Securities Litigation
FROM THE SECTION OF LITIGATION SECURITIES LITIGATION COMMITTEE

Spring 2012, Vol. 22 No. 3

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ARTICLES

The SEC's Public Focus on Private Equity

By Zesara C. Chan – May 10, 2012

The Securities and Exchange Commission (SEC) has long been a major force in the regulation of the federal securities laws governing publicly traded companies. From the time it was created, the SEC has supervised the integrity of securities markets, monitored the accuracy of periodic filings by public companies, and applied its enforcement authority to prevent and punish corporate abuses related to the securities industry. Over the past two years, however, the SEC has expanded its enforcement priorities and intensified its examination into private equity companies and investment managers.

In 2010, the SEC substantially reorganized its Division of Enforcement, creating special investigative units and multi-agency working groups devoted to high-priority areas of enforcement, including an Asset Management Unit, which targets examination into the practices and procedures of private equity firms, hedge funds, and investment advisers. The creation of the specialized enforcement units as investigatory tools reflects the impact of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, which includes new registration and reporting rules, as well as more extensive record-keeping standards applicable to investment advisers and private equity participants. To help pursue the goals of its expanding regulatory jurisdiction in the aftermath of the financial crisis and the reforms of the Dodd-Frank Act, the Division of Enforcement's Asset Management Unit has hired former investment managers and other industry experts to guide enforcement efforts; to provide experienced analysis for examinations, audits, and investigations; and to develop market monitoring tools to highlight private equity and asset management risk issues.

With its expanded role, the SEC has increased its enforcement activity in the private equity and investment adviser industry substantially, and the trend will likely continue. In the fiscal year ended September 2011, the first full year of the SEC's enforcement program using its restructured organization and additional resources, the SEC filed a record 735 enforcement actions, an 8 percent increase in relation to 2010. In 2011, there was a substantial leap in the number of actions against investment advisers and investment companies—146 actions, a 30 percent increase over the 112 actions brought in 2010. In 2009, the SEC reported only 76 enforcement actions against investment advisers and investment companies.

In recent commentary, the issues of enforcement interest in the private equity and investment management industry discussed by SEC officials include conflicts of interest, valuation of assets, past performance results, and accurate disclosure to current and potential investors. Carlo V. di Florio, Director, SEC Office of Compliance Inspections and Examinations, Private Equity International's Private Fund Compliance (May 3, 2011) (presentation in question-and-answer format with questions by David Snow of *Private Equity International* magazine). Detailed

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inquiry into all stages of a private equity fund—from solicitation and asset management to divestiture—should be expected. The economic incentives in the relationships between private equity companies and their business partners, such as investment bankers, third-party consultants, and lenders, that could give rise to conflicts of interest are likely SEC examination targets. The SEC is also likely to explore the conflicts that can emerge at the fund-raising stage of a private equity fund over how the fund is marketed, particularly where representations in marketing materials to potential investors describe returns on previous investments. Past performance data may be a key subject of inquiry. The SEC will likely take a close look at a private equity fund's statements about its past performance, the consistency and comparability of its valuation methods, and disclosure about pricing methodology and unrealized performance.

Even where private equity managers use independent financial experts or complicated methodologies to value their portfolio holdings, subjective assessments play a role in the value conclusions. The recent registration statement of one of the world's largest asset management firms, the Carlyle Group L.P., discloses its valuation methodologies as a "risk factor," warning potential investors about the subjectivity implicit in its valuation methodologies for certain assets, which could affect the accuracy of its representations of fund performance and accrued performance fees. The SEC's remarks show the concern that overstated valuations not only can mislead current investors but also can attract new investors with inflated results. *Id.*

In addition, SEC staff have noted the possible conflicts during the investing stage of a private equity firm, such as how investment opportunities are allocated among investors that may have differing investing strategies and multiple relationships with the manager. Public comments also suggest that the divesting stage of a private equity fund may be scrutinized to evaluate how liquidity events are implemented, such as when portfolio companies are sold to other funds or when joint holdings by several funds are not sold simultaneously. *Id.*

In recent months, media reports have revealed that the SEC launched an informal inquiry in December 2011 into the private equity industry and sent letters to certain firms, requesting information in various areas, including fund-raising, fund formation, and agreements between private equity funds and outside parties involved in valuing the funds' assets. Gregory Zuckerman, "SEC Launches Inquiry Aimed at Private Equity," *Wall St. J.*, Feb. 11, 2012. Not only can valuation policies and procedures raise questions, but also an SEC inquiry could be triggered by the extraordinary success of a portfolio manager's performance. The analytical tools used by the SEC include computer monitoring programs to uncover aberrational performance statistics that may suggest the need for potential investigation. Using proprietary risk analytics, the Asset Management Unit is evaluating returns and investigating extraordinary performance that appears inconsistent with a fund's investment strategy or other benchmarks. The SEC has already filed several enforcement actions under this "Aberrational Performance Inquiry" initiative where the adviser's exceptional results were allegedly "too good to be true," signaling that something could be amiss. *SEC Charges Multiple Hedge Fund Managers with Fraud in*

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Inquiry Targeting Suspicious Investment Returns, SEC News Dig., Issue No. 2011-231 (Dec. 1, 2011).

In January 2012, Robert Kaplan, co-chief of the Asset Management Unit, warned the private equity industry that it should expect more attention and enforcement actions in the years ahead, comparable to the amplified enforcement emphasis on hedge funds five or six years ago. Laura Kreutzer, *SEC Puts Private Equity Under the Enforcement Microscope*, Wall St. J., Jan. 25, 2012. The SEC is continuing its trend of increased examination and escalating enforcement in the private equity and investment management area with recent activity. In February 2012, news reports revealed that the SEC has opened an investigation into Oppenheimer Global Resource Private Equity Fund LP, alleging possibly inflated or exaggerated valuations of one of its holdings in 2009, purportedly to raise new capital commitments at that time. Gregory Zuckerman, *Private-Equity Fund in Valuation Inquiry*, Wall St. J., Feb. 24, 2012. According to business media reports, the Oppenheimer fund subsequently raised more than $55 million from other investors based on allegedly mistaken results. Following the news of the SEC investigation, a putative class action complaint against the fund was filed in March 2012, alleging that the solicitation documents used to entice new investors to the defendant's fund contained materially untrue and misleading statements regarding the purported value of the Oppenheimer fund's holdings and the profitability and performance of the fund.

In the current environment of intense regulatory scrutiny, the SEC has given notice of its expanding enforcement priorities against the private equity and asset management industry. Additional consideration and broad review of internal compliance programs and procedures will be necessary to minimize exposure to the regulatory floodlight now focused on these communities.

