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Supreme Court OT 2016: Securities Docket Focused on Class Suits, Disgorgement, Insiders; Disclosure and Whistleblowers Up Next

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Executive Summary

The Supreme Court once again heard several securities cases during its recently concluded October 2016 term and already has planned an active securities docket for its October 2017 term. Despite being one justice short for much of the term, the court began by deciding a case that reaffirmed a key principle of the court's insider trading jurisprudence. Later, newly confirmed Justice Gorsuch would begin his tenure on a fully staffed court by hearing two securities cases, one seeking resolution of a circuit split over tolling of class actions and another seeking to apply the court's precedent to define the SEC's disgorgement powers.

The court also has agreed to hear three cases next term. One case may significantly impact public company reporting liability for Regulation S-K disclosures. A second one could resolve questions about the Dodd-Frank Act's whistleblower provisions. The third case involves the Securities Litigation Uniform Standards Act and asks whether state courts have subject matter jurisdiction to hear covered class actions in which the complaint solely alleges Securities Act claims. The grant in the SLUSA case came one day after the court issued its last decisions for OT 2016. Looking still further ahead, could the Supreme Court get a cert-worthy petition next term regarding the SEC's administrative law judges?

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Introduction

The court's OT 2016 may be thought of as having been book-ended by securities cases. The term started with a December decision in the *Salman* insider trading case and ended with a rush of June decisions in *Kokesh* and *ANZ*, plus three new certiorari grants in other securities cases.

- The *ANZ* opinion resolved a circuit split over whether *American Pipe* tolling applies to a class action under Securities Act Section 13's one-year and three-year time limits. The court affirmed the Second Circuit's view in holding that equitable tolling in this context does not apply because the relevant part of Section 13

is a repose period. The outcome is significant because class members in these types of cases now must more aggressively take steps to preserve their rights, such as intervention, seeking to become a named plaintiff, or filing a separate lawsuit, all within the repose period. *ANZ* also continued a Roberts court trend of examining the procedural aspects of securities lawsuits.

- In *Kokesh*, the court held that a general federal statute of limitations applies to SEC disgorgement awards, effectively barring the agency from seeking to impose disgorgement for violations that occur before the limitations period. The decision in *Kokesh* extended principles first announced in the court's *Gabelli* decision, applying the same limitations period to the SEC's ability to seek monetary penalties. But a footnote in the court's unanimous opinion may have left open questions about the underlying authority for the SEC to seek, and the courts to impose, disgorgement awards.
- In *Salman*, the court reaffirmed that its *Dirks* precedent imposes liability for trading family members because the tipping of information mimics a gift of illicit trading proceeds to the trading family member. The decision was a narrow one that may have left open some issues not directly addressed by the court, but nevertheless raised by the failed certiorari petition regarding the Second Circuit's *Newman* case. The *Salman* case also demonstrated two hallmarks of the Roberts court—its tendency to reaffirm the court's precedents on stare decisis grounds, a trend recently seen, for example, in *Halliburton II* (reaffirming *Basic*), and a tendency to rule narrowly, when possible (Justice Alito's opinion for the court in *Salman* explicitly indicated the case involved a "narrow issue").
- The *Leidos* case, which the court agreed to hear late in the October 2016 term, will likely be heard before year's end as part of the court's October 2017 term. *Leidos* presents the justices an opportunity to resolve competing circuit court views of a Third Circuit opinion written by then-judge Alito. A decision in the case could reassure public companies that different principles of liability apply to Regulation S-K disclosures, or the court could impose new forms of liability for these disclosures and dramatically alter the nature of public company reporting.
- The Supreme Court agreed to hear *Cyan* shortly after issuing its final round of decisions for OT 2016. *Cyan* presents the question of whether amendments made to the Securities Act to prevent class action abuses preclude state court class action suits that raise only Securities Act claims. The justices could discuss a related California intermediate court opinion that answered that question in the negative and is blamed by companies for the rise in this type of class action generally—especially for suits filed in California. The government filed an amicus brief urging the justices to hear the case.
- *Somers*, another case to be heard in OT 2017, may clarify an issue that has divided circuit courts in their application of the Dodd-Frank Act's whistleblower provisions that became part of the Exchange Act: Does the statute's anti-retaliation provision embrace those who report alleged misconduct internally without reporting that same conduct directly to the SEC. The anti-retaliation provision appears to conflict with the statute's definition of "whistleblower," which describes an individual who provides information about a securities violation to the Commission. Recent Supreme Court decisions that discuss modes of statutory construction (including some outside the securities law context) may play an important role in resolving the split over the Exchange Act's whistleblower language.

American Pipe tolling returns to Supreme Court

The Supreme Court almost decided the question of whether *American Pipe* tolling applies to Securities Act Section 13 three years ago after initially deciding to review the Second Circuit's *IndyMac* decision. But a pending, partial settlement of that case prompted the justices to dismiss the earlier grant of certiorari as having been improvidently granted.

The issue returned to the court in another Second Circuit case (*ANZ*) arising from Lehman Brothers' collapse during the Great Recession. The Second Circuit in *ANZ* essentially invited the justices to review the Section 13 tolling question by noting in its closing remarks that *IndyMac* controls within the circuit absent a contrary holding by the Supreme Court. The justices agreed to hear the repose question but declined to hear a related question about when a member of a timely filed

putative class can file an individual case before a decision regarding class certification.

Setting the stage. Tolling can be problematic under Section 13 because of the statutory text and the practical realities of class action litigation, which are further tempered by concerns for judicial economy. The statute's first sentence provides for one-year limitations periods for two different types of actions: for violations of Sections 11 and 12(a)(2) and for Section 12(a)(1) actions. The second sentence of the statute states that "such action" may not be "brought" more than three years after a bona fide public offer under Sections 11 or 12(a)(1) or more than three years after the sale for an action under Section 12(a)(2).

The practical effect of upholding *ANZ* would be the need for an investor to move to intervene in a class action suit (not necessarily guaranteed because FRCP 24 provides for both intervention as of right and permissive intervention) or to file a separate lawsuit. Law professors who teach securities regulation and civil procedure told the justices in an amicus brief that such protective filings could be expected in 50 percent of securities class action cases that get far enough along for a court order on class certification and in 25 percent of all securities class actions.

Likewise, a group of retired federal district court judges told the court in an amicus brief that upholding the Second Circuit's view of *American Pipe* could produce similar unintended results. The retired federal judges said that not only could the number of protective filings rise, but that "factions" may develop among plaintiffs, the multidistrict litigation framework could become strained, and *pro se* filings may increase.

Both the law professors and the retired federal judges made similar arguments to the Supreme Court as amici in *IndyMac*. Several justices in *ANZ* probed CalPERS's and ANZ's counsel at oral argument regarding the consequences of upholding the Second Circuit determination. Justice Ginsburg even inquired if lead plaintiff and lead counsel have a duty to notify putative class members that the repose period is about to run so they can intervene or file separately, a point also raised by the retired federal judges, who noted the lack of clarity in the law while suggesting that notice is the better practice, even if it has costs and adds to similar notice requirements under the PSLRA and FRCP 23. ANZ suggested that Second Circuit practice did not comport with predictions made by the law professors and the retired federal judges.

Supreme Court decision. In *ANZ*, CalPERS filed a separate lawsuit more than three years after the events at issue, but before the court issued an order regarding class certification. When settlement appeared likely and the court preliminarily certified a class for purposes of settlement, CalPERS opted out of the settlement. The district court, later affirmed by the Second Circuit, found the CalPERS action untimely. The Supreme Court has now held that *American Pipe*'s equitable tolling rule is unavailable to save an individual suit filed outside the three-year repose period contained in Securities Act Section 13.

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Justice Kennedy wrote for the court in a 5-4 *ANZ* opinion that leaned heavily on his opinion for the court in *Waldburger*, which discussed at length the nature of a statute of repose (another justice wrote one part of *Waldburger*'s majority opinion). In *Waldburger*, the justices explained that a statute of limitations requires a plaintiff to diligently pursue known claims, while a statute of repose constitutes a legislative finding that a potential defendant should be free from liability after some fixed period of time.

