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SECURITIES REGULATION

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MATTHEW  BENDER

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Chapter 3

PRIMARY ISSUER TRANSACTIONS FROM REGISTRATION

§ 3.05 RULE 506 OF REGULATION D — THE SEC PRIVATE OFFERING EXEMPTION

Page 88: add:

Dodd-Frank Act Amendments — The Accredited Individual Investor and “Bad Actor” Modifications

The Dodd-Frank Act, enacted in 2010, made two significant changes to Regulation D.

– *First*, with respect to the definition of accredited investor, the individual net worth test eliminates one’s primary residence from the calculation. Thus, today, the individual net worth of an individual (or with such individual’s spouse) must be greater than \$1 million, *exclusive* of the value of such individual’s primary residence.

In this respect, a mortgage or debt that is secured by such individual’s primary residence is to be excluded from the calculation of the individual’s net worth, provided that such debt is not greater than the fair market value of such primary residence. Where the debt is greater than the fair market value of the primary residence and the lender has personal recourse against the individual for any deficiency, then this liability amount must be deducted from the individual’s net worth calculation.

Commencing in 2014, the SEC is directed, at least once every four years, to review the individual accredited investor net worth level to ascertain whether modifications should be made.

– *Second*, the “bad boy” (or now “bad actor”) disqualifier is extended to disqualify certain bad actors from using Rule 506 of Regulation D. The SEC, by rule to be adopted no later than one year after enactment of the Dodd-Frank Act, must disqualify from use of the Rule 506 exemption: (1) Those persons who have been convicted of a crime in connection with the purchase or sale of a security or making a false filing with the SEC; and (2) those persons who have been subject to a federal or state regulatory order that is based on deceptive, fraudulent, or manipulative misconduct. For such persons, the Section 4(2) private offering exemption may be the only viable exemption that may be available.

Chapter 5

DISCLOSURE, MATERIALITY AND SARBANES-OXLEY

§ 5.03 CONCEPTS OF DISCLOSURE

[E] Qualitative Materiality

[1] Disclosure Relating to “Integrity” or “Competency”

Page 235: add:

PROXY DISCLOSURE ENHANCEMENTS

SEC Release No. 34-61175 (2009)

We are adopting amendments to our rules that will enhance information provided in connection with proxy solicitations and in other reports filed with the Commission. The amendments will require registrants to make new or revised disclosures about: compensation policies and practices that present material risks to the company; stock and option awards of executives and directors; director and nominee qualifications and legal proceedings; board leadership structure; the board’s role in risk oversight; and potential conflicts of interest of compensation consultants that advise companies and their boards of directors. The amendments to our disclosure rules will be applicable to proxy and information statements, annual reports and registration statements under the Securities Exchange Act of 1934, and registration statements under the Securities Act of 1933 as well as the Investment Company Act of 1940. We are also transferring from Forms 10-Q and 10-K to Form 8-K the requirement to disclose shareholder voting results.

I. BACKGROUND AND OVERVIEW OF THE AMENDMENTS

On July 10, 2009, we proposed a number of revisions to our rules that were designed to improve the disclosure shareholders of public companies receive regarding compensation and corporate governance. [Securities Act Release No. 9052 (July 10, 2009).] As discussed in detail below, we have taken into consideration the comments received on the proposed amendments and are adopting several amendments to our rules. Among other improvements, the new disclosure requirements adopted today enhance the information provided in annual reports, and proxy and information statements to better enable shareholders to evaluate the leadership of public companies.

As discussed more fully in the Proposing Release, during the past few years, investors have increasingly focused on corporate accountability and have expressed the desire for additional information that would enhance their ability to make informed voting and investment decisions. The disclosure enhancements we are

adopting respond to this focus, and will significantly improve the information companies provide to shareholders with regard to the following:

- *Risk*: by requiring disclosure about the board's role in risk oversight and, to the extent that risks arising from a company's compensation policies and practices are reasonably likely to have a material adverse effect on the company, disclosure about such policies and practices as they relate to risk management;
- *Governance and Director Qualifications*: by requiring expanded disclosure of the background and qualifications of directors and director nominees and new disclosure about a company's board leadership structure, and accelerating the reporting of information regarding voting results; and
- *Compensation*: by revising the reporting of stock and option awards in the Summary Compensation Table and Director Compensation Table, and requiring disclosure of potential conflicts of interest of compensation consultants in certain circumstances.

We believe that providing a more transparent view of these key risk, government and compensation matters will help shareholders make more informed voting and investment decisions.

We received over 130 comment letters in response to the proposed amendments. These letters came from corporations, pension funds, professional associations, trade unions, accounting firms, law firms, consultants, academics, individual investors and other interested parties. In general, the commenters supported the objectives of the proposed new requirements. Most investors supported the manner in which we proposed to achieve these objectives and, in some cases, urged us to require additional disclosure from companies. Other commenters, however, opposed some of the proposed revisions and suggested modifications to the proposals.

We have reviewed and considered all of the comments that we received on the proposed amendments. The adopted rules reflect changes made in response to many of these comments. We discuss our revisions with respect to each proposed rule amendment in more detail throughout this release. The amendments that we are adopting will require:

- To the extent that risks arising from a company's compensation policies and practices for employees are reasonably likely to have a material adverse effect on the company, discussion of the company's compensation policies or practices as they relate to risk management and risk-taking incentives that can affect the company's risk and management of that risk;
- Reporting of the aggregate grant date fair value of stock awards and option awards granted in the fiscal year in the Summary Compensation Table and Director Compensation Table to be computed in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718, Compensation — Stock Compensation ("FASB ASC Topic 718"), rather than the dollar amount recognized for financial statement purposes for the

fiscal year, with a special instruction for awards subject to performance conditions;

- New disclosure of the qualification of directors and nominees for director, and the reasons why that person should serve as a director of the company at the time at which the relevant filing is made with the Commission; the same information would be required in the proxy materials prepared with respect to nominees for director nominated by others;
- Additional disclosure of any directorships held by each director and nominee at any time during the past five years at any public company or registered investment company;
- New disclosure regarding the consideration of diversity in the process by which candidates for director are considered for nomination by a company's nominating committee;
- Additional disclosure of other legal actions involving a company's executive officers, directors, and nominees for director, and lengthening the time during which such disclosure is required from five to ten years;
- New disclosure about a company's board leadership structure and the board's role in the oversight of risk;
- New disclosure about the fees paid to compensation consultants and their affiliates under certain circumstances; and
- Disclosure of the vote results from a meeting of shareholders on Form 8-K generally within four business days of the meeting.

With respect to management investment companies that are registered under the Investment Company Act ("funds"), the amendments we are adopting will require expanded disclosure regarding director and nominee qualifications; past directorships held by directors and nominees; and legal proceedings involving directors, nominees, and executive officers to funds; and new disclosure about leadership structure and the board's role in the oversight of risk.

II. DISCUSSION OF THE AMENDMENTS

A. Enhanced Compensation Disclosure

1. Narrative Disclosure of the Company's Compensation Policies and Practices as the Relate to the Company's Risk Management

We proposed amendments to our Compensation Discussion and Analysis ("CD&A") requirements to broaden their scope to include a new section regarding how the company's overall compensation policies for employees create incentives that can affect the company's risk and management of that risk. We are adopting the disclosure requirements generally as proposed, but we are revising the placement of the new required disclosures and the disclosure threshold, as suggested by commenters.

. . . .

After considering the comments, we are adopting the disclosure requirement substantially as proposed with some modifications. We continue to believe that it is important for investors to be informed of the compensation policies and practices that are likely to expose the company to material risk, but we recognize that, consistent with the comments received, we should revise our proposals. We have tailored the final amendments to address many of the concerns expressed by commenters, consistent with the purposes to be advanced by the disclosure.

The final rule requires a company to address its compensation policies and practices for all employees, including non-executive officers, if the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company. [T]he proposed rules would have required discussion and analysis of compensation policies if risks arising from those compensation policies “may have a material effect on the company.” We agree with the suggestions of several commenters that the new requirements should have a “reasonably likely” disclosure threshold. Companies are familiar with the “reasonably likely” disclosure threshold used in our Management Discussion and Analysis (“MD&A”) rules [Item 303 of Regulation S-K], and this approach would parallel the MD&A requirement, which requires risk-oriented disclosure of known trends and uncertainties that are material to the business. We believe that the “reasonably likely” threshold also addresses concerns of some commenters that the proposed requirements might have caused companies attempting compliance to burden shareholders and investors with voluminous disclosure of potentially insignificant and unnecessarily speculative information about their compensation policies. By focusing on risks that are “reasonably likely to have a material adverse effect” on the company, the amendments are intended to elicit disclosure about incentives in the company’s compensation policies and practices that would be most relevant to investors. This change from the proposal also addresses concerns some commenters raised that the proposal did not allow companies to consider compensating or offsetting steps or controls designed to limit risks of certain compensation arrangements. If a company has compensation policies and practices for different groups that mitigate or balance incentives, these could be considered in deciding whether risks arising from the company’s compensation policies and practices for employees are reasonably likely to have a material adverse effect on the company as a whole.

In addition, we have modified the proposal to provide that disclosure is only required if the compensation policies and practices are reasonably likely to have a material “adverse” effect on the company, as opposed to any “material effect” as proposed. As noted in the Proposing Release, well-designed compensation policies can enhance a company’s business interests by encouraging innovation and appropriate levels of risk-taking. By focusing the disclosure on material *adverse* effects, the final rule should help avoid voluminous and unnecessary discussion of compensation arrangements that may mitigate inappropriate risk-taking incentives.

. . . .

The final rule will contain, as proposed, the non-exclusive list of situations where compensation programs may have the potential to raise material risks to companies, and the examples of the types of issues that would be appropriate for a company to address. Under the amendments, the situations that would require disclosure will

vary depending on the particular company and its compensation program. We believe situations that potentially could trigger discussion include, among others, compensation policies and practices:

- At a business unit of the company that carries a significant portion of the company's risk profile;
- At a business unit with compensation structured significantly differently than other units within the company;
- At a business unit that is significantly more profitable than others within the company;
- At a business unit where the compensation expense is a significant percentage of the unit's revenues; and
- That vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

This is a non-exclusive list of situations where compensation programs may have the potential to raise material risks to the company. There may be other features of a company's compensation policies and practices that have the potential to incentivize its employees to create risks that are reasonably likely to have a material adverse effect on the company. However, disclosure under the amendments is only required if the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company. We note that in the situations listed above, a company may under appropriate circumstances conclude that its compensation policies and practices are not reasonably likely to have a material adverse effect on the company.

. . . .

2. Revisions to the Summary Compensation Table

We proposed to amend Item 402 of Regulation S-K to revise Summary Compensation Table and Director Compensation Table disclosure of stock awards and option awards to require disclosure of the aggregate grant date fair value of awards computed in accordance with FASB ASC Topic 718. The revised disclosure would replace previously mandated disclosure of the dollar amount recognized for financial statement reporting purposes for the fiscal year in accordance with FASB ASC Topic 718, and would affect the calculation of total compensation, including for purposes of determining who is a named executive officer. We are adopting the revisions substantially as proposed with some changes in response to comments.

. . . .

After considering the comments received, we are adopting the proposed amendments to revise Summary Compensation Table and Director Compensation Table disclosure of stock awards and option awards to require disclosure of the aggregate grant date fair value of awards computed in accordance with FASB ASC Topic 718, with a special instruction for awards subject to performance conditions as described

below. We agree with commenters that aggregate grant date fair value disclosure better reflects the compensation committee's decision with regard to stock and option awards. We remain of the view that it is more meaningful to shareholders if company compensation decisions — including decisions to grant large “one time” multi-year awards — cause the named executive officers to change. In circumstances where such a large “new hire” or “retention” grant results in the omission from the Summary Compensation Table of another executive officer whose compensation otherwise would have been subject to reporting, the company can consider including compensation disclosure for that executive officer to supplement the required disclosures.

. . . .

We are persuaded that the value of performance awards reported in the Summary Compensation Table, Grants of Plan-Based Awards Table and Director Compensation Table should be computed based upon the probable outcome of the performance condition(s) as of the grant date because that value better reflects how compensation committees take performance-contingent vesting conditions into account in granting such awards. We are adopting new Instructions to these tables to clarify that this amount will be consistent with the grant date estimate of compensation cost to be recognized over the service period, excluding the effect of forfeitures. To provide investors additional information about an award's potential maximum value subject to changes in performance outcome, we will also require in the Summary Compensation Table and Director Compensation Table footnote disclosure of the maximum value assuming the highest level of performance conditions is probable. Such footnote disclosure will permit investors to understand an award's maximum value without raising the concerns associated with requiring its tabular disclosure.

. . . .

B. Enhanced Director and Nominee Disclosure

We proposed to amend Item 401 of Regulation S-K to expand the disclosure requirements regarding the qualifications of directors and nominees, past directorships held by directors and nominees, and the time period for disclosure of legal proceedings involving directors, nominees and executive officers. We are adopting the changes generally as proposed, but have made revisions in response to comments.

. . . .

[W]e are adopting the amendments to Item 401, but with several revisions. We believe the amendments will provide investors with more meaningful disclosure that will help them in their voting decisions by better enabling them to determine whether and why a director or nominee is an appropriate choice for a particular company.

The final rules require companies to disclose for each director and any nominee for director the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director for the company as of

the time that a filing containing this disclosure is made with the Commission. The same disclosure, with respect to any nominee for director put forward by another proponent, would be required in the proxy soliciting materials of that proponent. This new disclosure will be required for all nominees and for all directors, including those not up for reelection in a particular year. The final rule requires this disclosure to be made annually because the composition of the entire board is important information for voting decisions. Although we are adopting the amendments to Item 401, we are not eliminating the disclosure requirements in Item 407(c)(2)(v) of Regulation S-K regarding the specific minimum qualifications and specific qualities or skills used by the nominating committee. We agree with commenters that this requirement should be retained because it will allow investors to compare and evaluate the skills and qualifications of each director and nominee against the standards established by the board.

The final rules do not require disclosure of the specific experience, qualifications or skills that qualify a person to serve as a committee member. In making this change from the proposal, we were persuaded by commenters who noted that many companies rotate directors among different committee positions to allow directors to gain different perspectives of the company. However, if an individual is chosen to be a director or a nominee to the board because of a particular qualification, attribute or experience related to service on a specific committee, such as the audit committee, then this should be disclosed under the new requirements as part of the individual's qualifications to serve on the board.

The final amendments do not specify the particular information that should be disclosed. We believe companies and other proponents should be afforded flexibility in determining the information about a director's or nominee's skills, qualifications or particular area of expertise that would benefit the company and should be disclosed to shareholders. Accordingly, we have deleted the reference to "risk assessment skills" that was included in the proposed amendments. However, we note that if particular skills, such as risk assessment or financial reporting expertise, were part of the specific experience, qualifications, attributes or skills that led the board or proponent to conclude that the person should serve as a director, this should be disclosed.

We are adopting substantially as proposed the amendments to require disclosure of any directorships at public companies and registered investment companies held by each director and nominee at any time during the past five years. Item 401 presently requires disclosure of any current director position held by each director and nominee in any company with a class of securities registered pursuant to Section 12 of the Exchange Act, or subject to the requirements of Section 15(d) of that Act, or any company registered as an investment company under the Investment Company Act. We believe that expanding this disclosure to include service on boards of those companies for the past five years (even if the director or nominee no longer serves on that board) will allow investors to better evaluate the relevance of a director's or nominee's past board experience, as well as professional or financial relationships that might pose potential conflicts of interest (such as past membership on boards of major suppliers, customers, or competitors).

In addition to these amendments, we are adopting amendments as proposed to

lengthen the time during which disclosure of legal proceedings involving directors, director nominees and executive officers is required from five to ten years. We believe it is appropriate to extend the required reporting period from five to ten years as a means of providing investors with more extensive information regarding an individual's competence and character. We were persuaded by commenters who believed that disclosures of legal proceedings during the ten-year period would provide investors with additional important information. We are also adopting amendments to expand the list of legal proceedings involving directors, executive officers, and nominees covered under Item 401(f) of Regulation S-K. Some commenters agreed that certain legal proceedings can reflect on an individual's competence and integrity to serve as a director, and that the additional disclosure noted in the proposing release would provide investors with valuable information for assessing the competence, character and overall suitability of a director, nominee or executive officer.

In addition, we are amending Item 401(f) to require disclosure of additional legal proceedings. These new legal proceedings include:

- Any judicial or administrative proceedings resulting from involvement in mail or wire fraud or fraud in connection with any business entity;
- Any judicial or administrative proceedings based on violations of federal or state securities, commodities, banking or insurance laws and regulations, or any settlement to such actions. This does not include disclosure of a settlement of a civil proceeding among private parties. We are including an instruction as part of the amendments to clarify this; and
- Any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

We believe this amendment will provide investors with information that is important to an evaluation of an individual's competence and character to serve as a public company official. Consistent with the current disclosure requirement regarding legal proceedings, the additional legal proceedings included in the new requirements will not need to be disclosed if they are not material to an evaluation of the ability or integrity of the director or director nominee.

In the Proposing Release, we also requested comment on whether we should amend our rules to require disclosure of additional factors considered by a nominating committee when selecting someone for a board position, such as board diversity. A significant number of commenters responded that disclosure about board diversity was important information to investors. Many of these commenters believed that requiring this disclosure would provide investors with information on corporate culture and governance practices that would enable investors to make more informed voting and investment decisions. Commenters also noted that there appears to be a meaningful relationship between diverse boards and improved corporate financial performance, and that diverse boards can help companies more effectively recruit talent and retain staff. We agree that it is useful for investors to understand how the board considers and addresses diversity, as well as the board's assessment of the implementation of its diversity policy, if any. Consequently, we are adopting amendments to Item 407(c) of Regulation S-K to require disclosure of

whether, and if so how, a nominating committee considers diversity in identifying nominees for director. In addition, if the nominating committee (or the board) has a policy with regard to the consideration of diversity in identifying director nominees, disclosure would be required of how this policy is implemented, as well as how the nominating committee (or the board) assesses the effectiveness of its policy. We recognize that companies may define diversity in various ways, reflecting different perspectives. For instance, some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender and national origin. We believe that for purposes of this disclosure requirement, companies should be allowed to define diversity in ways that they consider appropriate. As a result we have not defined diversity in the amendments.

C. New Disclosure about Board Leadership Structures and the Board's Role in Risk Oversight

We proposed a new disclosure requirement to Item 407 of Regulation S-K and a corresponding amendment to Item 7 of Schedule 14A to require disclosure of the company's leadership structure and why the company believes it is the most appropriate structure for it at the time of the filing. The proposal also required disclosure about the board's role in the company's risk management process. We are adopting the proposals with some changes.

. . . .

[W]e are adopting the proposals substantially as proposed with a few technical revisions in response to comments. We believe that, in making voting and investment decisions, investors should be provided with meaningful information about the corporate governance practices of companies. As we noted in the Proposing Release, one important aspect of a company's corporate governance practices is its board's leadership structure. Disclosure of a company's board leadership structure and the reasons the company believes that its board leadership structure is appropriate will increase the transparency for investors as to how the board functions.

As stated above, the amendments were designed to provide shareholders with disclosure of, and the reasons for, the leadership structure of a company's board concerning the principal executive officer, the board chairman position and, where applicable, the lead independent director position. We agree with commenters that the phrase "board leadership structure" instead of "company leadership structure" would avoid potential misunderstanding that the amendments require a discussion of the structure of a company's management leadership. We also agree with commenters that the phrase "risk oversight" instead of "risk management" would be more appropriate in describing the board's responsibilities in this area.

Under the amendments, a company is required to disclose whether and why it has chosen to combine or separate the principal executive officer and board chairman positions, and the reasons why the company believes that this board leadership structure is the most appropriate structure for the company at the time of the filing. In addition, in some companies the role of principal executive officer

and board chairman are combined, and a lead independent director is designated to chair meetings of the independent directors. In these circumstances, the amendments will require disclosure of whether and why the company has a lead independent director, as well as the specific role the lead independent director plays in the leadership of the company. As we previously stated in the Proposing Release, these amendments are intended to provide investors with more transparency about the company's corporate governance, but are not intended to influence a company's decision regarding its board leadership structure.

The final rules also require companies to describe the board's role in the oversight of risk. We were persuaded by commenters who noted that risk oversight is a key competence of the board, and that additional disclosures would improve investor and shareholder understanding of the role of the board in the organization's risk management practices. Companies face a variety of risks, including credit risk, liquidity risk, and operational risk. As we noted in the Proposing Release, similar to disclosure about the leadership structure of a board, disclosure about the board's involvement in the oversight of the risk management process should provide important information to investors about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company. This disclosure requirement gives companies the flexibility to describe how the board administers its risk oversight function, such as through the whole board, or through a separate risk committee or the audit committee, for example. Where relevant, companies may want to address whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board as a whole or to a board committee or how the board or committee otherwise receives information from such individuals.

The final rules also require funds to provide disclosure about the board's role in risk oversight. Funds face a number of risks, including investment risk, compliance, and valuation; and we agree with commenters who favored disclosure of board risk oversight by funds. As with corporate issuers, we believe that additional disclosures would improve investor understanding of the role of the board in the fund's risk management practices. Furthermore, the disclosure should provide important information to investors about how a fund perceives the role of its board and the relationship between the board and its advisor in managing material risks facing the fund.

D. New Disclosure Regarding Compensation Consultants

We proposed amendments to Item 407 of Regulation S-K to require, for the first time, disclosure about the fees paid to compensation consultants and their affiliates when they played a role in determining or recommending the amount or form of executive and director compensation, and they also provided additional services to the company. The proposed amendments also would have required a description of the additional services provided to the company by the compensation consultants and any affiliates of the consultants. We are adopting the amendments with changes in response to comments.

. . . .

[W]e are adopting a modified version of the proposed amendments. We believe the new disclosure requirements will provide investors with information that will enable them to better assess the potential conflicts a compensation consultant may have in recommending executive compensation, and the compensation decisions made by the board. As we noted in the Proposing Release, many companies engage compensation consultants to make recommendations on appropriate executive and director compensation levels, to design and implement incentive plans, and to provide information on industry and peer group pay practices. The services offered by compensation consultants, however, are often not limited to recommending executive and director compensation plans or policies. Many compensation consultants, or their affiliates, are retained by management to provide a broad range of additional services, such as benefits administration, human resources consulting and actuarial services. The fees generated by these additional services may be more significant than the fees earned by the consultants for their executive and director compensation services. The extent of the fees and provision of additional services by a compensation consultant or its affiliate may create the risk of a conflict of interest that may call into question the objectivity of the consultant's advice and recommendations on executive compensation.

At the same time, we are persuaded that there are circumstances where this disclosure should not be required either because of the limited nature of the additional services or because of other factors that mitigate the concern that the board may be receiving advice potentially influenced by a conflict of interest.

. . . .

E. Reporting of Voting Results on Form 8-K

We proposed to transfer the requirement to disclose shareholder vote results from Forms 10-Q and 10-K to Form 8-K, and to have that information filed within four business days after the end of the meeting at which the vote was held. We are adopting the proposal with some modifications in response to comments.

. . . .

[W]e are adopting the proposed amendments to Form 8-K, and are eliminating the requirement to disclose shareholder voting results on Forms 10-Q and 10-K. Accordingly, new Item 5.07 to Form 8-K requires companies to disclose on the form the results of a shareholder vote and to have that information filed within four business days after the end of the meeting at which the vote was held. Tying the filing requirement to the end of the meeting will provide shareholders, investors and other users of this information with a readily identifiable and certain date upon which a company would be required to disclose information on the results of the vote. We believe more timely disclosure of the voting results from an annual or special meeting would benefit investors and the markets. Under our prior disclosure requirements, it could be a few months before voting results are disclosed in a Form 10-Q or 10-K. Often, matters submitted for a shareholder vote at an annual or special meeting involve issues that directly impact shareholder interest, such as the election of directors, changes in shareholder rights, investments or divestments, and capital changes. The delay between the end of an annual or special meeting of

shareholders and when the voting results of the meeting are disclosed in a Form 10-Q or 10-K can make the information less useful to investors and the markets. We also understand that technological advances in shareholder communications and the growing use of third-party proxy services have increased the ability of companies to tabulate vote results and disseminate this information on a more expedited basis.

We agree with the suggestions of commenters that there may be situations other than contested elections where it may take a longer period of time to determine definitive voting results. As a result, we are expanding the instruction to Form 8-K as adopted to state that companies are required to file the preliminary voting results within four business days after the end of the shareholders' meeting, and then file an amended report on Form 8-K within four business days after the final voting results are known. However, if a company obtains the definitive voting results before the preliminary voting results must be reported and decides to report its definitive results on Form 8-K, it will not be required to file the preliminary voting results. For example, if a company obtains the definitive voting results two days after the end of the shareholders' meeting, it could report its definitive voting results on Form 8-K within four business days after the meeting and would not be required to file its preliminary voting results. To the extent that companies are concerned that the disclosure of preliminary voting results could be confusing to investors, they may include additional disclosure that helps to put the preliminary voting disclosure in a proper context.