Keywords: litigation, securities litigation, private equity firms, asset managers

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Pitfalls for Broker-Dealers: Selling Novel and Complex Products

By Daniel Nathan and James Day – May 10, 2012

The variety and the complexity of products offered and sold by broker-dealers are on the rise as investors seek alternatives to low-yielding run-of-the-mill equity and fixed-income securities. These alternative investments in so-called "complex" or "alternative" products come with risks, however, and require firms to pay particular attention to vetting the new products they approve and offer, training their brokers in selling those products, and implementing systems and procedures to reasonably ensure that brokers are making suitable recommendations. In recent years, the Financial Industry Regulatory Authority (FINRA) and other regulators have brought many formal disciplinary actions involving sales practice violations—including inadequate disclosure and, in extreme cases, fraud—with respect to many of these products, such as auction rate securities (ARS), collateralized mortgage obligations (CMOs), principal protected notes, and reverse convertible notes.

These actions invariably also allege systemic failures to supervise. Taken together with FINRA's periodic advice to firms (which includes FINRA's 2012 annual regulatory and examination priorities issued on January 31, 2012, these cases provide important guidance to the industry about the proper supervisory systems and procedures that a firm should put in place when first considering sales of complex products, as well as throughout the period of such sales. As these cases demonstrate, the failure to invest in procedures on the front end to track ongoing recommendations and sales can be very costly to a firm if the products blow up and the firm faces enforcement action and reputational harm.

FINRA's Guidance Concerning Supervision of Complex Products

A broker-dealer's systems and procedures should provide for adequate due diligence, before complex products are sold, thorough training of the sales force, heightened attentiveness to suitability issues, and ongoing review of the products. In January 2012, FINRA issued Regulatory Notice 12-03, noting that complex products are riskier for investors because they might be affected by factors in addition to fundamental market forces and that such complexity might impair the ability of brokers or their customers to understand how the product will perform in different markets. The notice defines the characteristics of complex products and provides a summary of appropriate supervisory procedures that a firm should institute when recommending or selling complex products. These procedures include a special mechanism for approving the sale of such products, continuing review of the products to determine any changes in their performance or risk in light of changes in market conditions, training of brokers, and considerations of the suitability and appropriateness of the product for the customer.

FINRA's Enforcement Actions Involving Complex Products

Recent FINRA disciplinary actions involving sales of complex products emphasize that firms

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need to make full and accurate disclosure about the products in view of their unusual features and pay attention to suitability concerns and recommendations that customers use leverage to pay for the purchases. Firms also need to make sure that their automated systems are appropriately tailored to these products and that their brokers are adequately trained to understand the products and to make full disclosure and appropriate suitability determinations.

Disclosure-Related Violations
False and Misleading Disclosures and Omissions. FINRA charges false and misleading disclosures under Rule 2010 (formerly 2110), which requires members to observe high standards of commercial honor and just and equitable principles of trade. This rule can be violated by providing false and misleading disclosures through either commission or omission.

The relative risk or safety of an investment is obviously among the most material considerations for investors. In the formal actions growing out of its ARS sweep, FINRA found that firms made affirmative misrepresentations concerning the attractiveness of ARS as an alternative to money market funds and certificates of deposit, as a place to put short-term funds. For example, in its marketing materials, Fifth Third Securities, Inc., inappropriately described ARS as a "great place for short-term money" and a "cash alternative." *Fifth Third Secs., Inc.*, Letter of Advice, Consent, and Waiver (AWC) No. 2008014620501 (2008). Investors are also concerned about the liquidity of an investment. FINRA found that SunTrust Robinson Humphrey, Inc., failed to adequately disclose all of the risks associated with ARS, including the risk that investments in ARS could become illiquid for substantial periods of time. *SunTrust Robinson Humphrey, Inc.*, AWC No. 2008013864101 (2011). Some materials used by SunTrust Robinson Humphrey also made misleading comparisons between ARS and other materially different investments, such as money market instruments. In a case against HSBC Securities (USA), Inc., FINRA found that in August 2007—when HSBC was aware that some of its institutional ARS holdings were frozen due to failed private auctions, other private ARS auctions had failed, general credit market conditions had deteriorated, and the firm had reduced the ARS held in its proprietary account—HSBC registered representatives continued to recommend the purchase of ARS to current and potential customers and to represent ARS as liquid and safe investments, without providing adequate notice of the increased risks of owning ARS. *HSBC Secs. (USA) Inc.*, AWC No. 2008013863801 (2010).

FINRA has also charged the failure of a firm or associated person to disclose material information as an omission in violation of Rule 2010. FINRA fined several firms—Deutsche Bank, Merrill Lynch, and Credit Suisse Securities—for negligently misrepresenting delinquency data in prospectus supplements for residential mortgage-backed securities. *Deutsche Bank Secs. Inc.*, AWC No. 20080128087 (2010); *Merrill Lynch, Pierce, Fenner & Smith Inc.*, AWC 2008012808201 (2011); *Credit Suisse Secs. (USA) LLC*, AWC No. 2008012808901 (2011). Delinquency rates constitute material information for residential mortgage-backed securities investments because the rates affect the investor's ability to evaluate the fair market value, the yields, and the projected holding periods for each of these securitizations. Investors may consider

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this information in assessing the profitability of these securitizations and in determining whether future returns would be disrupted by mortgage holders who fail to make loan payments.

FINRA has brought other, similar cases involving the failure to make appropriate disclosure to retail investors—by brokers and in advertising materials—regarding the risks of issuer default associated with Lehman Brothers principal protected notes.

Fraudulent Disclosures. In egregious cases of false and misleading disclosures, FINRA has charged its registrants with fraud under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. For example, in a case involving the sale of CMOs, FINRA found that several former Brookstreet Securities Corporation brokers committed fraud in violation of section 10(b) and Rule 10b-5. *Sheinkopf*, Notice of Acceptance of Offer of Settlement No. 2007011348301 (Sept. 3, 2010); *Gest*, Notice of Acceptance of Offer of Settlement No. 2007011348301 (June 22, 2010). FINRA barred two former brokers for making misrepresentations and omissions that led customers to believe that through CMO investments, they could safely achieve consistently high annual returns—in some cases, up to 10 percent (or 14 percent, in Gest's case)—year after year, regardless of market conditions, with the government backing the investments. The particular CMOs that they sold their customers were generally not guaranteed by the government and were subject to price volatility and to uncertain cash flows and maturities, based on changes in interest rates.

