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Going Green

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EUROPEAN FOCUS

Report from Amsterdam
Seeking Justice Outside the United States
Recent Fortis decision in Dutch Court is a victory for US shareholders
By Anatoli van der Krans

Fall 2018
As 2018 draws to a close, this edition of The Advocate takes stock of investor protections at the federal level. Our cover story discusses recent developments at the Securities and Exchange Commission, where new leadership has reduced enforcement actions against publicly traded companies and is facing calls from President Trump to eliminate quarterly reporting requirements.

Investors vindicating their rights themselves in the courts are also seeing a changing landscape in 2018. Our “Supreme Court Roundup” details a number of significant rulings affecting institutional investors. And as Justice Kavanaugh replaces Justice Kennedy, this edition attempts to read the tea leaves on whether that could signal a shift in the Supreme Court’s handling of securities cases. While some are advocating for removing investors’ cases from the courts, forcing them into closed-door arbitration, our article “Keeping Investors Out of Court” explains the dangers of that misguided notion. As usual, there is plenty happening these days to keep investor rights advocates busy and focused on first principles.

We are also excited to share with you some of the initial details about our upcoming Forum for Institutional Investors in New Orleans next April. One of the premier educational conferences in the field, the Forum brings together representatives of public pension systems, Taft-Hartley funds, and other institutional investors from around the globe with experts from corporate America, finance, the law, academia, and the media for a vital exchange of ideas. Details are available on page 9.

Please note that current and past issues of The Advocate are available on our website at www.blbglaw.com and, as always, we seek to make it a valuable read, highlighting the key recent legal, market and regulatory developments affecting the institutional investor community.

The Editors – Brandon Marsh and Julia Tebor
Several administration priorities are endangering financial markets by reducing corporate accountability and transparency. SEC enforcement actions under the administration continue to be much lower than in previous years. The Trump administration has also instructed the SEC to study reducing companies’ reporting obligations to investors, including by abandoning a hallmark of corporate accountability: the quarterly earnings report. Meanwhile, President Trump and Congress have passed new legislation loosening regulations on the same banks that played a central role in the Great Recession. It is important for institutional investors to stay abreast of these emerging developments as they understand the risk of their investments amid stark changes in the regulatory landscape.

The number of SEC actions against public companies is plummeting

The number of SEC actions enforcing the federal securities laws is now lower than in previous administrations. In 2016, before President Trump took office, the SEC filed 868 enforcement actions and recovered $4.08 billion in settlements. These figures dwindled to 754 enforcement actions and $3.78 billion in settlements in 2017. The decline in enforcement actions against public companies in particular was even more severe, dropping by a third, from 92 actions in 2016 to just 62 in 2017. The first half of 2018 witnessed an even more precipitous decline in SEC enforcement actions. Compared to the same six-month period in 2017, enforcement actions against public companies have dropped by 66 percent, from 45 to just 15 such actions. Recoveries over the same time period were down 93.5 percent.

Recently released data continues to confirm the trend. On November 2, 2018, the SEC released its fiscal year 2018 Annual Report: Division of Enforcement, which shows that enforcement action numbers have slightly increased, from 754 enforcement actions in 2017 to 821 in 2018. However, according to the report, the SEC’s activity and results during the first 20 months under the Trump administration pale in comparison to those of the same period under the Obama administration, with the SEC (1) charging far fewer high-profile defendants, including less than half as many banks and approximately 40 percent fewer public companies;
Given the SEC’s stark departure from its previous stance in favor of pursuing enforcement actions to protect investors, investors are encouraged to take extra measures to stay informed about the companies in which they are invested. Investors should also demand increased transparency in corporate reporting, and evaluate their rights in the face of suspected fraud.

(2) shifting its focus from complex, market-manipulation cases involving large numbers of investors, to simpler, less time-intensive cases involving fewer investors, such as actions against investment advisors accused of lying and stealing; (3) recovering nearly $1 billion less; and (4) returning approximately 62 percent less to investors ($1.7 billion compared to $5 billion).

The enforcement numbers with regard to public companies are consistent with Chairman Jay Clayton’s stated intention to change the SEC’s focus away from enforcement actions against large companies that commit fraud. During his first speech as SEC Chairman, Clayton expressed his disagreement with former SEC Chair Mary Jo White’s enforcement philosophy of being “aggressive and creative” in pursuing penalties against all wrongdoers to ensure that the SEC would “have a presence everywhere and be perceived to be everywhere.” Clayton stated that “the SEC cannot be everywhere” and that “increased disclosure and other burdens” on public companies “are, in two words, not good.” Rather than utilizing SEC enforcement powers, Clayton’s priority is to provide information to investors so they can protect themselves. As Clayton explained, his “short but important message” for investors is that “the best way to protect yourself is to check out who you are dealing with, and the SEC wants to make that easier.”

A recent appointee to the SEC under President Trump, Commissioner Hester M. Peirce, buttresses Chairman Clayton’s preference for limited enforcement. Peirce views civil penalties against corporations not as an effective regulatory tool, but rather as an “area of concern” that dissuades her from voting for enforcement actions. Commissioner Peirce has also publicly recognized that the current SEC is not inclined to bring any cases that involve novel issues that might “push the bounds of authority,” such as those involving “overly broad interpretations of ‘security’ or extraterritorial impositions of the law.” Peirce has expressed concern for the “psychological toll” that an SEC investigation can take on suspected perpetrators of fraud.

Given the SEC’s stark departure from its previous stance in favor of pursuing enforcement actions to protect investors, investors are encouraged to take extra measures to stay informed about the companies in which they are invested. Investors should demand increased transparency in corporate reporting, and evaluate their rights in the face of suspected fraud.

President Trump directs the SEC to consider eliminating quarterly reporting requirements

For generations, investors in the US stock markets have relied on quarterly reports to apprise them of companies’ financial condition, recent developments, and business prospects. Such quarterly reports have been required by the SEC since 1970, and are now widely considered part of the bedrock of corporate accountability to investors. Even before 1970, more than half of the companies listed on the New York Stock Exchange voluntarily issued quarterly reports.

In August 2018, however, President Trump instructed the SEC to study whether eliminating quarterly reporting requirements
will “allow greater flexibility and save money” and “make business (jobs) even better.” The President stated a preference for only twice-yearly reports, noting that companies “are not thinking far enough out” because of their focus on quarterly goals. President Trump stated that he based his instruction on advice from “some of the world’s top business leaders,” but provided no evidence of that assertion.

While eliminating quarterly reporting would certainly “allow greater flexibility” for corporations doing the reporting, investors would suffer from the resulting lack of transparency. Unsurprisingly, some of the world’s most prominent financial leaders, including Warren Buffett and Jamie Dimon, have denounced the suggested elimination of quarterly reporting. Buffett and Dimon have explained that such reporting is necessary for corporate transparency and “an essential aspect of US public markets.” This makes sense because without quarterly reports, significant corporate events that took place in between reporting periods could go unreported. However, Buffett and Dimon both suggested that quarterly earnings guidance can over-emphasize short-term profits at the expense of long-term focus and growth. As they explained, to meet short-term guidance and to appear to have more cash on hand, “[c]ompanies frequently hold back on technology spending, hiring, and research and development to meet quarterly earnings forecasts.” That said, issuing such guidance is not required under current law.