. . . .

Page 240: add new subsections [F] and [G]:

[F] Materiality — Recent Developments

MATRIXx INITIATIVES, INC. v. SIRACUSANO

United States Supreme Court
131 S. Ct. 1309 (2011)

JUSTICE SOTOMAYOR delivered the opinion of the Court.

This case presents the question whether a plaintiff can state a claim for securities fraud under § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, based on a pharmaceutical company's failure to disclose reports of adverse events associated with a product if the reports do not disclose a statistically significant number of adverse events. Respondents, plaintiffs in a securities fraud class action, allege that petitioners, Matrixx Initiatives, Inc., and three of its executives (collectively Matrixx), failed to disclose reports of a possible link between its leading product, a cold remedy, and loss of smell, rendering statements made by Matrixx misleading. Matrixx contends that respondents' complaint does not adequately allege that Matrixx made a material representation or omission or that it acted with scienter because the complaint does not allege that Matrixx knew of a statistically significant number of adverse events requiring disclosure. We conclude that the materiality of adverse event reports cannot be reduced to a bright-line rule. Although in many cases reasonable investors would

not consider reports of adverse events to be material information, respondents have alleged facts plausibly suggesting that reasonable investors would have viewed these particular reports as material. Respondents have also alleged facts “giving rise to a strong inference” that Matrixx “acted with the required state of mind.” We therefore hold, in agreement with the Court of Appeals for the Ninth Circuit, that respondents have stated a claim under § 10(b) and Rule 10b-5.

I

A

Through a wholly owned subsidiary, Matrixx develops, manufactures, and markets over-the-counter pharmaceutical products. Its core brand of products is called Zicam. All of the products sold under the name Zicam are used to treat the common cold and associated symptoms. At the time of the events in question, one of Matrixx’s products was Zicam Cold Remedy, which came in several forms including nasal spray and gel. The active ingredient in Zicam Cold Remedy was zinc gluconate. Respondents allege that Zicam Cold Remedy accounted for approximately 70 percent of Matrixx’s sales.

Respondents initiated this securities fraud class action against Matrixx on behalf of individuals who purchased Matrixx securities between October 22, 2003, and February 6, 2004 [on the NASDAQ National Market]. The action principally arises out of statements that Matrixx made during the class period relating to revenues and product safety. Respondents claim that Matrixx’s statements were misleading in light of reports that Matrixx had received, but did not disclose, about consumers who had lost their sense of smell (a condition called anosmia) after using Zicam Cold Remedy. Respondents’ consolidated amended complaint alleges the following facts, which the courts below properly assumed to be true.

In 1999, Dr. Alan Hirsch, neurological director of the Smell & Taste Treatment and Research Foundation, Ltd., called Matrixx’s customer service line after discovering a possible link between Zicam nasal gel and a loss of smell “in a cluster of his patients.” Dr. Hirsch told a Matrixx employee that “previous studies had demonstrated that intranasal application of zinc could be problematic.” He also told the employee about at least one of his patients who did not have a cold and who developed anosmia after using Zicam.

In September 2002, Timothy Clarot, Matrixx’s vice president for research and development, called Miriam Linschoten, Ph.D., at the University of Colorado Health Sciences Center after receiving a complaint from a person Linschoten was treating who had lost her sense of smell after using Zicam. Clarot informed Linschoten that Matrixx had received similar complaints from other customers. Linschoten drew Clarot’s attention to “previous studies linking zinc sulfate to loss of smell.” Clarot gave her the impression that he had not heard of the studies. She asked Clarot whether Matrixx had done any studies of its own; he responded that it had not but that it had hired a consultant to review the product. Soon thereafter, Linschoten sent Clarot abstracts of the studies she had mentioned. Research from the 1930’s and 1980’s had confirmed “[z]inc’s toxicity.” Clarot called Linschoten to

ask whether she would be willing to participate in animal studies that Matrixx was planning, but she declined because her focus was human research.

By September 2003, one of Linschoten's colleagues at the University of Colorado, Dr. Bruce Jafek, had observed 10 patients suffering from anosmia after Zicam use. Linschoten and Jafek planned to present their findings at a meeting of the American Rhinologic Society in a poster presentation entitled "Zicam® Induced Anosmia." The American Rhinologic Society posted their abstract in advance of the meeting. The presentation described in detail a 55-year-old man with previously normal taste and smell who experienced severe burning in his nose, followed immediately by a loss of smell, after using Zicam. It also reported 10 other Zicam users with similar symptoms.

Matrixx learned of the doctors' planned presentation. Clarot sent a letter to Dr. Jafek warning him that he did not have permission to use Matrixx's name or the names of its products. Dr. Jafek deleted the references to Zicam in the poster before presenting it to the American Rhinologic Society. The following month, two plaintiffs commenced a product liability lawsuit against Matrixx alleging that Zicam had damaged their sense of smell. By the end of the class period on February 6, 2004, nine plaintiffs had filed four lawsuits. Respondents allege that Matrixx made a series of public statements that were misleading in light of the foregoing information. In October 2003, after they had learned of Dr. Jafek's study and after Dr. Jafek had presented his findings to the American Rhinologic Society, Matrixx stated that Zicam was "'poised for growth in the upcoming cough and cold season'" and that the company had "'very strong momentum.'"¹ Matrix further expressed its expectation that revenues would "'be up in excess of 50% and that earnings, per share for the full year [would] be in the 25 to 30 cent range.'" In January 2004, Matrixx raised its revenue guidance, predicting an increase in revenues of 80 percent and earnings per share in the 33-to-38-cent range.

In its Form 10-Q filed with the SEC in November 2003, Zicam warned of the potential "'material adverse effect'" that could result from product liability claims, "'whether or not proven to be valid.'" It stated that product liability actions could materially affect Matrixx's "'product branding and goodwill,'" leading to reduced customer acceptance. It did not disclose, however, that two plaintiffs had already sued Matrixx for allegedly causing them to lose their sense of smell.

On January 30, 2004, Dow Jones Newswires reported that the Food and Drug Administration (FDA) was "'looking into complaints that an over-the-counter common-cold medicine manufactured by a unit of Matrixx Initiatives, Inc. (MTXX) may be causing some users to lose their sense of smell'" in light of at least three product liability lawsuits. Matrixx's stock fell from \$13.55 to \$11.97 per share after the report. In response, on February 2, Matrixx issued a press release that stated:

"All Zicam products are manufactured and marketed according to FDA guidelines for homeopathic medicine. Our primary concern is the health and safety of our customers and the distribution of factual information

¹ [2] At oral argument, counsel for the United States, which submitted an *amicus curiae* brief in support of respondents, suggested that some of these statements might qualify as nonactionable "puffery." This question is not before us, as Matrixx has not advanced such an argument.

about our products. Matrixx believes statements alleging that intranasal Zicam products caused anosmia (loss of smell) are completely unfounded and misleading.

“In no clinical trial of intranasal zinc gluconate gel products has there been a single report of lost or diminished olfactory function (sense of smell). Rather, the safety and efficacy of zinc gluconate for the treatment of symptoms related to the common cold have been well established in two double-blind, placebo controlled, randomized clinical trials. In fact, in neither study were there any reports of anosmia related to the use of this compound. The overall incidence of adverse events associated with zinc gluconate was extremely low, with no statistically significant difference between the adverse event rates for the treated and placebo subsets.

“A multitude of environmental and biologic influences are known to affect the sense of smell. Chief among them is the common cold. As a result, the population most likely to use cold remedy products is already at increased risk of developing anosmia. Other common causes of olfactory dysfunction include age, nasal and sinus infections, head trauma, anatomical obstructions, and environmental irritants.”

The day after Matrixx issued this press release, its stock price bounced back to \$13.40 per share.

On February 6, 2004, the end of the class period, Good Morning America, a nationally broadcast morning news program, highlighted Dr. Jafek’s findings. (The complaint does not allege that Matrixx learned of the news story before its broadcast.) The program reported that Dr. Jafek had discovered more than a dozen patients suffering from anosmia after using Zicam. It also noted that four lawsuits had been filed against Matrixx. The price of Matrixx stock plummeted to \$9.94 per share that same day. Zicam again issued a press release largely repeating its February 2 statement.

On February 19, 2004, Matrixx filed a Form 8-K with the SEC stating that it had “‘convened a two-day meeting of physicians and scientists to review current information on smell disorders’” in response to Dr. Jafek’s presentation. According to the Form 8-K, “‘In the opinion of the panel, there is insufficient scientific evidence at this time to determine if zinc gluconate, when used as recommended, affects a person’s ability to smell.’” A few weeks later, a reporter quoted Matrixx as stating that it would begin conducting “‘animal and human studies to further characterize these post-marketing complaints.’”

On the basis of these allegations, respondents claimed that Matrixx violated § 10(b) of the Securities Exchange Act and SEC Rule 10b-5 by making untrue statements of fact and failing to disclose material facts necessary to make the statements not misleading in an effort to maintain artificially high prices for Matrixx securities.

B

Matrixx moved to dismiss respondents' complaint, arguing that they had failed to plead the elements of a material misstatement or omission and scienter. The District Court granted the motion to dismiss. Relying on *In re Carter-Wallace, Inc., Securities Litigation*, 220 F.3d 36 (CA2 2000), it held that respondents had not alleged a statistically significant correlation between the use of Zicam and anosmia so as to make failure to public[ly] disclose complaints and the University of Colorado study a material omission." The District Court similarly agreed that respondents had not stated with particularity facts giving rise to a strong inference of scienter. It noted that the complaint failed to allege that Matrixx disbelieved its statements about Zicam's safety or that any of the defendants profited or attempted to profit from Matrixx's public statements.

The Court of Appeals reversed. 585 F.3d 1167 (CA9 2009). Noting that "[t]he determination [of materiality] requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him,'" the Court of Appeals held that the District Court had erred in requiring an allegation of statistical significance to establish materiality. It concluded, to the contrary, that the complaint adequately alleged "information regarding the possible link between Zicam and anosmia" that would have been significant to a reasonable investor. Turning to scienter, the Court of Appeals concluded that "[w]ithholding reports of adverse effects of and lawsuits concerning the product responsible for the company's remarkable sales increase is 'an extreme departure from the standards of ordinary care,' " giving rise to a strong inference of scienter.

We granted certiorari, and we now affirm.

II

Section 10(b) of the Securities Exchange Act makes it unlawful for any person to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." SEC Rule 10b-5 implements this provision by making it unlawful to, among other things, "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." We have implied a private cause of action from the text and purpose of § 10(b). See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U. S. 308, 318 (2007).

To prevail on their claim that Matrixx made material misrepresentations or omissions in violation of § 10(b) and Rule 10b-5, respondents must prove "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U. S. 148, 157 (2008). Matrixx contends that respondents have failed to

plead both the element of a material misrepresentation or omission and the element of scienter because they have not alleged that the reports received by Matrixx reflected statistically significant evidence that Zicam caused anosmia. We disagree.

A

We first consider Matrixx's argument that "adverse event reports that do not reveal a statistically significant increased risk of adverse events from product use are not material information."

1

To prevail on a § 10(b) claim, a plaintiff must show that the defendant made a statement that was "*misleading* as to a *material* fact."² In *Basic* [485 U.S. 224 (1988)], we held that this materiality requirement is satisfied when there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available." We were "careful not to set too low a standard of materiality," for fear that management would "bury the shareholders in an avalanche of trivial information." . . .

Basic involved a claim that the defendant had made misleading statements denying that it was engaged in merger negotiations when it was, in fact, conducting preliminary negotiations. The defendant urged a bright-line rule that preliminary merger negotiations are material only once the parties to the negotiations reach an agreement in principle. We observed that "[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive." We thus reject the defendant's proposed rule, explaining that it would "artificially exclud[e] from the definition of materiality information concerning merger discussions, which would otherwise be considered significant to the trading decisions of a reasonable investor."

Like the defendant in *Basic*, Matrixx urges us to adopt a bright-line rule that reports of adverse events³ associated with a pharmaceutical company's products cannot be material absent a sufficient number of such reports to establish a

² [4] Under the Private Securities Litigation Reform Act of 1995 (PSLRA), when a plaintiff's claim is based on alleged misrepresentations or omissions of a material fact, "the complaint shall specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading." 15 U.S.C. § 78u-4(b)(1).

³ [5] The FDA defines an "[a]dverse drug experience" as "[a]ny adverse event associated with the use of a drug in humans, whether or not considered drug related." 21 CFR § 314.80(a) (2010). Federal law imposes certain obligations on pharmaceutical manufacturers to report adverse events to the FDA. During the class period, manufacturers of over-the-counter drugs such as Zicam Cold Remedy had no obligation to report adverse events to the FDA. In 2006, Congress enacted legislation to require manufacturers of over-the-counter drugs to report any "serious adverse event" to the FDA within 15 business days. See 21 U.S.C. §§ 379aa(b), (c).

statistically significance that the product is in fact causing the events.⁴ Absent statistical significance, Matrixx argues, adverse event reports provide only “anecdotal” evidence that “the user of a drug experienced an adverse event at some point during or following the use of that drug.” Accordingly, it contends, reasonable investors would not consider such reports relevant unless they are statistically significant because only then do they “reflect a scientifically reliable basis for inferring a potential causal link between product use and the adverse event.”

As in *Basic*, Matrixx’s categorical rule would “artificially exclud[e]” information that “would otherwise be considered significant to the trading decision of a reasonable investor.” Matrixx’s argument rests on the premise that statistical significance is the only reliable indication of causation. This premise is flawed: As the SEC points out, “medical researchers . . . consider multiple factors in assessing causation.” Brief for United States as *Amicus Curiae* 12. Statistically significant data are not always available. For example, when an adverse event is subtle or rare, “an inability to obtain a data set of appropriate quality or quantity may preclude a finding of statistical significance.” Moreover, ethical considerations may prohibit researchers from conducting randomized clinical trials to confirm a suspected causal link for the purpose of obtaining statistically significant data.

A lack of statistically significant data does not mean that medical experts have no reliable basis for inferring a causal link between a drug and adverse events. As Matrixx itself concedes, medical experts rely on other evidence to establish an inference of causation. See Brief for Petitioners 44–45, n. 22.⁵ We note that courts frequently permit expert testimony on causation based on evidence other than statistical significance. . . . We need not consider whether the expert testimony was properly admitted in those cases, and we do not attempt to define here what constitutes reliable evidence of causation. It suffices to note that, as these courts have recognized, “medical professionals and researchers do not limit the data they consider to the results of randomized clinical trials or to statistically significant evidence.”

The FDA similarly does not limit the evidence it considers for purposes of assessing causation and taking regulatory action to statistically significant data. In assessing the safety risk posed by a product, the FDA considers factors such as “strength of the association,” “temporal relationship of product use and the event,” “consistency of findings across available data sources,” “evidence of a dose-response for the effect,” “biologic plausibility,” “seriousness of the event relative to the disease being treated,” “potential to mitigate the risk in the population,” “feasibility of further study using observational or controlled clinical study designs,” and “degree of benefit the product provides, including availability of other therapies.”

⁴ [6] “A study that is statistically significant has results that are unlikely to be the result of random error”

⁵ [7] Matrixx and its *amici* list as relevant factors the strength of the association between the drug and the adverse effects; a temporal relationship between exposure and the adverse event; consistency across studies; biological plausibility; consideration of alternative explanations; specificity (*i.e.*, whether the specific chemical is associated with the specific disease); the dose-response relationship; and the clinical and pathological characteristics of the event. Brief for Petitioners 44–45, n. 22; Brief for Consumer Healthcare Products Assn. et al. as *Amici Curiae* 12–13. These factors are similar to the factors the FDA considers in taking action against pharmaceutical products.

. . . It does not apply any single metric for determining when additional inquiry or action is necessary, and it certainly does not insist upon ‘statistical significance.’ ”

Not only does the FDA rely on a wide range of evidence of causation, it sometimes acts on the basis of evidence that suggests, but does not prove, causation. For example, the FDA requires manufacturers of over-the-counter drugs to revise their labeling “to include a warning as soon as there is reasonable evidence of an association of a serious hazard with a drug; a causal relationship need not have been proved.” More generally, the FDA may make regulatory decisions against drugs based on postmarketing evidence that gives rise to only a suspicion of causation. . . . Attaining a prominent degree of suspicion is much more likely, and may be considered a sufficient basis for regulatory decisions.”

This case proves the point. In 2009, the FDA issued a warning letter to Matrixx stating that “[a] significant and growing body of evidence substantiates that the Zicam Cold Remedy intranasal products may pose a serious risk to consumers who use them.” The letter cited as evidence 130 reports of anosmia the FDA had received, the fact that the FDA had received few reports of anosmia associated with other intranasal cold remedies, and “evidence in the published scientific literature that various salts of zinc can damage olfactory function in animals and humans.” It did not cite statistically significant data.

Given that medical professionals and regulators act on the basis of evidence of causation that is not statistically significant, it stands to reason that in certain cases reasonable investors would as well. As Matrixx acknowledges, adverse event reports “appear in many forms, including direct complaints by users to manufacturers, reports by doctors about reported or observed patient reactions, more detailed case reports published by doctors in medical journals, or larger scale published clinical studies.” As a result, assessing the materiality of adverse event reports is a “fact-specific” inquiry, that requires consideration of the source, content, and context of the reports. This is not to say that statistical significance (or the lack thereof) is irrelevant — only that it is not dispositive of every case.

Application of *Basic*’s “total mix” standard does not mean that pharmaceutical manufacturers must disclose all reports of adverse events. Adverse event reports are daily events in the pharmaceutical industry; in 2009, the FDA entered nearly 500,000 such reports into its reporting system. . . . The fact that a user of a drug has suffered an adverse event, standing alone, does not mean that the drug caused that event. The question remains whether a *reasonable* investor would have viewed the nondisclosed information “‘as having *significantly* altered the “total mix” of information made available.’ ” . . . For the reasons just stated, the mere existence of reports of adverse events — which says nothing in and of itself about whether the drug is causing the adverse events — will not satisfy this standard. Something more is needed, but that something more is not limited to statistical significance and can come from “the source, content, and context of the reports.” This contextual inquiry may reveal in some cases that reasonable investors would have viewed reports of adverse events as material even though the reports did not provide statistically significant evidence of a causal link.⁶

⁶ [10] We note that our conclusion accords with views of the SEC, as expressed in an *amicus curiae*

Moreover, it bears emphasis that § 10(b) and Rule 10b–5(b) do not create an affirmative duty to disclose any and all material information. Disclosure is required under these provisions only when necessary “to make . . . statements made, in the light of the circumstances under which they were made, not misleading. 17 CFR § 240.10b–5(b); see also *Basic*, 485 U. S., at 239, n. 17 (“Silence, absent a duty to disclose, is not misleading under Rule 10b–5”). Even with respect to information that a reasonable investor might consider material, companies can control what they have to disclose under these provisions by controlling what they say to the market.

2

Applying *Basic*’s “total mix” standard in this case, we conclude that respondents have adequately pleaded materiality. This is not a case about a handful of anecdotal reports, as Matrixx suggests. Assuming the complaint’s allegations to be true, as we must, Matrixx received information that plausibly indicated a reliable causal link between Zicam and anosmia. That information included reports from three medical professionals and researchers about more than 10 patients who had lost their sense of smell after using Zicam. Clarot told Linschoten that Matrixx had received additional reports of anosmia. (In addition, during the class period, nine plaintiffs commenced four product liability lawsuits against Matrixx alleging a causal link between Zicam use and anosmia.) Further, Matrixx knew that Linschoten and Dr. Jafek had presented their findings about a causal link between Zicam and anosmia to a national medical conference devoted to treatment of diseases of the nose.⁷ Their presentation described a patient who experienced severe burning in his nose, followed immediately by a loss of smell, after using Zicam — suggesting a temporal relationship between Zicam use and anosmia.

Critically, both Dr. Hirsch and Linschoten had also drawn Matrixx’s attention to previous studies that had demonstrated a biological causal link between intranasal application of zinc and anosmia. Before his conversation with Linschoten, Clarot, Matrixx’s vice president of research and development, was seemingly unaware of these studies, and the complaint suggests that, as of the class period, Matrixx had not conducted any research of its own relating to anosmia. . . . Accordingly, it can reasonably be inferred from the complaint that Matrixx had no basis for rejecting Dr. Jafek’s findings out of hand.

We believe that these allegations suffice to “raise a reasonable expectation that discovery will reveal evidence” satisfying the materiality requirement, and to

brief filed in this case. See Brief for United States as *Amicus Curiae* 11–12; see also *TSC Industries, Inc. v. Northway, Inc.*, 426 U. S. 438, 449, n. 10 (1976) (“[T]he SEC’s view of the proper balance between the need to insure adequate disclosure and the need to avoid the adverse consequences of setting too low a threshold for civil liability is entitled to consideration”).

⁷ [12] Matrixx contends that Dr. Jafek and Linschoten’s study was not reliable because they did not sufficiently rule out the common cold as a cause for their patients’ anosmia. We note that the complaint alleges that, in one instance, a consumer who did not have a cold lost his sense of smell after using Zicam. More importantly, to survive a motion to dismiss, respondents need only allege “enough facts to state a claim to relief that is plausible on its face.” *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007). For all the reasons we state in the opinion, respondents’ allegations plausibly suggest that Dr. Jafek and Linschoten’s conclusions were based on reliable evidence of a causal link between Zicam and anosmia.

“allo[w] the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.” . . . The information provided to Matrixx by medical experts revealed a plausible causal relationship between Zicam Cold Remedy and anosmia. Consumers likely would have viewed the risk associated with Zicam (possible loss of smell) as substantially outweighing the benefit of using the product (alleviating cold symptoms), particularly in light of the existence of many alternative products on the market. Importantly, Zicam Cold Remedy allegedly accounted for 70 percent of Matrixx’s sales. Viewing the allegations of the complaint as a whole, the complaint alleges facts suggesting a significant risk to the commercial viability of Matrixx’s leading product.

It is substantially likely that a reasonable investor would have viewed this information “‘as having significantly altered the “total mix” of information made available.’” Matrixx told the market that revenues were going to rise 50 and then 80 percent. Assuming the complaint’s allegations to be true, however, Matrixx had information indicating a significant risk to its leading revenue-generating product. Matrixx also stated that reports indicating that Zicam caused anosmia were “‘completely unfounded and misleading’” and that “‘the safety and efficacy of zinc gluconate for the treatment of symptoms related to the common cold have been well established.’” Importantly, however, Matrixx had evidence of a biological link between Zicam’s key ingredient and anosmia, and it had not conducted any studies of its own to disprove that link. In fact, as Matrixx later revealed, the scientific evidence at that time was “‘insufficient . . . to determine if zinc gluconate, when used as recommended, affects a person’s ability to smell.’”

Assuming the facts to be true, these were material facts “‘necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.’” We therefore affirm the Court of Appeals’ holding that respondents adequately pleaded the element of a material misrepresentation or omission.

B

Matrixx also argues that respondents failed to allege facts plausibly suggesting that it acted with the required level of scienter. “To establish liability under § 10(b) and Rule 10b–5, a private plaintiff must prove that the defendant acted with scienter, ‘a mental state embracing intent to deceive, manipulate, or defraud.’” We have not decided whether recklessness suffices to fulfill the scienter requirement. . . . Because Matrixx does not challenge the Court of Appeals’ holding that the scienter requirement may be satisfied by a showing of “deliberate recklessness,” we assume, without deciding, that the standard applied by the Court of Appeals is sufficient to establish scienter.⁸

Under the PSLRA, a plaintiff must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” This standard requires courts to take into account “plausible opposing inferences.” A

⁸ [14] Under the PLSRA, if the alleged misstatement or omission is a “forward-looking statement,” the required level of scienter is “actual knowledge.” 15 U.S.C. § 78u-5(c)(1)(B). Matrixx has not argued that the statements or omissions here are “forward-looking statement[s].”

complaint adequately pleads scienter under the PSLRA “only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.” [*Tellabs*, 551 U.S. at 324.] In making this determination, the court must review “all the allegations holistically.” The absence of a motive allegation, though relevant, is not dispositive.

Matrixx argues, in summary fashion, that because respondents do not allege that it knew of statistically significant evidence of causation, there is no basis to consider the inference that it acted recklessly or knowingly to be at least as compelling as the alternative inferences. “Rather,” it argues, “the most obvious inference is that petitioners did not disclose the [reports] simply because petitioners believed they were far too few . . . to indicate anything meaningful about adverse reactions to use of Zicam.” Matrixx’s proposed bright-line rule requiring an allegation of statistical significance to establish a strong inference of scienter is just as flawed as its approach to materiality.

