SECURITIES DOCKET
GLOBAL SECURITIES LITIGATION AND ENFORCEMENT REPORT

The Supreme Court and Securities Litigation: Recent Developments and Upcoming Cases

October 26, 2010

BLB&G Bernstein Litowitz Berger & Grossmann LLP
www.blbglaw.com

Introduction

In 2010, the Court has already decided two major securities cases and will soon be hearing two more. We will briefly review each of them today, and discuss their implications for investors.

- *Merck & Co., Inc. v. Reynolds* (2010) (statute of limitations)
- *National Australia Bank v. Morrison* (2010) (extraterritorial scope of securities laws)
- *Janus Capital Group, Inc. v. First Derivative Traders* (to be argued in December 2010) (liability of behind-the-scenes defendants)
- *Matrixx Initiatives v. Siracusano* (to be argued in early 2011) (what constitutes a "materially" false or misleading statement)

Faculty

James D. Cox, Brainerd Currie Professor of Law
Duke Law School

David C. Frederick, Partner
Kellogg, Huber, Hansen, Todd, Evans & Figel, P.L.L.C.

William C. Fredericks, Partner
Bernstein Litowitz Berger & Grossmann LLP

CLE Accreditation

www.blbglaw.com/webcasts
www.barancle.com/mcle

This program is CLE accredited in California, Texas, and Louisiana, and pending accreditation in New York, Florida, Illinois, and Ohio. If your state is not listed here, you may be entitled to reciprocal credit. To see if your state permits CLE reciprocity visit www.barancle.com/mcle. If your state is not listed or does not offer reciprocity, you may still apply for credit, as many states provide the option for attorneys to request approval of a CLE activity.

Later in the webcast you will be given a verification code. If you wish to apply for CLE credit, please write down and retain the code – you will need to include this code when you fill out your CLE Course Accreditation Form. Go to www.blbglaw.com/webcasts for information and links to the form which will be available shortly after the webcast.

BLB&G will provide a Uniform Certificate of Attendance upon request which you may use to complete your application. Please do not hesitate to contact us if we can assist you in any way. All inquiries and requests for assistance can be forwarded to Dalia El-Newehy at 212-554-1522 or dalia@blbglaw.com.

Morrison v. National Australia Bank Ltd., 130 S. Ct. 2869

Decision: June 24, 2010

When Do the U.S. Securities Laws Apply To Transnational Securities Transactions?

- U.S. Purchasers who buy shares of foreign companies on foreign exchanges ("F(oreign)-squared")
- Foreign Purchasers who buy shares of foreign companies on foreign exchanges ("F-cubed")
- "Other" transnational securities transactions

The Old Rules:

"Effects" Test (typically very favorable for U.S. investors):

- Did defendants' wrongful conduct have a "substantial effect in the U.S. or upon U.S. citizens"?

"Conduct" Test (typically necessary for foreign investors to have a claim)

- Was there sufficient wrongful conduct by the defendants *in the United States* to conclude that Congress would have "wished the precious resources of the U.S. Courts and law enforcement agencies" to be devoted to such cases, rather than leaving them to foreign authorities?

Morrison v. National Australia Bank

Decision: June 24, 2010

The *Morrison* Case:

- Major U.S. subsidiary ("HomeSide") of large foreign bank ("NAB") inflates the value of its U.S. mortgage servicing rights, which are fraudulently incorporated into parent NAB's books.
- *Foreign* (Australian) investors who bought "ordinary shares" of the *foreign* bank (NAB) on a *foreign* (Australian) stock exchange sue under §10(b) in the United States.
- Case dismissed because the foreign ("F-cubed") plaintiffs failed to show that the fraudulent conduct at issue (namely, the preparation of the parent's fraudulently inflated financials) involved sufficient "conduct" in the United States; Second Circuit affirms.

The Supreme Court's Decision:

- Rejects judge-made "conduct" test (bad news for foreign "F-cubed" plaintiffs).
- Applies presumption against extra-territorial application of §10(b) absent clear Congressional intent in the text of the statute.
- The new "Transactional Test" - two categories of covered transactions under §10(b):
  1. "Purchase or sale of a security ***listed on an American stock exchange"***
  2. "Purchase or sale of any other security in the United States" (**"domestic transactions")**
- Implications for ***American*** investors and the old "effects" test.