It is unclear how quickly the SEC may move to review President Trump’s suggested elimination of quarterly reporting. In October 2018, SEC Chairman Clayton explained that quarterly reporting will remain in effect, but days later it was announced that the SEC may, in fact, draft a notice for public feedback on the proposed change.

At the same time, Congress is moving forward with legislation that could lead to the elimination of quarterly reporting. In July 2018, the House of Representatives passed the JOBS and Investor Confidence Act of 2018 (aka “JOBS Act 3.0”). If enacted into law, the Act would require that the SEC provide to Congress a cost-benefit analysis of quarterly reporting requirements, as well as recommendations of ways to decrease corporate reporting costs. The Senate is expected to consider the JOBS 3.0 in the near term.

Congress and regulators weaken banking regulations

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is the landmark legislation passed in response to the high-risk, predatory and fraudulent banking practices that led to the Great Recession, and which has as a primary focus on increasing regulation of the financial services industry. President Trump, however, has referred to Dodd-Frank as a “disaster” that has prevented many “friends of [his], with nice businesses” from borrowing money. President Trump made promises on the campaign trail that he would “kill” Dodd-Frank and repeated the same vow early in his presidency, stating that he would “do a big number on” Dodd-Frank.

Making good on his promises, on May 24, 2018, President Trump signed into law Senator Mike Crapo’s Economic Growth,
Regulatory Relief and Consumer Protection Act (the Crapo Bill). The Crapo Bill removes many mandatory oversight measures put in place to ensure that banks engage in transparent and safe lending, investing, and leverage activities, striking a significant blow to Dodd-Frank protections and placing investors’ assets at risk.

As Senator Elizabeth Warren stated, despite the Crapo Bill being sold as one that will relieve “small” banks from “big” bank regulation, it puts “American consumers at greater risk.” The Crapo Bill rolled back certain regulations for banks with less than $250 billion in assets under management and rolled back additional regulations for banks with less than $10 billion in assets under management.

For example, the Crapo Bill raises from $50 to $250 billion the threshold at which a bank is considered a systemically important financial institution (SIFI) — the point at which the Federal Reserve’s heightened prudential standards become mandatory (e.g., mandatory stress tests that measure a bank’s ability to withstand a financial downturn). At the time Dodd-Frank was enacted, approximately 40 banks were considered SIFIs. Approximately 12 banks now meet that standard.

In short, the Crapo Bill essentially opens the door for the same type of high-risk, predatory and fraudulent banking practices that led to the financial crisis and threatens the stability and prominence of the United States’ financial markets.

A new direction at the Office of the Comptroller of the Currency (OCC) similarly invites banks to increase their leverage and thus threatens the stability of the financial system. OCC head Joseph Otting, a former CEO of OneWest Bank, recently instructed financial institutions that they should not feel bound by OCC leverage regulations, encouraging them to “do what you want as long as it does not impair safety and soundness. It’s not our position to challenge that.” Far from “challenging” the financial entities that the OCC is tasked with regulating, Otting instead has told bankers that they are the OCC’s “customers” and the Trump administration is “very banker-supportive.”

Institutional investors are the last line of defense

Congress and federal regulators have taken significant steps to change the regulatory landscape, and new efforts are underway to weaken well-established norms from SEC enforcement to quarterly reporting requirements. The institutional investor community should continue to speak out in favor of corporate transparency and help ensure the continued health and prominence of the United States’ financial markets.

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The Forum for Institutional Investors is designed to help fiduciaries deepen their knowledge of the US securities markets and their understanding of fiduciary responsibilities. We will explore important issues of shareholder rights, corporate governance, and securities litigation affecting pension funds today.

One of the premier educational conferences in the field, the Forum brings together representatives of public pension systems, Taft-Hartley funds, and other institutional investors from around the globe with experts from corporate America, finance, the law, academia, and the media in a relaxed, collegial setting. Our educational sessions will provide a valuable learning experience, while evening events at various New Orleans landmarks will be the backdrop for excellent networking opportunities with colleagues and friends.

The National WWII Museum will host educational portions of the Forum on Day One. Day Two will feature sessions at the renowned Arnaud’s Restaurant in the colorful French Quarter. On Day Three, the iconic Pontchartrain Hotel will host breakfast/brunch roundtables on a variety of industry topics.

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It’s All About Relationships

As the Interests of Accounting Firms and their Clients Become More Interconnected, Errors and Conflicts of Interest Abound

By Brenna Nelinson

Audits of public companies contain a shockingly high rate of errors, in part due to complicated relationships between auditing firms and their public company clients.

Investors rely on auditors to provide neutral, independent, and accurate assessments of the financial condition of public companies. Accounting figures are the bedrock of company valuation, and an auditor’s signed statement endorsing a company’s financial results is generally thought to be a high-quality, independent verification of the accuracy of reported figures.

Unfortunately, there are several reasons why investors should be skeptical of audit quality. Just a few years after a series of accounting scandals rocked US financial markets, audits of public companies contain a shockingly high rate of errors, in part due to complicated relationships between auditing firms and their public company clients.

An industry with a checkered history still struggles with conflicts of interest

US capital markets have a long history of accounting malfeasance. Perhaps most well-known today is the Enron scandal that surfaced in 2002 and took down one of the world’s largest accounting firms, Arthur Andersen, as it was revealed that Enron’s unprecedented success as an energy trading company was built on accounting fraud. Enron’s and Arthur Andersen’s relationship began as a client-auditor relationship. In the mid-1990s, however, Arthur Andersen developed a consulting business, and successfully looked to its most prominent client, Enron, as a source of consulting revenue. The year prior to its demise, Arthur Andersen generated more revenue from its consulting division than it did from its audits. Similarly, it earned more from consulting for Enron than for auditing Enron’s financials. The importance of this consulting revenue to Arthur Andersen, along with the inherent conflict in providing consulting services to a company also being audited, is generally thought to have resulted in Arthur Andersen knowingly or recklessly disregarding material defects in Enron’s financial statements.

Following Enron’s and Arthur Andersen’s downfall, Congress passed the Sarbanes-Oxley Act of 2002 (SOX), a legislative response to serial accounting frauds like...
Today, each of the “Big Four” accounting firms maintains a lucrative consulting business. Just like Arthur Andersen prior to its demise, each of these firms generated more revenue in 2017 from consulting services than it did from auditing. Enron. However, SOX’s passage may have lulled investors into a false sense of security. Though SOX implemented certain safeguards to promote the independence of auditors of public companies, audit quality continues to suffer and audit misconduct persists.

Indeed, audit statistics show that misrepresentations in audits are far too common. For example, the International Forum of Independent Audit Regulators found that 40 percent of 918 audits inspected in 2017 contained serious errors, including issues pertaining to accounting estimates and internal control testing. Similarly, in 2014, the Public Company Accounting Oversight Board (PCAOB), a private-sector, nonprofit board created pursuant to SOX to oversee public company audits, found that one third of audits it inspected were so deficient that they should not have been issued.

There are numerous reasons for these troubling statistics. To start, while SOX considerably limits the non-audit work that an accounting firm may provide to a company to which it also provides auditing services, there is still critical gray area. For example, SOX does not list most tax services as a prohibited non-audit service. SOX allows accounting firms to provide their clients tax compliance, planning and advice if such services are preapproved by the client’s audit committee. More importantly, however, the field of consulting has evolved in ways that legislators did not envision when Congress passed SOX. Since the passage of SOX, for instance, a new kind of consulting has grown out of the 2008 financial crisis known as “governance, risk, and compliance.” SOX says nothing about this new field — a hybrid between consulting and auditing — and thus does not prohibit accounting firms from also providing such consulting services to their audit clients.