Sales Practices—Suitability
General Suitability Considerations. National Association of Securities Dealers (NASD) Rule 2310 requires that, in recommending to a customer the purchase, sale, or exchange of any security, a broker shall have reasonable grounds for believing that the recommendation is suitable for the customer on the basis of the facts disclosed by the customer as to his or her other security holdings and as to his or her financial situation and needs. In formal disciplinary proceedings involving the sales of alternative products, FINRA frequently charges violations of this rule, because many customers lack the sophistication, experience, risk tolerance, or financial resources to invest in these products.

Reverse Convertibles. A reverse convertible note is a structured product that typically consists of a high-yield, short-term note that is linked to the performance of an unrelated reference asset, usually common stock, a basket of stocks, an index, or another instrument. The higher yield on these products reflects the risk that, instead of a full return of principal at maturity, the investor could receive less than a full return of principal if the value of the reference asset has fallen below a certain level, often referred to as the "knock-in" or "barrier" level.

In a notice to members, FINRA advised member firms that they are required to implement systems and written procedures that are reasonably designed to ensure that sales of structured products such as reverse convertible notes comply with the suitability requirements of NASD Conduct Rule 2310. NASD Notice to Members 05-59 (Sept. 2005). FINRA specifically

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cautioned members that the derivative component of structured products and the potential loss of the principal for many such products may make them unsuitable for retail investors seeking alternatives to debt securities. FINRA suggested that firms consider whether purchases of certain structured products should be limited to investors that have accounts that have been approved for options trading, because, even though structured products pay interest just as debt securities do, they often exhibit very different profit-and-loss potential and may be more akin to an options contract. FINRA issued a similar message in FINRA Regulatory Notice 10-09 (Feb. 2010).

Enforcement actions involving reverse convertibles have reinforced the message of these notices. FINRA recently found Wells Fargo liable when one of its brokers effected hundreds of unsuitable reverse convertible transactions in the accounts of 21 customers. Most of these customers were elderly, 15 of them over 80 years old and 4 of them over 90 years old. As of May 2008, each of the 21 customer accounts held over 50 percent of investible assets in reverse convertibles, and some accounts were entirely invested in reverse convertibles and stock put to the accounts from reverse convertibles. *Wells Fargo Invs., LLC*, AWC No. 2008015651901 (Dec. 15, 2011). FINRA earlier found that Ferris, Baker, Watts, Inc., made unsuitable recommendations of reverse convertible notes to 57 customers who were 85 years old or older or who had stated net worth of less than $50,000. *Ferris, Baker, Watts, Inc.*, AWC No. 20070091803 (2010). Sales of reverse convertibles at Wells Fargo and at Ferris, Baker were inconsistent with the customers' investment objectives, risk tolerance, age, net worth, and investment experience. Indeed, these customers suffered net losses on their reverse convertible investments.

Use of Leverage and Margin. As a general matter, the use of leverage or margin exacerbates any risks created by investments in complex products. In an AWC issued as to Santander Securities, FINRA found, among other things, that Santander had made unsuitable sales of these products by recommending that customers pay for the reverse convertible notes by borrowing money from the firm's banking affiliate, using securities in their brokerage accounts as collateral. *Santander Secs. Corp.*, AWC No. 2008011719301 (2011). Indeed, some brokers helped customers borrow the funds to use to buy reverse convertibles. If the reverse convertible returned the full principal at maturity, then the customer captured the spread between the interest paid to the bank and the higher coupon paid out by the reverse convertible. However, when reverse convertibles resulted in the reference asset being put to the customers at a value significantly below market, many customers not only lost the money that they invested but also owed additional money to the bank. In addition, FINRA found that the firm failed to supervise the recommendations that customers use pledged collateral accounts to purchase the CMOs. The firm had no policies and procedures, written or unwritten, that governed how supervisors were to monitor and review brokers' recommendations to purchase securities by using pledged collateral accounts.

In a series of cases involving fraudulent sales of CMOs by SAMCO Financial Services, Inc., FINRA found that the brokers made unsuitable sales because the customers funded much of their

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purchases of the CMOs with margin borrowing that exceeded their entire liquid net worth and created an unsuitable level of exposure to losses. *See, e.g.*, *Schwartz*, AWC No. 2006005546004 (2009); *Berkowicz*, AWC No. 2006005546003 (2009); *Webberly*, AWC No. 2006005546001 (2009). (A CMO is a security that pools together mortgages and issues shares in various tranches, which vary in their characteristics and risks. An "inverse floater" CMO is one of the most volatile and risky CMO tranches, paying an adjustable rate of interest that moves in the opposite direction from movements of an interest rate index.) When the value of the CMOs declined, they were unable to satisfy margin calls, and the firm sold out their positions at substantial losses. Purchases on margin clearly put the lie to the brokers' representations that an investor in inverse floaters could not lose more than their principal investments.

Supervision

FINRA exercises its missions of investor protection and market integrity through its vigilant efforts to improve broker-dealer supervision of their registered representatives, through training, guidance, examinations, and formal disciplinary proceedings. In the vast majority of enforcement actions in recent years involving complex products, FINRA found supervisory deficiencies. These deficiencies are typically linked to the nature of the products.

Tailoring Supervisory Systems to Complex Products. Firms selling new or complex products should ensure that the surveillance systems that they routinely use to monitor the suitability of transactions and the appropriateness of other sales practices are effective for all products sold by the firm, including alternative products. Two recent cases highlight the problems that arise when systems are deficient.

FINRA found that Northern Trust Securities, Inc., used an exception reporting system to monitor customer accounts for, among other things, account turnover and concentration levels in a particular security or particular class of security. *Northern Trust Secs., Inc.*, AWC No. 2009018771601 (2011). The system would flag transactions and accounts for review by the compliance department for suitability. However, the firm was unaware that the exception reporting system did not capture or analyze substantial portions of the firm's business. All CMO transactions, certain trades of 10,000 equity shares or more, and certain trades of 250 or more fixed-income bonds ("large block trades") were executed through a different system. As a result, Northern Trust failed to monitor and review potentially unsuitable CMO concentration levels in customer accounts. FINRA has brought other cases in recent years finding that firms had failed to configure their systems to adequately monitor concentrations of reverse convertible notes in customer accounts.

Conclusion

As demonstrated by its recent regulatory actions, FINRA remains committed to reviewing its member firms' sales of complex products and, when appropriate, bringing enforcement actions against member firms that do not adequately disclose the risks associated with selling these

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products, that make unsuitable sales of such products, or that fail to have adequate systems and procedures to oversee the sale of such products.