Section 13 is a repose period, said the court, because of its structure and language, something the court previously suggested in its 1991 *Lampf* decision. For one, the second sentence's "in no event" language does not contain any exceptions. The court also found support for the sentence being a repose period from its legislative history, which revealed a quick amendment a year after its original enactment to shorten both the limitations period and to dramatically shorten the outside time limit from 10 years to three years.

Moreover, *American Pipe* emphasized equitable principles, further suggesting that its application

is limited to a court's equitable powers to toll a statute of limitations. While equitable tolling functions to help a diligent plaintiff who encounters difficulties arising from extraordinary circumstances, a repose statute's purpose supplants a court's equitable powers. As a result, a statute of repose generally is not subject to equitable tolling. Having enumerated the differences between statutes of limitation and statutes of repose, the court concluded that *American Pipe* did not apply to the repose language contained in Section 13.

Lastly, the court spoke of the lack of exceptions inherent in the language of Section 13's repose clause (elsewhere, the court spoke of legislative intent to permit tolling, such as where a statute of repose has its own built-in exceptions). The court also noted that Section 13 is keyed not to the accrual of a cause of action but instead to a defendant's last culpable act. Here, the court was emphatic about that feature of the statute: "[u]nder CTS, this point is close to a dispositive indication that the statute is one of repose." Yet the court's conclusion that the *American Pipe* tolling rule is grounded in equity overshadowed its various explanations for why Section 13's second sentence is a repose period.

CalPERS arguments rejected—The majority rejected CalPERS's four arguments in favor of applying *American Pipe* tolling. First, Section 13 functioned as a repose period, while *American Pipe* involved a statute of limitations. Second, while general interests in notice of potential claims and in the generic identities of plaintiffs may be important for limitations periods, the interests backing limitations periods differ from those for repose periods. For example, the tolling of a repose period could raise a defendant's practical burdens and financial risk (i.e., an opt-out plaintiff has leverage to get "outsized recoveries"). The court also rebuffed arguments about limits on opt-out rights (still cannot disregard time limits) and about judicial inefficiencies if tolling is disallowed (worries about courts being flooded by protective filings "likely are overstated").

The majority suggested what class action practice going forward may look like. According to the court, a potential class member could file a motion to intervene or request to be included as a named plaintiff.

Lastly, the court rejected CalPERS's argument that tolling was not truly at issue in the case because the timely filed class action "brought" CalPERS's "action" in a timely manner. The court said "action" means judicial proceeding and that CalPERS's action was not the same one as the earlier, timely class action. The justices said CalPERS's suggested rule would stretch the "logical limit" of what it means to give repose.

Justice Ginsburg further argued that not only does the majority opinion "disserve[]" investors, but it also invites securities class action defendants to "slow walk" pre-class certification proceedings, such as discovery.

Dissent: 'slow walk' tactic and other consequences—Justice Ginsburg, joined by Justices Breyer, Sotomayor, and Kagan, pushed back against the majority's explanation of repose. For the dissenters, the notice to defendants of claims and potential plaintiffs within the repose period is key:

> But whether CalPERS stayed in the class or eventually filed separately, respondents would have known, within the repose period, of their potential liability to all putative class members.

Justice Ginsburg further argued that not only does the majority opinion "disserve[]" investors, but it also invites securities class action defendants to "slow walk" pre-class certification proceedings, such as discovery. Moreover, Justice Ginsburg suggested that class counsel and courts will need to do more to inform class members of the importance of taking protective actions to ensure they may pursue their claims, a point she had made during oral argument.

Pending cert petitions denied—The court subsequently, and quickly, disposed of three pending certiorari petitions that raised similar *American Pipe* tolling issues. The court had distributed all three petitions (*Dusek*; *SRM Global*; *DeKalb*) for the conference held the same day it decided *ANZ*.

Two of those petitions involved 28 U.S.C. §1658, which provides that securities fraud claims may be brought no later than the earlier of two years after the discovery of the facts constituting the violation or five years after the violation. The provision was

part of a package of amendments made by the Sarbanes-Oxley Act. One of the 28 U.S.C. §1658 petitions raised the question of applying *American Pipe* to a repose period in the context of suits over the Madoff Ponzi scheme (*Dusek* petition) and the other petition raised the same question regarding Bear Stearns's collapse during the financial crisis (*SRM Global* petition).

The third petition, seeking review of the Second Circuit's decision in *DeKalb* (Opinion; Amended Opinion), raised the question of *American Pipe* tolling in the context of Exchange Act Section 14(a) with respect to alleged securities violations related to the Deepwater Horizon tragedy. The Second Circuit declined to apply *American Pipe* to the judicially created time limits, which the court had borrowed from another securities law nearly three decades ago. The court also declined to alter the one-year/three-year structure of the time limits, despite the intervening SOX amendment to 28 U.S.C. §1658. Moreover, citing *Waldburger*, the court said the relevant time limits applied as of the defendant's last culpable act or omission—a feature that would influence the Supreme Court's analysis of Securities Act Section 13 in *ANZ*.

The circuit split. In reading cases on *American Pipe* tolling, one can find a variety of circuit splits involving a range of claims. But the split most on the minds of securities practitioners is the one between the Second Circuit's *IndyMac* and *ANZ* decisions and the Tenth Circuit's *Joseph* decision.

Tolling inapt in Second Circuit—In *IndyMac*, IndyMac had issued mortgage pass-through certificates in multiple offerings pursuant to three registration statements. The Police and Fire Retirement System of the City of Detroit (PFRS Detroit) and the Wyoming State Treasurer and Wyoming Retirement System sued *IndyMac* in separate putative class action cases.

Ultimately, the Wyoming plaintiffs would lead the class litigation as the only named plaintiff in a consolidated class action in the federal court for the Southern District of New York. Wyoming sought to amend the complaint to include claims by PFRS Detroit, but the court dismissed the Wyoming complaint regarding securities not purchased by the Wyoming plaintiffs due to Wyoming's lack of an injury and, thus, lack of constitutional standing. PFRS Detroit and five other entities, including Los Angeles County Employees Retirement Association (LACERA), Public Employees Retirement System of Mississippi (MS PERS), and General Retirement System of the City of Detroit (Detroit Retirement; separate from PFRS Detroit), would move to intervene following the denial of class certification in the Wyoming case.

Still, the attempt to intervene would face multiple challenges, prompting the district court to deny the motion. The court reasoned that the Section 13 repose period had lapsed and that *American Pipe* tolling was inapt. The court also held that the intervenors' FRCP 15(c) relation-back theory was inapt. LACERA, MS PERS, and Detroit Retirement appealed.

The Second Circuit began its *IndyMac* opinion by explaining that a statute of limitations limits the availability of remedies, although equity sometimes can apply via tolling to preserve claims by asserted class members. By contrast, a statute of repose affects the underlying right by extinguishing the cause of action after a fixed period of time. The Second Circuit also noted the Supreme Court's reference in *Lampf* to Section 13 being a statute of repose.

According to the Second Circuit, equitable tolling could not apply because Section 13 is a statute of repose. But even if legal tolling could apply under federal civil procedure rules, the Rules Enabling Act's command that a court rule must not "abridge, enlarge or modify any substantive right" would prevent tolling in *IndyMac*. The substantive right at stake was the right to be free from certain securities claims after three years. The court also rejected the would-be intervenors' argument that the denial of their claims would set a precedent that may upset the nation's class action regime and place new burdens on courts. But the court noted that "sophisticated" litigants can cope without tolling under Section 13 and that only Congress can alter the repose period in Section 13.

The Second Circuit also rejected the intervenors' relation-back argument under FRCP 15(c). A key problem for the intervenors was that they were not named plaintiffs in the Wyoming case, even if they were members of the asserted class. The court found the result consistent with the Private Securities Litigation Reform Act. The court also suggested that the intervenors had other options, including making a timely motion to intervene as named plaintiffs, filing their own timely actions, or seeking joinder under FRCP 20.

In the Second Circuit's more recent *ANZ* case, in which the Supreme Court later held that Section 13 is a repose period not subject to equitable tolling,

the Second Circuit had reiterated its *IndyMac* conclusion that *Lampf* indicated the three-year period in Section 13 was a repose period and *American Pipe* tolling did not apply. In doing so, the court rejected CalPERS's argument that, unlike *IndyMac*, a named plaintiff had commenced the cause of action and, thus, CalPERS's claims were asserted within the repose period.