Today, each of the “Big Four” accounting firms (KPMG, PricewaterhouseCoopers, Deloitte, and Ernst & Young) maintains a lucrative consulting business. Like Arthur Andersen, each of these firms generated more revenue in 2017 from consulting services than it did from auditing. Revenue growth numbers tell a similar story: since 2012, these firms have experienced 44 percent growth in consulting revenue and only three percent growth from auditing. This is hardly a surprise. Accounting firms seem to understand the obvious: that auditing is a lower growth business than consulting. Despite the Arthur Andersen fallout, auditors continued to invest heavily in developing their consulting businesses. As MarketWatch reporter and former PwC auditor Francine McKenna puts it, for these accounting firms, “audit is an afterthought. It is viewed as a necessary evil.”

The problems posed for the investor community

The risks to audit quality posed by this shift in focus are numerous. Given the disparity in revenue growth among the consulting and audit businesses of accounting firms, it is natural to fear that these firms, as for-profit businesses, might choose to dedicate more energy and resources to developing the consulting division at the expense of their auditing division. This could come in the form of fewer audit professionals hired, less qualified audit professionals hired, less
training of audit professionals, and/or less investment in relevant audit technology that might improve accuracy. Each of these possibilities carries a risk of reducing audit quality.

In addition, should accounting firms’ consulting businesses continue to outgrow their audit businesses, there is a risk that accounting firms may choose to place more emphasis on profitability when determining partner compensation. The PCAOB has observed instances in which an audit partner’s quality ratings (which, in part, determine compensation) were “significantly affected by the profitability of their audits or their ability to generate revenue.” The PCAOB also observed instances where audit quality “was not appropriately emphasized, or even appeared to be a significant factor, as compared to marketing or other activities of the firm” in compensation decisions for audit partners. Consequently, audit partners may find themselves in the unsavory position of needing to sacrifice audit quality in order to generate revenue, increase profitability, or take other similar actions purely in the interest of increasing their compensation—none of which, of course, would improve audit quality or be disclosed in the audit for investors to consider.

It is also important to understand that—contrary to popular belief—many auditors do not design their audits to ferret out fraud. A 2018 global study on occupational fraud found that only four percent of fraud is discovered by external audits. As a PwC audit partner famously testified under oath in 2016, “our audits are not designed to find fraud.” Indeed, accounts from inside the “Big Four” accounting firms suggest that auditors often exploit flexibility in accounting rules to do the opposite: paint an overly rosy picture of the client’s finances. Along with such distortion of company finances can come retaliation against auditors who attempt to do the right thing. For example, a recent Financial Times article recounts how a former PwC auditor, Mauro Botta, alleged that he experienced professional retaliation for raising internal concerns about the objectivity of the PwC partners performing audits for public companies. Botta was told that “you want these guys to like you,” and that he should prioritize generating revenue and nurturing client relationships and “build the relationships where the client would never want to leave PwC.” Ultimately, in response to client requests, Botta was removed from audits in which he raised concerns about audit accuracy.

Overly cozy auditor-client relationships can also drive down the number of financial restatements that companies issue. A financial restatement is defined by the Financial Accounting Standards Board as a revision of a previously issued financial

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Continued on page 32.
On page 17 of this issue of The Advocate, we describe Snap Inc.’s recent quarterly shareholder meeting, which lasted less than three minutes, and the share structure in place at the company that allowed it to happen. By granting the company’s founders and insiders close to 100 percent of the voting power, Snap prevents public shareholders from exercising their voices by voting their shares. While Snap’s voting structure is extreme, many public companies have imposed dual-class or multi-class voting structures on their stock.

Institutional investors, however, are calling out such practices and taking action. In late October 2018, the Council of Institutional Investors (CII), which represents pension funds, endowments, and other large investors, lobbied the New York Stock Exchange and Nasdaq, the country’s two largest stock exchanges, to amend their listing rules to require public companies to phase out dual-class or multi-class share structures within seven years of their initial public offerings. CII argues that, while dual-class share structures have benefits—namely helping companies stave off activist investors with short-term demands, which allows management to implement long-term goals—the practice can easily be abused. Such structures can lead to corporate governance models like Snap’s, in which company insiders control nearly all the voting shares, and public equity holders have no real voice.

CII is advocating for seven-year sunset provisions for dual-class structures, which its says can help restore the “one share, one vote” principle of corporate governance, provide public shareholders with a true voice, and impose real accountability on a company’s founders, insiders, and executives. In a statement, CII’s chairman Ash Williams said, “While some companies that are controlled by virtue of special voting rights function as benevolent dictatorships, we have seen others stumble because of self-dealing, lack of strategic planning, and ineffective boards. When problems emerge, external shareowners have little recourse.”

The exchanges are so far non-committal. In response to CII’s proposal, Nasdaq’s president Nelson Griggs stated that while the exchange is a “firm believer in the flexibility of share structure, in order to provide all investors access to growth companies,” Nasdaq also takes seriously “the input of all stakeholders when establishing and modifying listing standards.” He noted that the exchange “will continue to review our listing standards to make sure they protect investors, while also allowing those investors access to innovative companies.” The New York Stock Exchange has yet to comment on the proposal.

In general, the exchanges may feel compelled to support amending their listing rules to require sunset provisions because they want to keep the barriers to entry low for companies looking to conduct initial public offerings. The exchanges are in constant competition with one another for listings domestically—and with international exchanges for listings abroad. The Hong Kong Exchange, in fact, had previously banned dual-class stock structures but recently amended that rule in an attempt to attract more companies to list on the exchange.

Major industry players support CII’s proposal. Several large asset managers, including BlackRock and T. Rowe Price, and large pension funds, including the California State Teachers’ Retirement System and the California Public Employees’ Retirement System, have come out in favor of the proposal. CalPERS’s head of corporate governance, Simiso Nzima, noted that “mandatory time-based sunsets should act as an important safeguard against managerial entrenchment.”
Exxon Misrepresented Climate Change Risks, Says NY Attorney General

On October 24, 2018, New York State Attorney General Barbara Underwood filed a complaint against Exxon Mobil, alleging that the oil giant misled investors by minimizing the risks of climate change on its business. Bringing these claims under the Martin Act — New York’s securities law — Underwood has not charged that Exxon is responsible for causing climate change. Instead, the state intends to establish that Exxon defrauded shareholders by misrepresenting the financial ramifications of climate change.

The Attorney General’s suit stems from a three-year investigation, which Exxon fought hard to halt, into the company’s accounting practices. New York alleges that, while Exxon told the public that it was using a “proxy cost” to account for the future effects of combating climate change, in reality, the company discounted those potential costs. Prosecutors also assert that Exxon failed to account for climate change in determining its volume of oil and gas reserves, and in determining whether to write down the value of its assets.

Under the Martin Act, the state has broad powers to bring fraud cases against companies, and unlike under the federal securities laws, the state need not prove that Exxon knew fraud was underway. New York’s Attorney General has used this statute to target banks on behalf of investors for misconduct that preceded the financial crisis. If New York succeeds, Exxon could face hundreds of millions of dollars in fines and heightened public relations challenges.