Morrison v. National Australia Bank

Decision: June 24, 2010

Game Over? Questions in the Wake of *Morrison*

1. When does a purchase or sale involve a transaction "in a security ***listed on*** an American exchange"?
   - "listed on" vs. "traded on" (*Vivendi, Alstom* cases)
   - cross-listed securities that are "cross-traded"
   - ADRs (*Societe Generale*)
2. When will transactions – even if they do not involve a security "listed on" an American exchange – nonetheless be covered as a ***"domestic transaction"***?
   - purchases "originated" from within the U.S.?
   - purchases solicited within the U.S. (e.g., as part of an international offering)?
   - other
3. Other Litigation Options
   - bringing claims under *state law* (J. Breyer concurrence)
   - bringing claims under *foreign law*

Janus Capital Group, Inc. v. First Derivative Traders, No. 09-525

(Currently pending before the Supreme Court)

Janus Capital Group, Inc. v. First Derivative Traders:

§10(b) and Rule 10b-5:

- §10(b): Unlawful "for any person, directly or indirectly, to use or employ, in connection with the purchase or sale of any security … any manipulative or deceptive device or contrivance in contravention of [SEC] rules."
- Rule 10b-5(b) prohibits anyone, in connection with the purchase or sale of a security:

  To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made … not misleading.

Central Bank, N.A. v. First Interstate Bank, N.A. **(1994)** – "[§10(b)] prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act…. The proscription does ***not*** include giving aid to a person who commits a manipulative or deceptive act. We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute."

Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc. **(2008)** – Cable set-top box vendors ("Respondents") agreed to make sham advertising buys and backdate contracts to allow Charter, its customer, to falsely report revenues. "[R]espondents' deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance. It was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did."

Janus Capital Group, Inc. v. First Derivative Traders, No. 09-525

(Currently pending before the Supreme Court)

The *Janus* Case: Background

- Janus Capital Group (***JCG***) is a publicly-traded asset-management company.
- Janus Capital Management (***JCM***), a wholly-owned subsidiary of JCG, is the investment advisor to each of the Janus mutual funds (the ***"Funds"***), each one of which is a registered investment company and separate legal entity. JCM runs the Funds on a day-to-day basis.
- Each Fund prospectus falsely states that the Funds ***forbade*** the practice of market-timing. When NY AG Eliot Spitzer disclosed that the Janus Funds had ***permitted*** market timing, JCG's stock price fell.
- JCG shareholders sue JCG and JCM alleging that both entities had drafted false prospectuses for the Funds, even though prospectuses did not explicitly attribute their contents to either JCG or JCM.
- Fourth Circuit: Complaint adequately alleged that JCG and JCM ***had*** engaged in deceptive conduct by "help[ing to] draft the misleading prospectuses."
  - defendants "wrote and represented [their] policy against market timers,"
  - defendants "publicly issued false and misleading statements" and "***made*** these representations by caus[ing] mutual fund prospectuses to be issued for Janus mutual funds and ma[king] them available to the investing public" in SEC filings and on Janus's website.
- Fourth Circuit: to show ***reliance***, investors must know drafters' true identities. Here, investors likely knew that the Funds' investment advisor (JCM) was involved in drafting, but likely did not know the role played by JCG. Thus, complaint stated §10(b) claim against JCM, but ***not*** JCG.

Janus Capital Group, Inc. v. First Derivative Traders, No. 09-525

(Currently pending before the Supreme Court)

ISSUES BEFORE THE SUPREME COURT:

What Does it Mean to "Make" a Statement Under Rule 10b-5?

- Persons who draft false statements for distribution by others, without attribution to the drafters?
- Persons who "help" draft false statements for distribution by others, by editing the document or providing other assistance?
- Persons who "cause" misstatements to be made, disseminate them, or place them on a joint website?

Is Reliance Satisfied if the Document is Not Explicitly Attributed to the Drafter?

- Is knowledge of the drafter's true identity ***necessary*** before investors can be deemed to have relied on the drafter's conduct?
- Can knowledge of the drafter's true identity be based on sources other than the document containing the false statement?

Janus Capital Group, Inc. v. First Derivative Traders, No. 09-525

(Currently pending before the Supreme Court)

***Janus's* Implications:**

- Can drafters of false statements avoid liability by giving the statements to an unknowing party to sign and distribute to the public?
- Are corporate officers insulated from liability if they draft or supply information for false documents distributed under the corporate name?
- Does the "type of drafter" matter -- should the rule be different for parent or subsidiary corporations, attorneys, underwriters, or auditors?
    - Should the rules be different where (as here) there are special fiduciary duties (e.g., fiduciary duties of mutual fund sponsors and advisors to the mutual fund's shareholders?)

Policy implications:

- What type of impact might the Court's ruling have on strengthening/weakening compliance with federal securities laws?
- "safe harbors" for fraudsters?