The inference that Matrixx acted recklessly (or intentionally, for that matter) is at least as compelling, if not more compelling, than the inference that it simply thought the reports did not indicate anything meaningful about adverse reactions. According to the complaint, Matrixx was sufficiently concerned about the information it received that it informed Linschoten that it had hired a consultant to review the product, asked Linschoten to participate in animal studies, and convened a panel of physicians and scientists in response to Dr. Jafek’s presentation. It successfully prevented Dr. Jafek from using Zicam’s name in his presentation on the ground that he needed Matrixx’s permission to do so. Most significantly, Matrixx issued a press release that suggested that studies had confirmed that Zicam does not cause anosmia when, in fact, it had not conducted any studies relating to anosmia and the scientific evidence at that time, according to the panel of scientists, was insufficient to determine whether Zicam did or did not cause anosmia.⁹

These allegations, “taken collectively,” give rise to a “cogent and compelling” inference that Matrixx elected not to disclose the reports of adverse events not because it believed they were meaningless but because it understood their likely effect on the market. *Tellabs*, 551 U. S., at 323, 324. “[A] reasonable person” would deem the inference that Matrixx acted with deliberate recklessness (or even intent) “at least as compelling as any opposing inference one could draw from the facts alleged.” We conclude, in agreement with the Court of Appeals, that respondents have adequately pleaded scienter. Whether respondents can ultimately prove their allegations and establish scienter is an altogether different question.

⁹ [15] One of Matrixx’s *amici* argues that “the most cogent inference regarding Matrixx’s state of mind is that it delayed releasing information regarding anosmia complaints in order to provide itself an opportunity to carefully review all evidence regarding any link between Zicam and anosmia.” Brief for Washington Legal Foundation as *Amicus Curiae* 26. We do not doubt that this may be the most cogent inference in some cases. Here, however, the misleading nature of Matrixx’s press release is sufficient to render the inference of scienter at least as compelling as the inference suggested by *amicus*.

* * *

For the reasons stated, the judgment of the Court of Appeals for the Ninth Circuit is *Affirmed*.

[G] Environmental Disclosure

COMMISSION GUIDANCE REGARDING DISCLOSURE RELATED TO CLIMATE CHANGE SEC Release No. 33-9106 (2010)

The Securities and Exchange Commission (“SEC” or “Commission”) is publishing this interpretive release to provide guidance to public companies regarding the Commission’s existing disclosure requirements as they apply to climate change matters.

I. Background and purpose of interpretive guidance

A. Introduction

Climate change has become a topic of public discussion in recent years. Scientists, government leaders, legislators, regulators, businesses, including insurance companies, investors, analysts and the public at large have expressed heightened interest in climate change. International accords, federal regulations, and state and local laws and regulations in the U.S. address concerns about the effects of greenhouse gas emissions on our environment, and international efforts to address the concerns on a global basis continue. The Environmental Protection Agency is taking action to address climate change concerns, and Congress is considering climate change legislation. Some business leaders are increasingly recognizing the current and potential effects on their companies’ performance and operations, both positive and negative, that are associated with climate change and with efforts to reduce greenhouse gas emissions. Many companies are providing information to their peers and to the public about their carbon footprints and their efforts to reduce them.

This release outlines our views with respect to our existing disclosure requirements as they apply to climate change matters. This guidance is intended to assist companies in satisfying their disclosure obligations under the federal securities laws and regulations.

B. Background

1. Recent regulatory, legislative and other developments

In the last several years, a number of state and local governments have enacted legislation and regulations that result in greater regulation of greenhouse gas emissions. Climate change related legislation is currently pending in Congress. The House of Representatives has approved one version of a bill, and a similar bill

was introduced in the Senate in the fall of 2009. This legislation, if enacted, would limit and reduce greenhouse gas emissions through a “cap and trade” system of allowances and credits, among other provisions.

The Environmental Protection Agency has been taking steps to regulate greenhouse gas emissions. On January 1, 2010, the EPA began, for the first time, to require large emitters of greenhouse gases to collect and report data with respect to their greenhouse gas emissions. This reporting requirement is expected to cover 85% of the nation’s greenhouse gas emissions generated by roughly 10,000 facilities. In December 2009, the EPA issued an “endangerment and cause or contribute finding” for greenhouse gases under the Clean Air Act, which will allow the EPA to craft rules that directly regulate greenhouse gas emissions.

Some members of the international community also have taken actions to address climate change issues on a global basis, and those actions can have a material impact on companies that report with the Commission. One such effort in the 1990s resulted in the Kyoto Protocol. Although the United States has never ratified the Kyoto Protocol, many registrants have operations outside of the United States that are subject to its standards. Another important international regulatory system is the European Union Emissions Trading System (EU ETS), which was launched as an international “cap and trade” system of allowances for emitting carbon dioxide and other greenhouse gases, based on mechanisms set up under the Kyoto Protocol. In addition, the United States government is participating in ongoing discussions with other nations, including the recent United Nations Climate Conference in Copenhagen, which may lead to future international treaties focused on remedying environmental damage caused by greenhouse gas emissions. Those accords ultimately could have a material impact on registrants that file disclosure documents with the Commission.

The insurance industry is already adjusting to these developments. A 2008 study listed climate change as the number one risk facing the insurance business. Reflecting this assessment, the National Association of Insurance Commissioners recently promulgated a uniform standard for mandatory disclosure by insurance companies to state regulators of financial risks due to climate change and actions taken to mitigate them. We understand that insurance companies are developing new actuarial models and designing new products to reshape coverage for green buildings, renewable energy, carbon risk management and directors’ and officers’ liability, among other actions.

2. Potential impact of climate change related matters on public companies

For some companies, the regulatory, legislative and other developments noted above could have a less significant effect on operating and financial decisions, including those involving capital expenditures to reduce emissions and, for companies subject to “cap and trade” laws, expenses related to purchasing allowances where reduction targets cannot be met. Companies that may not be directly affected by such developments could nonetheless be indirectly affected by changing prices for goods or services provided by companies that are directly affected and that seek to reflect some or all of their changes in costs of goods in the prices they charge. For example, if a supplier’s costs increase, that could have a

significant impact on its customers if those costs are passed through, resulting in higher prices for customers. New trading markets for emission credits related to “cap and trade” programs that might be established under pending legislation, if adopted, could present new opportunities for investment. These markets also could allow companies that have more allowances than they need, or that can earn offset credits through their businesses, to raise revenue through selling these instruments into those markets. Some companies might suffer financially if these or similar bills are enacted by the Congress while others could benefit by taking advantage of new business opportunities.

In addition to legislative, regulatory, business and market impacts related to climate change, there may be significant physical effects of climate change that have the potential to have a material effect on a registrant’s business and operations. These effects can impact a registrant’s personnel, physical assets, supply chain and distribution chain. They can include the impact of changes in weather patterns, such as increases in storm intensity, sea-level rise, melting of permafrost and temperature extremes on facilities or operations. Changes in the availability or quality of water, or other natural resources on which the registrant’s business depends, or damage to facilities or decreased efficiency of equipment can have material effects on companies. Physical changes associated with climate change can decrease consumer demand for products or services; for example, warmer temperatures could reduce demand for residential and commercial heating fuels, service and equipment.

For some registrants, financial risks associated with climate change may arise from physical risks to entities other than the registrant itself. For example, climate change-related physical changes and hazards to coastal property can pose credit risks for banks whose borrowers are located in at-risk areas. Companies also may be dependent on suppliers that are impacted by climate change, such as companies that purchase agricultural products from farms adversely affected by droughts or floods.

3. Current sources of climate change related disclosures regarding public companies

There have been increasing calls for climate-related disclosures by shareholders of public companies. This is reflected in the several petitions for interpretive advice submitted by large institutional investors and other investor groups. The New York Attorney General’s Office recently has entered into settlement agreements with three energy companies under its investigation regarding their disclosures about their greenhouse gas emissions and potential liabilities to the companies resulting from climate change and related regulation. The companies agreed in the settlement agreements to enhance their disclosures relating to climate change and greenhouse gas emissions in their annual reports filed with the Commission.

Although some information relating to greenhouse gas emissions and climate change is disclosed in SEC filings,¹⁰ much more information is publicly available

¹⁰ [22] For example, in the electric utility industry, we have been informed by the Edison Electric Institute that 95% of the member companies it recently surveyed reported that they included at least some disclosure related to greenhouse gas emissions in their SEC filings, with 34% discussing quantities

outside of public company disclosure documents filed with the SEC as a result of voluntary disclosure initiatives or other regulatory requirements. For example, in addition to the disclosure requirements mandated in several states and the disclosure that the EPA began requiring at the start of 2010, The Climate Registry provides standards for and access to climate-related information. The Registry is a non-profit collaboration among North American states, provinces, territories and native sovereign nations that sets standards to calculate, verify and publicly report greenhouse gas emissions into a single public registry. The Registry supports both voluntary and state-mandated reporting programs and provides data regarding greenhouse gas emissions.

The Carbon Disclosure Project collects and distributes climate change information, both quantitative (emission amounts) and qualitative (risks and opportunities), on behalf of 475 institutional investors. Over 2500 companies globally reported to the Carbon Disclosure Project in 2009; over 500 of those companies were U.S. companies. Sixty-eight percent of the companies that responded to the Carbon Disclosure Project's investor requests for information made their reports available to the public.

The Global Reporting Initiative has developed a widely used sustainability reporting framework. That framework is developed by GRI participants drawn from business, labor and professional institutions worldwide. The GRI framework sets out principles and indicators that organizations can use to measure and report their economic, environmental, and social performance, including issues involving climate change. Sustainability reports based on the GRI framework are used to benchmark performance with respect to laws, norms, codes, performance standards and voluntary initiatives, demonstrate organizational commitment to sustainable development, and compare organizational performance over time.

These and other reporting mechanisms can provide important information to investors outside of disclosure documents filed with the Commission. Although much of this reporting is provided voluntarily, registrants should be aware that some of the information they may be reporting pursuant to these mechanisms also may be required to be disclosed in filings made with the Commission pursuant to existing disclosure requirements.

II. Historical background of SEC environmental disclosure

The Commission first addressed disclosure of material environmental issues in the early 1970s. The Commission issued an interpretive release stating that registrants should consider disclosing in their SEC filings the financial impact of

of greenhouse gases emitted and 23% discussing costs of climate-related compliance. Registrants include this type of disclosure in the risk factors, business description, legal proceedings, executive compensation, MD&A and financial statements sections of their annual reports. The Edison Electric Institute is an association of U.S. shareholder-owned electric companies. Their members serve 95 percent of the customers in the shareholder-owned segment of the industry, and represent approximately 70 percent of the U.S. electric power industry. The EEI also has more than 8 international electric companies as affiliate members, and nearly 200 industry suppliers and related organizations as associate members. The EEI described the results of its survey in a presentation to staff members of the Division of Corporation Finance.

compliance with environmental laws, based on the materiality of the information. [Securities Act Release No. 5170 (1971).] Throughout the 1970s, the Commission continued to explore the need for specific rules mandating disclosure of information relating to litigation and other business costs arising out of compliance with federal, state and local laws that regulate the discharge of materials into the environment or otherwise relate to the protection of the environment. These topics were the subject of several rulemaking efforts, extensive litigation, and public hearings, all of which resulted in the rules that now specifically address the disclosure of environmental issues. The Commission adopted these rules, which we discuss below, in final and current form in 1982, after a decade of evaluation and experience with the subject matter. [Securities Act Release No. 6383 (1982).]

Earlier, beginning in 1968, we began to develop and fine-tune our requirements for management to discuss and analyze their company's financial conditions and results of operations in disclosure documents filed with the Commission. During the 1970s and 1980s, materiality standards for disclosure under the federal securities laws also were more fully articulated. Those standards provide that information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or make an investment decision, or, put another way, if the information would alter the total mix or available information. In the articulation of the materiality standards, it was recognized that doubts as to materiality of information would be commonplace, but that, particularly in view of the prophylactic purpose of the securities laws and the fact that disclosure is within management's control, "it is appropriate that these doubts be resolved in favor of those the statute is designed to protect." With these developments, registrants had clearer guidance about what they should disclose in their filings.

More recently, the Commission reviewed its full disclosure program relating to environmental disclosures in SEC filings in connection with a Government Accountability Office review. The Commission also has had the opportunity to consider the thoughtful suggestions that many organizations have provided us recently about how the Commission could direct registrants to enhance their disclosure about the climate change related matters.

III. Overview of rules requiring disclosure of climate change issues

When a registrant is required to file a disclosure document with the Commission, the requisite form will largely refer to the disclosure requirements of Regulation S-K and Regulation S-X. Securities Act Rule 408 and Exchange Act Rule 12b-20 require a registrant to disclose, in addition to the information expressly required by Commission regulation, "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading." In this section, we briefly describe the most pertinent non-financial statement disclosure rules that may require disclosure related to climate change; in the following section, we discuss their application to disclosure of certain specific climate change related matters.

A. Description of business

Item 101 of Regulation S-K requires a registrant to describe its business and that of its subsidiaries. The Item lists a variety of topics that a registrant must address in its disclosure documents, including disclosure about its form of organization, principal products and services, major customers, and competitive conditions. The disclosure requirements cover the registrant and, in many cases, each reportable segment about which financial information is presented in the financial statements. If the information is material to individual segments of the business, a registrant must identify the affected segments.

Item 101 expressly requires disclosure regarding certain costs of complying with environmental laws.¹¹ In particular, Item 101(c)(1)(xii) states:

Appropriate disclosure also shall be made as to the material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries. The registrant shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material.

A registrant meeting the definition of “smaller reporting company” may satisfy its disclosure obligation by providing information called for by Item 101(h). Item 101(h)(4)(xi) requires disclosure of the “costs and effects of compliance with environmental laws (federal, state and local).”

B. Legal proceedings

Item 103 of Regulation S-K requires a registrant to briefly describe any material pending legal proceeding to which it or any of its subsidiaries is a party. A registrant also must describe material pending legal actions in which its property is the subject of the litigation. If a registrant is aware of similar actions contemplated by governmental authorities, Item 103 requires disclosure of those proceedings as well. A registrant need not disclose ordinary routine litigation incidental to its business or other types of proceedings when the amount in controversy is below thresholds designated in this Item.

Instruction 5 to Item 103 provides some specific requirements that apply to disclosure of certain environmental litigation.¹² Instruction 5 states:

¹¹ [40] The Commission first addressed disclosure of material costs and other effects on business resulting from compliance with existing environmental law in its first environmental disclosure interpretive release in 1971. *See* Release 33-5170 (July 19, 1971) [36 FR 13989]. The Commission codified that interpretive position in the disclosure forms two years later. *See* Release 33-5386 (April 20, 1973) [38 FR 12100]. The Commission provided additional interpretive guidance in the 1979 Release. With some adjustments to reflect experience with the subject matter, the requirements were moved to Item 101 in 1982, and they have not changed since that time. *See* Release No. 33-6383 (March 3, 1982) [47 FR 11380].

¹² [45] Instruction 5 in its current form was the product of the Commission’s experience with

Notwithstanding the foregoing, an administrative or judicial proceeding (including, for purposes of A and B of this Instruction, proceedings which present in large degree the same issues) arising under any Federal, State or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primary for the purpose of protecting the environment shall not be deemed “ordinary routine litigation incidental to the business” and shall be described if:

- (A) Such proceeding is material to the business or financial condition of the registrant;
- (B) Such proceeding involves primarily a claim for damages, or involves potential monetary sanctions, capital expenditures, deferred charges or charges to income and the amount involved, exclusive of interest and costs, exceeds 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis; or
- (C) A governmental authority is a party to such proceeding and such proceeding involves potential monetary sanctions, unless the registrant reasonably believes that such proceeding will result in no monetary sanctions, or in monetary sanctions, exclusive of interest and costs, of less than \$100,000; provided, however, that such proceedings which are similar in nature may be grouped and described generically.

C. Risk factors

Item 503(c) of Regulation S-K requires a registrant to provide where appropriate, under the heading “Risk Factors,” a discussion of the most significant factors that make an investment in the registrant speculative or risky. Item 503(c) specifies that risk factor disclosure should clearly state the risk and specify how the particular risk affects the particular registrant; registrants should not present risks that could apply to any issuer or any offering.

environmental litigation disclosure. In 1973, we added provisions to the legal proceedings requirements of various disclosure forms singling out legal actions involving environmental matters. *See* Release No. 33-5386 (Apr. 20, 1973) [38 FR 12100]. The new rules required disclosure of any pending legal proceeding arising under environmental laws if a governmental entity was involved in the proceeding, and any other legal proceeding arising under environmental laws unless it was not material, or if in a civil suit for damages, unless it involved less than 10% of the current assets of the registrant on a consolidated basis. The Commission provided additional interpretive guidance regarding environmental litigation in the 1979 Release. When the Commission, in connection with its development of the integrated disclosure system, moved these rules out of various forms and into Item 103 of Regulation S-K, the Commission modified the requirements related to actions involving governmental authorities to allow registrants to omit disclosure of a proceeding if they reasonably believed the action would result in a monetary sanction of less than \$100,000. *See* Release No. 33-6383 (Mar. 3, 1982) [47 FR 11380]. At the time, the Commission noted that the reason for the revision was to address the problem that disclosure documents were being filled with descriptions of minor infractions that distracted from the other material disclosures included in the document.

D. Management's discussion and analysis

Item 303 of Regulation S-K requires disclosure known as the Management's Discussion and Analysis of Financial Condition and Results of Operations, or MD&A. The MD&A requirements are intended to satisfy three principal objectives:

- to provide a narrative explanation of a registrant's financial statements that enables investors to see the registrant through the eyes of management;
- to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
- to provide information about the quality of, and potential variability of, a registrant's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

MD&A disclosure should provide material historical and prospective textual disclosure enabling investors to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrant's prospects for the future. Some of this information is itself non-financial in nature, but bears on registrants' financial condition and operating performance.

The Commission has issued several releases providing guidance on MD&A disclosure, including on the general requirements of the item and its application to specific disclosure matters. Over the years, the flexible nature of this requirement has resulted in disclosures that keep pace with the evolving nature of business trends without the need to continuously amend the text of the rule. Nevertheless, we and our staff continue to remind registrants, through comments issued in the filing review process, public statements by staff and Commissioners and otherwise, that the disclosure provided in response to this requirement should be clear and communicate to shareholders management's view of the company's financial condition and prospects.

Item 303 includes a broad range of disclosure items that address the registrant's liquidity, capital resources and results of operations. Some of these provisions, such as the requirement to provide tabular disclosure of contractual obligations, clearly specify the disclosure required for compliance. But others instead identify principles and require management to apply the principles in the context of the registrant's particular circumstances. For example, registrants must identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance. This disclosure should highlight issues that are unreasonably likely to cause reported financial information not to be necessarily indicative of future operating performance or of future financial condition. Disclosure decisions concerning trends, demands, commitments, events, and uncertainties generally should involve the:

- consideration of financial, operational and other information known to the registrant;
- identification, based on this information, of known trends and uncertainties; and

- assessment of whether these trends and uncertainties will have, or are reasonably likely to have, a material impact on the registrant's liquidity, capital resources or results of operations.

The Commission has not quantified, in Item 303 or otherwise, a specific future time period that must be considered in assessing the impact of a known trend, event or uncertainty that is reasonably likely to occur. As with any other judgment required by Item 303, the necessary time period will depend on a registrant's particular circumstances and the particular trend, event or uncertainty under consideration. For example, a registrant considering its disclosure obligation with respect to its liquidity needs would have to consider the duration of its known capital requirements and the periods over which cash flows are managed in determining the time period of its disclosure regarding future capital sources. In addition, the time horizon of a known trend, event or uncertainty may be relevant to a registrant's assessment of the materiality of the matter and whether or not the impact is reasonably likely. As with respect to other subjects of disclosure, materiality "with respect to contingent or speculative information or events . . . 'will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'" [*Basic, Inc. v. Levinson*, 485 U.S. 224, 238 (1988), quoting *Texas Gulf Sulfur Co.*, 401 F. 2d 833, 849 (2d Cir. 1968).]

The nature of certain MD&A disclosure requirements places particular importance on a registrant's materiality determinations. The Commission has recognized that the effectiveness of MD&A decreases with the accumulation of unnecessary detail or duplicative or uninformative disclosure that obscures material information. Registrants drafting MD&A disclosure should focus on material information and eliminate immaterial information that does not promote understanding of registrants' financial condition, liquidity and capital resources, changes in financial condition and results of operations. While these materiality determinations may limit what is actually disclosed, they should not limit the information that management considers in making its determinations. Improvements in technology and communications in the last two decades have significantly increased the amount of financial and non-financial information that management has and should evaluate, as well as the speed with which management receives and is able to use information. While this should not necessarily result in increased MD&A disclosure, it does provide more information that may need to be considered in drafting MD&A disclosure. In identifying, discussing and analyzing known material trends and uncertainties, registrants are expected to consider all relevant information even if that information is not required to be disclosed, and, as with any other disclosure judgments, they should consider whether they have sufficient disclosure controls and procedures to process this information.¹³

¹³ [62] Pursuant to Exchange Act Rules 13a-15 and 15d-15, a company's principal executive officer and principal financial officer must make certifications regarding the maintenance and effectiveness of disclosure controls and procedures. These rules define "disclosure controls and procedures" as those controls and procedures designed to ensure that information required to be disclosed by the company in the reports that it files or submits under the Exchange Act is (1) "recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms," and (2) "accumulated and communicated to the company's management . . . as appropriate to allow timely decisions regarding

Analyzing the materiality of known trends, events or uncertainties may be particularly challenging for registrants preparing MD&A disclosure. As the Commission explained in the 1989 Release, when a trend, demand, commitment, event or uncertainty is known, “management must make two assessments:

- Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
- If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant’s financial condition or results of operations is not reasonably likely to occur.”

Identifying and assessing known material trends and uncertainties generally will require registrants to consider a substantial amount of financial and non-financial information available to them, including information that itself may not be required to be disclosed.

Registrants should address, when material, the difficulties involved in assessing the effect of the amount and timing of uncertain events, and provide an indication of the time periods in which resolution of the uncertainties is anticipated. In accordance with Item 303(a), registrants must also disclose any other information a registrant believes is necessary to an understanding of its financial condition, changes in financial condition and results of operations.

E. Foreign private issuers

The Securities Act and Exchange Act disclosure obligations of foreign private issuer are governed principally by Form 20-F’s disclosure requirements and not those under Regulation S-K. However, most of the disclosure requirements applicable to domestic issuers under Regulation S-K that are most likely to require disclosure related to climate change have parallels under Form 20-F, although some of the requirements are not as prescriptive as the provisions applicable to domestic issuers. For example, the following provisions of Form 20-F may require a foreign private issuer to provide disclosure concerning climate change matters that are material to its business:

- Item 3.D, which requires a foreign private issuer to disclose its material risks;
- Item 4.B.8, which requires a foreign private issuer to describe the material effects of government regulation on its business and to identify the

required disclosure.” As we have stated before, a company’s disclosure controls and procedures should not be limited to disclosure specifically required, but should also ensure timely collection and evaluation of “information potentially subject to [required] disclosure,” “information that is relevant to an assessment of the need to disclose developments and risks that pertain to the [company’s] businesses,” and “information that must be evaluated in the context of the disclosure requirement of Exchange Act Rule 12b-20.” Release No. 33-8124 (Aug. 28, 2002) [67 FR 57276].

particular regulatory body;

- Item 4.D, which requires a foreign private issuer to describe any environmental issues that may affect the company's utilization of its assets;
- Item 5, which requires management's explanation of factors that have affected the company's financial condition and results of operations for the historical periods covered by the financial statements, and management's assessment of factors and trends that are anticipated to have a material effect on the company's financial condition and results of operations in future periods; and
- Item 8.A.7, which requires a foreign private issuer to provide information on any legal or arbitration proceedings, including governmental proceedings, which may have, or have had in the recent past, significant effects on the company's financial position or profitability.

Forms F-1 and F-3, Securities Act registration statement forms for foreign private issuers, also require a foreign private issuer to provide the information, including risk factor disclosure, required under Regulation S-K Item 503.

IV. Climate change related disclosures

In the previous section we summarized a number of Commission rules and regulations that may be the source of a disclosure obligation for registrants under the federal securities laws. Depending on the facts and circumstances of a particular registrant, each of the items discussed above may require disclosure regarding the impact of climate change. The following topics are some of the ways climate change may trigger disclosure required by these rules and regulations. These topics are examples of climate change related issues that a registrant may need to consider.

A. Impact of legislation and regulation

As discussed above, there have been significant developments in federal and state legislation and regulation regarding climate change. These developments may trigger disclosure obligations under Commission rules and regulations, such as pursuant to Items 101, 103, 503(c) and 303 of Regulation S-K. With respect to existing federal, state and local provisions which regulate to greenhouse gas emissions, Item 101 requires disclosure of any material estimated capital expenditures for environmental control facilities for the remainder of a registrant's current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material. Depending on a registrant's particular circumstances, Item 503(c) may require risk factor disclosure regarding existing or pending legislation or regulation that relates to climate change. Registrants should consider specific risks they face as a result of climate change legislation or regulation and avoid generic risk factor disclosure that could apply to any company. For example, registrants that are particularly sensitive to greenhouse gas legislation or regulation, such as restraints in the energy sector, may face significantly different risks from climate change legislation or regulation compared to regis-

trants that currently are reliant on products that emit greenhouse gases, such as registrants in the transportation sector.