Tenth Circuit approves tolling—The Tenth Circuit provided the initial impetus for a circuit split to develop over Section 13 when it decided the *Joseph* case more than a decade before the Second Circuit's *IndyMac* and *ANZ* cases. In *Joseph*, the court found that the plaintiff had standing to sue as an after-market purchaser (a question of first impression in the circuit at the time) but went on to reject all three of the plaintiffs' reliance theories, ultimately remanding the case to the district court rather than directing class certification. But in reaching these conclusions, the panel also determined that *American Pipe* tolling applied under Section 13.

The *Joseph* case arose from an offering of debentures in 1987. Debenture holders first sued the issuer in April 1989 for violation of Exchange Act Section 10(b) in the Colorado federal district court. A second suit against the issuer on behalf of all securities purchasers in the offering followed in California in May 1989; the suit alleged violations of state law and of Securities Act Section 11 (an amended complaint in the second case later dropped the federal claim).

In October 1989, the issuer's common stock and debenture purchasers initiated a third suit against the issuer in the Colorado federal district court alleging federal Section 10(b) and Section 11 claims. At a hearing on class certification, the court expressed reluctance to certify the class of debenture holders, but the court also said the debenture holders could file an amended complaint (the Tenth Circuit noted that the debenture holders appeared not to amend their complaint). Meanwhile, the court later certified the shareholder class in a related suit. But the court apparently never ruled on whether to certify the class of debenture holders.

Plaintiff Joseph then sued the issuer on behalf of all purchasers in California alleging only Section 11 claims; that case was removed to federal court and transferred to the district court in Colorado, which denied Joseph's motion to certify the case as a class action. The defendant in *Joseph* argued that Section 13 operated as a statute of repose and thus barred Joseph's suit. Joseph countered that two prior suits had been filed before the Section 13 time limits lapsed and had functioned to toll those time limits. The shareholder suit produced a settlement and, when ordered by the court, Joseph filed an amended complaint alleging Section 10(b) and Section 11 claims. The district court dismissed Joseph's suit because, among other things, it was untimely. The Tenth Circuit reversed.

The Tenth Circuit panel began its opinion by rejecting the argument that *Lampf* and circuit precedent (based on equitable tolling) applied because the tolling at issue in *Joseph* was legal, not equitable. According to the court, Joseph was part of a class in another suit against the issuer, but the court in the earlier case did not rule on the class certification question regarding the debenture holders. The panel observed that a lower court's non-decision on a key question should not operate to extinguish the defendant's potential liability. The court further explained:

> Statutes of repose are intended to demarcate a period of time within which a plaintiff must bring claims or else the defendant's liability is extinguished. Here, the claim was brought within this period on behalf of a class of which Mr. Joseph was a member. Indeed, in a sense, application of the *American Pipe* tolling doctrine to cases such as this one does not involve "tolling" at all. Rather, Mr. Joseph has effectively been a party to an action against these defendants since a class action covering him was requested but never denied.

But the court still had to determine the proper time from which Joseph's suit was tolled. That date could not be from an earlier case in which no named plaintiff represented the debenture holders. Instead, tolling would apply as of the date of a suit that did include debenture holders. The court determined that Joseph's suit was timely filed as measured from that point in time.

Limitations law defines reach of SEC disgorgement powers

The Supreme Court held in *Kokesh* that disgorgement in the context of SEC enforcement actions is a penalty and, thus, must comply with the five-

year statute of limitations contained in 28 U.S.C. §2462. The court's decision builds upon its earlier decision in *Gabelli*, which applied the same limitations law to SEC actions for statutory monetary penalties. Kokesh had asked the justices to review the question of whether 28 U.S.C. §2462 applies to disgorgement because the issue recurs frequently in securities enforcement cases.

But the Supreme Court also suggested that its *Kokesh* opinion had some limits. In a footnote, the court said the only question presented in *Kokesh* was whether the limitations period in 28 U.S.C. §2462 applied to disgorgement in the context of SEC enforcement cases. The justices said they would not use *Kokesh* to speak on other issues, such as the authority of courts to order disgorgement in SEC enforcement cases or whether courts had correctly applied disgorgement principles.

Kokesh ultimately turned on the meaning of "penalty" within 28 U.S.C. §2462:

> Except as otherwise provided by Act of Congress, an 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 if, within the same period, the offender or the property is found within the United States in order that proper service may be made thereon.

Circuit courts had struggled with the meaning of "penalty" in the disgorgement context but also had mulled if disgorgement could be a "forfeiture" under the limitations period. The Supreme Court's *Kokesh* opinion brings some judicial clarity at least in the context of securities enforcement cases.

The SEC itself may need to clarify its own standards for when it can seek disgorgement in light of the Supreme Court's decision in *Kokesh*. Currently, Section 3.1.2, "Statutes of Limitations and Tolling Agreements," within the SEC's Enforcement Manual (obtained from www.sec.gov, June 6, 2017) lists among its several considerations that staff should "[k]eep in mind that certain claims are not subject to the five-year statute of limitations under Section 2462, including claims for injunctive relief and disgorgement."

What is a penalty? According to the Supreme Court, "[a] 'penalty' is a 'punishment,' whether corporal or pecuniary, imposed and enforced by the State, for a crime or offen[s]e against its laws." The court derived this definition from its 1892 opinion in *Huntington v. Attrill*. The court explained that the definition implies two principles upon which cases like *Kokesh* turn: (1) Is the wrong to be redressed a wrong to the public or to the individual? and (2) Is the pecuniary sanction sought in order to punish or to deter, or to compensate?

The justices said they would not use Kokesh to speak on other issues, such as the authority of courts to order disgorgement in SEC enforcement cases or whether courts had correctly applied disgorgement principles.

In *Kokesh*, the court focused on three aspects of the disgorgement sought by the SEC. For one, the disgorgement was imposed due to violations of public laws—that is, for wrongs against the U.S., not an individual. Disgorgement also had a punitive goal; in fact, the court said the "'primary purpose'" is to deter securities violations by stripping the wrongdoer of her illicit gains. Moreover, the SEC's cases tend to lack a compensatory element because of the uneven distribution of funds, which sometimes go to victims but, at other times, go to the U.S. Treasury.

The court's decision rejected the government's argument that disgorgement is remedial. Specifically, the court noted that disgorgement can exceed the amount of illicit gains, and disgorgement orders sometimes ignore the defendant's expenses that could reduce the amount of illicit gains. All of these factors worked in favor of the court's holding that disgorgement is a punitive sanction.

District court disgorgement calculus. The SEC filed suit against Charles Kokesh on October 27, 2009, in a wide-ranging complaint alleging violations of the Investment Company Act, the Investment Advisers Act, and the Exchange Act. According to the SEC, Kokesh, who controlled a pair of SEC-registered investment advisory firms, misappropriated funds from multiple SEC-registered business development companies via the unlawful payment of salaries, bonuses, and office rent. Kokesh also allegedly made false and misleading reports to the SEC regarding "tax distributions." The five-year limitations period

under 28 U.S.C. §2462 began to run on October 27, 2004, and much of the alleged wrongdoing occurred between 1995 and 2007, with some of the alleged wrongful conduct falling within, and some outside of the limitations period.

After a five-day trial, a jury deliberated briefly before finding that Kokesh violated the Investment Company Act and that he aided and abetted violations of the Advisers Act and the Exchange Act. Then-SEC Enforcement Director Andrew Ceresney praised the verdict, noting that Kokesh allegedly had been "systematically looting" nearly $35 million from clients. Soon after the district court entered a final judgment in the case, including an award of disgorgement, the SEC brought a separate administrative proceeding against Kokesh.

The district court imposed a third-tier civil money penalty on Kokesh totaling $2.4 million; the amount reflected that some conduct occurred outside of the limitations period, which applied per *Gabelli* to the SEC's monetary penalty. The district court also concluded that the injunction sought by the SEC was not a penalty and was warranted under Tenth Circuit factors.

As for disgorgement, Kokesh, citing both *Gabelli* and the district court decision that would lead to the Eleventh Circuit's treatment of SEC disgorgement as a forfeiture, argued that disgorgement is a penalty and that the SEC's claims against him first accrued before the limitations period. Still, the district court concluded that disgorgement is not a penalty because, under the Tenth Circuit's *Telluride* precedent, the amount sought by the SEC was not unrelated to or beyond the damages allegedly caused by Kokesh. The district court then ordered Kokesh to pay disgorgement of $34.9 million with $18.1 million in prejudgment interest.

