Securities Roundtable

EXECUTIVE SUMMARY

Securities law enforcement in the United States is in flux. This month's roundtable discusses the U.S. Supreme Court's decision in *Tellabs, Inc. v. Makor* (127 S. Ct. 2499 (2007)), the Court's upcoming consideration of *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.* (127 S. Ct. 1873 (2007)), Brocade CEO Greg Reyes's criminal conviction for stock options backdating, and the SEC's new initiative on insider trading by hedge funds.

The panelists are Scott Fink and Daniel Floyd of Gibson, Dunn & Crutcher; Mark Conley and Bruce Vanyo of Katten Muchin Rosenman; Jeff Lawrence of Coughlin Stoia Geller Rudman & Robbins; and Michael Torpey and Robert Varian of Orrick, Herrington & Sutcliffe. The roundtable was moderated by Custom Publishing Editor Chuleenan Svetvilas and reported by Krishanna DeRita for Barkley Court Reporters.

MODERATOR: What are the implications of the U.S. Supreme Court decision in *Tellabs v. Makor*?

LAWRENCE: *Tellabs* cleared up some confusion in a couple of different Circuits. The lower courts are still working it out, but they did set out a standard that says in essence, if the plaintiffs or the complaint gets reasonably close, the tie goes to the plaintiffs. So *Tellabs* helped in terms of pleading, at least in the Sixth Circuit, and the Ninth Circuit.

TORPEY: The test is "a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference."

FLOYD: And it's got to be powerful regardless of how it compares to other inferences.

If you look at the Ninth Circuit, they have pretty consistently said that even if you have five or six facts that in and of themselves aren't sufficient for scienter, collectively they might lead to a strong inference of scienter. The Supreme Court turned that around and said it's not enough that you have a single fact or even facts that might, standing alone and taken as true, lead to a strong inference. You have to look at all of them to see that they may have a dilutive effect.

CONLEY: The holistic notion was discussed in the context of the comparative approach, where you are supposed to compare the competing inferences of the plaintiff and the defendant and it can be deductive instead of just additive.

VANYO: That's what the courts have been doing all along. I think the decision is not going to have much of an impact. Virtually every circuit has spoken multiple times on this and I don't think they are going to go back, reexamine and change what they've done in the past.

FINK: My view is that this arms the defendants with the ability to point to not only facts that negate inference from the complaint, but facts that negate inference from documents that can be judicially noticed. I often represent accountants, and in many of the cases there are allegations in judicially noticeable documents that the management was lying to and concealing information from the accountants. In those kinds of cases, it's very difficult to argue that it is at least as compelling an inference that the accountants were in on the fraud as they were being deceived.

VARIAN: I think there are good things and bad things for the defense side. The opinion is very clear that when you go through this netting process, you look at all the allegations in the complaint and you reach substantially beyond the complaint. That's a plus.

On the negative side, there are lots of decisions over the years that make it pretty clear that stock sales, even substantial stock sales, won't support scienter. I think some of the language in the opinion may erode that authority.

FLOYD: The Court was just laying out general rules. The courts can take different approaches on individual fact patterns depending on how they view securities class actions. But I think the Supreme Court established a basic useful framework for defendants that must be followed.

TORPEY: Most of the defense bar was disappointed by the decision. We were hoping for something a lot stronger.

One issue is: If there are two competing inferences, neither of which is strong, and the plaintiff's is at least as compelling as the one that the defense raises, some think you can read *Tellabs* to say the plaintiff wins.

VANYO: I don't think they win in that circumstance. The inference has to, on its own merit, have sufficient strength.

FINK: We went into *Tellabs* with the strongest test

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being that it had to be the most compelling inference, and you had to do a comparative analysis, and that meant 51/49. Then you had other circuits that said we don't have to do a comparative analysis at all, and we got a test that says 50/50. We now have a test that says 50/50. But the victory is that it has to be a comparative analysis. There were Circuits that said we don't have to consider the facts that negate inference. We do now.

TORPEY: All that's true, but I was hoping for better. This is the end of the game in terms of substantial jurisprudence on the test. We are going to move on to other things. We won't see very many Circuit decisions on this anymore and we won't see any more Supreme Court decisions on it.