Item 303 requires registrants to assess whether any enacted climate change legislation or regulation is reasonably likely to have a material effect on the registrant's financial condition or results of operation. In the case of a known uncertainty, such as pending legislation or regulation, the analysis of whether disclosure is required in MD&A consists of two steps. First, management must evaluate whether the pending legislation or regulation is reasonably likely to be enacted. Unless management determines that it is not reasonably likely to be enacted, it must proceed on the assumption that the legislation or regulation will be enacted. Second, management must determine whether the legislation or regulation, if enacted, is reasonably likely to have a material effect on the registrant, its financial condition or results of operations. Unless management determines that a material effect is not reasonably likely,¹⁴ MD&A disclosure is required. In addition to disclosing the potential effect of pending legislation or regulation, the registrant would also have to consider disclosure, if material, of the difficulties involved in assessing the timing and effect of the pending legislation or regulation.

A registrant should not limit its evaluation of disclosure of a proposed law only to negative consequences. Changes in the law or in the business practices of some registrants in response to the law may provide new opportunities for registrants. For example, if a "cap and trade" type system is put in place, registrants may be able to profit from the sale of allowances if their emissions levels end up being below their emissions allotment. Likewise, those who are not covered by statutory emissions caps may be able to profit by selling offset credits they may qualify for under new legislation.

Examples of possible consequences of pending legislation and regulation related to climate change include:

- Costs to purchase, or profits from sales of, allowances or credits under a "cap and trade" system;
- Costs required to improve facilities and equipment to reduce emissions in order to comply with regulatory limits or to mitigate the financial consequences of a "cap and trade" regime; and
- Changes to profit or loss arising from increased or decreased demand for goods and services produced by the registrant arising directly from legislation or regulation, and indirectly from changes in costs of goods sold.

We reiterate that climate change regulation is a rapidly developing area. Registrants need to regularly assess their potential disclosure obligations given new developments.

¹⁴ [71] Management should ensure that it has sufficient information regarding the registrant's greenhouse gas emissions and other operational matters to evaluate the likelihood of a material effect arising from the subject legislation or regulation.

B. International accords

Registrants also should consider, and disclose when material, the impact on their business of treaties or international accords relating to climate change. We already have noted the Kyoto Protocol, the EU ITS and other international activities in connection with climate change remediation. The potential sources of disclosure obligations related to international accords are the same as those discussed above for U.S. climate change regulation. Registrants whose businesses are reasonably likely to be affected by such agreements should monitor the progress of any potential agreements and consider the possible impact in satisfying their disclosure obligations based on the MD&A and materiality principles previously outlined.

C. Indirect consequences of regulation or business trends

Legal, technological, political and scientific developments regarding climate change may create new opportunities or risks for registrants. These developments may create demand for new products or services, or decrease demand for existing products or services. For example, possible indirect consequences or opportunities may include:

- Decreased demand for goods that produce significant greenhouse gas emissions;
- Increased demand for goods that result in lower emissions than competing products;¹⁵
- Increased competition to develop innovative new products;
- Increased demand for generation and transmission of energy from alternative energy sources; and
- Decreased demand for services related to carbon based energy sources, such as drilling services or equipment maintenance services.

These business trends or risks may be required to be disclosed as risk factors or in MD&A. In some cases, these developments could have a significant enough impact on a registrant's business that disclosure may be required in its business description under Item 101. For example, a registrant that plans to reposition itself to take advantage of potential opportunities, such as through material acquisitions of plants or equipment, may be required by Item 101(a)(1) to disclose this shift in plan of operation. Registrants should consider their own particular facts and circumstances in evaluating the materiality of these opportunities and obligations.

Another example of a potential indirect risk from climate change that would need to be considered for risk factor disclosure is the impact on a registrant's reputation. Depending on the nature of a registrant's business and its sensitivity to public opinion, a registrant may have to consider whether the public's perception of any

¹⁵ [74] For example, recent legislation will ultimately phase out most traditional incandescent light bulbs. This has resulted in the acceleration of the development and marketing of compact fluorescent light bulbs. *See* Energy Independence and Security Act of 2007, Pub. L. No. 110-140, 121 Stat. 1492 (2007).

publicly available data relating to its greenhouse gas emissions could expose it to potential adverse consequences to its business operations or financial condition resulting from reputational damage.

D. Physical impacts of climate change

Significant physical effects of climate change, such as effects on the severity of weather (for example, floods or hurricanes), sea levels, the arability of farmland, and water availability and quality, have the potential to affect a registrant's operations and results. For example, severe weather can cause catastrophic harm to physical plants and facilities and can disrupt manufacturing and distribution processes. A 2007 Government Accountability Office report states that 88% of all property losses paid by insurers between 1980 and 2005 were weather-related. As noted in the GAO report, severe weather can have a devastating effect on the financial condition of affected businesses. The GAO report cites a number of sources to support the view that severe weather scenarios will increase as a result of climate change brought on by an overabundance of greenhouse gases.

Possible consequences of severe weather could include:

- For registrants with operations concentrated on coastlines, property damage and disruptions to operations, including manufacturing operations or the transport of manufactured products;
- Indirect financial and operational impacts from disruptions to the operations of major customers or suppliers from severe weather, such as hurricanes or floods;
- Increased insurance claims and liabilities for insurance and reinsurance companies;
- Decreased agricultural production capacity in areas affected by drought or other weather-related changes; and
- Increased insurance premiums and deductibles, or a decrease in the availability of coverage, for registrants with plants or operations in areas subject to severe weather.

Registrants whose businesses may be vulnerable to severe weather or climate related events should consider disclosing material risks of, or consequences from, such events in their publicly filed disclosure documents.

V. Conclusion

This interpretive release is intended to remind companies of their obligations under existing federal securities laws and regulations to consider climate change and its consequences as they prepare disclosure documents to be filed with us and provided to investors. We will monitor the impact of this interpretive release on company filings as part of our ongoing disclosure review program. In addition, the

Commission's Investor Advisory Committee¹⁶ is considering climate change disclosure issues as part of its overall mandate to provide advice and recommendations to the Commission, and the Commission is planning to hold a public roundtable on disclosure regarding climate change matters in the spring of 2010. We will consider our experience with the disclosure review program together with any advice or recommendations made to us by the Investor Advisory Committee and information gained through the planned roundtable as we determine whether further guidance or rulemaking relating to climate change disclosure is necessary or appropriate in the public interest or for the protection of investors.

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§ 5.05 THE DODD-FRANK ACT — CORPORATE GOVERNANCE

Continuing the trend of the Sarbanes-Oxley Act of 2002, the Dodd-Frank Act of 2010 likewise impacts aspects of corporate governance that traditionally have been within the purview of state corporate law. Key provisions of the Dodd-Frank Act affecting corporate governance include:

(1) *“Say on Pay.”* Pursuant to Section 14A of the Securities Exchange Act, an *advisory vote* by a reporting issuer's shareholders on *executive compensation* is required. This mandatory non-binding shareholder vote — “Say on Pay Resolution” — calls for disclosure of compensation disclosure and analysis (CD&A) by the subject issuer to its stockholders. The CD&A must address in a meaningful way such issuer's executive compensation policies and determinations.

(2) *“Golden Parachutes.”* Golden parachutes generally are generous severance benefits that high level executives receive upon a “change in control” of the company. Section 14A of the Exchange Act requires that a subject company hold a non-binding shareholder vote on golden parachute arrangements.

(3) *Pay Versus Performance Disclosure.* Pursuant to Section 14(i) of the Exchange Act, the SEC must adopt rules to require a reporting company to disclose in its proxy solicitation materials for its annual shareholder meeting the payment of executive compensation as compared to the subject company's financial performance.

(4) *Dual Roles: CEO as Chairman of Board of Directors?* Section 14B of the Exchange Act mandates that the SEC adopt rules that require a reporting company to explain in its annual proxy statement why it has determined for the same person to act as both chief executive officer (CEO) and chairman of its board of directors, or, in the alternative situation, why the subject company has determined that different persons serve as CEO and chairman of its board of directors.

¹⁶ [78] The Investor Advisory Committee was formed on June 3, 2009 to advise the Commission on matters of concern to investors in the securities markets, provide the Commission with investors' perspectives on current, non-enforcement, regulatory issues and serve as a source of information and recommendations to the Commission regarding the Commission's regulatory programs from the point of view of investors. See Press Release No. 2009-126, “SEC Announces Creation of Investor Advisory Committee,” available at <http://www.sec.gov/news/press/2009/2009-126.htm>.

(5) *Internal Pay Equity Disclosure (Focus on the CEO)*. The Dodd-Frank Act (Section 953(b)) directs the SEC to amend Item 402 (entitled “Executive Compensation”) of Regulation S-K requiring a subject company to disclose: (a) the median of the annual total compensation paid to all employees (excluding the CEO); (b) the CEO’s annual total compensation; and (c) the ratio of the median compensation of all employees as set forth in (a) above to the CEO’s annual total compensation.

(6) *Disclosure of “Hedging.”* Pursuant to Section 14(j) of the Exchange Act, the SEC is directed to adopt rules mandating that a reporting company disclose in the proxy solicitation materials for its annual shareholder meeting whether the company allows its directors or employees to hedge such company’s equity securities.

(7) *Restrictions on Voting by Non-Beneficial Holders*. Section 6(b) of the Exchange Act sets forth that the rules of any national securities exchange may not permit any member (e.g., a broker-dealer firm) that does not beneficially own a subject security from voting that security on specified matters (such as an election of directors) unless authorized to do so by the beneficial owner of such security.

(8) *Independent Compensation Committee*. Section 10A of the Exchange Act directs the SEC to prohibit the national securities exchanges (such as the New York Stock Exchange) from listing (with certain exceptions) any equity security of any issuer that does not have a compensation committee comprised entirely of independent directors. This directive follows that set forth in the Sarbanes-Oxley Act requiring that a reporting company’s audit committee be comprised entirely of independent directors.

(9) *“Clawback” Entitlement*. Expanding the scope of the “clawback” provision contained in Section 304 of the Sarbanes-Oxley Act, Section 954 of the Dodd-Frank Act mandates that a subject-company’s former and current executives (not limited to the CEO and CFO) repay to the company any excessive incentive-driven compensation based on the restatement of such company’s financial statements. No showing of culpability or fault is required to be proven for recovery of such excessive compensation. The statute directs subject companies to adopt procedures and policies to recover this excessive compensation which implicitly is premised on the principle of unjust enrichment.

(10) *Proxy Access Rules*. Pursuant to the Dodd-Frank Act (Section 971, amending, Section 14(a) of the Exchange Act), the SEC is authorized to adopt rules whereby shareholders are granted access to a subject company’s proxy statement in order to nominate candidates for such company’s board of directors. Pursuant to that authorization, the SEC has adopted the proxy access rules. *See* Securities Exchange Release No. 62764 (2010). These rules generally entitle the largest shareholder (or largest group of shareholders), who own at least three percent of the shares entitled to be voted and who have held such shares for at least three years, to nominate the greater of one director-candidate or up to 25 percent of the total number of directors who serve on such company’s board of directors. To qualify, no such shareholder (or group) may intend to change control of the issuer or seek a greater number of seats on the board of directors than the proxy access rules permit. If more than one shareholder (or group of shareholders) qualify (namely, owning more than three percent of the subject issuer’s shares and holding such shares for at least three years), then only the shareholder (or group) with the largest ownership percentage may invoke the proxy “access” entitlement.

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The proxy access rules have been stayed by the SEC pending the outcome of a challenge launched in the courts as to their legality. (*Business Roundtable v. SEC*, No. 10-7305 (D.C. Cir.))

Chapter 8

SECTION 10(b) AND RELATED ISSUES

§ 8.05 CAUSATION AND RELATED REQUIREMENTS

[D] “Fraud on the Market” Theory

Page 458: add:

ERICA P. JOHN FUND, INC. v. HALLIBURTON COMPANY

United States Supreme Court
2011 U.S. LEXIS 4181 (2011)

CHIEF JUSTICE ROBERTS delivered the opinion of the Court.

To prevail on the merits in a private securities fraud action, investors must demonstrate that the defendant’s deceptive conduct caused their claimed economic loss. This requirement is commonly referred to as “loss causation.” The question presented in this case is whether securities fraud plaintiffs must also prove loss causation in order to obtain class certification. We hold that they need not.

I

Petitioner Erica P. John Fund, Inc. (EPJ Fund), is the lead plaintiff in a putative securities fraud class action filed against Halliburton Co. and one of its executives (collectively Halliburton). The suit was brought on behalf of all investors who purchased Halliburton common stock between June 3, 1999, and December 7, 2001.

EPJ Fund alleges that Halliburton made various misrepresentations designed to inflate its stock price, in violation of § 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5. The complaint asserts that Halliburton deliberately made false statements about (1) the scope of its potential liability in asbestos litigation, (2) its expected revenue from certain construction contracts, and (3) the benefits of its merger with another company. EPJ Fund contends that Halliburton later made a number of corrective disclosures that caused its stock price to drop and, consequently, investors to lose money.

After defeating a motion to dismiss, EPJ Fund sought to have its proposed class certified pursuant to Federal Rule of Civil Procedure 23. The parties agreed, and the District Court held, that EPJ Fund satisfied the general requirements for class actions set out in Rule 23(a): The class was sufficiently numerous, there were common questions of law or fact, the claims of the representative parties were typical, and the representative parties would fairly and adequately protect the interests of the class.

The District Court also found that the action could proceed as a class action

under Rule 23(b)(3), but for one problem: Circuit precedent required securities fraud plaintiffs to prove “loss causation” in order to obtain class certification. ([relying on] *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 269 (CA5 2007)). As the District Court explained, loss causation is the “causal connection between the material misrepresentation and the [economic] loss” suffered by investors. . . . After reviewing the alleged misrepresentations and corrective disclosures, the District Court concluded that it could not certify the class in this case because EPJ Fund had “failed to establish loss causation with respect to any” of its claims. The court made clear, however, that absent “this stringent loss causation requirement,” it would have granted the Fund’s certification request.

The Court of Appeals affirmed the denial of class certification. See 597 F.3d 330 (CA5 2010). It confirmed that, “[i]n order to obtain class certification on its claims, [EPJ Fund] was required to prove loss causation, i.e., that the corrected truth of the former falsehoods actually caused the stock price to fall and resulted in the losses.” *Id.*, at 334. Like the District Court, the Court of Appeals concluded that EPJ Fund had failed to meet the “requirements for proving loss causation at the class certification stage.” *Id.*, at 344.

We granted the Fund’s petition for certiorari to resolve a conflict among the Circuits as to whether securities fraud plaintiffs must prove loss causation in order to obtain class certification. Compare 597 F.3d, at 334 (case below), with *In re Salomon Analyst Metromedia Litigation*, 544 F.3d 474, 483 (CA2 2008) (not requiring investors to prove loss causation at class certification stage); *Schleicher v. Wendt*, 618 F.3d 679, 687 (CA7 2010) (same); *In re DVI, Inc. Securities Litigation*, No. 08-8033 etc., 2011 WL 1125926, *7 (CA3, Mar. 29, 2011) (same; decided after certiorari was granted).

II

EPJ Fund contends that the Court of Appeals erred by requiring proof of loss causation for class certification. We agree.

A

As noted, the sole dispute here is whether EPJ Fund satisfied the prerequisites of Rule 23(b)(3). In order to certify a class under that Rule, a court must find “that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy.” Fed. Rule Civ. Proc. 23(b)(3). Considering whether “questions of law or fact common to class members predominate” begins, of course, with the elements of the underlying cause of action. The elements of a private securities fraud claim based on violations of § 10(b) and Rule 10b-5 are: “(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.”

. . .

Whether common questions of law or fact predominate in a securities fraud action often turns on the element of reliance. The courts below determined that EPJ Fund had to prove the separate element of loss causation in order to establish that reliance was capable of resolution on a common, class wide basis.

“Reliance by the plaintiff upon the defendant’s deceptive acts is an essential element of the § 10(b) private cause of action.” . . . This is because proof of reliance ensures that there is a proper “connection between a defendant’s misrepresentation and a plaintiff’s injury.” *Basic Inc. v. Levinson*, 485 U. S. 224, 243 (1988). The traditional (and most direct) way a plaintiff can demonstrate reliance is by showing that he was aware of a company’s statement and engaged in a relevant transaction — *e.g.*, purchasing common stock — based on that specific misrepresentation. In that situation, the plaintiff plainly would have relied on the company’s deceptive conduct. A plaintiff unaware of the relevant statement, on the other hand, could not establish reliance on that basis.

We recognized in *Basic*, however, that limiting proof of reliance in such a way “would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.” *Id.*, at 245. We also observed that “[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would” prevent such plaintiffs “from proceeding with a class action, since individual issues” would “overwhelm[] the common ones.” *Id.*, at 242.

The Court in *Basic* sought to alleviate those related concerns by permitting plaintiffs to invoke a rebuttable presumption of reliance based on what is known as the “fraud-on-the-market” theory. According to that theory, “the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.” *Id.*, at 246. Because the market “transmits information to the investor in the processed form of a market price,” we can assume, the Court explained, that an investor relies on public misstatements whenever he “buys or sells stock at the price set by the market.” . . . The Court also made clear that the presumption was just that, and could be rebutted by appropriate evidence. . . .

B

It is undisputed that securities fraud plaintiffs must prove certain things in order to invoke *Basic*’s rebuttable presumption of reliance. It is common ground, for example, that plaintiffs must demonstrate that the alleged misrepresentations were publicly known (else how would the market take them into account?), that the stock traded in an efficient market, and that the relevant transaction took place “between the time the misrepresentations were made and the time the truth was revealed.” . . .

According to the Court of Appeals, EPJ Fund also had to establish loss causation at the certification stage to “trigger the fraud-on-the-market presumption.” 597 F.3d, at 335. . . . The court determined that, in order to invoke a rebuttable presumption of reliance, EPJ Fund needed to prove that the decline in Halliburton’s stock was “because of the correction to a prior misleading statement”

and “that the subsequent loss could not otherwise be explained by some additional factors revealed then to the market.” . . . This is the loss causation requirement as we have described [in] *Dura Pharmaceuticals*. . . .

The Court of Appeals’ requirement is not justified by *Basic* or its logic. To begin, we have never before mentioned loss causation as a precondition for invoking *Basic*’s rebuttable presumption of reliance. The term “loss causation” does not even appear in our *Basic* opinion. And for good reason: Loss causation addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock.

We have referred to the element of reliance in a private Rule 10b-5 action as “transaction causation,” not loss causation. . . . Consistent with that description, when considering whether a plaintiff has relied on a misrepresentation, we have typically focused on facts surrounding the investor’s decision to engage in the transaction. Under *Basic*’s fraud-on-the-market doctrine, an investor presumptively relies on a defendant’s misrepresentation if that “information is reflected in [the] market price” of the stock at the time of the relevant transaction. See *Basic*, 485 U.S., at 247.

Loss causation, by contrast, requires a plaintiff to show that a misrepresentation that affected the integrity of the market price *also* caused a subsequent economic loss. As we made clear in *Dura Pharmaceuticals*, the fact that a stock’s “price on the date of purchase was inflated because of [a] misrepresentation” does not necessarily mean that the misstatement is the cause of a later decline in value. 544 U.S., at 342. . . . We observed that the drop could instead be the result of other intervening causes, such as “changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events.” *Id.*, at 342–343. If one of those factors were responsible for the loss or part of it, a plaintiff would not be able to prove loss causation to that extent. This is true even if the investor purchased the stock at a distorted price, and thereby presumptively relied on the misrepresentation reflected in that price.

According to the Court of Appeals, however, an inability to prove loss causation would prevent a plaintiff from invoking the rebuttable presumption of reliance. Such a rule contravenes *Basic*’s fundamental premise — that an investor presumptively relies on a misrepresentation so long as it was reflected in the market price at the time of his transaction. The fact that a subsequent loss may have been caused by factors other than the revelation of a misrepresentation has nothing to do with whether an investor relied on the misrepresentation in the first place, either directly or presumptively through the fraud-on-the-market theory. Loss causation has no logical connection to the facts necessary to establish the efficient market predicate to the fraud-on-the-market theory.

The Court of Appeals erred by requiring EPJ Fund to show loss causation as a condition of obtaining class certification.

C

Halliburton concedes that securities fraud plaintiffs should not be required to prove loss causation in order to invoke *Basic*’s presumption of reliance or otherwise

achieve class certification. . . . Halliburton nonetheless defends the judgment below on the ground that the Court of Appeals did not actually require plaintiffs to prove “loss causation” as we have used that term. . . . According to Halliburton, “loss causation” was merely “shorthand” for a different analysis. The lower court’s actual inquiry, Halliburton insists, was whether EPJ Fund had demonstrated “price impact” — that is, whether the alleged misrepresentations affected the market price in the first place. . . .¹⁷

“Price impact” simply refers to the effect of a misrepresentation on a stock price. Halliburton’s theory is that if a misrepresentation does not affect market price, an investor cannot be said to have relied on the misrepresentation merely because he purchased stock at that price. If the price is unaffected by the fraud, the price does not reflect the fraud.

We do not accept Halliburton’s wishful interpretation of the Court of Appeals’ opinion. As we have explained, loss causation is a familiar and distinct concept in securities law; it is not price impact. While the opinion below may include some language consistent with a “price impact” approach, we simply cannot ignore the Court of Appeals’ repeated and explicit references to “loss causation”. . . .

Whatever Halliburton thinks the Court of Appeals meant to say, what it said was loss causation: “[EPJ Fund] was required to prove loss causation, i.e., that the corrected truth of the former falsehoods actually caused the stock price to fall and resulted in the losses.” 597 F.3d, at 334; see *id.*, at 335 (“we require plaintiffs to establish loss causation in order to trigger the fraud-on-the-market presumption”). . . . We take the Court of Appeals at its word. Based on those words, the decision below cannot stand.

* * *

Because we conclude the Court of Appeals erred by requiring EPJ Fund to prove loss causation at the certification stage, we need not, and do not, address any other question about *Basic*, its presumption, or how and when it may be rebutted. To the extent Halliburton has preserved any further arguments against class certification, they may be addressed in the first instance by the Court of Appeals on remand.

The judgment of the Court of Appeals is vacated, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

¹⁷ [*] Halliburton further concedes that, even if its conception of what the Court of Appeals meant by “loss causation” is correct, the Court of Appeals erred by placing the initial burden on EPJ Fund. See Tr. of Oral Arg. 29 (“We agree . . . that the Fifth Circuit put the initial burden of production on the plaintiff, and that’s contrary to *Basic*”). According to Halliburton, a plaintiff must prove price impact only after *Basic*’s presumption has been successfully rebutted by the defendant. Tr. of Oral Arg. 28, 38–40. We express no views on the merits of such a framework.

§ 8.09 DEFENSES AND STRATEGIC CONSIDERATIONS

[B] Statute of Limitations

Page 478: add new case:

MERCK & CO., INC. v. REYNOLDS

United States Supreme Court

130 S. Ct. 1784 (2010)

JUSTICE BREYER delivered the opinion of the Court.

This case concerns the timeliness of a complaint filed in a private securities fraud action. The complaint was timely if filed no more than two years after the plaintiffs “discover[ed] the facts constituting the violation.” 28 U.S.C. § 1658(b)(1). Construing this limitations statute for the first time, we hold that a cause of action accrues (1) when the plaintiff did in fact discover, or (2) when a reasonably diligent plaintiff would have discovered, “the facts constituting the violation” — whichever comes first. We also hold that the “facts constituting the violation” include the fact of scienter, “a mental state embracing intent to deceive, manipulate, or defraud,” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194, n. 12 (1976). Applying this standard, we affirm the Court of Appeal’s determination that the complaint filed here was timely.

I

The action before us involves a claim by a group of investors (the plaintiffs, respondents here) that Merck & Co. and others (the petitioners here, hereinafter Merck) knowingly misrepresented the risks of heart attacks accompanying the use of Merck’s pain-killing drug, Vioxx (leading to economic losses when the risks later became apparent). The plaintiffs brought an action for securities fraud under § 10(b) of the Securities Exchange Act of 1934 [and] SEC Rule 10b-5. . . .

The applicable statute of limitations provides that a “private right of action” that, like the present action, “involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws . . . may be brought not later than the earlier of —

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

“(2) 5 years after such violation.” 28 U.S.C. § 1658(b).

The complaint in this case was filed on November 6, 2003, and no one doubts that it was filed within five years of the alleged violation. Therefore, the critical date for timeliness purposes is November 6, 2001 — two years before this complaint was filed. Merck claims that before this date the plaintiffs had (or should have) discovered the “facts constituting the violation.” If so, by the time the plaintiffs filed their complaint, the 2-year statutory period in § 1658(b)(1) had run. The plaintiffs reply that they had not, and could not have, discovered by the critical date those

“facts,” particularly not the facts related to scienter, and that their complaint was therefore timely.

A

We first set out the relevant pre-November 2001 facts, as we have gleaned them from the briefs, the record, and the opinions below.