Navigating the circuit split. A trio of cases, including *Kokesh* from the Tenth Circuit and cases from the Eleventh and D.C. Circuits, highlight the issue before the Supreme Court in *Kokesh*. Each of these circuit courts had considered whether disgorgement in the context of an SEC enforcement case was a "penalty" or "forfeiture" under 28 U.S.C. §2462. The D.C. and Tenth Circuits held that disgorgement was not a penalty; the D.C. Circuit implied that a forfeiture theory would be foreclosed by circuit precedent, while the Tenth Circuit went on to conclude that disgorgement also was not a forfeiture, although the Tenth Circuit left several related questions unresolved. But the Eleventh Circuit held that the SEC could not obtain disgorgement outside the limitations period of 28 U.S.C. §2462 because disgorgement was a forfeiture (the court did not address whether disgorgement is also a penalty).

Tenth Circuit—The Tenth Circuit's *Kokesh* opinion dealt with three issues: disgorgement; injunctive relief; and evidentiary issues remaining after trial. The panel quickly dispatched the injunction issue, finding the SEC's requested obey-the-law injunction was not a penalty. The panel also rejected Kokesh's evidentiary arguments because he waived them by failing to preserve specific arguments about his reliance on professionals.

But the Tenth Circuit did examine whether disgorgement is a penalty or forfeiture under 28 U.S.C. §2462. First, the court concluded that disgorgement is not a penalty because it is remedial. The court cited the Restatement (Third) of Restitution and Unjust Enrichment for the proposition that disgorgement deprives a wrongdoer of profit without penalizing the wrongdoer—that is, the wrongdoer stands in the position he would have been in absent the wrongdoing. The court also cited the Tenth Circuit's *Telluride* opinion for the proposition that disgorgement is remedial and not a penalty; *Telluride* explained what it means for something to be a "penalty" under 28 U.S.C. §2462:

> Based on these definitions, we interpret a penalty for purposes of § 2462 as a sanction or punishment imposed for violating a public law which goes beyond compensation for the injury caused by the defendant (internal footnote omitted).

Kokesh had also argued that disgorgement in his case was improper because it would require him to pay more than he had gained from the alleged wrongdoing because some of the misappropriated funds had been distributed to third parties. The court rejected this argument and instead concluded that such a remedy would not be "punitive." After citing supporting cases from the Second, Ninth, and D.C. Circuits, the court concluded by likening the disgorgement scenario in Kokesh's case to a personal injury defendant who must pay all damages he caused regardless of the fact he gained nothing from his acts. The court also said the likelihood of the government recovering amounts ordered to be disgorged was "irrelevant" in rejecting Kokesh's argument that his advancing age and insolvency could make recovery difficult.

Moreover, the Tenth Circuit rejected Kokesh's argument that disgorgement was a forfeiture under 28 U.S.C. §2462. The court acknowledged the Eleventh Circuit's *Graham* opinion (finding disgorgement is forfeiture) while noting that numerous other courts had reached contrary conclusions. The court also acknowledged the general trend of including disgorgement-like remedies in forfeiture proceedings but said that trend was inapt in the context of traditional forms of disgorgement.

Still, the Tenth Circuit provided a list of open questions beyond its conclusion that disgorgement under 28 U.S.C. §2462 is neither a penalty nor a forfeiture:

- Is 28 U.S.C. §2462 inapplicable to all equitable remedies?
- Does 28 U.S.C. §2462 encompass disgorgement remedies in forfeiture laws?
- Is 28 U.S.C. §2462 jurisdictional?

The Supreme Court's *Kokesh* opinion in a footnote would later suggest the broad outlines of a future legal attack on the SEC's disgorgement authority.

D.C. Circuit—The D.C. Circuit's *Riordan* opinion is typical of the circuit splits cited by the Supreme Court that required clarification in *Kokesh*. In *Riordan*, New Mexico's treasurer pleaded guilty to extortion charges related to the abuse of that office in selecting brokerage firms to handle portions of the state's securities investments. The treasurer cooperated with law enforcement authorities and named Guy Riordan as someone who had paid kickbacks to the treasurer in exchange for the state directing securities transactions to Riordan's brokerage.

Riordan was not criminally prosecuted, but the SEC still brought a civil enforcement proceeding against him under the agency's antifraud authorities. An administrative law judge found Riordan liable and imposed a broker-dealer associational bar, a $500,000 civil fine, and disgorgement of nearly $1.4 million (with prejudgment interest). The Commission upheld the ALJ's decision, and Riordan filed a petition for review in the D.C. Circuit.

On appeal, Riordan asserted defects in the sanctions imposed by the Commission along with various evidentiary issues. With respect to the evidence questions, the court found a few "closer" arguments regarding the civil fines but concluded, overall, the evidence against Riordan was sufficient to uphold the Commission's findings. Ultimately, the associational bar and civil fine were found to be within the limitations period of 28 U.S.C. §2462. Although the court scrutinized the disgorgement amount more closely, the court still denied Riordan's petition for review.

The fact that some of the disgorgement amount fell within, and some outside of, the limitations period would have potentially resulted in a smaller disgorgement amount had the limitations period applied to the disgorgement award. According to the court, it was bound to apply circuit precedent holding that disgorgement is not a penalty if the amount of disgorgement imposed is causally related to the wrongdoing. The court characterized the limitations theory as Riordan's "most significant argument" before finding that the limitations period in 28 U.S.C. §2462 did not apply to disgorgement.

Moreover, the *Riordan* panel suggested in a footnote that one of the circuit's precedents (*Zacharias*) it had relied on for the proposition that disgorgement is not a penalty also could be understood to implicitly foreclose an argument that disgorgement is a "forfeiture" under 28 U.S.C. §2462. The *Riordan* court posited a scenario in which disgorgement benefitted the government instead of making a wronged party whole, thus operating like a forfeiture. In *Zacharias*, the D.C. Circuit had addressed only the "penalty" argument. But the *Riordan* court went on to note that amounts to be disgorged from Riordan would seemingly benefit New Mexico, not the U.S.

(One judge, who authored most of the *Zacharias* opinion, dissented from the court's conclusion about the amount of disgorgement imposed on two of the three individuals who were subject to SEC disgorgement orders. Although the dissenting judge would have deducted the value of certain options from the disgorgement amount, that same judge later wrote briefly to explain why he agreed with the D.C. Circuit's denial of en banc review: "Given apparent agreement on the key principles, I do not believe the case justifies spending the court's limited resources on en banc review." (Williams, J., concurring)).

Eleventh Circuit—The Eleventh Circuit would later take the leap not taken by the Tenth Circuit

in *Kokesh* and apparently foreclosed to the D.C. Circuit in *Riordan* and would instead hold in *Graham* that disgorgement in a case brought by the SEC was a forfeiture. In May 2016, the court reached this conclusion in a case the SEC brought alleging that multiple defendants engaged in the unlawful sale of condominiums that functioned like unregistered securities. The district court dismissed the case because, in its view, *all* of the SEC's remedies were time-barred under 28 U.S.C. §2462 because they occurred outside the limitations period; the SEC had sought an injunction, declaratory relief, and disgorgement. The Eleventh Circuit affirmed regarding declaratory relief and disgorgement but remanded the case for additional proceedings regarding injunctive relief.

With respect to the SEC's request for an injunction, the court concluded that circuit precedent treating injunctions as equitable remedies barred application of 28 U.S.C. §2462 to the SEC's request for injunctive relief. The court also said that, absent circuit precedent, the plain meaning of "penalty" (undefined in 28 U.S.C. §2462) is something that is a punishment for a past violation of public law. By contrast, an injunction is forward-looking and would not be time-barred under 28 U.S.C. §2462. Remand was necessary because, while obey-the-law injunctions are disfavored in the circuit because they are broad and unenforceable, the SEC could conceivably request an appropriately structured injunction.

The SEC also had asked for declaratory relief and disgorgement, which prompted the court to mull the scope of 28 U.S.C. §2462. The court reasoned that declaratory relief is backward-looking and functions like a penalty. As a result, the SEC's request for declaratory relief must comply with 28 U.S.C. §2462.