KPMG/PCAOB Theft Scandal Casts Doubt on Audit Quality

KPMG, a “Big Four” audit firm, is embroiled in a scandal regarding the theft of confidential information from the Public Company Accounting Oversight Board (“PCAOB”), which oversees auditors. In January 2018, the SEC and DOJ initiated an enforcement action against several former KPMG employees and one PCAOB employee in connection with attempts by KPMG to cheat on PCAOB inspections. At the same time, in a parallel proceeding, the DOJ issued an indictment against the same individuals in USA v. Middendorf et al., in federal court in the Southern District of New York. Earlier this year, defendants in the DOJ criminal action tried but failed to have several counts from the case dismissed. In October 2018, one of the defendants in the DOJ action, KPMG’s former partner-in-charge of inspections, changed his plea to guilty for all counts, admitting that he and “other partners and employees of KPMG…agreed to share and use confidential information from PCAOB, to which we were not entitled to have.” In his January 2018 statement announcing the actions, SEC Chairman Jay Clayton wrote that, based on discussions with SEC staff, he believed that investors could continue to rely on KPMG’s audit reports — despite the fact that KPMG was attempting to steal information from the PCAOB specifically in order to game the PCAOB’s inspection of its audits. Since that time, court filings have revealed details about some of the KPMG clients whose audits were implicated in the scandal, and experts believe that Chairman Clayton’s statement should be re-evaluated in light of these disclosures. For example, according to Nell Minow, a corporate governance expert, the “breadth and seriousness of the charges and the importance to the financial markets of the companies affected should require a thorough internal investigation with results made public. If the SEC or KPMG do not insist on it, investors and clients should.” Lynn Turner, the SEC’s former chief accountant, echoed such sentiments, stating: “I believe chairman Clayton misled investors when he said they could rely on the audits report issued by KPMG. In my opinion, the information that has come to light raises a serious question with respect to the integrity, objectivity and professionalism of the audits.” Given the conflicting views from the SEC and governance experts, investors and their counsel should think carefully about how much stock to put in these audits. Trial in the ongoing litigation is scheduled for February 2019.
On September 13, 2018, the SEC’s Division of Investment Management withdrew two SEC guidance letters, known as “no-action letters,” that have governed investment managers’ reliance on proxy advisors for well over a decade. Proxy advisors study and make recommendations regarding significant issues up for proxy vote at thousands of companies every year. For example, proxy advisors often recommend how shareholders should vote on executive compensation packages, the election of directors, and transactions, including mergers and acquisitions.

The SEC’s withdrawal of the 2003 and 2004 no-action letters injects uncertainty into investment managers’ decision-making. The now-withdrawn letters permitted fund managers to outsource their voting decisions to proxy advisors when the mutual funds had conflicts of interest. Conflicts of interest may arise when, for example, an asset manager has a contract with a public company to manage a corporation’s pension funds. Due to the no-action letters, such an asset manager could limit litigation risk by avoiding conflicts of interest and relying on a proxy advisor to recommend a voting decision to shareholders.

The SEC did not explain its rationale for withdrawing the no-action letters, merely noting that, in preparation for the upcoming Roundtable on the Proxy Process, the Division was “taking into account developments since 2004…in order to facilitate the discussion.” Despite the withdrawal of the no-action letters, investment advisors that depend on proxy advisors may still rely on another SEC guidance document, Staff Legal Bulletin No. 20, which essentially memorialized the same assurances that the no-action letters provided. Because Staff Legal Bulletin No. 20 has not been withdrawn, the SEC’s ultimate goals are ambiguous.

Though the ultimate effect of the SEC’s decision to withdraw the no-action letters remains unclear, experts argue that by rescinding the no-action letters, the SEC has created uncertainty for investment advisors and fund managers, who are required under the SEC’s rules to vote on items listed on a company’s annual proxy statement for stocks owned by their funds.

Does Misconduct Pay?

A new study by researchers at Columbia Business School has revealed several surprising facts about executives’ incentives to engage in misconduct. The study — entitled “Does financial reporting misconduct pay off even when discovered?” — reviewed 237 examples of severe misconduct, including SEC enforcement cases, restatements, and securities class actions involving significant market reaction. Analyzing whether the consequences for perpetrators of fraud on investors outweighed their personal benefits from it, the study found that the average benefit to senior executives from engaging in misconduct was approximately $10 million, while the average cost from being detected was approximately $26 million — suggesting that enforcement of the securities laws has the potential to serve as a significant deterrent to committing fraud.

However, the study also found that a quarter of executives who were caught still profited from their misconduct net of any consequences they faced. The study also determined that, if the likelihood of getting caught was 25 percent (as other academic studies have estimated), more than half of the executives studied would have found it in their interest to engage in misconduct and risk being detected, rather than avoid fraud entirely. These sobering results suggest that, for many executives, crime can pay. They also highlight the need for heightened levels of regulatory scrutiny and private enforcement actions by investors to change management’s fraud equation.

In Blow to Investors, SEC Rescinds Letters Facilitating Reliance on Proxy Advisors

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Snap, Inc. Draws Scrutiny for Three-Minute Long, First Annual Shareholder Meeting

Typically, a public company’s annual shareholder meeting is a regularly scheduled update on company business that provides material information to investors. Shareholders and analysts can ask questions, and often shareholders present proposals for corporate reform. Votes are held on important issues, such as executive compensation. For instance, at Berkshire Hathaway’s annual weekend-long meeting, legendary investor Warren Buffett speaks directly with investors, and there are multiple opportunities for investors to learn more about the company.

The first-ever annual shareholder meeting of Snap Inc., the parent company of social media giant Snapchat, was something quite different. Management made no presentation and provided no financial information or operational update whatsoever. Questions from analysts and shareholders were not permitted. Shareholders had no opportunity to speak at all. Instead, Snap used the time to do nothing more than elect a new director to Snap’s board and to reappoint Snap’s auditor. The meeting lasted 2 minutes and 46 seconds.

Snap’s management could do this because Snap is a public company in name only. Snap’s founders, Evan Spiegel and Robert Murphy, own the vast majority of the company’s voting stock, and in total, company insiders own 96 percent of Snap’s voting stock. Snap equity on public markets comes with no voting power, and the company makes no effort to create even a veneer of public accountability.

While other technology companies such as Facebook and Google have stock structures that provide public shareholders reduced voting rights, Snap is in a class of its own: its public shareholders have no voting rights whatsoever.

Seemingly, Snap might benefit from holding a substantive meeting and soliciting public investor input. Since its IPO in June 2017 at $17 per share, the company has struggled, and its stock price has plummeted. In August, the company disclosed a decline of 3 million daily active users in the prior quarter, and there has been an exodus of executives this year. While the company lost over $700 million in Spiegel’s first year as CEO of the public company, Spiegel received a $638 million bonus.