MODERATOR: What's at stake in *Stoneridge Investment Partners v. Scientific Atlanta*, which will be argued in the Court's fall term?

LAWRENCE: What's at stake is basically allowing accountants or underwriters or any other people who are directly involved in committing fraud the ability to avoid liability by simply not making a statement. There are a lot of cases, *Enron* being one of them, where you have people who are directly involved in the scheme to defraud who, if *Stoneridge* is allowed to stand, are going to escape liability.

FINK: I think the impact on the accountants will be very small. In most cases where accountants get sued, it's because they have made affirmative statements in audit opinions in a 10-K. So the cases are direct, primary liability cases.

LAWRENCE: Accountants are sued now for the statements they make at the 10-K, but that's because they say we didn't make a statement on review. Depending upon how *Stoneridge* comes out, it may change that.

TORPEY: There are a lot of obstacles that will stop the plaintiffs bar from adding a lot of collateral players as defendants, regardless of what happens in *Stoneridge*. There are a number of different ways to approach the analysis. I found the Solicitor General's brief fascinating. It had a completely different approach than either the plaintiffs bar or the defense bar has taken in the past.

CONLEY: The Solicitor General's brief, by bringing in liability for a deceptive act, endorsed the concept of scheme liability and placed all the weight on whether the plaintiff can show their reliance on what the deceptive acts were and how they factored into the investment decision. The control for liability of the secondary party is sort of in the hands of the issuer as to what they disclose with respect to the acts that are part of the so-called scheme.

FLOYD: The problem is for enforcement purposes, you are left in the brief with a broad definition of deceptive act, even as they argued no reliance. Most people have conceived that a deceptive act is one directed at the shareholding public, and the brief suggests that isn't necessarily the case. It could be something directed at an intermediate player, not the public.

TORPEY: The Solicitor General took a very broad position on what a deceptive act is, much broader than the defense bar would be comfortable with.

VARIAN: The broadening of the deceptive act concept sweeps in people who not only are not selling securities and not involved in the process of selling securities, but are not even associated with the issuer. They are not dealing with or responsible to the people who are purchasing the securities.

VANYO: If you expand "deceptive act," what are the elements of the claim? You'd be starting fresh. There aren't that many decisions out there on scheme liability, and most of them reject the idea. So why did the Supreme Court take this case?

LAWRENCE: Well, the Ninth Circuit was at odds in its *Charter* decision.

VANYO: It was and it wasn't. It didn't define liability, and that's one splinter decision from what's otherwise a uniform body of law.

TORPEY: There's a whole body of law about the limits of "deceptive act," and all of a sudden, you have the Solicitor General ignoring the SEC and filing a brief that blows up most of the defense theory about what a deceptive act is.

VANYO: The issue presented to the Court is a situation where respondents engaged in transactions with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements. If all the Supreme Court rules is that a transaction like that is a deceptive act and

PARTICIPANTS

SCOTT FINK is a partner in Gibson Dunn & Crutcher's San Francisco office. Mr. Fink specializes in accountants' liability and securities litigation. He has represented Big Four accounting firms, corporations, and underwriters in professional malpractice and securities actions and in SEC, DOJ, and PCAOB investigations. Mr. Fink graduated from Stanford University in 1974, and received his J.D. from the University of Michigan Law School in 1978. He was a member of the Order of the Coif and received a Henry M. Bates Scholarship Award.
sfink@gibsondunn.com

DANIEL S. FLOYD is a partner in Gibson, Dunn & Crutcher's Los Angeles office where he is co-chair of the Litigation Department. He has broad experience in securities litigation and related investigations, including representing issuers and directors in securities class actions, derivative actions, proxy and takeover litigation, ERISA litigation, mergers and acquisition litigation, and SEC investigations. Mr. Floyd graduated from UCLA in 1982 and received his J.D. from Boalt Hall in 1985, where he was a member of Order of the Coif.
dfloyd@gibsondunn.com

can constitute the basis for liability, it's not going to be very useful to the plaintiffs bar.

LAWRENCE: But I think the argument goes one step beyond that. If you limit that to the washed sales, then you have the secondary actor in this case, the corporation, doing other things to promote the false financial statements. So is it all part of the deceptive scheme to defraud?