1. *1990's*. In the mid-1990's Merck developed Vioxx. In 1999 the Food and Drug Administration (FDA) approved it for prescription use. Vioxx suppresses pain by inhibiting the body's production of an enzyme called COX-2 (cyclooxygenase-2). COX-2 is associated with pain and inflammation. Unlike some other anti-inflammatory drugs in its class like aspirin, ibuprofen, and naproxen, Vioxx does not inhibit production of a second enzyme called COX-1 (cyclooxygenase-1). COX-1 plays a part in the functioning of the gastrointestinal tract and also inhibits platelet aggregation (associated with blood clots).

2. *March 2000*. Merck announced the results of a study, called the “VIGOR” study. The study compared Vioxx with another painkiller, naproxen. The study showed that persons taking Vioxx suffered fewer gastrointestinal side effects (as Merck had hoped). But the study also revealed that approximately 4 out of every 1,000 participants who took Vioxx suffered heart attacks, compared to only 1 per 1,000 participants who took naproxen. . . .

Merck's press release acknowledged VIGOR's adverse cardiovascular data. But Merck said that these data were “consistent with naproxen's ability to block platelet aggregation.” Merck noted that, since “Vioxx, like all COX-2 selective medicines, does not block platelet aggregation[, it] would not be expected to have similar effects.” And Merck added that “safety data from all other completed and ongoing clinical trials . . . showed no indication of a difference in the incidence of thromboembolic events between Vioxx” and either a placebo or comparable drugs. . . .

This theory — that VIGOR's troubling cardiovascular findings might be due to the absence of a benefit conferred by naproxen rather than due to a harm caused by Vioxx — later became known as the “naproxen hypothesis.” In advancing that hypothesis, Merck acknowledged that the naproxen benefit “had not been observed previously.” Journalists and stock market analysts reported all of the above — the positive gastrointestinal results, the troubling cardiovascular finding, the naproxen hypothesis, and the fact that the naproxen hypothesis was unproved.

3. *February 2001 to August 2001*. Public debate about the naproxen hypothesis continued. In February 2001, the FDA's Arthritis Advisory Committee convened to consider Merck's request that the Vioxx label be changed to reflect VIGOR's positive gastrointestinal findings. The VIGOR cardiovascular findings were also discussed. In May, 2001, a group of plaintiffs filed a products-liability lawsuit against Merck, claiming that “Merck's own research” had demonstrated that “users of Vioxx were four times likely to suffer heart attacks as compared to other less expensive, medications.” In August 2001, the Journal of the American Medical Association wrote that the available data raised a “cautionary flag” and strongly urged that “a trial specifically assessing cardiovascular risk” be done. At about the

same time, Bloomberg News quoted a Merck scientist who claimed that Merck had “additional data” that were “very, very reassuring,” and Merck issued a press release stating that it stood “behind the overall and cardiovascular safety profile . . . of Vioxx.” . . .

4. *September and October 2001.* The FDA sent Merck a warning letter released to the public on September 21, 2001. It said that, in respect to cardiovascular risks, Merck’s Vioxx marketing was “false, lacking in fair balance, or otherwise misleading.” At the same time, the FDA acknowledged that the naproxen hypothesis was a “possible explanation” of the VIGOR results. But it found that Merck’s “promotional campaign selectively present[ed]” that hypothesis without adequately acknowledging “another reasonable explanation,” namely, “that Vioxx may have pro-thrombotic [*i.e.*, adverse cardiovascular] properties.” The FDA ordered Merck to send healthcare providers a corrective letter.

After the FDA letter was released, more products-liability lawsuits were filed. Merck’s share price fell by 6.6% over several days. By October 1, the price rebounded. On October 9, 2001, the New York Times said that Merck had reexamined its own data and “found no evidence that Vioxx increased the risk of heart attacks.” It quoted the president of Merck Research Laboratories as positing “‘two possible interpretations’”: “‘Naproxen lowers the heart rate, or Vioxx raises it.’” Stock analysts, while reporting the warning letter, also noted that the FDA had not denied that the naproxen hypothesis remained an unproven but possible explanation.

B

We next set forth three important events that occurred *after* the critical date.

1. *October 2003.* The Wall Street Journal published the results of a Merck-funded Vioxx study conducted at Boston’s Brigham and Women’s Hospital. After examining the medical records of more than 50,000 Medicare patients, researchers found that those given Vioxx for 30-to-90 days were 36% more likely to have suffered a heart attack than those given either a different painkiller or no painkiller at all. (That is to say, if patients given a different painkiller or given no painkiller at all suffered 10 heart attacks, then the same number of patients given Vioxx would suffer 13 or 14 heart attacks.) Merck defended Vioxx and pointed to the study’s limitations.

2. *September 30, 2004.* Merck withdrew Vioxx from the market. It said that a new study had found “an increased risk of confirmed cardiovascular events beginning after 18 months of continuous therapy.” A Merck representative publicly described the results as “totally unexpected.” Merck’s shares fell by 27% the same day.

3. *November 1, 2004.* The Wall Street Journal published an article stating that “internal Merck e-mails and marketing materials as well as interviews with outside scientists show that the company fought forcefully for years to keep safety concerns from destroying the drug’s commercial prospects. The article said that an early e-mail from Merck’s head of research had said that the VIGOR “results showed that the cardiovascular events ‘are clearly there,’” that is was “‘a shame but . . . a low incidence,’” and that it “‘is mechanism based as we worried it was.’” It also said

that Merck had given its salespeople instructions to “DODGE” questions about Vioxx’s cardiovascular effects.

C

The plaintiffs filed their complaint on November 6, 2003. As subsequently amended, the complaint alleged that Merck had defrauded investors by promoting the naproxen hypothesis, knowing the hypothesis was false. It said, for example, that Merck “knew, at least as early as 1996, of the serious safety issues with Vioxx,” and that a “1998 internal Merck clinical trial . . . revealed that . . . serious cardiovascular events . . . occurred six times more frequently in patients given Vioxx than in patients given a different arthritis drug or placebo.”

Merck, believing that the plaintiffs knew or should have known the “facts constituting the violation” at least two years earlier, moved to dismiss the complaint, saying it was filed too late. The District Court granted the motion. The court held that the (March 2001) VIGOR study, the (September 2001) FDA warning letter, and Merck’s (October 2001) response should have alerted the plaintiffs to a “possibility that Merck had knowingly misrepresented material facts” no later than October 9, 2001, thus placing the plaintiffs on “inquire notice” to look further. *In re Merck & Co. Securities, Derivative & “ERISA” Litigation*, 483 F. Supp. 2d 407, 423 (NJ 2007) (emphasis added). Finding that the plaintiffs had failed to “show that they exercised reasonable due diligence but nevertheless were unable to discover their injuries,” the court took October 9, 2001, as the date that the limitations period began to run and therefore found the complaint untimely.

The Court of Appeals for the Third Circuit reversed. A majority held that the pre-November 2001 events, while constituting “storm warnings,” did not suggest much by way of scienter, and consequently did not put the plaintiffs on “inquiry notice,” requiring them to investigate further. *In re Merck & Co. Securities, Derivative & “ERISA” Litigation*, 543 F.3d 150, 172 (2008). A dissenting judge considered the pre-November 2001 events sufficient to start the 2-year clock running. *Id.*, at 173 (opinion of Roth, J.).

Merck sought review in this Court, pointing to disagreements among the Court of Appeals. . . . We granted Merck’s petition.

II

Before turning to Merck’s arguments, we consider a more basic matter. The parties and the Solicitor General agree that § 1658(b)(1)’s word “discovery” refers not only to a plaintiff’s *actual* discovery of certain facts, but also to the facts that a reasonably diligent plaintiff would have discovered. We agree. But because the statute’s language does not make this interpretation obvious, and because we cannot answer the question presented without considering whether the parties are right about this matter, we set forth the reasons for our agreement in some detail.

We recognize that one might read the statutory words “after the discovery of the facts constituting the violation” as referring to the time a plaintiff *actually* discovered the relevant facts. But in the statute of limitations context, the word

“discovery” is often used as a term of art in connection with the “discovery rule,” a doctrine that delays accrual of a cause of action until the plaintiff has “discovered” it. The rule arose in fraud cases as an exception to the general limitations rule that a cause of action accrues once a plaintiff has a “complete and present cause of action”. . . . This Court long ago recognized that something different was needed in the case of fraud, where a defendant’s deceptive conduct may prevent a plaintiff from even *knowing* that he or she has been defrauded. Otherwise, “the law which was designed to prevent fraud” could become “the means by which it is made successful and secure.” *Bailey v. Glover*, 21 Wall. 342, 349 (1875). Accordingly, “where a plaintiff has been injured by fraud and remains in ignorance of it without any fault or want of diligence or care on his part, the bar of the statute does not begin to run until the fraud is *discovered*.” *Holmberg v. Armbrecht*, 327 U.S. 392, 397 (1946). . . . And for more than a century, courts have understood that “[f]raud is deemed to be discovered . . . when, in the exercise of reasonable diligence, it could have been discovered.” . . .

More recently, both state and federal courts have applied forms of the “discovery rule” to claims other than fraud. . . . Legislatures have codified the discovery rule in various contexts. . . . In doing so, legislators have written the word “discovery” directly into the statute. And when they have done so, state and federal courts have typically interpreted the word to refer not only to actual discovery, but also to the hypothetical discovery of facts a reasonably diligent plaintiff would know. . . .

Thus, treatise writers now describe “the discovery rule” as allowing a claim “to accrue when the litigant first knows *or with due diligence should know* facts that will form the basis for an action.” . . .

Like the parties, we believe that Congress intended courts to interpret the word “discovery” in § 1658(b)(1) similarly. Before Congress enacted that statute, this Court, having found in the federal securities laws the existence of an implied private § 10(b) action, determined its governing limitations period by looking to other limitations periods in the federal securities laws. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991). Noting the existence of various formulations “differ[ing] slightly in terminology,” the Court chose the language in 15 U.S.C. § 78i(e), the statutory provision that governs securities price manipulation claims. 501 U.S. at 364, n. 9. And in doing so, the Court said that private § 10(b) actions “must be commenced within one year *after the discovery of the facts constituting the violation* and within three years after such violation.” . . .

Subsequently, every Court of Appeals to decide the matter held that “discovery of the facts constituting the violation” occurs not only once a plaintiff *actually* discovers the facts, but also when a hypothetical reasonably diligent plaintiff would have discovered them. . . . Some of those courts noted that other limitations provisions in the federal securities laws explicitly provide that the period begins to run “after the discovery of the untrue statement . . . *or after such discovery should have been made by [the] exercise of reasonable diligence,*” whereas the formulation adopted by the Court in *Lampf* from 15 U.S.C. § 78i(e) does not. . . . But, courts reasoned, because the term “discovery” in respect to statutes of limitations for fraud has long been understood to include discoveries a reasonably diligent plaintiff would make, the omission of an explicit provision to that effect did not matter. . . .

In 2002, when Congress enacted the present limitations statute, it repeated *Lampf's* critical language. The statute says that an action based on fraud “may be brought not later than the earlier of . . . 2 years *after the discovery of the facts constituting the violation*” (or “5 years after such violation”). § 804 of the Sarbanes-Oxley Act, 116 Stat. 801, codified at 28 U.S.C. § 1658(b) (emphasis added). (This statutory provision does *not* make the linguistic distinction that the concurrence finds in a *different* statute, § 77m, and upon which its argument rests. Cf. 29 U.S.C. § 1113(2) (statute in which Congress provided that an action be brought “three years after the earliest date on which the plaintiff had *actual knowledge* of the breach or violation” (emphasis added)).) Not surprisingly, the Courts of Appeals unanimously have continued to interpret the word “discovery” in this statute as including not only facts a particular plaintiff knows, but also the facts any reasonably diligent plaintiff would know. . . .

We normally assume that, when Congress enacts statutes, it is aware of relevant judicial precedent. . . . Given the history and precedent surrounding the use of the word “discovery” in the limitations context generally as well as in this provision in particular, the reasons for making this assumption are particularly strong here. We consequently hold that “discovery” as used in this statute encompasses not only those facts the plaintiff actually knew, but also those facts a reasonably diligent plaintiff would have known. And we evaluate Merck’s claims accordingly.

III

We turn now to Merck’s arguments in favor of holding that petitioners’ claims accrued before November 6, 2001. First, Merck argues that the statute does not require “discovery” of scienter-related “facts.” . . . We cannot agree, however, that facts about scienter are unnecessary.

The statute says that the limitations period does not begin to run until “discovery of the *facts constituting the violation.*” 28 U.S.C. § 1658(b)(1) (emphasis added). Scienter is assuredly a “fact.” In a § 10(b) action, scienter refers to “a mental state embracing intent to deceive, manipulate, or defraud.” *Ernst & Ernst*, 425 U.S., at 194, n. 12. And the “state of a man’s mind is as much a fact as the state of his digestion.” *Postal Service Bd. of Governors v. Aikens*, 460 U.S. 711, 716 (1983) (quoting *Edgington v. Fitzmaurice*, [1885] 29 Ch. Div. 459, 483).

And this “fact” of scienter “constitut[es]” an important and necessary element of a § 10(b) “violation.” A plaintiff cannot recover without proving that a defendant made a material misstatement *with an intent to deceive* — not merely innocently or negligently. . . . Indeed Congress has enacted special heightened pleading requirements for the scienter element of § 10(b) fraud cases. See 15 U.S.C. § 78u-4(b)(2) (requiring plaintiffs to “state with particularity *facts* giving rise to a strong inference that the defendant acted with the required state of mind” (emphasis added)). As a result, unless a § 10(b) plaintiff can set forth facts in the complaint showing that it is more likely than not that the defendant acted with the relevant knowledge or intent, the claim will fail. See *Tellabs*, [551 U.S.], at 328. It would therefore frustrate the very purpose of the discovery rule in this provision — which, after all, specifically applies only in cases “involv[ing] a claim of fraud, deceit, manipulation, or contrivance,” § 1658(b) — if the limitations period began to run

regardless of whether a plaintiff had discovered any facts suggesting scienter. So long as a defendant concealed for two years that he made a misstatement with an intent to deceive, the limitations period would expire before the plaintiffs had actually “discover[ed]” the fraud.

We consequently hold that facts showing scienter are among those that “constitut[e] the violation.” In so holding, we say nothing about other facts necessary to support a private § 10(b) action. Cf. Brief for United States as *Amicus Curiae* 12, n. 1 (suggesting that facts concerning a plaintiff’s reliance, loss, and loss causation are not among those that constitute “the violation” and therefore need not be “discover[ed]” for a claim to accrue).

Second, Merck argues that, even if “discovery” requires facts related to scienter, facts that tend to show a materiality false of misleading statement (or material omission) are ordinarily sufficient to show scienter as well. But we do not see how that is so. We recognize that certain statements are such that, to show them false is normally to show scienter as well. It is unlikely, for example, that someone would falsely say “I am not married” without being aware of the fact that his statement is false. Where § 10(b) is at issue, however, the relation of factual falsity and state of mind is more context specific. An incorrect prediction about a firm’s future earnings, by itself, does not automatically tell us whether the speaker deliberately lied or just made an innocent (and therefore nonactionable) error. Hence, the statute may require “discovery” of scienter-related facts beyond the facts that show a statement (or omission) to be materially false or misleading. Merck fears that this requirement will give life to stale claims or subject defendants to liability for acts taken long ago. But Congress’ inclusion in the statute of an unqualified bar on actions instituted “5 years after such violation,” § 1658(b)(2), giving defendants total repose after five years, should diminish that fear.

Third, Merck says that the limitations period began to run prior to November 2001 because by that point the plaintiffs were on “inquiry notice.” Merck uses the term “inquiry notice” to refer to the point “at which a plaintiff possesses a quantum of information sufficiently suggestive of wrongdoing that he should conduct a further inquiry.” And some, but not all, Courts of Appeals have used the term in roughly similar ways. . . .

If the term “inquiry notice” refers to the point where the facts would lead a reasonably diligent plaintiff to investigate further, that point is not necessarily the point at which the plaintiff would already have discovered facts showing scienter or other “facts constituting the violation.” But the statute says that the plaintiff’s claim accrues only after the “discovery” of those latter facts. Nothing in the text suggests that the limitations period can sometimes begin *before* “discovery” can take place. Merck points out that, as we have discussed, the court-created “discovery rule” exception to ordinary statutes of limitations is not generally available to plaintiffs who fail to pursue their claims with reasonable diligence. But we are dealing here with a statute, not a court-created exception to a statute. Because the statute contains no indication that the limitations period should occur at some earlier moment before “discovery,” when a plaintiff would have *begun* investigating, we cannot accept Merck’s argument.

As a fallback, Merck argues that even if the limitations period does generally

begin at “discovery,” it should nonetheless run from the point of “inquiry notice” in one particular situation, namely, where the actual plaintiff fails to undertake an investigation once placed on “inquiry notice.” In such circumstances, Merck contends, the actual plaintiff is not diligent, and the law should not “effectively excuse a plaintiff’s failure to conduct a further investigation” by placing that nondiligent plaintiff and a reasonably diligent plaintiff “in the same position.”

We cannot accept this argument for essentially the same reason we reject “inquiry notice” as the standard generally: We cannot reconcile it with the statute, which simply provides that “discovery” is the event that triggers the 2-year limitations period — for all plaintiffs. Furthermore, the statute does *not* place all plaintiffs “in the same position” no matter whether they investigate when investigation is warranted. The limitations period puts plaintiffs who fail to investigate once on “inquiry notice” at a disadvantage because it lapses two years after a reasonably diligent plaintiff would have discovered the necessary facts. A plaintiff who fails entirely to investigate or delays investigating may well not have discovered those facts by that time or, at least, may not have found sufficient facts by that time to be able to file a § 10(b) complaint that satisfies the applicable heightened pleading standards.

Merck further contends that its proposed “inquiry notice” standard is superior, because determining when a hypothetical reasonably diligent plaintiff would have “discover[ed]” the necessary facts is too complicated for judges to undertake. But courts applying the traditional discovery rule have long had to ask what a reasonably diligent plaintiff would have known and done in myriad circumstances. And courts in at least five Circuits already ask this kind of question in securities fraud cases. . . . Merck has not shown this precedent to be unworkable. We consequently find that the “discovery” of facts that put a plaintiff on “inquiry notice” does not automatically begin the running of the limitations period.

We conclude that the limitations period in § 1658(b)(1) begins to run once the plaintiff did discover or a reasonably diligent plaintiff would have “discover[ed]” the facts constituting the violation — whichever comes first. In determining the time at which “discovery” of those “facts” occurred, terms such as “inquiry notice” and “storm warnings” may be useful to the extent that they identify a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating. But the limitations period does not begin to run until the plaintiff thereafter discovers or a reasonably diligent plaintiff would have discovered “the facts constituting the violation,” including scienter — irrespective of whether the actual plaintiff undertook a reasonably diligent investigation.

IV

Finally, Merck argues that, even if all its other legal arguments fail, the record still shows that, before November 6, 2001, the plaintiffs had discovered or should have discovered “the facts constituting the violation.” In respect to scienter Merck primarily relies upon (1) the FDA’s September 2001 warning letter, which said that Merck had “minimized” the VIGOR study’s “‘potentially serious cardiovascular finding’” and (2) pleadings filed in products-liability actions in September and October 2001 alleging that Merck had “‘omitted, suppressed, or concealed material

facts concerning the dangers and risks associated with Vioxx' ” and “*purposefully* downplayed and/or understated the serious nature of the risks associated with Vioxx.” . . .

The FDA's warning letter, however, shows little or nothing about the here-relevant scienter, *i.e.*, whether Merck advanced the naproxen hypothesis with fraudulent intent. The FDA itself described the pro-Vioxx naproxen hypothesis as a “possible explanation” for the VIGOR results, faulting Merck only for failing sufficiently to publicize the alternative less favorable to Merck, that Vioxx might be harmful.

The products-liability complaints' statements about Merck's knowledge show little more. Merck does not claim that these complaints contained any specific information suggesting the fraud alleged here, *i.e.*, that Merck knew the naproxen hypothesis was false even as it promoted it. And, without providing any reason to believe that the plaintiffs had special access to information about Merck's state of mind, the complaints alleged only in general terms that Merck had concealed information about Vioxx and “purposefully downplayed and/or understated” the risks associated with Vioxx — the same charge made in the FDA warning letter.

In our view, neither these two circumstances nor any of the other pre-November 2001 circumstances that we have set forth in Part I-A, *supra*, whether viewed separately or together, reveal “facts” indicating scienter. Regardless of which, if any, of the events following November 6, 2001, constituted “discovery,” we need only conclude that prior to November 6, 2001, the plaintiffs did not discover, and Merck has not shown that a reasonably diligent plaintiff would have discovered, “the facts constituting the violation.” In light of our interpretation of the statute, our holding in respect to scienter, and our application of those holdings to the circumstances of this case, we must, and we do, reach that conclusion. Thus, the plaintiffs' suit is timely. . . . The judgment of the Court of Appeals is *Affirmed*.

JUSTICE STEVENS, concurring in part and concurring in judgment.

In my opinion the Court's explanation of why the complaint was timely filed is convincing and correct. In this case there is no difference between the time when the plaintiffs actually discovered the factual basis for their claim and the time when reasonably diligent plaintiffs should have discovered those facts. For that reason, much of the discussion in Part II of the Court's opinion is not necessary to support the Court's judgment. Until a case arises in which the difference between an actual discovery rule and a constructive discovery rule would affect the outcome, I would reserve decision on the merits of Justice Scalia's argument. . . . With this reservation, I join the Court's excellent opinion.

JUSTICE SCALIA, with whom JUSTICE THOMAS joins, concurring in part and concurring in the judgment.

Private suits under § 10(b) of the Securities Exchange Act of 1934 must be brought within “(1) 2 years after the discovery of the facts constituting the violation” or “(2) 5 years after such violation,” whichever comes first. 28 U.S.C. § 1658(b)(1). I agree with the Court that scienter is among the “facts constituting

the violation” that a plaintiff must “discove[r]” for the limitations period to begin. I also agree that respondent’s suit is timely, but for a reason different from the Court’s: Merck has not shown that respondents actually “discover[ed]” scienter more than two years before bringing suit.

In ordinary usage, “discovery” occurs when one actually learns something new. See Webster’s New International Dictionary of the English Language 745 (2d ed. 1957) (defining “discovery” as “[f]inding out or ascertaining something previously unknown or unrecognized”). As the Court notes, however, in the context of the statutes of limitations “discovery” has long carried an additional meaning: It also occurs when a plaintiff, exercising reasonable diligence, *should have* discovered the facts giving rise to his claim. . . . Read in isolation, “discovery” in § 1658(b)(1) might mean constructive discovery.

In context, however, I do not believe it can. Section 13 of the Securities Act of 1933, 48 Stat. 84, explicitly established a constructive-discovery rule for claims under §§ 11 and 12 of that Act:

“No action shall be maintained to enforce any liability created under section 77k or 77 l (a)(2) of this title unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence. . . .” 15 U.S.C. § 77m.

“[D]iscovery in § 77m obviously cannot mean constructive discovery, since that would render superfluous the phrase “or after such discovery should have been made by the exercise of reasonable diligence.” With § 77m already on the books, Congress added limitations periods in the 1934 Act, 15 U.S.C. §§ 78i(e), 78r(c), that did not contain similar qualifying language; instead, each established a time bar that runs from “discovery” *simpliciter*. When Congress enacted § 1658(b)(1) in 2002, establishing a limitations period for private actions for “fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws,” specifically including the 1933 and 1934 Acts, see 15 U.S.C. § 78c(a)(47), it likewise included no constructive-discovery caveat. To interpret § 1658(b)(1) as imposing a constructive-discovery standard, one must therefore assume, contrary to common sense, that the same word means two very different things in the same statutory context of limitations periods for securities-fraud actions under the 1933 and 1934 Acts.

True, the sensible presumption that a word means the same thing when it appears more than once in the same statutory context — or even in the very same statute — is rebuttable. . . . Context may make clear that in one instance the word carries one meaning, and in a second instance another. But nothing in the context of § 77m or § 1658(b)(1) suggests that is the case. Both provisions impose limitations periods for federal-law claims based on various false statements or omissions involving securities. The former applies to false statements or omissions in registration statements, § 77k, and offers to sell securities, § 77 l (a)(2); the broad language of the latter (“claim[s] of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws”) covers other “manipulative or deceptive device[s] or contrivance[s]” made “in connection with the purchase or sale” of a security in violation of Securities and Exchange

Commission regulations, § 78j(b), including SEC Rule 10b-5. . . . There is good reason, moreover, for providing an actual-discovery rule for private § 10(b) claims but providing (explicitly) a constructive-discovery rule for claims governed by § 77m: The elements of § 10(b) claims, which include scienter, are likely more difficult to discover than the elements of claims under § 77k or § 77 l (a)(2), which do not. . . . And a constructive-discovery standard may be easier to apply to the claims covered by § 77m. Determining when the plaintiff should have uncovered an untrue assertion in a registration statement or prospectus is much simpler than assessing when a plaintiff should have learned that the defendant deliberately misled him using a deceptive device covered by § 10(b).