These recent matters illustrate the pitfalls that may trip up broker-dealers as they sell new or alternative products. Such products may have begun as relatively plain vanilla securities but took on complex features over time. Or such products—ARS, for one—may have been relatively conservative products at one point, but changes in the markets or other external events may have radically altered the risks associated with the products. Some products, such as reverse convertibles, may be suitable for only a portion of the investing public and only in limited concentrations. Broker-dealers must remain vigilant in assessing the risks of these products when they begin offering them, as the products change, or as external events alter the risks faced in investing in complex products, and determine whether they have sufficient systems and procedures to oversee the sales of such products.

Keywords: litigation, securities litigation, FINRA, ARS, CMO

Daniel Nathan is a partner at Morrison & Foerster LLP and until recently was a vice president and the director of regional enforcement in FINRA's Department of Enforcement, and Jim Day is an associate vice president and a chief counsel in the department.

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Regulators React to the Rise of Social Media

By Julie H. Firestone and Christine J. Kim – May 10, 2012

Businesses are quickly recognizing the growing importance of using social media websites, such as Facebook, Twitter, and LinkedIn, as well as personal and professional blogs. Social media can improve a business's connection with its customers and potential customers, making the business more accessible and allowing the business to more readily receive and respond to customer inquiries and feedback. Indeed, although social media websites have been banned by businesses in the work setting in the past, those who continue to prohibit the use of social media outright may find themselves falling behind in a rapidly growing communication field. By creating more avenues to connect to customers, businesses that use social media receive more exposure to potential and existing clients and position themselves to better respond to customers' needs.

On the other hand, businesses also recognize that allowing employees to engage in social media invites a host of problems. In the financial services industry, the use of social media can even create violations of securities regulations. Although registered investment advisers (RIAs) and broker-dealers should already have procedures and policies in place with respect to written and electronic communications, the movement from two-party communications to an interactive multi-party exchange on social media websites raises new questions regarding compliance. Because existing regulations and procedures often were not created with current social media in mind, the struggle for RIAs and broker-dealers will be in applying the "old" rules to a new medium of communication. In an effort to aide RIAs and broker-dealers in treading through this murky new territory, both the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) have issued releases setting forth important guidelines to consider.

SEC Issues Alert on Investment Adviser Use of Social Media

In January 2012, the SEC released a National Examination Risk Alert providing staff observations and guidelines that RIAs should consider in using social media. More generally, the alert reminds investment advisers that the use of social media must comply with antifraud, compliance, and record-keeping provisions under the Investment Advisers Act of 1940, Securities Act of 1933, and Securities Exchange Act of 1934. As described below, SEC staff members detailed their observations regarding (1) the application of compliance programs to the use of social media, (2) consideration of third-party content on social media websites, and (3) the need to reevaluate record-keeping responsibilities. Although the alert itself is not binding, RIAs should take careful note of SEC staff observations, as regulators are likely to refer to the alert in future proceedings.

Compliance Programs

The alert reinforced the importance of reviewing and updating compliance programs pursuant to Advisers Act Rule 206(4)-7, which requires RIAs to periodically review the effectiveness of

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their policies. SEC staff noted that, although existing compliance programs may address certain issues relating to the use of social media, the lack of specificity in the programs—such as the type of social networking activity permitted; the use of social media by solicitors; and overlapping policies on advertisements, client communications, and electronic communications—may lead to confusion as to which particular rules are applicable to social media and how those rules apply.

Accordingly, SEC staff suggested that RIAs identify potential conflicts and factors that may create risk, then evaluate their compliance programs to see whether those risks are effectively addressed. For instance, RIAs may want to provide "usage guidelines" that inform investment adviser representatives and solicitors on the appropriate use of and restrictions on social media, such as providing a specific list of approved social media websites or prohibiting the use of specific functions on a site. SEC staff also suggested creating clear guidelines as to "content standards," which would identify whether content on a social media website may implicate a fiduciary duty or other regulatory issue. RIAs may also want to consider how to effectively monitor social media websites being used by its employees, including whether to require preapproval of content (as opposed to "after-the-fact review") and how often social media sites should be monitored.

Third-Party Content

SEC staff addressed the issue of third-party content, meaning content posted by a person other than the RIA or its employees, noting that many RIAs varied on the policies and procedures for third-party postings. For instance, while some RIAs allowed third parties to freely post on their social media sites, other RIAs strictly limited interaction with third parties by prohibiting responses to third-party postings or limiting third-party postings to authorized users. For those RIAs allowing open communication with third parties, SEC staff warned that third-party statements could be considered "testimonials" under Advisers Act Rule 206(4)-1(a)(1), which states that it is a fraudulent, deceptive, or manipulative act, practice, or course of business for an RIA to publish, circulate, or distribute "any advertisement which refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or concerning any advice, analysis, report or other service rendered by such investment adviser." SEC staff stated that although "testimonial" is not defined in the act, it has been consistently interpreted by SEC staff to include a statement of a client's experience with or endorsement of an investment adviser. Accordingly, using the "like" button on a social media site could be considered a testimonial if it implicates a client's experience with or endorsement of an investment adviser.

Record-Keeping Responsibilities

SEC staff emphasized the importance of an RIA's record-keeping obligations related to social media sites. Considering the many different forums available to communicate with clients on social media—such as status updates, discussion boards, emails, texting, direct messaging, or chat rooms—SEC staff advised that RIAs intending to communicate through social media sites should consider whether they have the capability to maintain all required records, keeping in

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mind that, to comply with federal securities laws, these records should be easily accessible for a period of not less than five years. SEC staff suggested that RIAs should determine whether each social media communication is a required record for purposes of securities laws and, if so, figure out the applicable retention period and the accessibility of the records. Other factors RIAs should consider with respect to record-keeping responsibilities include implementing programs to train employees in the maintenance of required records, periodic testing to ensure that employees are complying with compliance policies, and consideration of the use of third parties to aid in implementing compliance programs.

FINRA Issues Regulatory Notices

Regulatory Notice 10-06: Social Media Websites

FINRA issued a regulatory notice in January 2010 with the dual purpose of protecting investors from false or misleading claims and representations on social media websites, as well as guiding broker-dealers in adequately supervising their associated persons' participation on these sites. Regulatory Notice 10-06 addressed several pertinent issues, including record-keeping and suitability responsibilities, appropriate use of interactive electronic forums, supervision of social media websites, and third-party postings.