FINK: I think the answer is no. If I help you defraud your investors, am I liable for primary liability? That sounds to me like aiding and abetting. I help you breach some duty that you have to some third party.

VARIAN: The Solicitor General's brief threw open the deceptive act concept a lot wider than some of us thought it is or should be. But it also took the position that if you deliberately engage in conduct knowing that it will inflate the financial statements, you get a pass because that part of your conduct wasn't disclosed, which really misses the point.

LAWRENCE: But scheme liability and aiding and abetting are two different theories of liability. When you prosecute them, you can distinguish between them. Take your typical mail fraud scheme. You've got a guy at the top who says this is what we are going to do and has people make phone calls and gin up some way to get money for no products, and then they take it and steal it. The guy in the back room may never have made a phone call, but he is definitely involved in the scheme to defraud.

FLOYD: Sounds like a conspiracy though. Maybe the courts moved too quickly over conspiracy liability and secondary liability.

LAWRENCE: It is a conspiracy as well, but the difference is if I was the guy in the back room and I had all these people who sit around and decide to commit this mail fraud and one of the people in the room happens to be tape recording that, they could turn it over and I could be prosecuted for the conspiracy without necessarily ever defrauding anybody. The conspiracy is the agreement to defraud others; scheme liability arises when you actually go out and defraud them. Under federal law, both can be prosecuted.

FINK: But even the Solicitor General puts all his cards into reliance, and doesn't that imply that the fraud is statement-type fraud and not some undefined scheme?

CONLEY: In the *Stoneridge* case, did Scientific-Atlanta and the defendants actually make statements to the auditors that were false?

FINK: It doesn't say that in the description of the facts. It says that they agreed to backdate documents, and that the conduct of backdating the documents may have deceived the auditors.

MODERATOR: What will the impact of Brocade CEO Greg Reyes's conviction on the stock options backdating be on future criminal cases?

VANYO: People are speculating it will produce more prosecutions, principally because the evidence and intent in the case was a little bit on the weak side. And if that can produce a criminal conviction, that's going to encourage a lot of prosecutors to go forward. On the other hand, to a certain extent the prosecution got lucky based on some tactical decisions made in the case.

FINK: What I thought was interesting was the DOJ picking that case to be the first one in the Northern District. I would have thought we would have seen a case where an executive made tens of millions of dollars. The fact that they got a conviction without that big personal benefit bodes very poorly for upcoming defendants.

CONLEY: Maybe one reason why that case was successful was because it seemed like the scheme for backdating was pretty clear—the defendant was deliberately participating in backdating the options for the purpose of lowering the grant date price and there were other actions including the manipulation of the employment dates and things like that to try and buttress the backdating.

FINK: That, however, exists in many of the other cases that I'm thinking of where executives reaped very, very substantial amounts of profits.

TORPEY: It was happenstance that *Brocade* got out in front of all of the other cases.

CONLEY: It was also one of the first cases that the prosecutor started investigating.

FINK: I've seen a lot of these where there haven't been indictments yet.

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MARK A. CONLEY is the co-chair of Katten Muchin Rosenman's corporate group in the Los Angeles office, specializing in corporate securities, private equity, mergers and acquisitions, and corporate governance. He represents public and private companies in the defense, commodities, financial services, new media, and high-technology industries. He regularly works with the firm's Securities Litigation Practice on internal investigations and matters concerning directors and officers' fiduciary duties. He was recently recognized as a Securities/Corporate Finance Southern California Super Lawyer by *Southern California Super Lawyers Magazine*.
mark.conley@kattenlaw.com

BRUCE G. VANYO is national co-chair of the Securities Litigation Practice at Katten Muchin Rosenman. He has practiced securities litigation for 33 years and defended more than 250 major securities cases. He has represented clients from such diverse industries as high tech, life sciences, airlines, motion pictures, banking, and insurance, including Krispy Kreme Doughnuts, Dell Computer, Boeing Company, Fluor Corp., Amdocs Limited, and Genentech. He was named to the *National Law Journal*'s 2006 list of 100 Most Influential Lawyers in America.
bruce@kattenlaw.com

LAWRENCE: Realistically if you are going to try to settle the criminal case, you want to plead it before the grand jury hands up an indictment.

