a former managing director of McKinsey & Co., is alleged to have disclosed to Rajaratnam material, nonpublic information concerning Berkshire Hathaway Inc.'s $5 billion investment in Goldman Sachs before it was publicly announced on September 23, 2008, as well as information about the investment bank's financial results for both the second and fourth quarters of 2008.

Key Takeaways

These insider trading cases raise several pertinent issues to be examined by public companies and their employees as well as research analysts, hedge funds and other money managers. Public companies should have clear insider trading and shareholder communication policies. Only designated individuals should be permitted to speak on behalf of a company. Problems with rogue employees may persist, but well-documented policies and ongoing training programs for Regulation FD compliance for public company executives, boards of directors and investor relations departments are critical to minimizing the release of material, nonpublic information. Moreover, companies should review their relationships with third-party consultants and vendors to ensure that their contracts are designed to guard against the distribution or misappropriation of confidential information. Third parties should have access to such information only as needed to perform their duties.

Analysts and traders should be mindful of the fine line between channel checks (i.e., procuring manufacturing and sales data from third-party suppliers, vendors and retailers), which traditionally factor into fundamental investment research, and trading on material, nonpublic information. No doubt investors may be wary of research practices such as channel checks after the SEC's most recent aggressive insider trading investigations.

It is important to note that the SEC's current activity should not eliminate established research practices, but it highlights the importance of sound compliance programs. Similar to operating companies, investment companies should have well-documented insider trading policies, which promote practices that (1) educate analysts, traders and other employees, (2) encourage communication with legal and compliance personnel regarding research practices, (3) seek thorough due diligence and supervision of any third-party expert network firm or consultant and (4) facilitate the isolation of suspected material, nonpublic information and prevent trading on such information. ■

FCPA Trends

Recent high-profile settlements stemming from alleged violations of the Foreign Corrupt Practices Act, 15 U.S.C. §§ 78dd-1 et seq. (FCPA), together with the nearly twofold increase in enforcement actions brought in 2010, underscore the necessity for multinational corporations to implement detailed compliance guidelines to mitigate potential FCPA exposure.

FCPA Overview

Congress enacted the FCPA in 1977 in an attempt to curb the bribery of foreign officials and to restore public confidence in the integrity of the American business system.

Specifically, the FCPA's antibribery provisions make it unlawful for a U.S. person, and certain foreign issuers of securities, to make a corrupt payment to a foreign official for the purpose of obtaining or retaining business for or with, or directing business to, any person. Since 1998, these antibribery provisions also apply to foreign

firms and persons who take any act in furtherance of such a corrupt payment while in the United States.

In addition to the antibribery provisions, the FCPA contains a books-and-records provision requiring issuers to make and keep accurate books, records and accounts that correctly and fairly reflect, in reasonable detail, the issuer's transactions and disposition of assets. Finally, the FCPA's internal-controls provision requires that issuers devise and maintain reasonable internal accounting controls aimed at preventing and detecting FCPA violations. Regulators frequently leverage these accounting provisions to facilitate settlements because there is no requirement that a false record or deficient control be linked to an improper payment. Even a payment that does not constitute a violation of the antibribery provisions can lead to prosecution under the accounting provisions if inaccurately recorded or attributable to an internal-controls deficiency.

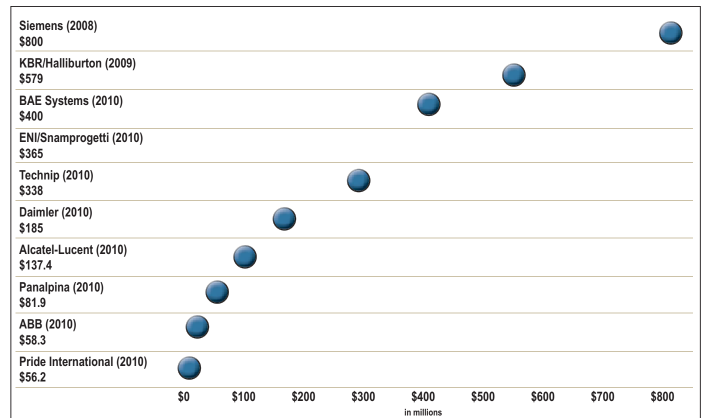
While the SEC is responsible for civil enforcement of the FCPA with respect to issuers, the Department of Justice (DOJ) is responsible for all criminal enforcement and for civil enforcement with respect to domestic concerns, foreign companies and nationals.