RIP Evelyn Davis, Shareholder Advocate

Evelyn Y. Davis spent a half century haranguing American executives at shareholder meetings as she pushed companies to be more frugal and transparent. Ms. Davis died on November 4, 2018, at the age of 89. She had a flamboyant approach to communicating with corporate leadership and often appeared in costumes to garner attention and underscore her messages. She wore a Batman mask for an American Broadcasting Company meeting in 1966, not long after the network’s campy series “Batman” had its premiere; and for a meeting of U.S. Steel shareholders in 1968, she wore an aluminum dress. Despite, or perhaps partly because of, her antics, Ms. Davis could be effective. She questioned chief executives relentlessly on their compensation, whether companies had donated money to political groups, and how board elections were carried out. She was credited with helping to advance stricter rules for corporate governance. “She was definitely ahead of most of the rest of the world…. The issues she raised were almost always excellent — they were well researched,” said investor advisor and corporate governance expert Nell Minow. While her antics and personality sometimes got in the way, it was impossible to ignore Ms. Davis, and many CEOs tried to placate her by giving her special attention. Some courted her good favor by subscribing to her newsletter, “Highlights and Lowlights of Annual Meetings,” which she published from 1965 to 2011.

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Supreme Court Roundup

by Michael Mathai and Kate Aufses

**China Agritech**

In June 2018, the Supreme Court limited how long investors are permitted to rely on a filed class action before deciding whether to potentially assert their rights in a separate class action litigation. In *China Agritech v. Resh*, the Court reaffirmed that if an investor is a passive member of an asserted class of investors — meaning that they are not named plaintiffs — the applicable statute of limitations for the investor to file suit individually is tolled until a decision denying class certification, if any. In other words, the investor can wait and see if it is necessary to file an individual suit (while remaining mindful of any expiring statute of repose — a separate time limitation often applicable to investors’ securities claims). However, the *China Agritech* Court announced a new rule that limits investors’ choices if they wait to file suit: the Court held that the statute of limitations is not tolled in the same way if the investor filing separately frames her litigation as a class action. If an investor remains a passive member of an existing class action past the expiration of the statute of limitations, the only separate suit it can file is an individual suit. *China Agritech* meaningfully alters strategic considerations for proposed class members who wish to see class claims pursued. Rather than remain as passive proposed class members waiting to see the result of class certification, such parties must now carefully consider filing a separate complaint early in order to avoid the risk of a denial of class certification in the already-pending action. In addition, this case leaves unchanged prior rulings finding that the statute of repose cannot be tolled. Thus, investors and their counsel should remain vigilant in monitoring expiring statutes of limitations in light of *China Agritech*.

**Lorenzo v. SEC**

On June 18, 2018, the Supreme Court granted a writ of certiorari in *Lorenzo v. SEC*. *Lorenzo* has potentially wide-ranging implications for the scope of liability for people who deceive investors by passing along misleading statements. By way of background, the Supreme Court’s 2011 decision in *Janus Capital Group, Inc. v. First Derivative Traders* clarified that liability under SEC Rule 10b-5(b) could only attach to the “maker” of a statement — i.e., “the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.” Under *Janus*, therefore, a person who merely repeats a false and misleading statement made by another cannot ordinarily be held liable under Rule 10b-5(b). At issue in *Lorenzo* is whether such a person can be held liable under Rules 10b-5(a) and (c). While Rule 10b-5(b) prohibits fraudulent “statements,”
Rules 10b-5(a) and (c) prohibit defrauding investors through deceptive schemes, acts, or practices.

In *Lorenzo*, an investment banker sent emails to prospective investors containing false representations about a company’s financials, but the false representations were written by the banker’s boss and the emails were sent at the boss’s direction. The SEC determined that the banker had violated Rule 10b-5(b) by making materially misleading statements in the emails, as well as Rules 10b-5(a) and (c), by knowingly sending materially misleading information to prospective investors. On appeal, the DC Circuit Court of Appeals, in a 2-1 opinion, partly affirmed the SEC’s decision. The majority found that Lorenzo had not violated Rule 10b-5(b) because Lorenzo was not the “maker” of the challenged statements under *Janus* — his boss was. However, the court found the trader liable for the scheme under Rules 10b-5(a) and (c). As discussed on page 22, then-Judge Brett Kavanaugh issued a strong dissent to the DC Circuit panel opinion. He wrote that under *Janus* and other Supreme Court precedent, the investment banker could not be held liable.

Before President Trump nominated Judge Kavanaugh to the Supreme Court, many commentators expected that the Court, as then constituted, would vote 5-4 to overturn the DC Circuit’s decision and thereby limit the scope of scheme liability. It was expected that Justice Kennedy would vote with Justices Thomas, Gorsuch, Roberts, and Alito to form the majority, and that the remaining four Justices would dissent—as they had all done in *Janus*. Justice Kavanaugh’s confirmation creates an interesting twist on this guessing game. Under standard Supreme Court practice, Justice Kavanaugh must recuse himself from participating in the Supreme Court’s adjudication of *Lorenzo* because he participated in the DC Circuit decision that is being appealed. This, in turn, suggests that the Supreme Court could likely split 4-4 on the case and the DC Circuit’s decision would stand. Such a result would, for now, maintain a broader view of primary scheme liability under Rules 10b-5(a) and (c).

**Cyan Inc. v. Beaver County Employees Retirement Fund**

The Supreme Court’s recent ruling in *Cyan Inc. v. Beaver County Employees Retirement Fund* is a positive development for investors. Issued in March 2018, the *Cyan* opinion preserves plaintiff investors’ right to choose the venue — either state court or federal court — for their lawsuits alleging violations of the Securities Act of 1933. Defendants have often filed removal motions to thwart investors’ selection of state court for their Securities Act claims and this ruling closes the door on such maneuvers.

As discussed in the winter 2018 issue of *The Advocate*, *Cyan* resolved a split among lower courts over whether the 1998 Securities Litigation Uniform Standards Act (SLUSA) deprived state courts of jurisdiction over certain class actions asserting only federal Securities Act claims. In a unanimous decision authored by Justice Kagan, the Court held that SLUSA “did nothing to strip state courts of their longstanding jurisdiction to adjudicate class actions alleging only [Securities] Act violations.”

*Cyan* means that plaintiff investors retain their ability to choose whether to assert Securities Act claims in state courts or federal courts. Plaintiffs should understand, however, that when Securities Act claims are combined with additional federal claims in the same case, the case still may be removable to federal court under *Cyan*. Thus, when a plaintiff chooses to assert not only Securities Act claims, but also additional claims, federal court may be the only option. After *Cyan*, it is particularly important for investors and their counsel to think critically about available claims and jurisdictions when crafting their allegations under the federal securities laws.

**Lucia v. SEC**

In *Raymond J. Lucia and Raymond J. Lucia Companies, Inc. v. Securities & Exchange Commission*, the Supreme Court held in June 2018 that administrative law judges of the Securities and Exchange Commission are “inferior officers of the United States subject to the Appointments Clause of the Constitution.” This means that, contrary to the prior practice of the SEC—by which the SEC selected ALJs through an in-house hiring practice — ALJs must now be appointed by the President, a court, or a department head. The Court held that because ALJs hold a continuing office established by law and have the authority to conduct hearings similar to federal trials, and because the SEC may decline to review an ALJ’s decision, the ALJs are officers of the United States and must be appointed pursuant to the Appointments Clause.