TORPEY: There were some really interesting legal issues in *Brocade*. First, the evidence of the mental state was very thin, and for the government to get a conviction on that evidence was very surprising. Also, the first count was a criminal books and records charge. The judge took the prosecutor's view that the mental state was, "all you need to do is know that the books and records are wrong and that you are doing something wrong by signing these books and records."

LAWRENCE: So when you say it was thin evidence on intent, what about Reyes saying it's illegal to backdate options?

VANYO: He didn't say that. He made a broad statement that "it's not illegal unless you get caught." And it wasn't clear from the testimony in what context he made that statement.

VARIAN: You've got thin evidence. You've got a guy who didn't profit from the conduct and arguably was trying to do the best thing for the company, trying to use rank and file options to recruit good people and do the right thing for the shareholders. And you have an instruction that would have given the jury a pretty easy out if they wanted to treat him more kindly. And the jury apparently blew right past all of that and slammed him, which is scary.

LAWRENCE: Talent recruitment is just not a good reason to backdate options, it seems to me.

CONLEY: The reason that was used in *Brocade* is probably because A., it's not enriching the people who are making the decision, and B., it's being used for the good of the company, as Bob [Varian] said.

LAWRENCE: Then pay them and tell the shareholders that you are paying them.

CONLEY: You are paying them, but you are paying them with the cheapest currency available in the company.

FINK: What's different about this is the commonsense visceral reaction to backdating documents. It just rubs people the wrong way. If you intentionally backdate a document, somebody is going to say, "Look, you must have known there was something wrong with that. You don't just backdate documents."

TORPEY: One of the instructions that Judge Breyer gave was that backdating itself is not illegal.

LAWRENCE: Maybe it's not illegal per se, but backdating documents—particularly when there are millions gained by virtue of the earlier, improper date—suggests wrongdoing in and of itself. Especially when the backdating is not disclosed.

CONLEY: The problem was that they treated it as though the back date was the correct date in transactions. When you are documenting a transaction, you may consider what the appropriate date is, but the choice is determined by when the deal was struck, not by what is convenient economically.

LAWRENCE: The defense argued that this is not material because shareholders didn't care about it. But if that's true, why do they go to such great lengths to hide it? There's no good answer.

FLOYD: This discussion ultimately relates to prosecutorial discretion whether to bring charges, not just whether it may be a violation. Why pick this conduct to single out for criminal prosecution?

TORPEY: It's terribly unfair against this guy.

FLOYD: It has lot of cascading consequences for people. If something that might ordinarily subject a client to meaningful civil liability also might now put him in jail, how do you handle an investigation as a lawyer? It creates uncertainty.

FINK: One thing we certainly see is companies involved in the backdating issue are tripping all over themselves in every conceivable way to cooperate with DOJ, the SEC, and everybody else.

VARIAN: What about the SEC? Isn't this going to strengthen their hand? They can now say the prosecutor down the hall wants to bring this as a criminal matter.

TORPEY: I think the *Brocade* verdict is going to have a larger impact on the SEC than on the DOJ. These are hard cases to prosecute and the DOJ knows it. Even today, it is not clear that Judge Breyer thinks that Reyes's conduct was particularly onerous. It will be interesting to see how the sentencing turns out.

PARTICIPANTS

JEFFREY W. LAWRENCE is a partner in the San Francisco office of Lerach Coughlin Stoia Geller Rudman & Robbins. His practice focuses on plaintiffs rights through class actions with a particular emphasis on securities and shareholder litigation. Mr. Lawrence's clients span a wide range—from individual consumers to some of the largest Taft-Hartley and public pension funds. From 1983 to 1994, he was an Assistant U.S. Attorney in the Criminal Division, where he obtained extensive trial experience in white-collar crimes, ranging from money laundering to stock fraud.
jeffreyl@lerachlaw.com

MICHAEL TORPEY is the chair of Orrick's Securities Litigation Group and specializes in securities litigation of all types, including cases involving the PSLRA, the Securities Act of 1933, the Securities Exchange Act of 1934, the Uniform Standards Act, proceedings initiated by the SEC, and other self-regulatory organizations; litigation involving breaches of fiduciary duty; and conducting various types of corporate investigations. Mr. Torpey has authored numerous articles on securities and complex litigation, lectures extensively, and has chaired the securities litigation sections of many bar associations.
mtorpey@orrick.com

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VANYO: In light of this, now the SEC has to do something about the 200 cases that they've been sitting on all this time. They have to start disposing of them, cutting deals, and working their way through it.