Recent Trends in FCPA Enforcement

The emerging era of FCPA enforcement activity is characterized by escalating numbers of enforcement actions, bolstered by industry-wide investigations with a focus on prosecuting individuals, and heightened levels of international anticorruption cooperation and enforcement.

Each of these trends continued in 2010, a year in which there was an unprecedented number of FCPA enforcement actions brought by the SEC and the DOJ—26 and 48, respectively. In comparison, the SEC brought a total of 14 and 13 enforcement actions in 2009 and 2008, while the DOJ brought 26 and 20 such actions, respectively, in those years. Not only is 2010 notable for the sheer number of enforcement actions, but the monetary penalties assessed in 2010 also reached historic heights: eight of the top ten monetary settlements in FCPA history were reached in 2010.

Top 10 FCPA-Related Monetary Settlements



A number of prosecutions in 2010 also centered on corruption in the telecommunications industry, principally in Latin America, but also in Africa and the Far East.

Most recently, on December 27, 2010, the SEC and DOJ announced a joint settlement with Alcatel-Lucent, S.A., a global telecommunications giant, to resolve allegations of widespread bribery of foreign government officials. According to the charging documents, from 2002 to 2006, prior to its merger with Lucent Technologies, Inc., Alcatel S.A. used third-party agents to pay more than $8 million in bribes to government officials in Costa Rica, Honduras, Malaysia and Taiwan in exchange for hundreds of millions of dollars worth of public-sector telecommunications contracts. Also, Alcatel-Lucent allegedly hired agents without proper controls in Kenya, Nigeria, Bangladesh, Ecuador, Nicaragua, Angola, Ivory Coast, Uganda and Mali. Alcatel-Lucent was alleged to have won more than $450 million in contracts, and $48.1 million in profit, stemming from improper payments to foreign officials.

To resolve the SEC's complaint, Alcatel-Lucent agreed to pay $45.4 million in disgorgement and consented to an injunction from future violations of the antibribery and accounting provisions of the FCPA. To resolve the criminal charges with the DOJ, Alcatel-Lucent consented to the filing of an information charging it with violating the accounting provisions; three of its subsidiaries pleaded guilty to FCPA conspiracy counts, and all the companies paid a combined criminal fine of $92 million.

Among many other notable issues from the Alcatel-Lucent case, it marks just the second time in the history of the FCPA (the first being Siemens AG in 2008) that a company has resolved criminal internal-control charges. Moreover, in January 2010, Alcatel-Lucent paid $10 million to settle corruption charges filed by Costa Rican authorities, the first time in Costa Rica's history that it has recovered damages from a foreign corporation for alleged corruption of its own government officials.

The increased focus and resources being devoted to FCPA enforcement at both the SEC and DOJ suggests that the prolific pace of FCPA prosecutions is unlikely to abate.

These enforcement trends are by now familiar to directors, officers and general counsels of multinational companies. However, as the level of enforcement activity continues to escalate, multinational companies and their employees must be increasingly vigilant in conducting their business abroad. To guard against FCPA exposure, multinational corporations should implement and reinforce several compliance themes, including (1) sophisticated and organized anticorruption due diligence, (2) close scrutiny and examination of third-party agents and distributors and (3) a focused awareness of industry business practices, investigations and litigation. To be sure, corporations that embrace a proactive approach to investigating red flags and, if necessary, self-reporting FCPA violations to the SEC and/or the DOJ are far more likely to avoid crippling liability than corporations that turn a blind eye to their self-reporting obligations, and which are all too often left to react—at the eleventh hour—to enforcement actions. ■