The notice stated that broker-dealers communicating on social media websites must be able to retain records of those communications as required by Securities Exchange Act Rules 17a-3 and 17a-4 and by National Association of Securities Dealers (NASD) Rule 3110. With respect to suitability, the notice warned that communications that recommend a specific investment product may trigger the requirements of NASD Rule 2310 regarding suitability, as well as other requirements under the federal securities laws. Accordingly, the notice suggested that, as a "best practice," broker-dealers should prohibit all interactive electronic communications that recommend a specific investment product unless previously approved by a registered principal.

The notice also differentiated between static content (including profile, background, or wall information on a social media website), which must be approved by a registered principal, and non-static real-time communications, which require supervision but not prior approval. The notice reiterated that broker-dealers should adopt policies and procedures for the use of social media websites to ensure that associated persons are appropriately supervised, have the necessary training and background, and do not present undue risks to investors.

With respect to third-party postings, the notice stated that FINRA does not treat third-party postings as broker-dealer communications with the public subject to NASD Rule 2210, which requires prior principal approval and specifies content and filing requirements. However, the notice stated that a third-party posting could become attributable to a broker-dealer if the broker-dealer involves itself in the preparation of the content (referred to by the SEC as the "entanglement theory") or if the broker-dealer explicitly or implicitly endorses or approves the content (referred to by the SEC as the "adoption theory"). The notice suggested several "best practices" for third-party postings, including the adoption and disclosure of usage guidelines for

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customers and third parties, and the establishment of procedures for screening third-party content.

Regulatory Notice 11-39
FINRA followed up by issuing Regulatory Notice 11-39 in August 2011. In addition to reiterating and clarifying record-keeping and supervisory obligations of broker-dealers on social media websites, the notice discussed the use of links to third-party sites and management of data feeds. Moreover, the notice stated that associated persons may access social media websites from their personal devices, such as smart phones and tablet computers. But the notice suggested that personal devices should separate business and personal communications, and the notice reminded broker-dealers that they must maintain their ability to retain and supervise business communications conducted on a device owned by the broker-dealer or associated person.

Conclusion
The difficulty for businesses regulated by the SEC and FINRA will be in finding the ability to create programs that can take advantage of the benefits of using social media, while at the same time complying with securities laws and other applicable rules and regulations. By their recent alerts and notices, the SEC and FINRA have put RIAs and broker-dealers on notice that their use of social media must adhere to the same rules and regulations that written and electronic communications must adhere to and that regulators will be watching.

Keywords: litigation, securities litigation, SEC, FINRA, Facebook, Twitter

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Securities Litigation
FROM THE SECTION OF LITIGATION SECURITIES LITIGATION COMMITTEE
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An Uncertain Future for "Neither Admit nor Deny" Settlements

By Ghillaine A. Reid – May 10, 2012

The future of the Securities and Exchange Commission's (SEC's) long-standing practice of allowing defendants who settle enforcement actions with the agency to do so without admitting or denying the allegations is uncertain. For well over 30 years, the SEC's "neither admit nor deny" settlement practice has allowed the agency to resolve the majority of its enforcement actions with relative ease—while also saving limited resources that otherwise would be spent on protracted litigation. The now infamous decision of U.S. District Judge Jed S. Rakoff to reject the proposed settlement in the case of *SEC v. Citigroup Global Markets Inc.* has changed the landscape on which the SEC has long been accustomed to resolving enforcement actions. Whether this established settlement practice continues will depend greatly on the decision by the Second Circuit Court of Appeals whether to affirm Judge Rakoff's decision to reject the settlement. On March 19, 2012, the Second Circuit announced that it will decide the appeal in September 2012.

Regardless of the outcome of the appeal, Judge Rakoff's decision has upset the proverbial apple cart with respect to SEC settlement practices. The decision has resulted in greater judicial scrutiny of proposed SEC settlements, spawned an official policy change by the SEC to its application of the "neither admit nor deny" provision, and ignited congressional interest in the SEC's settlement practices.

The *Citigroup* Decision

After conducting a four-year investigation, on October 19, 2011, the SEC filed a civil enforcement action against Citigroup Global Markets, Inc., alleging that Citigroup defrauded investors by misrepresenting that the assets of a fund created and sold by Citigroup were solid, promising investments when, in fact, Citigroup intentionally selected for the fund poorly rated mortgage-backed securities and took a short position in the fund to protect itself against losses from the investment. *SEC v. Citigroup Global Markets Inc.*, No. 11 Civ. 7387 (JSR), slip op. at 1 (S.D.N.Y. Nov. 28, 2011). The SEC alleged that Citigroup purposely structured the fund as a vehicle to unload these low-grade assets on investors, who collectively suffered over $700 million in losses, while Citigroup realized alleged profits of approximately $160 million. *Id.*at 2.

As is common in SEC enforcement practice, simultaneous with the filing of its complaint against Citigroup, the SEC presented to the court for approval a final judgment as to Citigroup and a consent judgment of Citigroup. The proposed consent judgment (which outlines the terms of the settlement) contained language and provisions that are, and have long been, standard for consent judgments in SEC settlements. Specifically, Citigroup agreed to the entry of the judgment without "admitting or denying the allegations of the complaint"; to a permanent injunction from future securities law violations; to pay disgorgement, prejudgment interest, and a civil penalty (a

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total payment of $285 million); and to establish internal measures to prevent the recurrence of similar misconduct. *Id.*at 3.

For years, judges have approved proposed settlements like this one without questioning the terms, relying instead on the presumption that the SEC's mandate to serve the investing public resulted in a fitting settlement. Judge Rakoff, however, did not grant the anticipated approval of the proposed *Citigroup* settlement and, as a result, has drawn sharp criticism from the defense bar, the SEC, the media, and, more recently, the Second Circuit. In his decision on November 28, 2011, Judge Rakoff declined to approve the proposed settlement on the ground that the court had "not been provided with any proven or admitted facts upon which to exercise even a modest degree of independent judgment." *Id.* at 4. Judge Rakoff's reasoning started with the standard of review by which consent judgments should be evaluated by the courts—whether the proposed consent judgment is "fair, reasonable, adequate, and in the public interest." *Id.*He focused most on whether a settlement serves the public interest and cited Supreme Court jurisprudence for the proposition that a court cannot grant the extraordinary remedy of injunctive relief without determining whether the public interest will be served by that relief. *Id.* at 5.