*Continued on page 23.*
From Justice Kennedy To Justice Kavanaugh

Is a Shift in Securities Law Underway?

by Michael Mathai and Kate Aufses

On October 6, 2018, Justice Brett M. Kavanaugh was sworn in as the newest Associate Justice of the Supreme Court, assuming the seat recently vacated by retiring Justice Anthony Kennedy. During his 30-year tenure on the Court, Justice Kennedy joined both pro-investor and anti-investor decisions, though on balance, he tended to side against plaintiff investors in federal securities cases. By contrast, during Justice Kavanaugh’s twelve years as a judge on the DC Circuit Court of Appeals, he appears to have taken a decidedly more negative view of federal investor protections than Justice Kennedy did. The change in staffing on the high court may portend significant changes in investor rights in years to come.

While Justice Kennedy was not a particularly vocal jurist in the realm of securities litigation, in the last decade, he authored majority opinions in two significant securities cases — Stoneridge Investment Partners v. Scientific-Atlanta, Inc. (2008) and CalPERS v. ANZ Securities, Inc. (2017). Both of these decisions curtailed investors’ ability to enforce the federal securities laws. In Stoneridge, the Court broke from long-standing precedent among the lower courts and held that investors cannot hold lawyers and accountants liable as “aiders and abettors” of a company’s scheme to commit securities fraud. More recently, Justice Kennedy’s majority opinion in ANZ Securities limited the amount of time that investors can take to decide whether they will remain part of a securities class action or, instead, file their own individual suit. As we have explained in previous editions of The Advocate, this ruling limits investors’ options and, in certain circumstances, forces them into tough choices regarding litigation strategy.

At the same time, Justice Kennedy joined several pro-investor opinions that the Supreme Court has issued over the years. For example, Justice Kennedy joined the Court’s unanimous 2011 Matrixx opinion, which explained several ways in which the Securities Exchange Act of 1934
The comparison of Justice Kennedy’s and Justice Kavanaugh’s records regarding federal securities claims suggests that corporate management may well view Justice Kavanaugh’s confirmation to the Supreme Court as welcome news.

contains strong protections for plaintiff investors. Justice Kennedy also joined the Court’s majority in the 2007 Tellabs decision, which reiterated the Court’s long-held view that private securities class actions under the Exchange Act are an “indispensable tool” for regulating the US public securities markets. Tellabs also set forth a reasonable standard for investors to follow when pleading violations of the Exchange Act, rejecting the calls of Justices Scalia and Alito, who favored a higher pleading standard for investors who seek redress for such violations.

As a judge on the DC Circuit Court of Appeals, Justice Kavanaugh, by contrast, has not built any substantial record of supporting investor rights. Rather, Judge Kavanaugh regularly affirmed orders dismissing private suits by institutional investors to enforce the federal securities laws. For example, in In re InterBank Funding Corp. Securities Litigation, he was a member of a panel that affirmed the dismissal of securities claims because, contrary to the investor’s view, he believed the investor was required to plead a reliance on alleged misrepresentations, but failed to do so. Similarly, in Wu v. Stomber, Judge Kavanaugh authored an opinion affirming dismissal of securities claims. The opinion disagreed with investors regarding what company disclosures were pertinent, and held that “reasonable” investors “surely would have paid close attention” to certain supplemental disclosures relating to a securities offering that contained corrective information. Judge Kavanaugh has also authored opinions affirming dismissals of corporate governance actions, including in Pirelli v. Raines. In Pirelli, the court affirmed the dismissal of derivative claims for failing to first make a demand on the board of directors, reasoning that the investors did not meet the “stringent” standards for such claims under Delaware law.

Justice Kavanaugh’s most well-known authorship on a securities case while serving as a judge on the DC Circuit may be his dissent in Lorenzo v. SEC. In Lorenzo, a two-judge majority affirmed a ruling that an investment banker was liable for a scheme to mislead investors by emailing false and misleading statements to investors. Then-Judge Kavanaugh dissented from the majority, disputing what he viewed as an overly aggressive application of the federal securities laws. He wrote that the investment banker should not be held liable because the banker’s boss—not the banker—had drafted the emails in question and asked the banker to send them to clients. Judge Kavanaugh disagreed with the factual finding by the judge who handled the case that the banker’s actions were “willful.” He also disagreed with the SEC’s characterization of the facts, and called into question the
heavy sanctions imposed on the investment banker, including a lifetime ban from the securities industry. “So much for a fair trial,” he lamented, expressing a surprising amount of sympathy for an investment banker who had sent false and misleading statements to investors.

The comparison of Justice Kennedy’s and Justice Kavanaugh’s records regarding federal securities claims suggests that corporate management may well view Justice Kavanaugh’s confirmation to the Supreme Court as welcome news. While this change to the Supreme Court’s makeup may ultimately result in no significant change in the Court’s view of the federal securities laws—depending on the cases brought, the makeup of the Court at the time, and the issues to be decided—evidence suggests that Justice Kavanaugh may be more skeptical of private securities actions than Justice Kennedy was. In this context, it remains incumbent on institutional investors to employ experienced counsel and sound strategy in seeking to enforce the protections of the securities laws in federal courts.

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Justice Kavanaugh’s most well-known authorship on a securities case while serving as a judge on the DC Circuit may be his dissent in Lorenzo v. SEC, in which he expressed a surprising amount of sympathy for an investment banker who made false and misleading statements to investors.

Supreme Court Roundup
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While the Lucia decision resolved an important circuit split on this issue, it also created uncertainty. The Court decided that the “remedy for an adjudication tainted with an appointments violation is a new hearing before a properly appointed official.” Many such “tainted” adjudications surely exist, as numerous past and current ALJs across various government agencies were not installed under the Appointments Clause—the validity of these decisions is now called into question. To take one example, the Court did not consider whether the SEC must, or can, reopen for rehearing cases that have long since been decided by ALJs who were not properly appointed under Lucia. Litigants may argue that Lucia upset settled law in numerous fields of regulatory law, including securities regulation and enforcement.

Contributing further to the uncertainty surrounding ALJs, on July 10, 2018, President Trump issued an executive order eliminating the competitive examination and selection procedures used to appoint ALJs across federal agencies. The order allows the heads of agencies, who are political appointees, to hire ALJs directly, thus bypassing the traditional merit-based hiring process. This gives political agency heads vast discretion to determine who will serve as ALJs. Commentators fear that this action could further politicize the civil service.

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Keeping Investors out of Court

The Looming Threat of Mandatory Arbitration

By Robert Trisotto

Over eighty years ago, federal securities laws were enacted to safeguard investments on national securities markets. These securities laws — premised on the notion that investors should receive accurate and thorough information regarding the public companies that they own — have transformed United States stock exchanges into the most prominent and trusted exchanges in the world.

Despite this impressive history, the management of some publicly-traded companies have increasingly sought to evade federal securities laws by altering their charters or bylaws in ways that the drafters of securities laws likely never imagined. For instance, companies have attempted to deter shareholders from filing lawsuits against corporate management by adopting fee-shifting provisions in their charters or bylaws. Such provisions would place a losing shareholder on the hook for the company’s attorney’s fees and expenses in disputes over management’s actions on behalf of investors.

Companies have also tried to restrict shareholders’ access to certain forums to enforce the securities laws. For example, after the US Supreme Court held that state courts are open to investors to file class actions alleging claims under the Securities Act of 1933 in Cyan, Inc. v. Beaver County Employees’ Retirement Fund, companies such as Blue Apron Holdings, Inc., Stitch Fix, Inc., and Roku, Inc. adopted clauses in their charters aimed at requiring shareholders to file Securities Act claims in what management viewed to be a more favorable forum: federal court.