Janus Capital Group v. First Derivative Traders: Supreme Court to Decide Key Questions Regarding Secondary Actor Liability

The scope of securities fraud liability for service providers to publicly held companies (such as investment advisers and attorneys) may increase depending on the forthcoming decision of the U.S. Supreme Court in *Janus Capital Group v. First Derivative Traders*. Oral arguments were heard on December 7, 2010, and the Supreme Court will soon decide whether a service provider may be held primarily liable in a private securities fraud action for (1) "helping" or "participating in" another company's publicly available misstatements or (2) publicly available misstatements that were not directly and contemporaneously attributed to the service provider.

Background

Janus Capital Management Group, Inc. (Janus Capital) is a publicly traded asset management firm that, directly or through subsidiaries, sponsors and markets mutual funds and provides investment advice and other services to those funds. Janus Capital Management LLC (Janus Management) is a wholly owned subsidiary of Janus Capital that acts as the primary operating company for Janus Capital. Janus Management serves as the investment adviser for and administrator of various Janus mutual funds.

Shares in the Janus funds were offered for sale by prospectuses that Janus Capital and Janus Management allegedly caused to be issued and made available to the investing public. The prospectuses for a number of the Janus funds stated that the funds discouraged market-timing trades.[1] However, in 2003, the New York State Attorney General charged a hedge fund with market-timing trading in certain Janus mutual funds. This disclosure allegedly caused investors to withdraw nearly $14 billion from various Janus funds and, as a result, the stock price of Janus Capital fell considerably.

Several Janus Capital shareholders filed private securities fraud actions—which were subsequently consolidated in the District of Maryland—against both Janus Capital and Janus Management. Specifically, plaintiffs sued Janus Capital and Janus

[1] Market timing refers to the practice of rapidly trading in and out of a mutual fund to take advantage of inefficiencies in the way the fund values its shares.

Management, seeking to hold them liable for fraud under Section 10(b) of the Securities and Exchange Act of 1934 and under the Securities and Exchange Commission (SEC) Rule 10b-5. Plaintiffs alleged that Janus Capital and Janus Management were primarily liable for unlawfully making misleading statements in prospectuses about various Janus funds, most notably that Janus funds' managers did not permit, and took active measures to prevent, "market timing" of the funds. Plaintiffs also alleged a "control person" claim against Janus Capital, asserting that Janus Capital controls Janus Management and is responsible for Janus Management's claimed violations.

Janus Capital and Janus Management argued in response that they were mere outside service providers or "secondary actors," so they could not be held liable for unattributed misstatements made by the Janus funds in the funds' respective prospectuses, even if they helped to draft or distribute such misstatements. The district court dismissed the complaint, holding that the plaintiffs failed to state a claim.

The U.S. Court of Appeals for the Fourth Circuit reversed. First, the Fourth Circuit found the allegation that Janus Capital and Janus Management "caused mutual fund prospectuses to be issued for Janus mutual funds and made them available to the investing public" to be sufficient to plead that Janus Capital and Janus Management "*made*" the misleading statements in the prospectuses. *See In re Mutual Funds Inv. Litig.*, 566 F.3d 111, 121 (4th Cir. 2009). Second, the Fourth Circuit held that if an interested investor could have attributed the alleged misstatement to the defendant service provider, then it is unnecessary for a plaintiff to allege that the misleading statements were contemporaneously attributable to the service provider. *See id*. at 127. This test is to be applied on a case-by-case basis to determine whether investors "would attribute to the defendant a substantial role in preparing or approving the allegedly misleading statement." *Id*. at 124. The Fourth Circuit held that Janus Management had a substantial management role and had inherent responsibilities with the Janus mutual funds; therefore, the Fourth Circuit reasoned that an investor could have reasonably assumed that Janus Management had control over the allegedly misleading content placed in the Janus funds' prospectuses. *Id*. at 127.