As for disgorgement, the court looked to the ordinary meaning of "forfeiture," which it said meant when a person must surrender money or property for having committed a crime or other wrong. The court suggested there was "no meaningful difference" between "disgorgement" and "forfeiture" and that 28 U.S.C. §2462 applied to the SEC's disgorgement request. But, in a footnote, the court declined to address the defendant's argument that disgorgement also is a penalty.

The Supreme Court Addresses Insider Trading in *Salman v. U.S.*

Early in the 2016 term, the Supreme Court unanimously affirmed a conviction arising out of an insider trading scheme between family members in *Salman v. U.S.* Prior to *Salman*, lower courts had hewed to the court's 1983 holding in *Dirks v. SEC*. In that case, the court held that a tippee's duty to disclose inside information or abstain from trading on it derives from that of the insider who made information available to them improperly and in violation of the insider's duty to disclose or abstain. The test is whether the insider obtains a personal benefit from the disclosure. Without some personal gain, there has been no breach of duty to stockholders, and, absent a breach by the insider, there is no derivative breach.

One of the most significant insider trading actions after *Dirks* was the Second Circuit's decision in *U.S. v. Newman*. In *Newman*, a unanimous Second Circuit panel vacated the insider trading convictions of two hedge fund portfolio managers because there was no evidence that the managers knew they were trading on information obtained from insiders, that those insiders received any benefit in exchange for the disclosures, or even that the portfolio managers consciously avoided learning of these facts. According to the court, the government failed to present sufficient evidence showing that the portfolio managers willfully engaged in substantive insider trading or a conspiracy to commit insider trading. There was no evidence that the managers knew they were trading on information obtained from insiders or that those insiders received any benefit in exchange for the disclosures. In order to sustain an insider trading conviction against a tippee, the government must prove that the corporate insider was entrusted with a fiduciary duty and breached that duty by disclosing confidential information to a tippee in exchange for a personal benefit and the tippee knew of the tipper's breach. The Second Circuit held that an inference that the insiders received a personal benefit was impermissible "in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."

The government asked the *Newman* panel and the full circuit court to rehear the decision because it believed the panel went too far in limiting the types of insider trading cases the government can bring. The SEC, in an amicus brief, also urged the appeals court to take a second look. The petition was denied.

In its petition for certiorari in *Newman*, the government argued that the Second Circuit's decision conflicted with Supreme Court precedent. In *Dirks*, the court held, as relevant to Salman's case, that a "personal benefit" constituting a breach of fiduciary duty includes the "gift of confidential information to a trading relative." The petition argued that the Second Circuit rewrote the concept of a "gift" so as to eliminate it in an "unprecedented" redefinition of an insider trading theory long recognized under the *Dirks* precedent. The government also pointed out that the Second Circuit's decision clashed with other circuits that had faithfully applied the *Dirks* personal-benefit standard, noting decisions in the Ninth (*Salman*) and Seventh Circuits (*SEC v. Maio*). On its return to the bench for the October 2015 term, the court denied the *Newman* petition.

The Ninth Circuit affirms Salman's conviction. In 2003, petitioner Bassam Salman's sister became engaged to an employee in Citigroup's healthcare investment banking group. As time went on, Salman grew close to the fiancé's brother, who began to share with Salman inside information that he had learned from the fiancé. Salman traded through an intermediary and eventually amassed over $2 million from his trades. Salman was eventually convicted of one count of conspiracy to commit securities fraud and four counts of securities fraud. At trial, the government presented evidence that Salman knew that the fiancé was the source of the information that he traded on and that he was aware of the brothers' close relationship. Salman timely appealed the district court's denial of his motion for a new trial, but, in late 2014, the Second Circuit decided *Newman*.

On appeal, Salman urged the Ninth Circuit to adopt *Newman's* stricter personal-benefit standard, arguing that the evidence was insufficient to find that the fiancé gave information to his brother in exchange for some tangible benefit, or, if he did, that Salman knew of any such benefit. The circuit panel disagreed, finding that the Supreme Court's holding in *Dirks v. SEC* governed. According to the panel, this interpretation would depart from "the clear holding of *Dirks*" and, moreover, *Newman* itself said that "personal benefit" is broadly defined and includes gifts of information to friends. "Proof that the insider disclosed material nonpublic information with the intent to benefit a trading relative or friend is sufficient to establish the breach of fiduciary duty element of insider trading," the panel said, and that was what occurred in this case.

The Supreme Court affirms based on *Dirks*. Salman then petitioned for certiorari, which was granted in January 2016. In his petition, Salman asked if it is enough that an insider and tippee share a close family relationship without proof of an exchange that represents a potential gain of a pecuniary or similarly valuable nature. This personal-benefit question was identical to the issue on which the government unsuccessfully sought certiorari in *Newman*. Unlike *Newman,* the petition argued, this issue was determinative in Salman's case: if there was no evidence of "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature" between the tipper siblings and no evidence that Salman knew of any such exchange, Salman would prevail. The government, for its part, argued for a broad application of the *Dirks* standard and posited that a gift of information would be sufficient if the information was disclosed for a non-corporate purpose.

The justices adhere to *Dirks*. The Supreme Court unanimously affirmed Salman's conviction. The court said in *Dirks* that the purpose for disclosing confidential information is critical, and disclosure without a personal benefit to the insider is insufficient to establish insider trading. Noting the court's adherence to the precedent set in *Dirks*, Justice Alito explained that *Dirks* had provided courts with tools to evaluate insider trading cases, including instructions to look for direct or indirect personal benefits (*e.g.*, money or reputational benefits) and offered principles regarding the gift of confidential information to a trading relative or friend. *Dirks* makes it clear that a tipper breaches a fiduciary duty by making a gift of confidential information to "a trading relative." The court agreed with the Ninth Circuit that *Newman* is inconsistent with *Dirks* to the extent that the Second Circuit held that a tipper must also receive something

of a "pecuniary or similarly valuable nature" in exchange for a gift to family or friends.

The *Dirks* approach easily resolved the narrow issue presented in this case, the court said. Here, the tipper disclosed information as a gift to his brother with the expectation that he would trade on it, which was a breach of a duty of trust and confidence to the tipper's employer. Salman, the brother-in-law of the tippee, then "acquired" that duty and proceeded to breach it by trading on the information with full knowledge that the information was improperly disclosed. While Salman pointed to many insider trading cases involving insiders who personally profited through the misuse of trading information, this did not undermine the "common sense point" made in *Dirks*. Making a gift of inside information to a trading relative, Justice Alito explained, is not much different than trading on that information and giving the profits to the relative.

Vagueness and lenity. The court also rejected Salman's argument that the *Dirks* gift-giving standard was unconstitutionally vague. *Dirks*, the court said, contains a "simple and clear 'guiding principle.'" Even a clear rule can leave circumstances in which assessing liability for gift-giving will be difficult, the court said, but Salman failed to show that there is a "grave uncertainty" or "hopeless indeterminacy" about how to estimate the risks of trading on inside information.

The court then rebuffed Salman's invocation of the rule of lenity. Salman's case simply did not present major uncertainties or otherwise present the kinds of challenging facts that might justify application of the rule of lenity. "To the contrary, Salman's conduct is in the heartland of *Dirks*'s rule concerning gifts," said the court.

Finally, in a footnote, the court declined to address the question of whether the *Dirks* personal-benefit analysis applies in classical or misappropriation insider trading cases. There was no need to decide this question because the parties had agreed, and the court assumed, that *Dirks* applies in both settings. The Ninth Circuit had said in a footnote of its own that Salman's case was a misappropriation case.

The landscape after *Salman*. In *Salman*, the Supreme Court agreed with the Ninth Circuit that *Newman* is inconsistent with *Dirks* to the extent that it held that a tipper must also receive something of a "pecuniary or similarly valuable nature" in exchange for a gift to family or friends. However, the court did not venture into other issues in the *Newman* opinion and only disagreed with the Second Circuit's approach to gifts.

Justices decline to hear similar case—In the wake of the *Salman* decision, the high court denied certiorari for David Riley's petition to vacate and remand a Second Circuit decision upholding his insider trading conviction. The petition involved the same issue under consideration in *Salman*—that is, whether the "personal benefit" element of the insider trading proscription of Section 10(b), established in *Dirks*, required the government to show that the insider/tipper disclosed material, nonpublic information in order to obtain tangible, pecuniary gain. The purported personal benefit in this case involved business and career advice and a couple of stock tips, which, the petitioner contended, were intangible and de minimis benefits that did not amount to a personal benefit that would support an insider trading conviction.