After articulating the standard of review, Judge Rakoff challenged the notion that he can satisfy that standard without a strong factual predicate. This is the linchpin of the decision and the point that has altered the manner in which many judges have since evaluated proposed SEC settlements. Judge Rakoff rejected the proposed settlement because the parties failed to provide the court with sufficient facts to enable the court to evaluate whether the terms of the settlement satisfied the standard of review. In his opinion, Judge Rakoff stated that "the proposed Consent Judgment is neither fair, nor reasonable, nor adequate, nor in the public interests . . . [b]ecause it does not provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified under any of these standards." *Id.* at 8.

In Judge Rakoff's view, the government, by seeking to invoke the court's injunctive authority, was asking the court to "become its partner in enforcement"—a role that requires the court to have "some knowledge of what the underlying facts are" lest the court "becomes a mere handmaiden to a settlement privately negotiated on the basis of unknown facts, while the public is deprived of ever knowing the truth . . . ." *Id.* Judge Rakoff contrasted the circumstances surrounding the *Citigroup* settlement with those in the recent settlement of *SEC v. Goldman Sachs & Co.*, No. 10 Civ. 3229 (BSJ) (S.D.N.Y. July 10, 2010),in which the consent judgment contained an admission by Goldman Sachs that its marketing materials regarding a particular asset transaction were incomplete and lacked adequate disclosure. Although Goldman Sachs did not admit or deny the allegations of the SEC's complaint, it provided the court and the public, through its admission, with facts on which the settlement was based.

The Appeal to and Preliminary Decision of the Second Circuit
Judge Rakoff's decision to reject the proposed settlement led to a series of protracted procedural activities by the SEC, Citigroup, and Judge Rakoff. On December 15, 2011, the SEC and

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Citigroup filed a notice of appeal and moved the district court for a stay of the proceedings pending a decision from the Second Circuit. Judge Rakoff denied the stay on December 27, 2011, but before he did so, the SEC filed an emergency motion for a stay with the Second Circuit. The Second Circuit ordered a temporary stay, which has since become a permanent stay. On December 29, 2011, the SEC filed a mandamus petition requesting that the Second Circuit direct Judge Rakoff to enter the proposed consent judgment, and also requesting a stay pending the appeal and mandamus petition.

On March 15, 2012, the Second Circuit published a decision that upgraded the temporary stay into a permanent stay pending the decision on the appeals (which will be made in September 2012). *SEC v. Citigroup Global Markets Inc.*, No. 11-5227 (2d Cir. Mar. 15, 2012). Although the decision did not determine the merits, the panel criticized Judge Rakoff's disapproval of the proposed settlement and the reasoning behind his decision. Significantly, the Second Circuit stated that although it had not received briefing in support of Judge Rakoff's position, the SEC and Citigroup demonstrated a likelihood of success that their motion to overturn the decision would be granted. Counsel has since been appointed to represent Judge Rakoff.

The Second Circuit criticized what it characterized as Judge Rakoff's lack of deference to the SEC regarding its policies and stated that it is not the "proper function of federal courts to dictate policy to executive administrative agencies." *Id.* at 7–8. In addition, the court stated that requiring an admission of liability from a defendant "undermines any chance for compromise" and makes settlement nearly impossible. The Second Circuit also challenged Judge Rakoff's position that it was unfair to Citigroup to impose liability based solely on the SEC's allegations. On this point, the Second Circuit stated that Citigroup is a "private, sophisticated, counseled litigant" in whose province it is to decide to voluntarily pay a fine without admitting wrongdoing. *Id.* at 10. Finally, the Second Circuit rejected the idea that Judge Rakoff lacked sufficient information to evaluate the settlement, citing the SEC's investigative record and the SEC's responses to the court's requests for information regarding the settlement. *Id.* at 11.

The History of "Neither Admit Nor Deny" Settlements

By demanding a factual predicate to support the terms of a settlement, Judge Rakoff has altered a time-honored policy governing SEC settlements. It has long been a standard practice of the SEC to allow defendants to settle enforcement cases without admitting or denying the allegations. In fact, these "neither admit nor deny" settlements have been codified in the SEC's Rules of Practice since 1972. "Policy re Consent Orders Announced," *SEC News Dig.*, Issue No. 72-227, at 2 (Nov. 28, 1972); 17 C.F.R. § 202.5(e) (2012). Until recently, judges accepted the policy and routinely approved consent judgments based on the allegations in the SEC's complaint. The settlement of SEC enforcement actions typically have followed the same general pattern:

- The staff of the SEC negotiates the terms of the settlement with the defendant (which generally includes disgorgement, prejudgment interest, and a civil penalty);

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- the settlement allows the defendant to accept the terms without admitting or denying the allegations of the SEC's complaint;
- the parties present the proposed consent judgment to the court for approval; and
- the court approves the settlement based on the SEC's complaint and general averment that the settlement is reasonable.

The fact that Judge Rakoff has, essentially, put this practice at risk is worrisome to the SEC and to corporate defendants—both of whom reap valuable benefits from this practice. One obvious benefit is expediency and convenience. The SEC is able to resolve cases with relative ease and secure substantial funds from disgorgement and penalties without the time and expense of a trial on the merits. As the SEC's enforcement director acknowledged in a press release regarding the agency's decision to appeal Judge Rakoff's decision, that the "neither admit nor deny" settlement practice allows the SEC to save time and resources that otherwise would be spent trying cases that could be settled, which liberates the agency to apply its limited resources to other enforcement efforts. Press Release, SEC, SEC Enforcement Director's Statement on Citigroup Case (Dec. 15, 2011).

Defendants, too, benefit from the speed and convenience of these settlements. They can quickly resolve an otherwise protracted regulatory enforcement proceeding by paying disgorgement and a fine (which most corporate defendants with deep pockets can easily do), but without admitting any wrongdoing. This is particularly valuable to corporate defendants because it precludes shareholders from using admissions to support derivative actions against the company. Thus, the SEC has long used the "neither admit nor deny" provision as an incentive for defendants to settle cases. Without it, fewer cases would settle, and more defendants might run the risk of going to trial against the SEC rather than exposing themselves to further private litigation.