Unable to identify anything in the statutory context that warrants giving “discovery” two meanings, the Court relies on the historical treatment of “discovery” in limitations periods (particularly for fraud claims) as incorporating a constructive-discovery rule. But that history proves only that “discovery” *can* carry that technical meaning, and that without § 77m it would be reasonable (other things equal) to read it that way here. It does not show what “discovery” means in § 1658(b)(1) *in light of* § 77m’s codification of a constructive-discovery rule. In my view, the meaning of “discovery” in the broader context of limitations provisions is overcome by its meaning in the more specific context of the federal securities laws.

The Court’s other reason for rejecting the more natural reading of § 1658(b)(1) rests on a consensus among the Courts of Appeals before the provision’s enactment. . . . In *Lampf, Pleva, Lipkind & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), the Court notes, we explicitly adopted the terms of § 78i(e) — which like § 1658(b)(1) refers only to discovery with no mention of reasonable diligence — as the limitations period for the private § 10(b) cause of action we created. Since every Circuit to address the issue between *Lampf* and § 1658(b)(1)’s enactment 11 years later had held constructive discovery applicable to § 10(b) claims — and since Congress copied § 78i(e)’s key text into § 1658(b)(1) with no indication it intended to adopt a contrary rule — the Court assumes Congress meant to codify (or at least not to disturb) that consensus.

Even assuming that Congress intended to incorporate the Circuits’ view — which requires the further unrealistic assumption that a majority of each House knew of and agreed with the Courts of Appeals’ opinions — that would be entirely irrelevant. Congress’s collective intent (if such a thing even exists) cannot trump the text it enacts, and in any event we have no reliable way to ascertain that intent apart from reading the text. . . .

The only way in which the Circuits’ pre-2002 decisions might bear on § 1658(b)(1)’s meaning is if all (or nearly all) of the Circuits had interpreted “discovery” in § 78i(e) to mean constructive discovery. If that were true, one could say that those decisions had established the public meaning of the term in this context — whether Congress knew of (or agreed with) that meaning or not. . . .

But as *amici* note, that is not so. See Brief for Faculty at Law and Business Schools as *Amici Curiae* 23-29 (hereinafter Faculty Brief). *Some* circuit cases cited by the Court and *amici* can conceivably be read as interpreting the language *Lampf* adopted from § 78i(e) as imposing some form of constructive discovery. . . . Others, however, cannot be so construed. Two were not interpreting § 78i(e) at all, but

looked directly to § 77m, despite *Lampf*'s explicit selection of § 78i(e)'s terms. . . . Another court candidly acknowledged that § 78i(e)'s text — unlike § 77m's — forecloses constructive discovery, but it nonetheless held that courts remain “free to apply to [§ 78i(e)] the judge-made doctrine of inquiry notice” as a “modest and traditional . . . exercise of judicial creativity,” since “Congress could not have known when it enacted [§ 78i(e)] that this section would someday provide the statute of limitations for a wide range of securities frauds.” . . .

The rest of the Circuits apparently had not decided the issue before § 1658(b)(1)'s enactment. . . . And of those that were undecided, two had cast doubt on a constructive-discovery view in dicta — of which the omniscient Congress of the Court's imagining should also have been aware. . . .

This motley assortment of approaches comes nowhere near establishing that the word “discovery” in § 78i(e) meant constructive rather than actual discovery despite § 77m. Absent any textual or contextual reason to read “discovery” differently in § 1658(b)(1) and § 77m, I would hold that only actual discovery suffices to start the limitations period for § 10(b) claims. Since Merck points to no evidence showing respondents actually discovered scienter more than two years before bringing this suit, I agree with the Court that the suit was not time barred.

Respondents suggested at oral argument, and their *amici* imply, that in fraud-on-the-market cases there is little if any difference between actual and constructive discovery because of the presumption of reliance applicable in such cases, see *Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988). It seems to me *Basic* has no bearing on the question discussed here. A presumption of knowledge upon market-price signals is not a presumption of knowledge of all public information, much less knowledge of nonpublic information that a reasonably diligent investor would have independently uncovered. In any event, whether or not a constructive-discovery standard will in many cases yield the same result, actual discovery is what § 1658(b)(1) requires to start the limitations period.

Page 501: add new § 8.13:

§ 8.13 EXTRATERRITORIAL REACH OF SECTION 10(b)

MORRISON v. NATIONAL AUSTRALIA BANK LTD.

United States Supreme Court
130 S. Ct. 2869 (2010)

JUSTICE SCALIA delivered the opinion of the Court.

We decide whether § 10(b) of the Securities Exchange Act of 1934 provides a cause of action to foreign plaintiffs suing foreign and American defendants for misconduct in connection with securities traded on foreign exchanges.

I

Respondent National Australia Bank Limited (National) was, during the relevant time, the largest bank in Australia. Its Ordinary Shares — what in America would be called “common stock” — are traded on the Australian Stock Exchange Limited and on other foreign securities exchanges, but not on any exchange in the United States. There are listed on the New York Stock Exchange, however, National’s American Depositary Receipts (ADRs), which represent the right to receive a specified number of National’s Ordinary Shares.

The complaint alleges the following facts, which we accept as true. In February 1998, National bought respondent HomeSide Lending, Inc., a mortgage servicing company headquartered in Florida. HomeSide’s business was to receive fees for servicing mortgages (essentially the administrative tasks associated with collecting mortgage payments). The rights to receive those fees, so-called mortgage-servicing rights, can provide a valuable income stream. How valuable each of the rights is depends, in part, on the likelihood that the mortgage to which it applies will be fully repaid before it is due, terminating the need for servicing. HomeSide calculated the present value of its mortgage-servicing rights by using valuation models designed to take this likelihood into account. It recorded the value of its assets, and the numbers appeared in National’s financial statements.

From 1998 until 2001, National’s annual reports and other public documents touted the success of HomeSide’s business, and respondents Frank Cicutto (National’s managing director and chief executive officer), Kevin Race (HomeSide’s chief operating officer), and Hugh Harris (HomeSide’s chief executive officer) did the same in public statements. But on July 5, 2001, National announced that it was writing down the value of HomeSide’s assets by \$450 million; and then again on September 2, by another \$1.75 billion. The prices of both Ordinary Shares and ADRs slumped. After downplaying the July write-down, National explained the September write-down as the result of a failure to anticipate the lowering of prevailing interest rates (lower interest rates lead to more refinancings, *i.e.*, more early repayments of mortgages), other mistaken assumptions in the financial models, and the loss of goodwill. According to the complaint, however, HomeSide, Race, Harris, and another HomeSide senior executive who is also a respondent here had manipulated HomeSide’s financial models to make the rates of early repayment unrealistically low in order to cause the mortgage-servicing rights to appear more valuable than they really were. The complaint also alleges that National and Cicutto were aware of this deception by July 2000, but did nothing about it.

As relevant here, petitioners Russell Leslie Owen and Brian and Geraldine Silverlock, all Australians, purchased National’s Ordinary Shares in 2000 and 2001, before the write-downs.¹⁸ They sued National, HomeSide, Cicutto, and the three HomeSide executives in the United States District Court for the Southern District

¹⁸ [1] Robert Morrison, an American investor in National’s ADRs, also brought suit, but his claims were dismissed by the District Court because he failed to allege damages. *In re National Australia Bank Securities Litigation*, No. 03 Civ. 6537(BSJ), 2006 WL 3844465, *9 (S.D.N.Y., Oct. 25, 2006). Petitioners did not appeal that decision, 547 F.3d 167, 170, n. 3 (C.A.2 2008) (case below), and it is not before us. Inexplicably, Morrison continued to be listed as a petitioner in the Court of Appeals and here.

of New York for alleged violations of §§ 10(b) and 20(a) [control person liability] of the Securities and Exchange Act of 1934. . . . They sought to represent a class of foreign purchasers of National's Ordinary Shares during a specified period up to the September write-down.

Respondents moved to dismiss for lack of subject-matter jurisdiction under Federal Rule of Civil Procedure 12(b)(1) and for failure to state a claim under Rule 12(b)(6). The District Court granted the motion on the former ground, finding no jurisdiction because the acts in this country were, "at most, a link in the chain of an alleged overall securities fraud scheme that culminated abroad." . . . The Court of Appeals for the Second Circuit affirmed on similar grounds. The acts performed in the United States did not "compris[e] the heart of the alleged fraud." 547 F.3d at 175–176. We granted certiorari. . . .

II

Before addressing the question presented, we must correct a threshold error in the Second Circuit's analysis. It considered the extraterritorial reach of § 10(b) to raise a question of subject-matter jurisdiction, wherefore it affirmed the District Court's dismissal under Rule 12(b)(1). See 547 F.3d, at 177. In this regard it was following Circuit precedent, see *Schoenbaum v. Firstbrook*, 405 F.2d 200, 208, modified on other grounds en banc, 405 F.2d 215 (1968). The Second Circuit is hardly alone in taking this position, see, e.g., *In re CP Ships Ltd. Securities Litigation*, 578 F.3d 1306, 1313 (C.A.11 2009); *Continental Grain (Australia) PTY. Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 421 (C.A.8 1979).

But to ask what conduct § 10(b) reaches is to ask what conduct § 10(b) prohibits, which is a merits question. Subject-matter jurisdiction, by contrast, "refers to a tribunal's "power to hear a case." ' . . . It presents an issue quite separate from the question whether the allegations the plaintiff makes entitle him to relief. . . . The District Court here had jurisdiction under 15 U.S.C. § 78aa¹⁹ to adjudicate the question whether § 10(b) applies to National's conduct.

In view of this error, which the parties do not dispute, petitioners ask us to remand. We think that unnecessary. Since nothing in the analysis of the courts below turned on the mistake, a remand would only require a new Rule 12(b)(6) label for the same Rule 12(b)(1) conclusion. As we have done before in situations like this, . . . we proceed to address whether petitioners' allegations state a claim.

¹⁹ Section 78aa provides:

"The district courts of the United States . . . shall have exclusive jurisdiction of violations of [the Exchange Act] or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by [the Exchange Act] or the rules and regulations thereunder."

III

A

It is a “longstanding principle of American law ‘that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.’” . . . This principle represents a canon of construction, or a presumption about a statute’s meaning, rather than a limit upon Congress’s power to legislate. . . . It rests on the perception that Congress ordinarily legislates with respect to domestic, not foreign matters. Thus, “unless there is the affirmative intention of the Congress clearly expressed” to give a statute extraterritorial effect, “we must presume it is primarily concerned with domestic conditions.” . . . The canon or presumption applies regardless of whether there is a risk of conflict between the American statute and a foreign law. . . . When a statute gives no clear indication of an extraterritorial application, it has none.

Despite this principle of interpretation, long and often recited in our opinions, the Second Circuit believed that, because the Exchange Act is silent as to the extraterritorial application of § 10(b), it was left to the court to “discern” whether Congress would have wanted the statute to apply. See 547 F.3d, at 170 (internal quotation marks omitted). This disregard of the presumption against extraterritoriality did not originate with the Court of Appeals panel in this case. It has been repeated over many decades by various courts of appeals in determining the application of the Exchange Act, and § 10(b) in particular, to fraudulent schemes that involve conduct and effects abroad. That has produced a collection of tests for divining what Congress would have wanted, complex in formulation and unpredictable in application.

As of 1967, district courts at least in the Southern District of New York had consistently concluded that, by reason of the presumption against extraterritoriality, § 10(b) did not apply when the stock transactions underlying the violation occurred abroad. See *Schoenbaum v. Firstbrook*, 268 F. Supp. 385, 392 (1967) (citing *Ferraoli v. Cantor*, CCH Fed. Sec. L. Rep. ¶ 91615 (S.D.N.Y. 1965) and *Kook v. Crang*, 182 F. Supp. 388, 390 (S.D.N.Y. 1960)). *Schoenbaum* involved the sale in Canada of the treasury shares of a Canadian corporation whose publicly traded shares (but not, of course, its treasury shares) were listed on both the American Stock Exchange and the Toronto Stock Exchange. Invoking the presumption against extraterritoriality, the court held that § 10(b) was inapplicable (though it incorrectly viewed the defect as jurisdictional). The decision in *Schoenbaum* was reversed, however, by a Second Circuit opinion which held that “neither the usual presumption against extraterritorial application of legislation nor the specific language of [§] 30(b) show Congressional intent to preclude application of the Exchange Act to transactions regarding stocks traded in the United States which are effected outside the United States” *Schoenbaum*, 405 F.2d, at 206. It sufficed to apply § 10(b) that, although the transaction in treasury shares took place in Canada, they affected the value of the common shares publicly traded in the United States. Application of § 10(b), the Second Circuit found, was “necessary to protect American investors,” *id.*, at 206.

The Second Circuit took another step with *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326 (1972), which involved an American company that had been fraudulently induced to buy securities in England. There, unlike in *Schoenbaum*, some of the deceptive conduct had occurred in the United States but the corporation whose securities were traded (abroad) was not listed on any domestic exchange. *Leasco* said that the presumption against extraterritoriality applies only to matters over which the United States would not have prescriptive jurisdiction to regulate the deceptive conduct in this country, the language of the Act could be read to cover that conduct, and the court concluded that “if Congress had thought about the point,” it would have wanted § 10(b) to apply. *Id.*, at 1334–1337.

With *Schoenbaum* and *Leasco* on the books, the Second Circuit had excised the presumption against extraterritoriality from the jurisprudence of § 10(b) and replaced it with the inquiry whether it would be reasonable (and hence what Congress would have wanted) to apply the statute to a given situation. As long as there was prescriptive jurisdiction to regulate, the Second Circuit explained, whether to apply § 10(b) even to “predominately foreign” transactions became a matter of whether a court thought Congress “wished the precious resources of United States courts and law enforcement agencies to be devoted to them rather than leave the problem to foreign countries.” *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 985 (1975); see also *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1017–1018 (C.A.2 1975).

The Second Circuit had thus established that application of § 10(b) could be premised upon either some effect on American securities markets or investors (*Schoenbaum*) or significant conduct in the United States (*Leasco*). It later formalized these two applications into (1) an “effects test,” “whether the wrongful conduct had a substantial effect in the United States or upon United States citizens,” and (2) a “conduct test,” “whether the wrongful conduct occurred in the United States.” *SEC v. Berger*, 322 F.3d 187, 192–193 (C.A.2 2003). These became the north star of the Second Circuit’s § 10(b) jurisprudence, pointing the way to what Congress would have wished. Indeed, the Second Circuit declined to keep its two tests distinct on the ground that “an admixture or combination of the two often gives a better picture of whether there is sufficient United States involvement to justify the exercise of jurisdiction by an American court.” *Itoba Ltd. v. Lep Group PLC*, 54 F.3d 118, 122 (1995). The Second Circuit never put forward a textual or even extratextual basis for these tests. As early as *Bersch*, it confessed that “if we were asked to point to language in the statutes, or even in the legislative history, that compelled these conclusions, we would be unable to respond,” 519 F.2d, at 993.

As they developed, these tests were not easy to administer. The conduct test was held to apply differently depending on whether the harmed investors were Americans or foreigners: When the alleged damages consisted of losses to American investors abroad, it was enough that acts “of material importance” performed in the United States “significantly contributed” to that result; whereas those acts must have “directly caused” the result when losses to foreigners abroad were at issue. See *Bersch*, 519 F.2d, at 993. And “merely preparatory activities in the United States” did not suffice “to trigger application of the securities laws for injury to foreigners located abroad.” *Id.*, at 992. This required the court to

distinguish between mere preparation and using the United States as a “base” for fraudulent activities in other countries. *Vencap*, [519 F.2d] at 1017–1018. But merely satisfying the conduct test was sometimes insufficient without “some additional factor tilling the scales’” in favor of the application of American law. *Interbrew v. Edperbrascan Corp.*, 23 F. Supp. 2d 425, 432 (S.D.N.Y. 1998) (quoting *Europe & Overseas Commodity Traders, S.A. v. Banque Paribas London*, 147 F.3d 118, 129 (C.A.2 1998)). District courts have noted the difficulty of applying such vague formulations. See, e.g., *In Alstom SA*, 406 F. Supp. 2d 346, 366–385 (S.D.N.Y. 2005). There is no more damning indictment of the “conduct” and “effects” tests than the Second Circuit’s own declaration that “the presence or absence of any single factor which was considered significant in other cases . . . is not necessarily dispositive in future cases.” *IIT v. Cornfeld*, 619 F.2d 909, 918 (1980). . . .

Other Circuits embraced the Second Circuit’s approach, though not its precise application. Like the Second Circuit, they described their decisions regarding the extraterritorial application of § 10(b) as essentially resolving matters of policy. See, e.g., *SEC v. Kasser*, 548 F.2d 109, 116 (C.A.3 1977); *Continental Grain*, 592 F.2d, at 421–422; *Gruenthal GmbH v. Hotz*, 712 F.2d 421, 424–425 (C.A.9 1983); *Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 667 (C.A.7 1998). While applying the same fundamental methodology of balancing interests and arriving at what seemed the best policy, they produced a proliferation of vaguely related variations on the “conduct” and “effects” tests. As described in a leading Seventh Circuit opinion: “Although the circuits . . . seem to agree that there are some transnational situations to which the antifraud provisions of the securities laws are applicable, agreement appears to end at that point.” . . .²⁰

At least one Court of Appeals has criticized this line of cases and the interpretive assumption that underlies it. In *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 32 (1987) (Bork, J.), the District of Columbia Circuit observed that rather than courts’ “divining what ‘Congress would have wished’ if it had addressed the problem[, a] more natural inquiry might be what jurisdiction Congress in fact thought about and conferred.” Although tempted to apply the presumption against extraterritoriality and be done with it, see *id.*, at 31–32, that court deferred to the Second Circuit because of its “preeminence in the field of securities law”

Commentators have criticized the unpredictable and inconsistent application of § 10(b) to transnational cases. . . . Some have challenged the premise underlying the Courts of Appeals’ approach, namely that Congress did not consider the

²⁰ [4] The principal concurrence (see Stevens, J., concurring in judgment) (hereinafter concurrence) disputes this characterization, launching into a Homeric simile which takes as its point of departure (and mistakes for praise rather than condemnation) then-Justice Rehnquist’s statement in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) that “[w]hen we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn.” The concurrence seemingly believes that the Courts of Appeals have carefully trimmed and sculpted this “judicial oak” into a cohesive canopy, under the watchful eye of Judge Henry Friendly, the “master arborist,” *ibid.* Even if one thinks that the “conduct” and “effects” tests are numbered among Judge Friendly’s many fine contributions to the law, his successors, though perhaps under the impression that they nurture the same mighty oak, are in reality tending each its own botanically distinct tree. It is telling that the concurrence never attempts its own synthesis of the various balancing tests the Circuits have adopted.

extraterritorial application of § 10(b) (thereby leaving it open to the courts, supposedly, to determine what Congress would have wanted). See, *e.g.*, Sachs, *The International Reach of Rule 10b-5: The Myth of Congressional Silence*, 28 Colum. J. Transnat'l L. 677 (1990) (arguing that Congress considered, but rejected, applying the Exchange Act to transactions abroad). Others, more fundamentally, have noted that using congressional silence as a justification for judge-made rules violates the traditional principle that silence means no extraterritorial application. . . .

The criticisms seem to us justified. The results of judicial-speculation-made-law — divining what Congress would have wanted if it had thought of the situation before the court — demonstrate the wisdom of the presumption against extraterritoriality. Rather than guess anew in each case, we apply the presumption in all cases, preserving a stable background against which Congress can legislate with predictable effects.²¹

B

Rule 10b-5, the regulation under which petitioners have brought suit, was promulgated under § 10(b), and “does not extend beyond conduct encompassed by § 10(b)’s prohibition.” . . . Therefore, if § 10(b) is not extraterritorial, neither is Rule 10b-5. On its face, § 10(b) contains nothing to suggest it applies abroad:

“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any securities registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive devise or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe. . . .” 15 U.S.C. 78j(b).

Petitioners and the Solicitor General contend, however, that three things indicate that § 10(b) or the Exchange Act in general has at least some extraterritorial application.

First, they point to the definition of “interstate commerce,” a term used in § 10(b), which includes “trade, commerce, transportation, or communication . . . between any foreign country and any State.” 15 U.S.C. § 78c(a)(17). But “we have repeatedly held that even statutes that contain broad language in their definitions

²¹ [5] The concurrence urges us to cast aside our inhibitions and join in the judicial lawmaking, because “[t]his entire area of law is replete with judge-made rules”. . . . It is doubtless true that, because the implied private cause of action under § 10(b) and Rule 10b-5 is a thing of our own creation, we have also defined its contours. See, *e.g.*, *Blue Chip Stamps, supra*. But when it comes to “the scope of [the] conduct prohibited by [Rule 10b-5 and] § 10(b), the text of the statute controls our decision.” *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994). It is only with respect to the additional “elements of the 10b-5 private liability scheme” that we “have had ‘to infer how the 1934 Congress would have addressed the issue[s] had the 10b-5 action been included as an express provision in the 1934 Act.’” *Ibid.* (quoting *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 294 (1933)).

of ‘commerce’ that expressly refer to ‘foreign commerce’ do not apply abroad.” *Aramco*, 499 U.S., at 251. . . . The general reference to foreign commerce in the definition of “interstate commerce” does not defeat the presumption against extraterritoriality.²²

Petitioners and the Solicitor General next point out that Congress, in describing the purposes of the Exchange Act, observed that the “prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries.” 15 U.S.C. § 78b(2). The antecedent of “such transaction,” however, is found in the first sentence of the section, which declares that “transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest.” § 78b. Nothing suggests that this *national* public interest pertains to transactions conducted upon *foreign* exchanges and markets. The fleeting reference to the dissemination and quotation abroad of the prices of securities traded in domestic exchanges and markets cannot overcome the presumption against extraterritoriality.

Finally, there is § 30(b) of the Exchange Act, 15 U.S.C. § 78dd(b), which *does* mention the Act’s extraterritorial application: “The provisions of [the Exchange Act] or of any rule or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States,” unless he does so in violation of regulations promulgated by the Securities and Exchange Commission “to prevent . . . evasion of [the Act].” (The parties have pointed us to no regulation promulgated pursuant to § 30(b).) The Solicitor General argues that “[this] exemption would have no function if the Act did not apply in the first instance to securities transactions that occur abroad.” Brief for United States as *Amicus Curiae* 14.

We are not convinced. In the first place, it would be odd for Congress to indicate the extraterritorial application of the whole Exchange Act by means of a provision imposing a condition precedent to its application abroad. And if the whole Act applied abroad, why would the Commission’s enabling regulations be limited to those preventing “evasion” of the Act, rather than all those preventing “violation”? The provision seems to us directed at actions abroad that might conceal a domestic violation, or might cause what would otherwise be a domestic violation to escape on a technicality. At most, the Solicitor General’s proposed inference is possible; but possible interpretations of statutory language do not override the presumption against extraterritoriality.

The Solicitor General also fails to account for § 30(a), which reads in relevant part as follows:

²² [7] This conclusion does not render meaningless the inclusion of “trade, commerce, transportation, or communication . . . between any foreign country and any State” in the definition of “interstate commerce.” 15 U.S.C. § 78c(a)(17). For example, an issuer based abroad, whose executives approve the publication in the United States of misleading information affecting the price of the issuer’s securities traded on the New York Stock Exchange, probably will make use of some instrumentality of “communication . . . between [a] foreign country and [a] State.”

“It shall be unlawful for any broker or dealer . . . to make use of the mails or of any means or instrumentality of interstate commerce for the purpose of effecting on an exchange not within or subject to the jurisdiction of the United States, any transaction in any security the issuer of which is a resident of, or is organized under the laws of, or has its principal place of business in, a place within or subject to the jurisdiction of the United States, in contravention of such rules and regulations as the Commission may prescribe. . . .” 15 U.S.C. § 78dd(a).

Subsection 30(a) contains what § 10(b) lacks: a clear statement of extraterritorial effect. Its explicit provision for a specific extraterritorial application would be quite superfluous if the rest of the Exchange Act already applied to transactions on foreign exchanges — and its limitation of that application to securities of domestic issuers would be inoperative. Even if that were not true, when a statute provides for some extraterritorial application, the presumption against extraterritoriality operates to limit that provision to its terms. See *Microsoft Corp. v. AT&T Corp.*, 550 U.S. 437, 455–456 (2007). No one claims that § 30(a) applies here.

The concurrence claims we have impermissibly narrowed the inquiry in evaluating whether a statute applies abroad. . . . But we do not say, as the concurrence seems to think, that the presumption against extraterritoriality is a “clear statement rule,” if by that is meant a requirement that a statute say “this law applies abroad.” Assuredly context can be consulted as well. But whatever sources of statutory meaning one consults to give “the most faithful reading” of the text, there is no clear indication of extraterritoriality here. The concurrence does not even try to refute that conclusion, but merely puts forward the same (at best) uncertain indications relied upon by petitioners and the Solicitor General. . . . [T]hose uncertain indications do not suffice.