Noting the court's adherence to the precedent set in Dirks, Justice Alito explained that Dirks had provided courts with tools to evaluate insider trading cases, including instructions to look for direct or indirect personal benefits (e.g., money or reputational benefits) and offered principles regarding the gift of confidential information to a trading relative or friend.

First Circuit—One circuit court has addressed personal benefits after *Salman*. In February 2017, a golfer convicted of trading on a tip passed to him by a fellow country-club member lost his appeal to the First Circuit. In *U.S. v. Bray*, the court ultimately concluded that the record evidence and testimony provided a sufficient basis to show more than a casual or social relationship between the tipper and tippee and that the tip was disclosed in expectation of a personal benefit.

The golfer, Robert Bray, admitted that he traded based on material, nonpublic information and that the tipper breached his duty of loyalty and confidentiality, but argued that there was insufficient evidence that the tipper expected a

personal benefit or that Bray had knowledge of such an expectation or breach of fiduciary duty. Bray's argument was based in part on *Newman's* holding that a personal benefit may not be inferred in the absence of "a meaningfully close personal relationship." This position, the court remarked in a footnote, was not foreclosed by *Salman*, which only rejected any requirement that the tipper receive a pecuniary or similarly valuable benefit. In another footnote, the court noted that *Salman* did not address what level of knowledge a tippee must have regarding the tipper's receipt of a personal benefit. This issue, the court said, was of no consequence in this case because a jury could reasonably conclude that Bray had the requisite knowledge even under *Newman's* higher standard requiring that the tippee know that the tipper disclosed the information in exchange for a personal benefit.

Bray also argued that the trial court clearly erred by instructing the jury that it could convict if he "should have known" that the tipper had an obligation to keep the information confidential. He also claimed that the trial court wrongly equated the concept of "willful blindness" with negligence. The appeals court agreed that there was plain error on both these points. However, to establish reversible plain error, a defendant must show not only that a clear or obvious error occurred, but also that the error affected his substantial rights and seriously impaired the fairness, integrity, or public reputation of the judicial proceedings. Bray could not satisfy the last prong of this test because the government's case was sufficiently strong that it was unlikely a properly instructed jury would have acquitted.

Bray has since filed a petition for rehearing and rehearing en banc. The petition takes issue with the court's articulation of the fourth prong of plain-error review, objecting to the panel's conclusion that the evidence provided a solid base on which a jury could find Bray guilty. That Bray "could" be found guilty is not the standard set out by Supreme Court and circuit court precedent, the petition says; instead, the evidence must be "overwhelming and essentially uncontroverted." The petition notes in closing that the 79-year-old Bray faces two years in prison based on an erroneous instruction permitting conviction based on mere negligence.

Looking ahead: disclosure, SLUSA, whistleblowers, and ALJs

The Supreme Court's OT 2017 securities docket already has become a bit crowded. The court will mull questions about Regulation S-K disclosures, class actions under SLUSA, and Dodd-Frank Act language regarding whistleblowers. But could the justices take even more securities cases next term? One possibility is the now-explicit circuit split over the SECs ALJs.

***Leidos* and the duty to disclose.** There are many explicit disclosure duties under the Commission's regulatory regime. However, the existence or lack of a duty to disclose specific information by regulation does not resolve all questions concerning whether companies were obligated to reveal the information in question. Several aspects of this issue have generally been settled. For example, a person who chooses to speak in a manner reasonably calculated to influence investors assumes the duty to speak. In the case of a failure to speak, however, the question can be more difficult to resolve.

In 2011, the Supreme Court reemphasized in *Matrixx Initiatives, Inc. v. Siracusano* that Section 10(b) and Rule 10b-5(b) do not create an affirmative duty to disclose any and all material information. Disclosure is required under these provisions only when necessary to make statements made, in the light of the circumstances under which they were made, not misleading. Companies are entitled to keep silent about good news, as well as bad news, unless positive law creates a duty to disclose, even with respect to information that a reasonable investor might consider material. Issuers may control what they have to disclose under these provisions by controlling what they say to the market.

Disclosure under Item 303 and the Exchange Act—In its next term, the Court will consider whether Item 303 of Regulation S-K creates a duty to disclose that is actionable under Section 10(b) and Rule 10b-5. Certiorari was granted late in the term, and the Court currently awaits briefs on the merits from both parties.

The petition in *Leidos, Inc. v. Indiana Public Retirement System* asks the court to resolve a split involving a holding by the Second Circuit, which found that Item 303 creates an independent duty to disclose under the antifraud provisions that is

in direct conflict with decisions of the Third and Ninth Circuits. Item 303 (17 C.F.R. § 229.303(a)(3)(ii)) requires a company to describe known trends, events, or uncertainties that are reasonably likely to impact the company materially. The courts that have construed the provision have held that there is no private cause of action under Item 303 itself.

In 2000, the petitioner, known at the time as SAIC, Inc., became the prime government contractor on a project with New York City to develop and implement CityTime, an automated timekeeping program for employees of various city agencies. While the project was underway, two SAIC employees engaged in a kickback scheme with a subcontractor that resulted in overcharges. The employees went to great lengths to keep the scheme a secret, and SAIC and its management were unaware of the scheme until it was uncovered by government investigators in December 2010. SAIC's audit team reported the findings of its investigation on March 9, 2011.

SAIC's Form 10-K, filed on March 25, 2011, did not discuss the CityTime project. A Form 8-K filed in June 2011 finally disclosed that: there was a criminal investigation into the CityTime contract; one of the employees had been arrested for fraud; that SAIC had offered to refund the city $2.5 million billed as part of the scheme; and that there could be additional exposure to loss if there were adverse outcomes in any of the investigations. A second Form 8-K included a formal demand that SAIC reimburse the city approximately $600 million.

In 2012, investors filed suit alleging that SAIC's statements, including its SEC filings, contained false statements and omissions about SAIC's exposure to liability related to the CityTime fraud scheme. The complaint also asserted that the filings failed to disclose known trends and uncertainties associated with the fraud as required by Item 303. The district court ultimately dismissed the complaint with prejudice.

Actual knowledge required—On appeal, the Second Circuit for the first time specifically held that the plain language of Item 303 requires actual knowledge. Prior to this case, the court had never directly addressed the issue but generally required an allegation or showing of actual knowledge. Item 303, the court held, "requires a registrant to disclose only those trends, events or uncertainties that it actually knows of when it files the relevant report with the SEC." It is not enough, the court continued, that a registrant should have known of the existing trend, event, or uncertainty.

The court went on to find that the complaint supported a strong inference that SAIC actually knew about the CityTime fraud and that it could be implicated in the fraud, before filing its Form 10-K. Moreover, exposure of the fraud also jeopardized SAIC's existing or future relationships with other governmental entities that accounted for a significant amount of its revenue. Under these circumstances, the court said, SAIC was required under Item 303 to disclose the expectation of a material impact to its future revenues.

In its next term, the Court will consider whether Item 303 of Regulation S-K creates a duty to disclose that is actionable under Section 10(b) and Rule 10b-5.

Circuit split—The petition argues that the Second Circuit's holding entrenches a deep circuit split, particularly between the Second and Ninth Circuits, which see more securities cases than the rest combined. According to the Second Circuit, the petition explains, a duty to disclose under Section 10(b) can derive from statutes or regulations obliging a party to speak, including Item 303, even if those omissions do not make any affirmative statements misleading. This holding is in direct conflict with Third and Ninth Circuit decisions holding that Item 303 does not create such an independent duty to disclose. The Second Circuit's position is also at odds with views expressed within the Sixth and Eleventh Circuits, the petition adds, and this inconsistency has fueled forum shopping in Section 10(b) litigation.