Although the challenge to the "neither admit nor deny" policy gained attention after the *Citigroup* decision, that was not the first time the practice was questioned. In a previous case, Judge Rakoff warned that he found the "neither admit nor deny" practice problematic. Early last year, at the beginning of his opinion in *SEC v. Vitesse Semiconductor Corp.*, Judge Rakoff stated that the proposed consent judgment raised "difficult questions of whether the SEC's practice of accepting settlements in which the defendants neither admit nor deny the SEC's allegations meets the standards necessary for approval by the district court."771 F. Supp. 2d 304 (S.D.N.Y. 2011). There, Judge Rakoff accused the parties of being "confident that the courts in th[at] judicial district were no more than rubber stamps" when they filed the proposed settlement simultaneously with the complaint without "so much as a word of explanation as to why the Court should approve th[e] Consent Judgments or how the Consent Judgments met the legal standards the Court is required to apply before granting such approval." *Id.*

Judge Rakoff reluctantly approved the settlement in *Vitesse* after the parties responded to the court's questions about the settlement through written submissions and at a hearing. One of the facts included in those submissions was that the defendants had pleaded guilty to parallel

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criminal charges. Although Judge Rakoff sharply criticized the "neither admit nor deny" practice as a "palpable" disservice to the public who "will never know whether the SEC's charges are true," he noted that this issue becomes moot where the defendants admit their guilt in a related criminal case. *Id.*at 309. The SEC seems to have recognized the discord inherent in allowing a defendant who has pleaded guilty to settle with the agency without admitting or denying wrongdoing. In January 2012, the SEC amended the customary "neither admit nor deny" policy to allow an exemption for defendants who have pleaded guilty in parallel criminal proceedings.

Although this policy is a change in practice, it is not much of a change in substance given that a defendant who has pleaded guilty to criminal charges loses nothing by admitting civil liability also.

The Impact of Judge Rakoff's Decision on Other Cases
Judge Rakoff is not alone in his concern about the "neither admit nor deny" settlement paradigm. More and more judges are scrutinizing and questioning the terms of proposed settlements since the *Citigroup* decision. Even if Citigroup wins on appeal, this pattern may continue.

Late last year, Judge Rudolph Randa of the U.S. District Court for the Eastern District of Wisconsin declined to approve a settlement in the case of *SEC v. Koss Corp.*, No. 11 Civ. 991 (E.D. Wis. Dec. 20, 2011), on the ground that the court lacked sufficient facts to determine whether the settlement was fair, reasonable, and in the public interest. Citing Judge Rakoff's decision in the *Citigroup* case, Judge Randa requested that the SEC "provide a written factual predicate for why it believes the Court should find that the proposed final judgments are fair, reasonable, adequate and in the public interest." *Id.*Just as Judge Rakoff did in *Vitesse*, Judge Randa ultimately approved the settlement in *Koss* after the SEC provided facts sufficient to establish that the proposed judgment was fair, reasonable, and in the public interest. *SEC v. Koss*, No. 11 Civ. 991 (E. D. Wis. Feb. 22, 2012) (approving settlement after the SEC filed a "brief with nine exhibits" establishing why the terms of the settlement were appropriate).

More recently, Judge Renee Bumb of the U.S. District Court for the District of New Jersey ordered the parties in *FTC v. Davidson*, No. 11 Civ. 2172 (D.N.J. Feb. 22, 2012), to make written submissions demonstrating, among other things, how a proposed "neither admit nor deny" settlement with the Federal Trade Commission will serve the public interest. Citing the *Citigroup* decision, Judge Bumb stated that the proposed FTC order presented concerns "similar" to the concerns presented by the proposed order in *Citigroup* and requested that the parties explain how the order is "fair, adequate, reasonable and in the public interest." *Id.*

Even outside the "neither admit nor deny" context, judges are requesting that parties explain why the proposed settlement is reasonable. Just a few weeks ago, in *SEC v. Meredon Mining (Nevada) Inc.*, No. 10 Civ. 00955 (W.D. Wash. Mar. 5, 2012), Judge Richard Jones of the U.S. District Court for the Western District of Washington rejected a proposed SEC settlement that imposed permanent injunctive relief but reserved for an unspecified later date a determination

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concerning disgorgement and penalties. Although the court did not address the "neither admit nor deny" aspect of the settlement, Judge Jones stated that a proposed judgment that "does not resolve the monetary relief that the SEC seeks against any defendant is scarcely a judgment." *Id.* at 2. The court requested that the SEC submit a statement outlining how it plans to obtain final judgments against the parties.

These recent decisions suggest that more judges will require parties to provide a detailed factual predicate to support proposed settlements with government agencies, irrespective of the outcome of the *Citigroup* appeal.

A Changed Landscape for SEC Settlements
Although the recent Second Circuit decision criticized Judge Rakoff's ruling in the *Citigroup* case, the future of "neither admit nor deny" settlement remains unclear. The Second Circuit's determination of the merits, after considering briefing from Judge Rakoff's counsel, will have a great impact on the future of SEC settlement practices. Although the Second Circuit focused on the "deference" that federal courts must accord administrative agency recommendations, established case law provides that courts must independently evaluate whether the exercise of their injunctive powers benefits the public interest. *See SEC v. Randolph*, 736 F. 2d 525, 529 (9th Cir. 1984) (stating that the "initial decision to approve or reject a settlement proposal is committed to the sound discretion of the trial judge") (internal citations omitted); *United States v. Trucking Emp'rs, Inc.*, 561 F. 2d 313, 319 (D.C. Cir. 1977) (stating that "prior to approving a consent decree a court must satisfy itself of the settlement's 'overall fairness to beneficiaries and consistency with the public interest'") (internal citations omitted).

The SEC and Judge Rakoff part ways regarding who among them ultimately decides whether a settlement is in the public interest: The SEC believes that it should make this determination; Judge Rakoff believes that this is the province of the courts. The courts, however, must play a role—after all, it is the injunctive authority of *the courts* that the SEC seeks to invoke. The issue is whether courts should evaluate settlements by relying solely on the allegations of the SEC's complaint or whether they need something more. If they need something more, what more do they need?—proven or admitted facts, as Judge Rakoff demands, or something less?

There is a middle ground that resolves the dilemma in some instances, as demonstrated by the outcome of recent cases. In *Vitesse and Koss*, for example, the courts considered and approved the proposed settlements after the SEC provided facts sufficient to demonstrate why the settlement was reasonable. If necessary, the court can hold a hearing (as it did in *Vitesse*) to allow the parties to further explain the terms of the proposed settlement. With sufficient factual detail regarding the settlement, courts can fulfill their mandate to determine independently whether the settlement is fair, reasonable, and in the public interest. In light of *Citigroup*, the tide is turning and more judges are demanding such a factual predicate anyway. This paradigm works only as long as the court believes the settlement is reasonable after evaluating the facts presented.

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If it does not, then who has the last word—the SEC or the courts? This is what the Second Circuit decision likely will resolve.