Issues and Potential Impact

It has long been held that there is no aiding-and-abetting liability in private actions under Section 10(b) of the Securities Exchange Act of 1934. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1944). When Congress passed the Private Securities Litigation Reform Act of 1995, it allowed the SEC to prosecute aiders and abettors under Section 10(b), but Congress did not provide a private cause of action. Therefore, a service provider, such as an auditor, attorney, bank or investment adviser, that provides assistance to a company that makes a public misstatement cannot be held liable in a private securities fraud action for that misstatement. *See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

If the Supreme Court upholds the decision of the Fourth Circuit, primary liability under Section 10(b) of the of the Securities and Exchange Act of 1934 will extend to an investment adviser where such adviser exercises day-to-day management over a mutual fund. Taken further, if the Supreme Court upholds the Fourth Circuit decision, the amount of litigation against service providers—such as bankers, lawyers, auditors and accountants who review a company's public statements—may increase. Indeed, if the Supreme Court adopts the Fourth Circuit's test, a private plaintiff may only need to allege that a service provider played a "substantial role" in the drafting, making or disseminating of a misleading public statement in order to sufficiently allege a private securities fraud cause of action against that provider. On the other hand, if the Supreme Court overturns the Fourth Circuit decision and adopts a more stringent pleading standard for service providers' liability, that may greatly reduce litigation against and liability of secondary actors in several different fields. ■

Southern District of New York Judge Applies *Morrison* to Dismiss Federal Securities Claims Brought by U.S. Investors Against the Royal Bank of Scotland

Relying on the U.S. Supreme Court's recent decision in *Morrison v. Nat'l Australia Bank, Ltd.*, No. 08–1191, 561 U.S. __, 130 S. Ct. 2869 (June 24, 2010), Judge Deborah Batts of the Southern District of New York dismissed Section 10(b) and Rule 10b-5 subprime-related securities claims asserted by a class of U.S. investors against the Royal Bank of Scotland (RBS) and several underwriters relating to the purchase of ordinary (common) RBS shares listed on foreign exchanges. *In re Royal Bank of Scotland Group PLC Sec. Litig.*, 09-Civ-00300, 2011 U.S. Dist. LEXIS 3974 (S.D.N.Y. Jan. 11, 2011). In *In re Royal Bank of Scotland Group PLC Sec. Litig.*, plaintiffs alleged that RBS had fraudulently misled them regarding the extent of RBS's substantial holdings in subprime and other mortgage-backed securities. Notwithstanding the fact that plaintiffs resided in the United States and decided to purchase foreign shares while in the United States, Judge Batts concluded that *Morrison* mandated the dismissal of plaintiffs' securities claims where the securities at issue were not listed on U.S. domestic exchanges.

The dismissal in In re Royal Bank of Scotland is only the latest decision that has applied Morrison to reject claims asserted by purchasers of foreign securities. In Morrison, a decision issued in June 2010, the Supreme Court held that federal securities fraud laws do not apply to investment deals that take place outside the United States, even if such investments have an impact on the United States. The Supreme Court narrowed years of federal jurisprudence on the extraterritorial application of securities fraud laws, noting that Section 10(b) applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities." *Morrison*, 130 S. Ct. at 2884. It is critical to note that Morrison applies only to private securities actions. The Dodd-Frank Act, signed into law on July 21, 2010, overruled Morrison in part by expanding federal jurisdiction to give extraterritorial effect to U.S. securities laws in proceedings brought by the Securities Exchange Commission or Department of Justice.

In *In re Royal Bank of Scotland*, RBS moved to dismiss plaintiffs' claims relating to the investors' purchase of ordinary shares. RBS contended that the amended complaint should have been dismissed because the securities at issue were not purchased or sold in the United States or on an American stock exchange, as required by *Morrison*. In contrast, plaintiffs argued that, because RBS listed American Depositary Shares (ADS) on the New York Stock Exchange (NYSE), the court had jurisdiction under Section 10(b) even if the securities at issue in the litigation were listed on foreign exchanges.