The Second Circuit's reasoning was based on its 2015 *Stratte-McClure v. Morgan Stanley* decision, which held that the management's discussion and analysis (MD&A) requirement of Item 303 creates an affirmative duty to disclose that can serve as the basis for an Exchange Act Section 10(b) fraud claim. The court in *Stratte-McClure* noted that the circuits have "long recognized that a duty to disclose under Section 10(b) can derive from

statutes or regulations that obligate a party to speak." The court had previously established that Item 303 creates a duty to disclose for the purposes of liability under Securities Act Section 12(a)(2). Obligatory Item 303 disclosures "give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's financial condition and results of operations," the court said, quoting an interpretive release regarding the disclosure required by Item 303. A reasonable investor would interpret the absence of an obligatory disclosure to imply the nonexistence of "known trends or uncertainties." It follows, said the court, that Item 303 imposes the type of duty to speak that can give rise to liability under Section 10(b). All the other requirements attendant in a Section 10(b) action still apply, the court added.

Third Circuit: Oran v. Stafford—The court in *Stratte-McClure* acknowledged that its holding was contrary to the conclusion reached in the Ninth Circuit in *In re NVIDIA Corp. Securities Litigation*, which relied on a 2000 Third Circuit opinion written by then-Judge Alito that concluded that Item 303's disclosure duty is not actionable under Section 10(b) and Rule 10b-5. In *Oran v. Stafford*, the Third Circuit held that a duty to disclose arises, among other circumstances, when there a statute requiring disclosure or an inaccurate, incomplete, or misleading prior disclosure. *Oran* also held that a violation of Item 303 does not automatically constitute a violation of Section 10(b) because the materiality standards for Rule 10b-5 and Item 303 differ significantly. The court quoted the SEC's interpretive release as saying that the test for materiality set out in *Basic Inc. v. Levinson* (requiring a balancing of the probability that the event will occur and the anticipated magnitude of the event) is "inapposite to Item 303 disclosure." Item 303, in other words, requires disclosure of much more information that Section 10(b), the petition remarks.

Ninth Circuit: In re NVIDIA—The Ninth Circuit decided *NVIDIA* in 2014, approximately one year before *Stratte-McClure*. While the circuit had suggested that a violation of Item 303 could not be used to show a violation under the Exchange Act, it had never directly decided the issue. In this case, the appellant urged the court to find that NVIDIA was required by Item 303 to disclose a known problem with one of its products as long as a potential liability *could* have a material impact on its financial condition. If the information is material, failure to disclose it constitutes a material omission under Section 10(b) and Rule 10b-5. The appellant's brief maintained that the complaint adequately alleged that NVIDIA acted with scienter because it knew, but withheld, facts that it had a duty to disclose.

The Ninth Circuit held that Item 303's disclosure duty is not actionable under Section 10(b) and Rule 10b-5. The court followed *Oran's* lead in finding that the disclosure requirements of Item 303 differ considerably from what is required under Section 10(b), and a duty to disclose under Section 10(b) must be separately shown according to the principles set forth by the Supreme Court in *Basic* and *Matrixx*. The "demonstration of a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5," the court explained in a direct quote from *Oran*. The Supreme Court denied certiorari on a petition addressing the Item 303 claim and pointing out the conflict with *Stratte-McClure*.

The Second Circuit stands alone—The Second Circuit took a narrower view of *Oran*, saying: "Contrary to the Ninth Circuit's implication that *Oran* compels a conclusion that Item 303 violations are never actionable under 10b-5, *Oran* actually suggested, without deciding, that in certain instances a violation of Item 303 *could* give rise to a material 10b-5 omission." The court also noted that the *NVIDIA* panel found decisions, including those from the Ninth Circuit, holding that Item 303 creates a duty to disclose under Section 12(a)(2) irrelevant to its interpretation of Rule 10b-5. The Second Circuit stated in contrast that Section 12(a)(2)'s prohibition on omissions is "textually identical" to that of Rule 10b-5. The *Leidos* petition points out, however, that *Stratte-McClure* does not acknowledge, as the Ninth Circuit did, that the reasoning in these cases was actually based on Securities Act Section 11, which imposes strict liability for failures to disclose, calling it a "crucial" distinction.

The Sixth and Eleventh Circuits have made less definitive statements but suggest that Item 303 does not create a duty under the antifraud provisions. The Sixth Circuit, in *In re Sofamor Danek Group, Inc.* (1997) was not persuaded by the plaintiffs' suggestion that a disclosure duty

under a Rule 10b-5 claim may stem from Item 303, and the court found that the complaint did not sufficiently show a violation of Item 303 in the first place. More recently, a concurring opinion in *Thompson v. RelationServe Media, Inc.* (3rd Cir. 2010) cited *Oran* in a footnote, observing that the assumption that Item 303 of Regulation S-B (which was, at the time, materially identical to Item 303 of Regulation S-K) would impose an actionable duty under Rule 10b-5 was "generous."

This circuit split has led to "confusion" among the district courts, the petition argues. A court in North Carolina has accepted *NVIDIA's* reasoning, and, on the other hand, a Minnesota district court was persuaded by *Stratte-McClure's*. (*See* two cases compared in the *Leidos* petition: *Ash v. Powersecure International, Inc.* (E.D.N.C. 2015) and *Beaver County Employees' Retirement Fund v. Tile Shop Holdings, Inc.* (D. Minn. 2015)). More importantly, the circuit split has led to forum-shopping, and the petition notes that, since *NVIDIA* was decided, more than four times as many complaints based on Item 303 have been filed in the Second Circuit as compared to the Ninth.

When is a duty to disclose imposed?—The petition also urges the Supreme Court to take the opportunity to clarify the scope of the duty to disclose under Section 10(b). The court reaffirmed in *Matrixx* that Section 10(b) and Rule 10b-5 do not create an affirmative duty to disclose any and all material information. Since 1934, the petition observes, the court has recognized only two situations giving rise to an affirmative duty to disclose: in the context of insider trading and when necessary to make earlier statements not misleading. The Second Circuit's holding, the petition contends, undermines and conflicts with the court's holdings on Section 10(b) liability by adding a third situation: when a statute or regulation mandates disclosure. No other court, the petition maintains, has found Section 10(b) liability based on the failure to disclose information required to be disclosed by a statute or regulation, and this upends the fundamental tenet that companies may control what they have to disclose by controlling what they say to the market.

Left undisturbed, the petition concludes, the Second Circuit's holding could expose issuers to massive liability for omitting information that might later be found to be a trend or uncertainty under Item 303. The Second Circuit's position is an "unprecedented expansion" of liability under Section 10(b) that will lead to a significant increase in fraud claims, according to the petition. The petition adds that the Second Circuit's holding allows plaintiffs to do an end-run around the well-settled rule that Item 303 does not by itself create a private cause of action and encourages fraud-by-hindsight pleading. Finally, the petition cautions that the risk of securities fraud actions based on Item 303 violations will force issuers to inundate shareholders and the market with non-material and trivial information, defeating the purpose of a regulation intended to promote "meaningful" disclosure.

The Cyan *petition has roots in both SLUSA's amendments to the Securities Act and in a California intermediate appellate court decision.*

Amicus briefs filed in support of the *Leidos* petitioners agree that the Second Circuit's holding has far-reaching consequences. A brief by the National Association of Manufacturers contends that the Second Circuit's rulings "expand the private right of action under Rule 10b-5 far beyond what Congress intended." The logical recourse for NAM's members is to overdisclose in order to mitigate the increased likelihood of being sued, an outcome "as predictable as it is harmful." Moreover, the brief says, the logic behind the rulings can be expanded to encompass other regulations setting forth public disclosure requirements, opening "the floodgates of vexatious Rule 10b-5 litigation." A joint brief by SIFMA and the U.S. Chamber of Commerce similarly observes that Rule 10b-5 liability for failures to disclose under Item 303 would "strongly skew managers' behavior toward the overly cautious, self-preserving end of the spectrum." The Second Circuit's position also undermines management's ability to make judgment calls about what forward-looking information merits disclosure, the brief says.

SLUSA: 1933 Act-only claims in state class action. The late-term *Cyan* grant offers the Supreme Court a chance to re-examine the scope of SLUSA. Depending on one's perspective, the question is

whether state courts lack subject matter jurisdiction over, or retain concurrent jurisdiction (with federal courts) over, class action suits that allege only Securities Act claims. The *Cyan* case arose when investors in Cyan sued following the company's disappointing results after an initial public offering. Investors sued the company in California state court for violations of Securities Act Sections 11, 12(a)(2), and 15. The California courts, all the way up to the state supreme court, ruled in favor of the investors, prompting Cyan to seek review by the Supreme Court.