In short, there is no affirmative indication in the Exchange Act that § 10(b) applies extraterritorially, and we therefore conclude that it does not.

IV

A

Petitioners argue that the conclusion that § 10(b) does not apply extraterritorially does not resolve this case. They contend that they seek no more than domestic application anyway, since Florida is where HomeSide and its senior executives engaged in the deceptive conduct of manipulating HomeSide’s financial models; their complaint also alleged that Race and Hughes made misleading public statements there. This is less an answer to the presumption against extraterritorial application than it is an assertion — a quite valid assertion — that that presumption here (as often) is not self-evidently dispositive, but its application requires further analysis. For it is a rare case of prohibited extraterritorial application that lacks *all* contact with the territory of the United States. But the presumption against extraterritorial application would be a craven watchdog indeed if it retreated to its kennel whenever *some* domestic activity is involved in the case. The concurrence seems to imagine just such a timid sentinel, but our cases are to the contrary. . . .

Applying the same mode of analysis here, we think that the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States. Section 10(b) does not punish deceptive conduct, but only deceptive conduct “in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered.” 15 U.S.C. § 78j(b). . . . Those purchase-and-sale transactions are the objects of the statute’s solicitude. It is those transactions that the statute seeks to “regulate” . . . ; it is parties or prospective parties to those transactions that the statute seeks to “protect” And it is in our view only transactions in securities listed on domestic exchanges, and domestic transactions in other securities, to which § 10(b) applies.

The primacy of the domestic exchange is suggested by the very prologue of the Exchange Act, which sets forth as its object “[t]o provide for the regulation of securities exchanges . . . operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges” 48 Stat. 881. We know of no one who thought that the Act was intended to “regulat[e]” *foreign* securities exchanges — or indeed who even believed that under established principles of international law Congress had the power to do so. The [Exchange] Act’s registration requirements apply only to securities listed on national securities exchanges. 15 U.S.C. § 78(a).

With regard to securities *not* registered on domestic exchanges, the exclusive focus on *domestic* purchases and sales is strongly confirmed by § 30(a) and (b), discussed earlier. The former extends the normal scope of the Exchange Act’s prohibitions to acts effecting, in violation of rules prescribed by the Commission, a “transaction” in a United States security “on an exchange not within or subject to the jurisdiction of the United States.” § 78dd(a). And the latter specifies that the Act does not apply to “any person insofar as he transacts a business in securities without the jurisdiction of the United States,” unless he does so in violation of regulations promulgated by the Commission “to prevent evasion [of the Act].” § 78dd(b). Under both provisions it is the foreign location of the *transaction* that establishes (or reflects the presumption of) the Act’s inapplicability, absent regulations by the Commission.

The same focus on domestic transactions is evident in the Securities Act of 1933, 48 Stat. 74, enacted by the same Congress as the Exchange Act, and forming part of the same comprehensive regulation of securities trading. . . . That legislation makes it unlawful to sell a security, through a prospectus or otherwise, making use of “any means or instruments of transportation or communication in interstate commerce or of the mails,” unless a registration statement is in effect. 15 U.S.C. 77e(a)(1). The Commission has interpreted that requirement “not to include . . . sales that occur outside the United States.” 17 C.F.R. § 230.901 (2009) [as defined pursuant to Regulation S].

Finally, we reject the notion that the Exchange Act reaches conduct in this country affecting exchanges or transactions abroad for the same reason that *Aramco* [499 U.S. 244 (1991)] rejected overseas application of Title VII to all domestically concluded employment contracts or all employment contracts with American employers: The probability of incompatibility with the applicable laws of

other countries is so obvious that if Congress intended such foreign application “it would have addressed the subject of conflicts with foreign laws and procedures.” 499 U.S., at 256. Like the United States, foreign countries regulate their domestic securities exchanges and securities transactions occurring within their territorial jurisdiction. And the regulation of other countries often differs from ours as to what constitutes fraud, what disclosures must be made, what damages are recoverable, what discovery is available in litigation, what individual actions may be joined in a single suit, what attorney’s fees are recoverable, and many other matters. See, e.g., Brief for United Kingdom of Britain and Northern Ireland as *Amicus Curiae* 16–21. The Commonwealth of Australia, the United Kingdom of Great Britain and Northern Ireland, and the Republic of France have filed *amicus* briefs in this case. So have (separately or jointly) such international and foreign organizations as the International Chamber of Commerce, the Swiss Bankers Association, the Federation of German Industries, the French Business Confederation, the Institute of International Bankers, the European Banking Federation, [and] the Australian Bankers’ Association. . . . They all complain of the interference with foreign securities regulation that application of § 10(b) abroad would produce, and urge the adoption of a clear test that will avoid that consequence. The transactional test we have adopted — whether the purchase or sale is made in the United States, or involves a security listed on a domestic exchange — meets that requirement.

B

The Solicitor General suggests a different test, which petitioners also endorse: “[A] transnational securities fraud violates [§] 10(b) when the fraud involves significant conduct in the United States that is material to the fraud’s success.” Brief for United States as *Amicus Curiae* 16; see Brief for Petitioners 26. Neither the Solicitor General nor petitioners provide any textual support for this test. The Solicitor General sets forth a number of purposes such a test would serve: achieving a high standard of business ethics in the securities industry, ensuring honest securities markets and thereby promoting investor confidence, and preventing the United States from becoming a “Barbary Coast” for malefactors perpetrating frauds in foreign markets. But it provides no textual support for the last of these purposes, or for the first two as applied to the foreign securities industry and securities markets abroad. It is our function to give the statute the effect its language suggests, however modest that may be; not to extend it to admirable purposes it might be used to achieve.

If, moreover, one is to be attracted by the desirable consequences of the “significant and material conduct” test, one should also be repulsed by its adverse consequences. While there is no reason to believe that the United States has become the Barbary Coast for those perpetrating frauds on foreign securities markets, some fear that it has become the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets. See . . . European Aeronautic Defence & Space Co. N.V. et al. as *Amici Curiae* 2–4; Brief for Securities Industry and Financial Markets Association et al. as *Amici Curiae* 10–16. . . .

As case support for the “significant and material conduct” test, the Solicitor

General relies primarily on *Pasquantino v. United States*, 544 U.S. 349 (2005). In that case we concluded that the wire-fraud statute, 18 U.S.C. § 1343 (2009 ed., Supp. II), was violated by defendants who ordered liquor over the phone from a store in Maryland with the intent to smuggle it into Canada and deprive the Canadian Government of revenue. Section 1343 prohibits “any scheme or artifice to defraud,” — fraud *simpliciter*, without any requirement that it be “in connection with” any particular transaction or event. The *Pasquantino* Court said that the petitioners’ “offense was complete the moment they executed the scheme inside the United States,” and that it was “[t]his domestic element of petitioners’ conduct [that] the Government is punishing.” 544 U.S., at 371. Section 10(b), by contrast, punishes not all acts of deception, but only such acts “in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered.” Not deception alone, but deception with respect to certain purchases or sales is necessary for a violation of the statute.

The Solicitor General points out that the “significant and material conduct” test is in accord with prevailing notions of international comity. If so, that proves that *if* the United States asserted prescriptive jurisdiction pursuant to the “significant and material conduct” test it would not violate customary international law; but it in no way tends to prove that that is what Congress has done.

Finally, the Solicitor General argues that the Commission has adopted an interpretation similar to the “significant and material conduct” test, and that we should defer to that. In the two adjudications the Solicitor General cites, however, the Commission did not purport to be providing its own interpretation of the statute, but relied on decisions of federal courts — mainly Court of Appeals decisions that in turn relied on the *Schoenbaum* and *Leasco* decisions of the Second Circuit that we discussed earlier. . . . We need “accept only those agency interpretations that are reasonable in light of the principles of construction courts normally employ.” . . . Since the Commission’s interpretations relied on cases we disapprove, which ignored or discarded the presumption against extraterritoriality, we owe them no deference.

. . . .

Section 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States. This case involves no securities listed on a domestic exchange, and all aspects of the purchases complained of by those petitioners who still have live claims occurred outside the United States. Petitioners have therefore failed to state a claim on which relief can be granted. We affirm the dismissal of petitioners’ complaint on this ground.

It is so ordered.

JUSTICE BREYER, concurring in part and concurring in the judgment.

Section 10(b) of the Securities Exchange Act of 1934 applies to fraud “in connection with” two categories of transactions: (1) “the purchase or sale of any security registered on a national securities exchange” or (2) “the purchase or sale

of . . . any security not so registered.” 15 U.S.C. § 78j(b). In this case, the purchased securities are listed only on a few foreign exchanges, none of which has registered with the Securities and Exchange Commission as a “national securities exchange.” The first category therefore does not apply. Further, the relevant purchases of these unregistered securities took place entirely in Australia and involved only Australian investors. And in accordance with the presumption against extraterritoriality, I do not read the second category to include such transactions. Thus, while state law or other federal fraud statutes, see, *e.g.*, 18 U.S.C. § 1341 (mail fraud), § 1343 (wire fraud), may apply to the fraudulent activity alleged here to have occurred in the United States, I believe that § 10(b) does not. This case does not require us to consider other circumstances.

To the extent the Court’s opinion is consistent with these views, I join it.

JUSTICE STEVENS, with whom JUSTICE GINSBURG joins, concurring in the judgment.

While I agree that petitioners have failed to state a claim on which relief can be granted, my reasoning differs from the Court’s. I would adhere to the general approach that has been the law in the Second Circuit, and most of the rest of the country, for nearly four decades.

I

Today the Court announces a new “transactional test,” for defining the reach of § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. . . . Henceforth, those provisions will extend only to “transactions in securities listed on domestic exchanges . . . and domestic transactions in other securities”. . . . If one confines one’s gaze to the statutory text, the Court’s conclusion is a plausible one. But the federal courts have been construing § 10(b) in a different manner for a long time, and the Court’s textual analysis is not nearly so compelling, in my view, as to warrant the abandonment of their doctrine.

The text and history of § 10(b) are famously opaque on the question of when, exactly, transnational securities frauds fall within the statute’s compass. As those types of frauds became more common in the latter half of the 20th century, the federal courts were increasingly called upon to wrestle with that question. The Court of Appeals for the Second Circuit, located in the Nation’s financial center, led the effort. Beginning in earnest with *Schoenbaum v. Firstbrook*, 405 F.2d 200, rev’d on rehearing on other grounds, 405 F.2d 215 (1968) (en banc), that court strove, over an extended series of cases, to “discern” under what circumstances “Congress would have wished the precious resources of the United States courts and law enforcement agencies to be devoted to [transnational] transactions,” 547 F.3d 167, 170 (2008) (internal quotation marks omitted). Relying on opinions by Judge Henry Friendly, the Second Circuit eventually settled on a conduct-and-effects test. This test asks “(1) whether the wrongful conduct occurred in the United States, and (2) whether the wrongful conduct had a substantial effect in the United States or upon United States citizens.” *Id.*, at 171. Numerous cases flesh out the proper application of each prong.

The Second Circuit’s test became the “north star” of § 10(b) jurisprudence, not

just regionally but nationally as well. With minor variations, other courts converged on the same basic approach. See Brief for United States as *Amicus Curiae* 15 (“The courts have uniformly agreed that Section 10(b) can apply to a transnational securities fraud either when fraudulent conduct has effects in the United States or when sufficient conduct relevant to the fraud occurs in the United States”); see also 1 Restatement (Third) of Foreign Relations Law of the United States § 416 (1986) (setting forth conduct-and-effects test). Neither Congress nor the Securities Exchange Commission (Commission) acted to change the law. To the contrary, the Commission largely adopted the Second Circuit’s position in its own adjudications.

In light of this history, the Court’s critique of the decision below for applying “judge-made rules” is quite misplaced. This entire area of law is replete with judge-made rules, which give concrete meaning to Congress’ general commands. . . .²³

The development of § 10(b) law was hardly an instance of judicial usurpation. Congress invited an expansive role for judicial elaboration when it crafted such an open-ended statute in 1934. And both Congress and the Commission subsequently affirmed that role when they left intact the relevant statutory and regulatory language, respectively, throughout all the years that followed. . . .

. . . .

Thus, while the Court devotes a considerable amount of attention to the development of the case law, it draws the wrong conclusions. The Second Circuit refined its test over several decades and dozens of cases, with the tacit approval of Congress and the Commission and with the general assent of its sister Circuits. That history is a reason we should give additional weight to the Second Circuit’s “judge-made” doctrine, not a reason to denigrate it. “The longstanding acceptance by the courts, coupled with Congress’ failure to reject [its] reasonable interpretation of the wording of § 10(b), . . . argues significantly in favor of acceptance of the [Second Circuit] rule by this Court.” *Blue Chip*, 421 U.S., at 733.

II

The Court’s other main critique of the Second Circuit’s approach — apart from what the Court views as its excessive reliance on functional considerations and reconstructed congressional intent — is that the Second Circuit has “disregard[ed]” the presumption against extraterritoriality. It is the Court, however, that misapplies the presumption, in two main respects.

First, the Court seeks to transform the presumption from a flexible rule of thumb into something more like a clear statement rule. . . .

Yet even *Aramco* [499 U.S. 244 (1991)] — surely the most extreme application of

²³ [3] It is true that “when it comes to ‘the scope of [the] conduct prohibited by [Rule 10b-5 and] § 10(b), the text of the statute [has] control[led] our decision[s].’” . . . [See] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994) . . .] The problem, when it comes to transnational securities frauds, is that the text of the statute does not provide a great deal of control. As with any broadly phrased, longstanding statute, courts have had to fill in the gaps.

the presumption against extraterritoriality in my time on the Court²⁴ — contained numerous passages suggesting that the presumption may be overcome without a clear directive. . . . And our cases both before and after *Aramco* make perfectly clear that the Court continues to give effect to “*all available evidence* about the meaning” of a provision when considering its extraterritorial application, lest we defy Congress’ will. . . . Contrary to Justice Scalia’s personal view of statutory interpretation, that evidence legitimately encompasses more than the enacted text. Hence, while the Court’s dictum that “[w]hen a statute gives no clear indication of an extraterritorial application, it has none,” makes for a nice catchphrase, the point is overstated. The presumption against extraterritoriality can be useful as a theory of congressional purpose, a tool for managing international conflict, a background norm, a tiebreaker. It does not relieve courts of their duty to give statutes the most faithful reading possible.

Second, and more fundamentally, the Court errs in suggesting that the presumption against extraterritoriality is fatal to the Second Circuit’s test. For even if the presumption really were a clear statement (or “clear indication,”) rule, it would have only marginal relevance to this case.

. . . [T]he presumption against extraterritoriality “provides a sound basis for concluding that Section 10(b) does not apply when a securities fraud with no effects in the United States is hatched and executed entirely outside this country.” Brief for United States as *Amicus Curiae* 22. But that is just about all it provides a sound basis for concluding. And the conclusion is not very illuminating, because no party to the litigation disputes it. No one contends that § 10(b) applies to wholly foreign frauds.

Rather, the real question in this case is how much, and what kinds of, *domestic* contacts are sufficient to trigger application of § 10(b). In developing its conduct-and-effects test, the Second Circuit endeavored to derive a solution from the Exchange Act’s text, structure, history, and purpose. Judge Friendly and his colleagues were well aware that United States courts “cannot and should not expend [their] resources resolving cases that do not affect Americans or involve fraud emanating from America.” 547 F.3d at 175. . . .

The question just stated does not admit of an easy answer. The text of the Exchange Act indicates that § 10(b) extends to at least some activities with an international component, but again, it is not pellucid as to which ones. The Second Circuit draws the line as follows: § 10(b) extends to transnational frauds “only when substantial acts in furtherance of the fraud were committed within the United States,” *SEC v. Berger*, 322 F.3d 187, 193 (C.A.2 2003), or when the fraud was “‘intended to produce’” and did produce “‘detrimental effects within’” the United States, *Schoenbaum*, 405 F.2d, at 206.

This approach is consistent with the understanding shared by most scholars that Congress, in passing the Exchange Act, “expected U.S. securities laws to apply to certain international transactions or conduct.” Buxbaum, *Multinational Class Actions Under Federal Securities Law: Managing Jurisdictional Conflict*, 46 Colum.

²⁴ [6] And also one of the most short lived. See Civil Rights Act of 1991, § 109, 105 Stat. 1077 (repudiating *Aramco*).

J. Transnat'l L. 14, 19 (2007). . . . It is also consistent with the traditional understanding, regnant in the 1930's as it is now, that the presumption against extraterritoriality does not apply "when the conduct [at issue] occurs within the United States," and has lesser force when "the failure to extend the scope of the statute to a foreign setting will result in adverse effects within the United States". . . . And it strikes a reasonable balance between the goals of "preventing the export of fraud from America," protecting shareholders, enhancing investor confidence, and deterring corporate misconduct, on the one hand, and conserving United States resources and limiting conflict with foreign law, on the other. . . .

Thus, while § 10(b) may not give any "clear indication" on its face as to how it should apply to transnational securities frauds, it does give strong clues that it should cover at least some of them. . . . And in my view, the Second Circuit has done the best job of discerning what sorts of transnational frauds Congress meant in 1934 — and still means today — to regulate. I do not take issue with the Court for beginning its inquiry with the statutory text, rather than the doctrine in the Courts of Appeals. I take issue with the Court for beginning *and ending* its inquiry with the statutory text, when the text does not speak with geographic precision, and for dismissing the long pedigree of, and the persuasive account of congressional intent embodied in, the Second Circuit's rule.

Repudiating the Second Circuit's approach in its entirety, the Court establishes a novel rule that will foreclose private parties from bringing § 10(b) actions whenever the relevant securities were purchased or sold abroad and are not listed on a domestic exchange. . . . And while the clarity and simplicity of the Court's test may have some salutary consequences, like all bright-line rules it also has drawbacks.

Imagine, for example, an American investor who buys shares in a company listed only on an overseas exchange. That company has a major American subsidiary with executives based in New York City; and it was in New York City that the executives masterminded and implemented a massive deception which artificially inflated the stock price — and which will, upon its disclosure, cause the price to plummet. Or, imagine that those same executives go knocking on doors in Manhattan and convince an unsophisticated retiree, on the basis of material misrepresentations, to invest her life savings in the company's doomed securities. Both of these investors would, under the Court's new test, be barred from seeking relief under § 10(b).

The oddity of that result should give pause. For in walling off such individuals from § 10(b), the Court narrows the provision's reach to a degree that would surprise and alarm generations of American investors — and, I am convinced, the Congress that passed the Exchange Act. Indeed, the Court's rule turns § 10(b) jurisprudence (and the presumption against extraterritoriality) on its head, by withdrawing the statute's application from cases in which there is *both* substantial wrongful conduct that occurred in the United States *and* a substantial injurious effect on United States markets and citizens.

III

In my judgment, if petitioners' allegations of fraudulent misconduct that took place in Florida are true, then respondents may have violated § 10(b), and could potentially be held accountable in an enforcement proceeding brought by the Commission. But it does not follow that shareholders who have failed to allege that the bulk or the heart of the fraud occurred in the United States, or that the fraud had an adverse impact on American investors or markets, may maintain a private action to recover damages they suffered abroad. Some cases involving foreign securities transactions have extensive links to, and ramifications for, this country; this case has Australia written all over it. Accordingly, for essentially the reasons stated in the Court of Appeals' opinion, I would affirm its judgment.

The Court instead elects to upend a significant area of securities law based on a plausible, but hardly decisive, construction of the statutory text. In so doing, it pays short shrift to the United States' interest in remedying frauds that transpire on American soil or harm American citizens, as well as to the accumulated wisdom and experience of the lower courts. I happen to agree with the result the Court reaches in this case. But "I respectfully dissent," once again, "from the Court's continuing campaign to render the private cause of action under § 10(b) toothless." *Stoneridge*, 552 U.S., at 175 (Stevens, J., dissenting).

SEC EXTRATERRITORIAL JURISDICTION

Recognizing the devastating impact that the Supreme Court's decision in *Morrison* would have on government enforcement, in its enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Congress nullified *Morrison's* severe impact in this context. With respect to the extraterritorial reach of the securities laws' antifraud provisions (such as Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act), the pertinent provisions vest federal court jurisdiction in an action brought by the SEC or the Department of Justice that involves

- (1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or
- (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

This formulation basically adopts in the government enforcement setting the “conduct” and the “effect” test that was embraced by the federal appellate courts prior to *Morrison* as well as in the concurring opinion of JUSTICE STEVENS in *Morrison*.

NOTE

After *Morrison*, in private litigation involving alleged violations of Section 10(b), numerous lawsuits have been dismissed that would have survived prior to that Supreme Court decision. See, e.g., *Plumbers Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, 2010 U.S. Dist. LEXIS 105720 (S.D.N.Y. 2010) (although trade orders were electronically placed in United States, case dismissed due to that company’s stock was listed only on the SWX Swiss Exchange); *In re Alstom SA Securities Litigation*, 741 F. Supp. 2d 469 (S.D.N.Y. 2010) (even though defendant’s stock was listed on the New York Stock Exchange, case dismissed because plaintiffs purchased their stock solely on a French stock exchange (the Premier Marche of Euronext Paris)); *Cornwell v. Credit Suisse Group*, 270 F.R.D. 145 (S.D.N.Y. 2010) (dismissing case where investors, although placing their orders from the United States, purchased securities traded on the Swiss Stock Exchange).

Chapter 9

ALTERNATIVE PROVISIONS

§ 9.08 STATE SECURITIES AND COMMON LAW REMEDIES

Page 566: add new case:

HOLMES v. GRUBMAN
Georgia Supreme Court
691 S.E.2d 196 (2010)

CARLEY, PRESIDING JUSTICE.

As of June 1999, Appellants William K. Holmes and four entities controlled by him owned 2.1 million shares in WorldCom, Inc., the major telecommunications company which went bankrupt after the revelation of massive accounting fraud in 2002. In this suit against Appellees Citigroup Global Markets, Inc., f/k/a Salomon Smith Barney & Co., Inc. (SSB), and its financial analyst, Jack Grubman, Appellants allege that, on June 25, 1999, Holmes verbally ordered his broker at SSB to sell all of Appellants' WorldCom stock, which was then being traded at approximately \$92 per share. Appellants further allege that the SSB broker convinced Holmes not to sell, based on recent research reports by Grubman and on his reputation, and that Appellees were operating under a conflict of interest, knowing that WorldCom stock was grossly overvalued, but nevertheless promoting it in order to retain WorldCom's lucrative investment banking business. Instead of selling, Holmes purchased additional shares as the stock price declined. In October 2000, Appellants were forced to sell all of their WorldCom shares in order to meet margin calls, resulting in alleged losses of nearly \$200 million.

Appellants filed for bankruptcy and, in 2003, brought this action for damages under Georgia law in the United States Bankruptcy Court for the Middle District of Georgia. The case was transferred to the United States District Court for the Southern District of New York and consolidated for pre-trial purposes with the multi-district WorldCom Securities Litigation. Appellants' third amended complaint included claims of fraud, negligent misrepresentation, negligence in making disclosures, and breach of fiduciary duty. The district court dismissed that complaint for failure to state a claim upon which relief can be granted. *Holmes v. Grubman (In re WorldCom, Inc. Securities Litigation)*, 456 F. Supp. 2d 508 (S.D.N.Y. 2006). On appeal, the United States Court of Appeals for the Second Circuit certified the following three questions to this court:

- (1) Does Georgia common law recognize fraud claims based on forbearance in the sale of publicly traded securities?

- (2) With respect to a tort claim based on misrepresentations or omissions concerning publicly traded securities, is proximate cause adequately pleaded under Georgia law when a plaintiff alleges that his injury was a reasonably foreseeable result of defendant's false or misleading statements but does not allege that the truth concealed by the defendant entered the market place, thereby precipitating a drop in the price of the security?
- (3) Under Georgia law, does a brokerage firm owe a fiduciary duty to the holder of a non-discretionary account?

Holmes v. Grubman, 568 F.3d 329, 340–341 (2d Cir. 2009).

1. [*Regarding the first question:*] The claims to which the first question refers are often called “holder” claims. Although this Court has never specifically addressed such claims, it is well-settled that one of the elements of the tort of fraud in Georgia is an “intention to induce the plaintiff to act *or refrain from acting*. . . .” This language is consistent with the Restatement (Second) of Torts § 525 (1977) and the general rule that “induced forbearance can be the basis for tort liability.” [See] *Small v. Fritz Cos.*, 30 Cal. 4th 167, 132 Cal. Rptr. 2d 490, 65 P. 3d 1255, 1259 (Cal. 2003).

The public policy underlying the actionability of fraud exists regardless of whether plaintiff is induced to act or refrain from action. Lies which deceive and injure do not become innocent merely because the deceived continue to do something rather than begin to do something else. Inducement is the substance of reliance; the form of reliance — action or inaction — is not critical to the actionability of fraud.