TORPEY: This could also have an impact on the 150 or so derivative actions that are sitting out there. I see an increasing settlement pressure on the individuals who actually did something wrong. A lot of companies are forming Special Litigation Committees. And the SLCs are frequently making significant distinctions between the various individuals involved. The SLCs are having a difficult time getting global resolution. These are hard cases to settle because the carriers are taking the position that they are not going to pay anything.

FLOYD: A lot of people, basically their professional life will be ruined from this. If it had gone in a different direction, then those people might have been able to get out on a much less draconian result.

MODERATOR: What do you think is going to happen as a result of the SEC's working group to combat hedge fund insider trading?

CONLEY: Well, SEC Chairman Cox told the Senate Banking and Housing Committee that the SEC had organized the working group to explore insider trading by hedge funds. This was one of a number of initiatives the SEC has undertaken in the past year and a half or so, after *Goldstein v. SEC* (451 F. 3d 873 (2006) overturned the rule requiring the registration of managers for hedge funds.

The SEC has pursued a number of cases where hedge funds were allegedly trading on inside information. For example, there was a case involving an informal network of hedge fund managers who were trading nonpublic information about upgrades and downgrades where the SEC successfully brought charges against them.

The chairman's announcement was only three days before the Senate Judiciary and Finance committees issued their report on how the SEC's enforcement unit handled the allegations of insider trading against Pequot, in connection with their trading of Heller Financial's stock just before it was acquired by General Electric. The SEC is trying to reestablish its credibility and authority to regulate the conduct of hedge funds. Hedge funds reportedly manage about 5 percent of U.S. assets and are responsible for 30 percent of the trading of public trade securities here in the United States.

VARIAN: Are they are going to look at market manipulation? One of the problems that has come up over the years is hedge funds that specialize in shorting stocks occasionally planting false stories. There have been times when clients came to me and said, "Can't we sue this hedge fund partner?" A couple of instances, I thought were market manipulation that could have been proven. But the SEC did not seem very interested.

FINK: There have been something like 100 enforcement actions against hedge funds in the last seven or eight years. So this is something that's definitely big on the radar screen and it covers a whole host of different types of practices that may be manipulative or unlawful. Some of these hedge funds allegedly have been using their private investment in public equity or PIPE investments—stock that they acquire that's not registered—to then cover short sales later on. The SEC's been going after them, saying they are essentially getting around the registration requirements by doing this.

CONLEY: The SEC has been successful in pursuing that kind of short selling in advance of a PIPEs offering, where the short seller knows that he'll be able to readily cover the short sales in the future. But there have been other kinds of allegations of short selling to try and drive the price down. It's very difficult for the SEC to prove the conduct they need to in order to attack insider training in those cases. The SEC also is looking into insider trading that allegedly occurs when there's a large M&A transaction involving a public company, and the information leaks out from the advisors or participants.

TORPEY: Is there going to be a time in the not-too-distant future where the hedge funds register and then start issuing investment documents that the plaintiffs bar could bring an action on?

CONLEY: The SEC adopted the rule requiring hedge fund managers to register. The rule became effective before it got overturned, so quite a few registered. But it's unlikely that the SEC will try to promulgate that rule again.

The SEC is likely to pursue more limited action, such as a new rule adopted in July to make it clear that it is a fraudulent practice to misrepresent the information about the hedge fund to prospective or actual investors. ■

PARTICIPANTS

ROBERT VARIAN is a partner in the San Francisco office of Orrick's Securities Litigation Group. He is one of the few attorneys who have tried securities class actions to verdict. Mr. Varian represents issuers, officers, directors, underwriters, and accountants in securities and merger litigation throughout the U.S., and in internal investigations and investigations and proceedings by the SEC and SROs. He earned degrees from Lafayette College and the University of Maryland School of Law, where he was editor-in-chief of the *Maryland Law Review*.
rvarian@orrick.com

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