If Citigroup's appeal is unsuccessful, the established "neither admit nor deny" settlement practice will come to a certain end, and the SEC will likely have to reevaluate and modify its enforcement program. What is more likely, however, in light of its recent interim decision at least, is that the Second Circuit will reverse the *Citigroup* decision. In that case, "neither admit nor deny" settlements will remain, but judges may continue to prod the SEC for greater detail to demonstrate that proposed settlements are appropriate.

Keywords: litigation, securities litigation, SEC, Citigroup, Judge Rakoff

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NEWS & DEVELOPMENTS

Obama Signs Jumpstart Our Business Startups Act into Law

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (the JOBS Act). The JOBS Act eliminates a number of securities regulations, and permits so-called crowd funding, allowing companies to raise small amounts of capital from large pools of individual non-accredited investors by "notices," which direct investors to the Internet funding portal for the offering or to a broker offering the shares.

Through crowd funding, a company can now raise up to $1 million in the aggregate in a 12-month period from non-accredited investors, provided investors invest only limited sums and certain required disclosures are made. The limits range from the greater of $2,000 or five percent of an investor's annual income or net worth, up to a cap of $10,000 for people earning or having a net worth of $100,000 or more. In other words, shares can be sold in small companies to non-accredited investors in amounts of $1 to $10,000. The shares, however, only can be sold through "funding portals" or brokers registered with the Securities and Exchange Commission (SEC) or a self-regulatory organization.

To attempt to prevent fraud, the JOBS Act requires companies to provide basic financial information to investors in seeking crowd funding, and empowers the SEC to monitor and pass anti-fraud regulation in implementation of the legislation.

The JOBS Act also allows companies to stay private longer, by increasing the number of investors a company can have before the number of shareholders triggers an obligation to become a public reporting company. Previously, a company was obligated to become a public reporting company when a company's assets reached $10 million and it had 500 shareholders. Now, a company must become a reporting company only when it has $10 million in assets and 500 "unaccredited" shareholders, or 2,000 total shareholders. The JOBS Act also removes the ban on general solicitation and advertising for private offerings in connection with Rule 506 offerings to accredited investors, and under Rule 144A for qualified institutional investors.

The JOBS Act also creates a new class of companies called emerging growth companies, which are newly public companies with less than $1 billion in annual gross revenues. Emerging growth companies are now exempted from providing auditor attestation reports on internal controls under section 404(b) of Sarbanes-Oxley, need not provide more than two years of audited financial statements in an IPO registration statement, and can take advantage of confidential submissions of draft IPO registration statements.

Supporters of the legislation believe it makes it easier for startups to raise money by getting rid of limits on obtaining funds only from accredited or institutional investors, while critics complain that the JOBS Act will give rise to unprecedented exploitation of non-accredited

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investors in crowd-funding scams. The SEC has up to 270 days to revise its rules to be consistent with the legislation. The SEC is required to report once every two years on the amount of fraud related to the JOBS Act.

— *Erik A. Christiansen, Parsons Behle & Latimer, Salt Lake City, UT*

Supreme Court Rejects Whittaker Rule for Tolling Section 16(b) Claims

On March 26, 2012, the U.S. Supreme Court unanimously held that the two-year limitations period for insider-trading claims under section 16(b) of the Securities Exchange Act of 1934 is not automatically tolled pending the filing by an insider of the public-disclosure statement required by section 16(a). *See Credit Suisse Secs. v. Simmonds*, No. 10–1261 (decided March 26, 2012).

In 2007, Simmonds filed 55 "nearly identical actions under § 16(b) against financial institutions that had underwritten various initial public offerings (IPOs) in the late 1990's and 2000." Opinionat 2. Simmonds alleged that the underwriters of certain IPOs, as well as corporate insiders, "employed various mechanisms to inflate the aftermarket price of the stock to a level above the IPO price, allowing them to profit from the aftermarket rate." *Id.*at 2–3. Simmonds further alleged that the underwriters and insiders as a group "owned in excess of 10% of the outstanding stock during the relevant time period, which subjected them to both disgorgement of profits under §16(b) and the reporting requirements of §16(a)." *Id.*at 3.

The District Court for the Western District of Washington dismissed all of Simmonds's complaints, 24 of which—those at issue before the Supreme Court—were dismissed on the ground that the two-year time limit under section 16(b) had expired. The Ninth Circuit reversed in relevant part on the basis of its earlier decision in *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir. 1981), which held that "tolling of the two year time period is required when the pertinent § 16(a) reports are not filed." *Id.*at 528.

In a decision authored by Justice Scalia, the Supreme Court squarely rejected the *Whittaker* rule, holding it is "completely divorced from long-settled equitable-tolling principles." Opinion at 5. Relying on the well-established principle that, "when a limitations period is tolled because of fraudulent concealment of facts, the tolling ceases when fraudulently concealed facts are, or should have been, discovered by the plaintiff," *id.*, the Court observed that "[a]llowing tolling to continue beyond the point at which a §16(b) plaintiff is aware, or should have been aware, of the facts underlying the claim would quite certainly be *inequitable* and inconsistent with the general purpose of statutes of limitations: 'to protect defendants against stale or unduly delayed claims.'" *Id.* (emphasis in original).Justice Scalia explained that "Congress could have very easily

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provided that 'no such suit [under § 16(b)] shall be brought more than two years after *the filing of a statement under subsection (a)(2)(C)*.' But it did not. The text of section 16 simply does not support the *Whittaker* rule." *Id.*at 4–5 (emphasis in original). Reflecting on the case at bar, the Court observed:

> The oddity of Simmonds' position is well demonstrated by the circumstances of this case. Under the *Whittaker* rule, because petitioners have yet to file § 16(a) statements (as noted earlier they do not think themselves subject to that requirement), Simmonds still has two years to bring suit, even though she is so well aware of her alleged cause of action that she has already sued. If § 16(a) statements were, as Simmonds suggests, indispensable to a party's ability to sue, Simmonds would not be here.

*Id.*at 7.

Accordingly, the Supreme Court remanded the case back to the district court to apply "the usual rules of equitable tolling." *Id.*at 8. The Court divided four to four (Justice Roberts recused himself) concerning the petitioners' contention that the two-year period in section 16(b) establishes a statute of repose immune to equitable tolling, leaving the issue undecided and the Ninth Circuit's opinion that equitable tolling may apply untouched.

Having discarded the prospect of any bright-line rule based on the filing of section 16(a) forms, the Supreme Court has left it to the lower courts to decide how equitable tolling applies to insider trading claims under section 16(b) on a case-by-case basis.

— Kenneth Grad and Patrick G. Rideout, Skadden, Arps, Slate, Meagher & Flom LLP, New York, NY

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