Matrixx Initiatives v. Siracusano and NECA-IBEW Pension Fund

(Currently pending before the Supreme Court)

Repeated statements by Matrixx of increasing revenues and profits in late 2003 and early 2004 from Zicam nasal spray while knowing:

1. Dr. Hirsch informed customer service that one patient developed anosmia.
2. Matrixx VP called Linchoten (researcher at U. Colorado) because the researcher had patient treated for anosmia after using Zicam.
3. Linchoten shared with VP study of 10 patients who developed anosmia after using Zicam.
4. October 2003 - two patients sue Matrixx for anosmia following use of Zicam.
5. October 22, 2003 - Matrix announces net sales increase of 163% for 3rd Quarter of 2003 compared to the 3rd Quarter of 2002.
6. Two more suits filed in December 2003.

Matrixx Initiatives v. Siracusano and NECA-IBEW Pension Fund

(Currently pending before the Supreme Court)

Repeated statements by Matrixx of increasing revenues and profits in late 2003 and early 2004 from Zicam nasal spray while knowing*:*

7. January 2004 - suits consolidated and later joined by 261 additional plaintiffs.
8. February 6, 2004 - Good Morning America airs reports of connection between Zicam and anosmia.
9. January 7, 2004 - Matrixx increases its earnings guidance for fiscal year 2003.
10. February 19, 2004 - Matrixx files with SEC Form 8-K announcing convening meeting with physicians and scientists "to review current information on smell disorders."
11. March 19, 2004 - Form 10-K reveals 19 different suits involving 284 individuals.
12. Stock collapses.

Matrixx Initiatives v. Siracusano and NECA-IBEW Pension Fund

(Currently pending before the Supreme Court)

- **Materiality Test**: Fact would assume actual significance in investor's decision; does not have to change the decision from buy to sell or sell to buy; and where it involves uncertain event, materiality is determined by balancing the magnitude of the event against the probability of its occurrence.
- **Issue**: Do reports of health hazard of a drug become material only when those reports reach the level of being statistically significant?
- **Implications**:
  1. Materiality is a gateway concept
  2. Judge or Jury question
  3. If statistical significance is needed for reports of injury would a similar high showing be required for other speculative information, e.g., Company denies it is in merger discussion. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988)

Merck & Co. v. Reynolds

Decision: April 27, 2010

When Does the Statute of Limitations Begin to Run in a §10(b) Case?

Relevant Statute: 28 U.S.C. §1658(b)

A securities fraud action under §10(b) "may be brought not later than the ***earlier*** of –

(1) 2 years after discovery of the facts constituting the violation; or

(2) 5 years after such violation."

Primary Issue:

Does the 2 year limitations period begin to run as soon as Plaintiff discovers (or should have discovered) that Defendants' statements were ***false or misleading*** ("falsity"). . .

. . . ***or***, does the 2 year limitations period begin to run ***only*** after the Plaintiff ***also*** discovers that Defendants acted with ***scienter*** (i.e., with intent to defraud)

Held: "Discovery of the facts constituting the violation" does not occur until the date that a reasonable investor actually discovers, or should have discovered, "scienter facts"

Investors win!

Merck & Co. v. Reynolds

Decision: April 27, 2010

Lawyer's Question:

How many "scienter facts" do you need before 2 year period is triggered?

- actual v. constructive knowledge

Likely Answer:

Opinion indicates that limitations period does not run until Plaintiff discovers (or should have discovered) enough "scienter facts" to meet the PSLRA's heightened standard for pleading scienter.

Caveat:

5 year statute of repose

Merck & Co. v. Reynolds

Decision: April 27, 2010

***Merck's* Practical Implications**

- Most §10(b) cases against defendant companies and their officers are already brought promptly after the market becomes aware that Defendants' prior statements were ***false***.
- For example, the facts evidencing the ***falsity*** of Defendants' prior statements will often be the same as those evidencing Defendants' ***scienter*** (intent to defraud).

  -e.g., disclosure of massive ***Enron*** or ***WorldCom***-type accounting restatement

- ***In some cases, however, Plaintiffs may have discovered a fraud, but will only learn much later (e.g. not until discovery) the extent to which ADDITIONAL DEFENDANTS were also involved.***

  -Plaintiffs may quickly discover facts showing that "insider" executives committed fraud, but may not discover facts showing fraudulent intent of a company's outside ***auditors, underwriters*** and/or ***attorneys*** until several years later.

Bottom Line: Much harder now for Defendants to toss §10(b) cases as time-barred.

Other Past (and Possibly Future) Supreme Court Cases: Are There Any Trends?

- *Tellabs* (2007) (§10b pleading standards)
- *StoneRidge* (2008) (persons liable)
- The pending *Halliburton* certiorari petition (loss causation)
- The pending *Omnicare* certiorari petition (§11 pleading standards)

Where is the Court going?
Any trends?

AUDIENCE QUESTIONS