Perhaps most troubling, companies have tried, albeit unsuccessfully, to adopt mandatory arbitration provisions in their charters or bylaws to completely shut off the courtroom to investors. Companies’ past efforts to force arbitration on investors were rejected by the SEC. But, recent commentary from the SEC suggests it may revisit its policy against mandatory arbitration provisions. This has sparked a vigorous discussion about
Forced arbitration raises serious concerns about depriving investors of important federal rights to litigate securities fraud violations in court.

the practical effects that mandatory arbitration provisions would have on investors’ ability to adequately vindicate their rights under the securities laws. As detailed further below, forced arbitration raises serious concerns about depriving investors of important federal rights to litigate securities fraud violations in court. Although arbitration may offer benefits to companies and their management, many scholars and advocates have concluded that the potential harm to investors of being forced to arbitrate securities violations significantly outweighs such benefits.

The SEC has historically protected investors from forced arbitration

The SEC has long protected investors from companies’ efforts to force them into mandatory arbitration instead of litigation in federal courts. For instance, in 1988, Franklin First Financial Corporation declared its intention to include a mandatory arbitration provision in its charter and bylaws in advance of its planned IPO. Similarly, in 2012, The Carlyle Group LP filed a draft registration statement with the SEC that would have required investors to arbitrate disputes. In both cases, the SEC refused to accelerate the effective date of the companies’ registration statements, thereby effectively blocking the companies’ ability to proceed with their planned IPOs. The result: Both companies abandoned their plan to prohibit shareholders from filing class-action lawsuits.

The SEC has also prevented public companies from modifying their existing bylaws to provide for mandatory shareholder arbitration. For example, when a proposal was made to amend the bylaws of Gannett Co., Inc. to require investor disputes to be submitted to arbitration, the SEC encouraged Gannett to omit the proposal from its proxy materials (by stating that it would “not recommend enforcement action to the Commission” if it was indeed omitted) as there was support for the view that “implementation of the proposal would cause the company to violate the federal securities laws.” The SEC has also supported other companies’ (Alaska Air Group, Inc. and Pfizer Inc., for example) decisions to exclude similar pro-arbitration proposals.

SEC officials have signaled potential policy shift towards arbitration

Despite repeatedly rejecting companies’ attempts to force arbitration on investors for the past three decades, the SEC has recently suggested that it may reconsider its position on mandatory arbitration provisions. In a July 2017 speech to the Heritage Foundation, former SEC Commissioner Michael Piwowar supported changing the SEC’s policy to allow companies to force shareholders to resolve claims through arbitration rather than in court. Piwowar stated that “[f]or shareholder lawsuits, companies can come to us to ask for relief to put in mandatory arbitration into their charters…I would encourage companies to come and talk to us about that.” Additionally, the US Department of the Treasury issued a report in October 2017 suggesting that mandatory arbitration be used as a tool to reduce the costs of shareholder litigation and recommended that “the SEC continue to investigate the various means to reduce costs of securities litigation for issuers in a way that protects investors’ rights and interests, including allowing companies and shareholders to settle
disputes through arbitration.” More recently, in August 2018, SEC Commissioner Hester Peirce stated in a public interview that she “absolutely” thinks that public companies should have the option to require investors to resolve shareholder disputes through arbitration.

This is not the view of all SEC officials. For example, in February 2018, SEC Commissioner Robert J. Jackson, Jr. expressed his “concern” about mandatory arbitration provisions because of the important role shareholder litigation plays in policing corporate misconduct and given the SEC’s limited resources. Also in February 2018, SEC Investor Advocate Rick Fleming called mandatory arbitration “draconian” because it would “strip[] away the right of shareholders to bring a class action lawsuit,” which is vital in “helping to protect investors and deter wrongdoing.” But the fact remains that certain SEC officials appear to be inclined to open the door for mandatory arbitration.

**Mandatory arbitration provisions may significantly erode investor rights**

Mandatory arbitration provisions have the potential to undermine investors’ ability to prosecute securities claims in court and hold companies accountable for their misconduct. Under the Federal Rules of Civil Procedure, investors can institute a class action to hold companies liable for their violations of securities laws in federal court. But, if limited to arbitration and subjected to class action waivers, individual investors may not be able to afford to pursue their claims unless they have very large losses.

In a class action, a plaintiff seeks relief for a company’s securities violations on behalf of itself and the class, allowing it to share the cost of litigating with all investors. In contrast, in arbitration subject to class action waiver provisions, the claimant can only seek relief for its own claims and thus must bear the costs of the arbitration alone. Securities fraud cases are often complex cases, requiring multi-million-dollar capital expenditures before trial. If the case goes to trial, litigation expenses could be much more. By preventing investors from asserting their claims in a class action in the federal courts, mandatory arbitration provisions could force countless investors to forego meritorious claims.

Mandatory arbitration provisions could also eliminate shareholder litigation’s ability to deter violations of securities laws. Arbitration generally takes place in a private setting and arbitration clauses typically prohibit the disclosure of any information about the proceedings. Absent public accountability, companies can keep their misconduct a secret, hiding it from the public in perpetuity.

Arbitration and class action waiver provisions could also stifle critical enforcement of the securities laws. Shareholder litigation serves as an essential tool to enforce securities violations, along with enforcement by the SEC and the Department of Justice. Each year, private litigants hold public companies accountable for billions of dollars of securities fraud violations. Their results compare well to governmental enforcement actions. SEC Commissioner Jackson noted earlier this year that, following securities fraud scandals at WorldCom, Enron, Tyco, Bank of

**Despite repeatedly rejecting companies’ attempts to force arbitration on investors for the past three decades, the SEC has recently suggested that it may reconsider its position on mandatory arbitration provisions.**

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In July 2018, the Amsterdam Court of Appeal approved a €1.3 billion collective settlement of claims by shareholders of the former Fortis (now Ageas). This settlement is the largest shareholder collective action settlement ever in Europe, or indeed anywhere outside the US. Shareholders of Fortis brought the case pursuant to the Dutch Act on Collective Settlement of Mass Claims (WCAM), a statute that provides for class-wide settlement of legal claims. One of several recent securities cases approved by the Amsterdam Court of Appeal, it confirms the viability of WCAM to resolve transnational disputes, and is encouraging to investors who purchase shares outside of the United States.

**Background of the Fortis action**

The settlement arose from shareholder litigation filed against Fortis, an insurance company, in Belgium, the Netherlands, and elsewhere following the 2007/2008 financial collapse. Prior to the financial crisis, Fortis participated (along with banks RBS and Banco Santander) in acquiring ABN AMRO, a Dutch bank, for €72 billion. At the time, it was the largest-ever bank acquisition. The transaction depleted Fortis’s balance sheet just as the financial crisis began to emerge. On October 4, 2008, the Dutch government took over Fortis’s operations, and required Fortis to sell a majority of its assets to BNP Paribas, a French banking group, for €16.8 billion ($23 billion USD), a small percentage of Fortis’ worth. Shareholders lost billions on their investments in Fortis and blamed Fortis, certain of its directors and officers, and underwriters of certain offerings for misrepresenting: (i) the value of its collateralized debt obligations; (ii) the extent to which its assets were held as subprime-related mortgage backed securities; and (iii) the extent to which its decision to acquire ABN AMRO had compromised the company’s solvency.