The Southern District of New York rejected plaintiffs' "listing theory," noting that the determining factor in applying Section 10(b) would be the "true territorial location where the purchase or sale was executed," rather than the fact that RBS listed any stock on a U.S. market. *In re Royal Bank of Scotland*, 2011 U.S. Dist. LEXIS 3974 at *18. The court specifically stated: "The idea that a foreign company is subject to a U.S. securities law everywhere it conducts foreign transactions merely because it has 'listed' some securities in the United States is simply contrary to the spirit of Morrison." *Id*. at *17–18.

Judge Batts likewise rejected plaintiffs' contention that both their U.S. residences and their U.S.-based decisions to invest in foreign shares provided a sufficient nexus for their securities claims. In the court's view, plaintiffs' suggested fact-intensive approach—"that it is enough to allege that plaintiffs are U.S. residents who were in the country when they decided to buy RBS shares—is exactly the type of analysis that Morrison seeks to prevent." *Id*. at *20.

The dismissal of federal securities claims in *In re Royal Bank of Scotland* suggests that future courts applying *Morrison* will likely adhere to a narrow view of the extraterritorial reach of Section 10(b). Indeed, both investors in foreign securities and foreign companies with U.S. investors should familiarize

themselves with *Morrison* and continue to monitor lower courts' application of the Supreme Court decision in the coming months. ■

Second Circuit Affirms the Importance of Adequately Pleading Loss Causation in Securities Fraud Claims

On February 2, 2011, the U.S. Court of Appeals for the Second Circuit handed down its opinion in *Amorosa v. AOL Time Warner, Inc.*, one of the last cases stemming from an alleged fraud perpetrated by AOL executives pursuant to a merger with Time Warner. AOL executives allegedly overstated their revenues, profits and future business prospects in order to secure the merger. Afterwards, while the company's stock prices were still artificially inflated, executives allegedly cashed in hundreds of millions of dollars in personal shares, ultimately triggering a massive plummet in the value of the company's stock.

The plaintiff, a holder of common stock in America Online predating the company's merger with Time Warner, brought suit in federal court, alleging fraudulent accounting practices by AOL's accounting firm, Ernst & Young. The allegations stemmed from a "clean" audit opinion provided by Ernst & Young prior to the merger, which, according to plaintiff, ultimately led to the dramatic decline in the value of his stock. Specifically, plaintiff alleged violations of Sections 14(a) and 10(b) of the Securities Exchange Act of 1934.[1]

The U.S. District Court for the Southern District of New York dismissed plaintiff's Section 14(a) and 10(b) claims for failure to adequately plead that Ernst & Young's alleged misrepresentations proximately caused his investment losses (this causal link—referred to as "loss causation"—is a requisite component of securities fraud claims). Plaintiff appealed to the Second Circuit Court of Appeals, which affirmed the district court's rulings. Regarding the Section 14(a) and 10(b) claims, the appellate court held that it was plaintiff's burden to plead and prove loss causation, and that he had failed to do so. Plaintiff's attempt to plead loss causation consisted of his allegation that, as the public became aware of AOL Time Warner's accounting practices, his stock lost value.

In assessing the sufficiency of plaintiff's securities claims, the appellate court articulated the standard for proving loss causation under a "materialization of risk" theory: a plaintiff must show that "the fraudulent statement or omission concealed something from the market that, when disclosed, negatively affected the value of the security." Plaintiff had to allege specific misstatements or omissions made by the defendant that were connected to his eventual economic loss. Because plaintiff alleged only that Ernst & Young's audit report was the cause of his losses, but did not point to any specific misrepresentations or omissions regarding the disputed report or AOL's accounting practices in general, the Second Circuit affirmed the district court's dismissal of plaintiff's securities fraud claims.

With its holding, the Second Circuit further entrenched the importance of pleading and proving loss causation in securities fraud cases. In the process, it demonstrated that even sympathetic plaintiffs who appear to have suffered legitimate pecuniary injury from an alleged fraud—which, in this case, resulted in the SEC bringing multiple civil suits against AOL executives—will be given no quarter when they fail to meet this requirement.