There is little dispute between the parties in *Cyan* that, for much of the existence of the Securities Act, these types of claims were subject to concurrent federal and state court jurisdiction. The parties agree that the Private Securities Litigation Reform Act created a situation where some state court actions sought to exploit a loophole that made state courts preferred forums. But the parties also agree that SLUSA was an attempt by Congress to close much of that loophole. Still, the parties disagree about how far Congress went in shuttering state courts for purposes of Securities Act-based class actions: Cyan argues that all such actions are barred under SLUSA; the respondent, Beaver Creek Employee' Retirement Fund, argues that SLUSA left state court doors open to state actions alleging only Securities Act claims.

Securities Act Section 22 states, in part:

> The district courts of the United States and United States courts of any territory shall have jurisdiction of offenses and violations under this title and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and territorial courts, except as provided in Section 16 with respect to covered class actions, of all suits in equity and actions at law brought to enforce any liability or duty created by this title.

Section 16 defines "covered class action" to mean, among other things, any single lawsuit or group of lawsuits filed in which damages are sought on behalf of more than 50 persons. A covered class action that involves "covered securities" (*i.e.*, per Section 18(b), listed on specified stock exchanges or a national securities exchange or issued by a registered investment company) is removable to federal district court where it would be dismissed if it is a type of suit barred by Section 16(b).

The *Cyan* petition has roots in both SLUSA's amendments to the Securities Act and in a California intermediate appellate court decision. The California case involved an investor lawsuit over securities issued by Countrywide Financial Corporation. The trial court sustained Countrywide's demurrer and the investors appealed to the California Court of Appeal, which, after reviewing the matter de novo, reversed. According to the court, the case involved a covered class action, but not a covered security, so the case was not removeable under SLUSA. Moreover, the case did not involve state law, only Securities Act claims, so it was not precluded.

Are Dodd-Frank's whistleblower protections available only to those who report misconduct to the SEC?

Cyan argues that *Countrywide* pried open the loophole closed by SLUSA, resulting in "chaos" in federal and state courts, and is responsible for a 1,400 percent spike in Securities Act class actions being filed in California. Respondents in *Cyan* equally dispute Cyan's characterization of *Countrywide's* impact and the accuracy of Cyan's statistic. The U.S. Solicitor General weighed in via amicus brief and recommended that the court hear the case. The U.S. noted "confusion" in lower courts and suggested that a grant could produce a decision that promotes uniformity in applying SLUSA.

The similar *FireEye* petition is still pending before the Supreme Court. Fire Eye asked to consolidate its petition with Cyan's petition, but the grant in *Cyan* did not mention Fire Eye. In the *FireEye* petition, much as in *Cyan*, the corporate petitioners noted that there apparently was no dispute over whether the suit was a covered class action or whether a covered security was involved. In March, the court extended the time to file a response to the *FireEye* petition until late August.

Dodd-Frank Whistleblowers. The Supreme Court will also consider next term an issue that has divided circuit courts: Are Dodd-Frank's whistleblower protections available only to those

who report misconduct to the SEC? The court granted certiorari to review a Ninth Circuit holding that internal whistleblowers are protected from employment retaliation. The Second Circuit also takes that view, but the Fifth Circuit read the plain language of the statute to require SEC reporting.

Exchange Act Section 21F, added by Dodd-Frank, bars employers from discriminating against "a whistleblower" for providing information to the SEC; being involved in an investigation or action based on the information; or making disclosures required or protected under the securities laws. That third category of protected disclosures includes certain categories of internal reporting and other reports that are not necessarily made to the SEC. But "whistleblower" is defined elsewhere in Section 21F as "any individual who provides … information relating to a violation of the securities laws to the Commission, in a manner established, by rule or regulation, by the Commission." In light of this apparent tension, many employees argue that the statute is ambiguous, warranting *Chevron* deference to the SEC's rule, which does not require reporting to the agency.

The Fifth Circuit was the first circuit court of appeals to rule on this issue, holding in *Asadi v. G.E. Energy* that the plain language of Dodd-Frank unambiguously requires SEC reporting as a prerequisite to protection from retaliation. The Second Circuit created a split by holding in *Berman v. Neo@Ogilvy LLC* that the statute is sufficiently ambiguous to warrant *Chevron* deference to the SEC's rulemaking. In the decision to be taken up by the Supreme Court, the Ninth Circuit also took a more deferential approach, although, unlike the *Berman* court, it did not invoke *Chevron*. Rather, the court held that the Dodd-Frank provision "unambiguously protects from retaliation all those who report to the SEC and who report internally."

The defendants in *Berman* contemplated seeking certiorari but ultimately opted not to. Then, the Supreme Court denied review of a Sixth Circuit retaliation case decided against the employee. In that decision, the appeals court did not address the SEC-reporting question at all. Rather, it affirmed dismissal of the employee's complaint on the basis that it suffered from a "fundamental defect" of pleading.

In its own, successful cert petition, the employer, Digital Realty Trust, urged that its case was "an optimal vehicle for resolving" the conflict because it presents the question squarely and cleanly and the arguments on both sides of the conflict have been aired in dozens of cases. In the petitioner's view, the Ninth Circuit decision upsets the balance between the retaliation protections offered by Sarbanes-Oxley and Dodd-Frank. Expanding the Dodd-Frank provision to protect even internal whistleblowers would render Sarbanes-Oxley's provisions obsolete, because Dodd-Frank affords whistleblowers advantages that SOX does not.

Looking even further ahead, could the Supreme Court get one or more petitions asking it to review the appointment of SEC administrative law judges?

Constitutionality of SEC ALJs. Looking even further ahead, could the Supreme Court get one or more petitions asking it to review the appointment of SEC administrative law judges? That possibility seems more likely now that an equally divided en banc D.C. Circuit has denied a petition for review in a case that raises the question of whether the SEC's ALJs are inferior officers that must be appointed in accord with the Appointments Clause of the U.S. Constitution.

Previously, a D.C. Circuit panel had ruled in favor of the SEC based on its Landry circuit precedent, but one judge concurred in the earlier precedential case because he believed the panel had read the Supreme Court's *Freytag* opinion too narrowly in making finality the touchstone for whether ALJs are inferior officers. The Tenth Circuit has denied rehearing in a similar case that found an SEC ALJ was unconstitutionally appointed.

In *Free Enterprise*, the Supreme Court held 5-4 that the structure of the Public Company Accounting Oversight Board violated the Appointments Clause because its members enjoyed dual for cause removal; the court resolved the issue by severing the offending tenure language from the relevant statute such that the Commission can terminate PCAOB members at will. But of significance for the SEC's ALJs, the main text of the opinion declined to address application of

the civil service system to independent agencies. A footnote attached to that part of the opinion's text noted that the court also did not deal with issues related to administrative law judges. The footnote cited the D.C. Circuit's *Landry* case as an example of the uncertainty about whether ALJs are "'Officers of the United States.'"

The Supreme Court has declined to hear several related ALJ cases raising district court jurisdiction issues; the *Lucia* and *Bandimere* cases are different because they raise the constitutional issue via petitions for review of Commission orders. The court did deny certiorari in one case that also involved a petition for review, but the constitutional question had been raised for the first time at the petition for rehearing stage in the court of appeals. These and other related ALJ decisions should be monitored for further developments.

Conclusion

The Supreme Court in OT 2016 appeared to settle important questions regarding class actions and the SEC's powers, but it also left some open questions, either by deciding cases narrowly or by postponing decisions until next term. While *ANZ* and *Kokesh* further settled the law on tolling and disgorgement, the court implicitly questioned the underlying justification for SEC disgorgement awards. Moreover, *Salman* likely kept alive some questions about the meaning of "personal benefit" in tipper-tippee insider trading cases.

Certiorari petitions granted late in OT 2016 address a range of securities topics: *Leidos* has potentially unsettling aspects for public company disclosure liability; *Somers* may clarify whether a whistleblower must report to the SEC; *Cyan* affords the justices yet another opportunity to examine securities class actions. While *Leidos*, *Somers*, and *Cyan* will likely see briefing activity over the summer recess, oral argument and decisions await the start of OT 2017. Yet another possibility is that one or more of the conflicting cases on the constitutionality of the SEC's ALJs could generate a certiorari petition before the justices return on the first Monday in October.