By Anatoli van der Krans, Senior Advisor, European Investor Relations
Although the US accounts for 96 percent of securities litigation recoveries globally since 1995, this case underscores the potential of non-US jurisdictions to recover fraud-related investment losses.

In the past, global securities problems of this type had often been resolved in US courts under the federal securities laws. However, in 2010, the US Supreme Court held in *Morrison v. National Australia Bank* that the federal securities laws apply only to misstatements or omissions made in connection with the purchase or sale of: (i) securities listed on a US exchange; or (ii) any other securities in US transactions. Thus, persons who had purchased securities of Fortis (a Belgian/Dutch issuer) in non-US transactions could not pursue their claims under the US securities laws. Investors, however, were not without recourse and were able to file an action under WCAM in the Netherlands and Belgium.

The Act On the Collective Settlement of Mass Claims

In 2005, the Netherlands enacted WCAM. WCAM is distinct from US class actions in two key ways: (i) WCAM cannot be used to litigate claims on a class-wide basis, but only to settle them, and (ii) class members do not need to decide whether to opt out until after objections to settlement have been filed and the court has approved settlement.

WCAM assumed a truly international scope after its use in connection with two high-profile collective investor actions: the $381 million settlement between shareholders and Royal Dutch Shell (an Anglo/Dutch company) in 2009; and the $58.4 million settlement involving Converium Holding AG (a Swiss company) in 2012. Even though both settlements involved significant numbers of non-Dutch shareholders (as few as three percent of shareholders in Converium were Dutch), the Amsterdam Court of Appeal upheld jurisdiction over the global classes and approved both settlements. For many, the Converium case proved the viability of the Netherlands as a global settlement hub.

**The Ageas (Fortis) settlement**

There are several important lessons to be learned from the Amsterdam Court of Appeal’s decision approving the €1.3 billion Ageas collective settlement, and the settlement has distinct implications for future settlements under WCAM.

First, the Court held that differences in compensation for aggrieved shareholders could not depend solely on whether a class member was active or inactive in
pursuing litigation. This bodes well for investors who wish to seek relief, but who, for various reasons, may not wish to take a leadership role in litigation or settlement proceedings. For those investors that do take a leadership role, there is, however, now precedent for monetary “incentive awards” for such leadership. The Court did not object to incentive awards for lead or active claimants as long as those awards were related to the claimants’ reasonable costs and expenses and as long as the court was informed of any expenses incurred and fees awarded to representative organizations.

Second, the settlement provides a recovery not only to investors who purchased Fortis shares during the relevant period of alleged misrepresentations, but also to those who purchased shares prior to that period and merely continued to hold them during the time of misrepresentations (the “Holders”). The Holders, however, will receive a smaller settlement amount compared to stock purchasers during the relevant period. This decision marks the first time the Court has addressed Holders’ claims. In future adversarial proceedings (as opposed to this non-adversarial settlement proceeding), the Court may have room to take a different tack regarding Holders’ claims.

Third, the Court stated that any fee agreements must be part of the court’s review of a proposed WCAM settlement, regardless of whether the parties have expressly included fee provisions in the settlement documents. The Court’s demand for transparency on fees and funding arrangements is somewhat similar to the information that US courts request about attorneys’ fees and reimbursements requested by class representatives when considering class settlements.

Conclusion

As discussed above, the Fortis settlement is the largest shareholder collective action settlement ever outside the US. If it had taken place in the US, it would have been among the ten largest US securities class action lawsuits settlements ever. Although the US accounts for 96 percent of securities litigation recoveries globally since 1995, this case underscores the potential of non-US jurisdictions to recover fraud-related investment losses. The Amsterdam Court’s decision confirms that WCAM remains a viable way to settle — on a transnational, opt-out basis — potential securities and other claims that might not be litigable or resolvable on a class-wide basis in many countries. The potential availability of a Dutch forum has become more important post-Morrison as the United States has retreated from serving as an international dispute-resolution jurisdiction. WCAM thus provides shareholders with a much-needed alternative route to resolve transnational problems that cannot be settled or litigated in US courts.

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The Fortis settlement is the largest shareholder collective action settlement ever outside the US. If it had taken place in the US, it would have been among the ten largest US securities class action settlements ever.

Fortis Settlement Compared to Top Ten US Settlements

<table>
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<tr>
<th>Settlement</th>
<th>Amount</th>
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<tbody>
<tr>
<td>Enron</td>
<td>$7.242</td>
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<tr>
<td>WorldCom</td>
<td>$6.194 billion</td>
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<tr>
<td>Cendant Corporation</td>
<td>$3.319 billion</td>
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<tr>
<td>Tyco International</td>
<td>$3.2 billion</td>
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<tr>
<td>AOL Time Warner</td>
<td>$2.5 billion</td>
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<tr>
<td>Bank of America</td>
<td>$2.425 billion</td>
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<tr>
<td>Household International</td>
<td>$1.575 billion</td>
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<tr>
<td>Fortis ($1.474 billion)</td>
<td>€1.3 billion</td>
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<tr>
<td>Nortel Networks (1)</td>
<td>$1.143 billion</td>
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<tr>
<td>Royal Ahold</td>
<td>$1.100 billion</td>
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<tr>
<td>Nortel Networks (2)</td>
<td>$1.074 billion</td>
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Source: ISS Securities Class Action Services
Mandatory Arbitration
Continued from page 27.

America, and Global Crossing, the SEC recovered only about $1.75 billion while investors in private class action suits recovered more than ten times that amount, or about $19.4 billion. Without shareholder class actions to seek relief for securities violations, companies’ misconduct could get a free pass, investors could be undercompensated, and there would be far fewer factors deterring fraud and other corporate misconduct. With a reduced probability of being caught, corporate managers could commit fraud without fear of serious consequence.

The way forward — institutional investors must proactively address managerial overreach and fraud

Institutional investors should remain vigilant in monitoring and combating efforts by corporate management to strip them of their valuable rights to litigate securities fraud claims in court. With companies, the business lobby, and other anti-shareholder special interests ready to reignite the fight over mandatory arbitration provisions, investors must voice their concerns about forced arbitration to legislators and the SEC, and be prepared to pursue available legal remedies to challenge the attempted use of mandatory arbitration provisions. Investors should stand together against these renewed attacks on fundamental shareholder rights.

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Auditors
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statement to correct an error that was material enough to render a company’s previous financial reports unreliable. Restatements are meant to be a mechanism for companies to admit accounting failings. But because restatements are embarrassing and potentially costly for both auditors and company management, accounting firms may choose not to recommend necessary restatements, and, even if an accounting firm advises a client to restate its financials, the company can refuse to restate — leaving investors in the dark. Tellingly, at the same time audit firms are expanding their non-audit services for US public companies, the total number of restatements by publicly traded US companies has declined, hitting a 17-year low in 2017.

Solutions are challenging and not imminent

Given the ongoing threats to audit quality, there are numerous governance and regulatory proposals aimed at improving audit integrity. Some commentators have suggested that increasing the level of regulation of public company accounting is an appropriate way to fix the problem. Others have suggested that audit firms should adjust their bonus metrics so that auditors are rewarded for high audit quality instead of retaining or securing business. Until the ultimate solution takes shape, the prospect of unreliable auditing is a further reason for institutional investors to remain vigilant and selective with their asset allocations, and consider advocating for appropriate regulatory enhancements.

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