Application to Securities Fraud Cases Generally

There is no appellate-circuit-transcending standard for pleading and proving loss causation, and many cases explain only what does *not* amount to loss causation. *See*, *e.g.*, *Dura Pharms., Inc. v. Brudo*, 544 U.S. 336, 342 (2005) (plaintiff's demonstration that the price of a security on its date of purchase was inflated due to an alleged misrepresentation was insufficient to plead loss causation); *New York City Employees Ret. Sys. v. Jobs*, 593 F.3d 1018, 1023–24 (9th Cir. 2010) (allegation of share dilution

[1] Plaintiff's complaint contained other allegations as well, but such claims are beyond the scope of this article and were dismissed along with the securities fraud claims.

was insufficient to plead loss causation because economic loss does not necessarily accompany dilution).

Some courts, however, have articulated clearer guidelines. The Seventh Circuit, for example, has spelled out three theories of loss causation: (1) materialization of risk; (2) fraud on the market; and (3) risk-free assurance by defendant. *See Ray v. Citigroup Global Mkts., Inc.*, 482 F.3d 991, 995 (7th Cir. 2007). The standard for the materialization of risk theory—claimed by the plaintiff in *Amorosa*—is discussed above. For the fraud-on-the-market theory, a plaintiff must show "both that the defendants' alleged misrepresentations artificially inflated the price of the stock and that the value of the stock declined once the market learned of the deception." *Id.* Finally, under the aptly named "risk-free assurance by defendant" theory, a plaintiff must show that a broker falsely assured him or her that the disputed investment was risk free.

Looking Forward

The issue of loss causation will be addressed by the Supreme Court this month, when it hears *Erica P. John Fund, Inc. v. Halliburton Co.*, on appeal from the Fifth Circuit. At issue in that case is whether loss causation must be established as a prerequisite for class certification, or whether it is an issue best left for trial. ■

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222 NORTH LASALLE STREET
CHICAGO, ILLINOIS 60601
312-609-7500 | 312-609-5005 • FAX

1633 BROADWAY, 47th FLOOR
NEW YORK, NEW YORK 10019
212-407-7700 | 212-407-7799 • FAX

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If you have any questions regarding material in this issue of Securities Litigation and Enforcement Trends or suggestions for a specific topic you would like addressed in a future issue, please contact the Co-Editors, **Thomas P. Cimino, Jr.** (312-609-7784 or at tcimino@vedderprice.com) or **Junaid A. Zubairi** (312-609-7720 or at jzubairi@vedderprice.com). Rachel C. Jennings, Rachel T. Copenhaver, William W. Thorsness, William K. Hadler, Joshua Nichols and Meredith A. Nelson assisted in the publication of this issue.

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Members of the Securities Litigation Team

Thomas P. Cimino, Jr. *(Practice Leader and Co-Editor)* 312-609-7784
Junaid A. Zubairi *(Co-Editor)* 312-609-7720
James A. Arpaia 312-609-7618
David E. Bennett 312-609-7714
John T. Blatchford 312-609-7605
Rachel T. Copenhaver 312-609-7514
Mark A. Diomede 312-609-7727
John H. Eickemeyer *(New York)* 212-407-7760
Joel S. Forman *(New York)* 212-407-7775
James V. Garvey 312-609-7712
Michael Goettig *(New York)* 212-407-7781
Mark S. Goldstein *(New York)* 212-407-6941
Dan L. Goldwasser *(New York)* 212-407-7710
Daniel C. Green *(New York)* 212-407-7735
Nicole J. Highland 312-609-7914
Rachel C. Jennings 312-609-7813
Brian W. Ledebuhr 312-609-7845
Randall M. Lending 312-609-7564
Joseph M. Mannon 312-609-7883
James S. Montana, Jr. 312-609-7820
Jeanah Park 312-609-7532
Mark A. Partin 312-609-7536
William W. Thorsness 312-609-7595