The Supreme Court of the United States has held that only actual purchasers or sellers of securities can make a claim pursuant to Rule 10b-5, promulgated by the Securities and Exchange Commission under § 10(b) of the Securities Exchange Act of 1934. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730–731 (1975). However, that Court also noted that one disadvantage of its holding “is attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law.” Indeed, the Supreme Court recognized that it has “long been established in the ordinary case of deceit that a misrepresentation which leads to a refusal to purchase or to sell is actionable in just the same way as a misrepresentation which leads to the consummation of a purchase or sale.” [*Id.*] at 744. Compare *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 547 U.S. 71, (2006) (Securities Litigation Uniform Standards Act preempts state-law holder class-action claims).

Furthermore, although Appellees “are immune from [Rule] 10b-5 liability, they should not be immunized from common law liability merely because their alleged fraud occurred in the securities market rather than the real estate or used car market.” The Georgia Court of Appeals has acknowledged that “evidence of fraud . . . includ[es] evidence which supported the conclusion that [the plaintiffs] were fraudulently induced into making *and keeping* their investments.” (Emphasis supplied.) *Argentum Intl. v. Woods*, 634 S.E. 2d 195 (2006). Most other states that have confronted this issue have concluded that forbearance from selling stock is

sufficient reliance to support a cause of action. . . .

Appellees offer several policy grounds for barring holder claims, including, as the Second Circuit noted, “(1) incoherent theories of proximate cause and damages, (2) speculative damages, and (3) unprovable claims of a subjective intent to sell.” After reviewing all such policy considerations, we conclude that, although they

may justify placing limitations on a holder’s cause of action, they do not justify a categorical denial of that cause of action. . . . [T]he high court’s decision in *Blue Chip Stamps*, while recognizing policy considerations similar to those defendants advance here, did not view those considerations as justification for a total denial of relief to defrauded holders; it reasoned only that the *federal* courts could deny a forum to wronged stockholders who are not sellers or buyers without unjust consequences because these stockholders retained a remedy in *state* courts. (Emphasis in original).

Small v. Fritz Cos., [65 P. 3d at] 1261. “Persons claiming that, for reasons of policy, they should be immune from liability for intentional fraud bear a very heavy burden of persuasion, one that defendants here have not sustained.” [*Id.*] at 1265.

In many of the decisions on which Appellees rely, holder claims were not categorically rejected, but the plaintiffs failed to allege or prove that they specifically desired to sell their stock at a certain time, or causation was not sufficiently alleged or proved. . . . Similarly, although we have determined that holder claims should be recognized under Georgia law, we further conclude that the limitations imposed in other jurisdictions are appropriate. When acknowledging in *Blue Chip Stamps* the continuing viability of common-law holder claims, “[t]he Supreme Court considered the typical fraud context to be one in which the parties knew each other and the alleged misrepresentations occurred through direct communication.” . . . Indeed, the Supreme Court distinguished the “universe of transactions governed by the 1934 Act, [where] privity of dealing or even personal contact between potential defendant and potential plaintiff is the exception and not the rule.” . . . Accordingly, we conclude that Georgia law permits holder claims

where, as here, plaintiffs allege that misrepresentations were directed at them to their injury. Although the price of allowing cases like [Appellees’] to go forward may be that some such cases will unfairly waste the Court’s time and the defendants’ reputation and money, that is a price the common law has always paid.

. . . .

We further agree with those courts which require specific reliance on the defendants’ representations: for example, that if the plaintiff had read a truthful account of the corporation’s financial status the plaintiff would have sold the stock, how many shares the plaintiff would have sold, and when the sale would have taken place. The plaintiff must allege actions, as distinguished from unspoken and unrecorded thoughts and decisions, that would indicate that the plaintiff actually relied on the misrepresentations.

. . . . Such distinction reinforces the reliance requirement by separating plaintiffs who actually and justifiably relied upon the misrepresenta-

tions from the general investing public, who, though they did not so rely, suffered the loss due to the decline in share value. This distinction also separates common law fraud claims, which must prove actual reliance, from federal securities fraud claims, which may rely upon the fraud-on-the-market theory.

. . . .

Although the Second Circuit's first question was limited to fraud claims, the particular phrasing thereof does not prevent us from reformulating or expanding upon the question. We see no reason why our authorization of common fraud claims based on forbearance in the sale of publicly traded securities, along with the limitations articulated above, should not extend to Appellants' other common-law tort claims. In particular, we note that "(t)he same principles apply to both fraud and negligent misrepresentation cases" and that "the only real distinction between negligent misrepresentation and fraud is the absence of the element of knowledge of the falsity of the information disclosed." . . . Thus, we hold that negligent misrepresentation claims, like fraud claims, can be based on forbearance in the sale of publicly traded securities. The direct communication and specific reliance limitations on fraud claims by "holders" also apply to negligent misrepresentation claims. . . .

2. *Regarding the second question*, we initially recognize that this Court is not authorized to determine what allegations are necessary for a pleading to be adequate in a federal diversity action. "Although state law governs the burden of proving fraud at trial, the procedure for pleading fraud in federal courts in all diversity suits is governed by the special pleading requirements of Federal Rule of Civil Procedure 9(b)." . . . Thus, we will address only the burden placed on a plaintiff at trial to prove proximate cause with respect to a tort claim based on misrepresentations or omissions concerning publicly traded securities.

Appellants contend that Georgia law has incorporated neither the loss causation standard from securities law nor the negligence concept of proximate causation into the intentional tort of fraud. For several decades, however, we have held that, in order to recover in tort for fraud, the plaintiff must prove that he sustained loss or damage as the proximate result of the alleged misrepresentations.

Once again, precedent of the Supreme Court of the United States is informative. *Blue Chips Stamps* involved an aspect of federal securities law which differed from the common law. However, the Supreme Court recently adopted common law causation requirements:

Judicially implied private securities fraud actions resemble in many (but not all) respects common-law deceit and misrepresentation actions. . . . And the common law has long insisted that a plaintiff in such a case show not only that had he known the truth he would not have acted but also that he suffered actual economic loss. . . . Indeed, the Restatement [Second] of Torts, in setting forth the judicial consensus, says that a person who "misrepresents the financial condition of a corporation in order to sell its stock" becomes liable to a relying purchaser "for the loss" the purchaser sustains "when the facts . . . become generally known" and "as a result"

share value “depreciate(s).” § 548A, Comment b, at 107. Treatise writers, too, have emphasized the need to prove proximate causation.

Dura Pharmaceuticals v. Broudo, 544 U.S. 336, 343–344 (2005). We find “nothing in the *Dura* court’s analysis of the common law loss causation requirements that justifies a different standard for plaintiffs’ common law fraud claim under [Georgia] law.” . . . “The reasoning of *Dura* . . . is equally applicable to any securities claim, be it statutory or based in the common law, because any such claim for damages requires a showing of proximate cause.” . . .

In answer to the second question, we conclude that, with respect to a tort claim based on misrepresentations or omissions concerning publicly traded securities, a plaintiff at trial has the burden of proving that the truth concealed by the defendant entered the marketplace, thereby precipitating a drop in the price of the security. Having reviewed the already-extensive precedent regarding the parameters of the loss causation standard in *Dura*, we note that while some courts have held that

the truth could be revealed by the actual materialization of the concealed risk rather than by a public disclosure that the risk exists, any theory of loss causation would still have to identify when the materialization occurred and link it to a corresponding loss.

. . . .

“Even if the truth has made its way into the marketplace, *Dura* requires that a plaintiff show that it was this revelation that caused the loss and not one of the ‘tangle of factors’ that affect price. . . .”

3. [Regarding the third question:] Like a majority of courts, the Georgia Court of Appeals has recognized that a stockbroker and his customer have a fiduciary relationship as principal and agent pursuant to OCGA § 23-2-58:

A stock broker’s duty to account to its customer is fiduciary in nature, so that the broker is obligated to exercise the utmost good faith. “‘Requirements of good faith demand that in the principal’s interest it is the agent’s duty to make known to the principal all material facts which concern the transactions and subject matter of his agency.’”

. . . .

Looking to federal precedent, the Court of Appeals has also determined that a stockbroker has limited fiduciary duties towards a customer who holds a non-discretionary account:

In considering the extent of a broker’s duty to its client, federal cases have drawn a distinction between discretionary and nondiscretionary accounts. In a discretionary account, the broker is authorized to carry out transactions on behalf of its client without prior authorization, while in a nondiscretionary account the broker is only authorized to transact business after receiving authorization from the client. With respect to a nondiscretionary account . . ., the broker owes a number of duties to the client, including the duty to transact business only after receiving prior authorization from the client and the duty not to misrepresent any fact material to

the transaction.

. . . We approve of this analysis. However, we further conclude that the fiduciary duties owed by a broker to a customer with a nondiscretionary account are not restricted to the actual execution of transactions. The broker will generally have a heightened duty, even to the holder of a nondiscretionary account, when recommending an investment which the holder has previously rejected or as to which the broker has a conflict of interest. . . .

Certified questions answered.

Chapter 10

SECONDARY LIABILITY

§ 10.03 DISTINGUISHING PRIMARY FROM SECONDARY CONDUCT

Page 594: add new case:

**JANUS CAPITAL GROUP, INC. v. FIRST
DERIVATIVE TRADERS**
United State Supreme Court
2011 U.S. LEXIS 4380 (Jun 13, 2011)

JUSTICE THOMAS delivered the opinion of the Court.

This case requires us to determine whether Janus Capital Management LLC (JCM), a mutual fund investment adviser, can be held liable in a private action under Securities and Exchange Commission (SEC) Rule 10b-5 for false statements included in its client mutual funds’ prospectuses. Rule 10b-5 prohibits “mak[ing] any untrue statement of a material fact” in connection with the purchase or sale of securities. We conclude that JCM cannot be held liable because it did not make the statements in the prospectuses.

I

Janus Capital Group, Inc. (JCG) is a publicly traded company that created the Janus family of mutual funds. These mutual funds are organized in a Massachusetts business trust, the Janus Investment Fund. Janus Investment Fund retained JCG’s wholly owned subsidiary, JCM, to be its investment adviser and administrator. JCG and JCM are the petitioners here.

Although JCG created Janus Investment Fund, Janus Investment Fund is a separate legal entity owned entirely by mutual fund investors. Janus Investment Fund has no assets apart from those owned by the investors. JCM provides Janus Investment Fund with investment advisory services, which include “the management and administrative services necessary for the operation of [Janus] Fun[d],” but the two entities maintain legal independence. At all times relevant to this case, all of the officers of Janus Investment Fund were also officers of JCM, but only one member of Janus Investment Fund’s board of trustees was associated with JCM. This is more independence than is required: By statute, up to 60 percent of the board of a mutual fund may be composed of “interested persons.”

. . .

As the securities laws require, Janus Investment Fund issued prospectuses describing the investment strategy and operations of its mutual funds to investors.

The prospectuses for several funds represented that the funds were not suitable for market timing and can be read to suggest that JCM would implement policies to curb the practice.²⁵ For example, the Janus Mercury Fund prospectus dated February 25, 2002, stated that the fund was “not intended for market timing or excessive trading” and represented that it “may reject any purchase request . . . if it believes that any combination of trading activity is attributable to market timing or is otherwise excessive or potentially disruptive to the Fund.” Although market timing is legal, it harms other investors in the mutual fund.

In September 2003, the Attorney General of the State of New York filed a complaint against JCG and JCM alleging that JCG entered into secret arrangements to permit market timing in several funds run by JCM. After the complaint’s allegations became public, investors withdrew significant amounts of money from the Janus Investment Fund mutual funds.²⁶ Because Janus Investment Fund compensated JCM based on the total value of the funds and JCM’s management fees comprised a significant percentage of JCG’s income, Janus Investment Fund’s loss of value affected JCG’s value as well. JCG’s stock price fell nearly 25 percent, from \$17.68 on September 2 to \$13.50 on September 26.

Respondent First Derivative Traders (First Derivative) represents a class of plaintiffs who owned JCG stock as of September 3, 2003. Its complaint asserts claims against JCG and JCM for violations of Rule 10b-5 and § 10(b) of the Securities Exchange Act of 1934. . . . First Derivative alleges that JCG and JCM “caused mutual fund prospectuses to be issued for Janus mutual funds and made them available to the investing public, which created the misleading impression that [JCG and JCM] would implement measures to curb market timing in the Janus [mutual funds].” [As alleged:] “Had the truth been known, Janus [mutual funds] would have been less attractive to investors, and consequently, [JCG] would have realized lower revenues, so [JCG’s] stock would have traded at lower prices.” . . .

First Derivative contends that JCG and JCM “materially misled the investing public” and that class members relied “upon the integrity of the market price of [JCG] securities and market information relating to [JCG and JCM].” The complaint also alleges that JCG should be held liable for the acts of JCM as a

²⁵ [1] Market timing is a trading strategy that exploits time delay in mutual funds’ daily valuation system. The price for buying or selling shares of a mutual fund is ordinarily determined by the next net asset value (NAV) calculation after the order is placed. The NAV calculation usually happens once a day, at the close of the major U.S. markets. Because of certain time delays, however, the values used in these calculations do not always accurately reflect the true value of the underlying assets. For example, a fund may value its foreign securities based on the price at the close of the foreign market, which may have occurred several hours before the calculation. But events might have taken place after the close of the foreign market that could be expected to affect their price. If the event were expected to increase the price of the foreign securities, a market-timing investor could buy shares of a mutual fund at the artificially low NAV and sell the next day when the NAV corrects itself upward. See Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 68 Fed. Reg. 70402 (proposed Dec. 17, 2003).

²⁶ [2] In 2004, JCG and JCM settled these allegations and agreed to reduce their fees by \$125 million and pay \$50 million in civil penalties and \$50 million in disgorgement to the mutual fund investors.

§ 10.03 DISTINGUISHING PRIMARY FROM SECONDARY CONDUCT 85

“controlling person” under 15 U.S.C.A. § 78t(a) (§ 20(a) of the [Securities Exchange] Act).

The District Court dismissed the complaint for failure to state a claim. The Court of Appeals for the Fourth Circuit reversed, holding that First Derivative had sufficiently alleged that “JCG and JCM, by participating in the writing and dissemination of the prospectuses, made the misleading statements contained in the documents.” *In re Mutual Funds Inv. Litigation*, 566 F.3d 111, 121 (2009) (emphasis in original). With respect to the element of reliance, the court found that investors would infer that JCM “played a role in preparing or approving the content of the Janus fund prospectuses,” but that investors would not infer the same about JCG, which could be liable only as a “control person” of JCM under § 20(a). . . .

II

We granted certiorari to address whether JCM can be held liable in a private action under Rule 10b-5 for false statements included in Janus Investment Fund’s prospectuses. Under Rule 10b-5, it is unlawful for “any person, directly or indirectly, . . . [t]o make any untrue statement of a material fact” in connection with the purchase or sale of securities. To be liable, therefore, JCM must have “made” the material misstatements in the prospectuses. We hold that it did not.

A

The SEC promulgated Rule 10b-5 pursuant to authority granted under § 10(b) of the Securities Exchange Act of 1934. . . . Although neither Rule 10b-5 nor § 10(b) expressly creates a private right of action, this Court has held that “a private right of action is implied under § 10(b).” . . . That holding “remains the law” . . . but “[c]oncerns with the judicial creation of a private cause of action caution against its expansion” Thus, in analyzing whether JCM “made” the statements for purposes of Rule 10b-5, we are mindful that we must give “narrow dimensions . . . to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.” . . .

1

One “makes” a statement by stating it. When “make” is paired with a noun expressing the action of a verb, the resulting phrase is “approximately equivalent in sense” to that verb. . . . For instance, “to make a proclamation” is the approximate equivalent of “to proclaim,” and “to make a promise” approximates “to promise.” . . . The phrase at issue in Rule 10b-5, “[t]o make any . . . statement,” is thus the approximate equivalent of “to state.”

For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not “make” a statement in its own right. One who prepares or publishes a statement on behalf of another is not its maker. And in the ordinary

case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by — and only by — the party to whom it is attributed. This rule might best be exemplified by the relationship between a speechwriter and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit — or blame — for what is ultimately said.

This rule follows from *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N. A.*, 511 U. S. 164 (1994), in which we held that Rule 10b-5's private right of action does not include suits against aiders and abettors. Such suits — against entities that contribute “substantial assistance” to the making of a statement but do not actually make it — may be brought by the SEC, but not by private parties. A broader reading of “make,” including persons or entities without ultimate control over the content of a statement, would substantially undermine *Central Bank*. If persons or entities without control over the content of a statement could be considered primary violators who “made” the statement, then aiders and abettors would be almost nonexistent.²⁷

This interpretation is further supported by our recent decision in *Stoneridge*. There, investors sued “entities who, acting both as customers and suppliers, agreed to arrangements that allowed the investors' company to mislead its auditor and issue a misleading financial statement.” 552 U.S., at 152–153. We held that dismissal of the complaint was proper because the public could not have relied on the entities' undisclosed deceptive acts. Significantly, in reaching that conclusion we emphasized that “nothing [the defendants] did made it necessary or inevitable for [the company] to record the transactions as it did.”²⁸ This emphasis suggests the rule we adopt today: that the maker of a statement is the entity with authority over the content of the statement and whether and how to communicate it. Without such authority, it is not “necessary or inevitable” that any falsehood will be contained in the statement.

Our holding also accords with the narrow scope that we must give the implied private right of action. Although the existence of the private right is now settled, we will not expand liability beyond the person or entity that ultimately has authority over a false statement.

²⁷ [6] The dissent correctly notes that *Central Bank* involved secondary, not primary, liability. . . . But for *Central Bank* to have any meaning, there must be some distinction between those who are primarily liable (and thus may be pursued in private suits) and those who are secondarily liable (and thus may not be pursued in private suits).

We draw a clean line between the two — the maker is the person or entity with ultimate authority over a statement and others are not. In contrast, the dissent's only limit on primary liability is not much of a limit at all. It would allow for primary liability whenever “[t]he specific relationships alleged . . . warrant [that] conclusion” — whatever that may mean. . . .

²⁸ [7] We agree that “no one in *Stoneridge* contended that the equipment suppliers were, in fact, the makers of the cable company's misstatements.” If *Stoneridge* had addressed whether the equipment suppliers were “makers,” today's decision would be unnecessary. The point is that *Stoneridge*'s analysis suggests that they were not.

The Government contends that “make” should be defined as “create.” Brief for United States as *Amicus Curiae* 14–15 (citing Webster’s New International Dictionary 1485 (2d ed. 1958) (defining “make” as “[t]o cause to exist, appear, or occur”). This definition, although perhaps appropriate when “make” is directed at an object unassociated with a verb (*e.g.*, “to make a chair”), fails to capture its meaning when directed at an object expressing the action of a verb.

Adopting the Government’s definition of “make” would also lead to results inconsistent with our precedent. The Government’s definition would permit private plaintiffs to sue a person who “provides the false or misleading information that another person then puts into the statement.” Brief for United States as *Amicus Curiae* 13.²⁹ But in *Stoneridge*, we rejected a private Rule 10b-5 suit against companies involved in deceptive transactions, even when information about those transactions was later incorporated into false public statements. We see no reason to treat participating in the drafting of a false statement differently from engaging in deceptive transactions, when each is merely an undisclosed act preceding the decision of an independent entity to make a public statement.

For its part, First Derivative suggests that the “well recognized and uniquely close relationship between a mutual fund and its investment adviser” should inform our decision. It suggests that an investment adviser should generally be understood to be the “maker” of statements by its client mutual fund, like a playwright whose lines are delivered by an actor. We decline this invitation to disregard the corporate form. Although First Derivative and its *amici* persuasively argue that investment advisers exercise significant influence over their client funds, it is undisputed that the corporate formalities were observed here. JCM and Janus Investment Fund remain legally separate entities, and Janus Investment Fund’s board of trustees was more independent than the statute requires. [See] 15 U. S. C. § 80a-10.³⁰ Any reapportionment of liability in the securities industry in light of the close relationship between investment advisers and mutual funds is properly the responsibility of Congress and not the courts. Moreover, just as with the Government’s theory, First Derivative’s rule would create the broad liability that we rejected in *Stoneridge*.

Congress also has established liability in § 20(a) for “[e]very person who,

²⁹ [8] Because we do not find the meaning of “make” in Rule 10b-5 to be ambiguous, we need not consider the Government’s assertion that we should defer to the SEC’s interpretation of the word elsewhere. Brief for United States as *Amicus Curiae* 13. . . . We note, however, that we have previously expressed skepticism over the degree to which the SEC should receive deference regarding the private right of action. See *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 41, n. 27 (1977) (noting that the SEC’s presumed expertise “is of limited value” when analyzing “whether a cause of action should be implied by judicial interpretation in favor of a particular class of litigants”). This also is not the first time this Court has disagreed with the SEC’s broad view of § 10(b) or Rule 10b-5. See, *e.g.*, *Central Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A.*, 511 U.S. 164, 188–191 (1994); *Dirks v. SEC*, 463 U.S. 646, 666, n. 27 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 207 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 746, n. 10 (1975).

³⁰ [9] Nor does First Derivative contend that any statements made by JCM to Janus Investment Fund were “public statements” for the purposes of *Basic Inc. v. Levinson*, 485 U.S. 224, 227–228 (1988). We do not address whether and in what circumstances statements would qualify as “public.” . . .

directly or indirectly, controls any person liable” for violations of the securities laws. First Derivative’s theory of liability based on a relationship of influence resembles the liability imposed by Congress for control. To adopt First Derivative’s theory would read into Rule 10b-5 a theory of liability similar to — but broader in application than — what Congress has already created expressly elsewhere. We decline to do so.

B

Under this rule, JCM did not “make” any of the statements in the Janus Investment Fund prospectuses; Janus Investment Fund did. Only Janus Investment Fund — not JCM — bears the statutory obligation to file the prospectuses with the SEC. . . . The SEC has recorded that Janus Investment Fund filed the prospectuses. . . . There is no allegation that JCM in fact filed the prospectuses and falsely attributed them to Janus Investment Fund. Nor did anything on the face of the prospectuses indicate that any statements therein came from JCM rather than Janus Investment Fund — a legally independent entity with its own board of trustees.³¹

First Derivative suggests that both JCM and Janus Investment Fund might have “made” the misleading statements within the meaning of Rule 10b-5 because JCM was significantly involved in preparing the prospectuses. But this assistance, subject to the ultimate control of Janus Investment Fund, does not mean that JCM “made” any statements in the prospectuses. Although JCM, like a speechwriter, may have assisted Janus Investment Fund with crafting what Janus Investment Fund said in the prospectuses, JCM itself did not “make” those statements for purposes of Rule 10b-5.³²

* * *

The statements in the Janus Investment Fund prospectuses were made by Janus Investment Fund, not by JCM. Accordingly, First Derivative has not stated a claim against JCM under Rule 10b-5. The judgment of the United States Court of

³¹ [11] First Derivative suggests that “indirectly” in Rule 10b-5 may broaden the meaning of “make.” We disagree. The phrase “directly or indirectly” is set off by itself in Rule 10b-5 and modifies not just “to make,” but also “to employ” and “to engage.” We think the phrase merely clarifies that as long as a statement is made, it does not matter whether the statement was communicated directly or indirectly to the recipient. A different understanding of “indirectly” would, like a broad definition of “make,” threaten to erase the line between primary violators and aiders and abettors established by *Central Bank*.

In this case, we need not define precisely what it means to communicate a “made” statement indirectly because none of the statements in the prospectuses were attributed, explicitly or implicitly, to JCM. Without attribution, there is no indication that Janus Investment Fund was quoting or otherwise repeating a statement originally “made” by JCM. . . . More may be required to find that a person or entity made a statement indirectly, but attribution is necessary.

³² [12] That JCM provided access to Janus Investment Fund’s prospectuses on its Web site is also not a basis for liability. Merely hosting a document on a Web site does not indicate that the hosting entity adopts the document as its own statement or exercises control over its content. . . . In doing so, we do not think JCM made any of the statements in Janus Investment Fund’s prospectuses for purposes of Rule 10b-5 liability, just as we do not think that the SEC “makes” the statements in the many prospectuses available on its Web site.

Appeals for the Fourth Circuit is reversed.

It is so ordered.

JUSTICE BREYER, with whom JUSTICE GINSBURG, JUSTICE SOTOMAYOR, and JUSTICE KAGAN join, dissenting.

This case involves a private Securities and Exchange Commission (SEC) Rule 10-5 action brought by a group of investors against Janus Capital Group, Inc., and Janus Capital Management LLC (Janus Management), a firm that acted as an investment adviser to a family of mutual funds (collectively, the Janus Fund or Fund). The investors claim that Janus Management knowingly made materially false or misleading statements that appeared in prospectuses issued by the Janus Fund. They say that they relied upon those statements, and that they suffered resulting economic harm.

Janus Management and the Janus Fund are closely related. Each of the Fund's officers is a Janus Management employee. Janus Management, acting through those employees (and other of its employees), manages the purchase, sale, redemption, and distribution of the Fund's investments. Janus Management prepares, modifies, and implements the Janus Fund's long-term strategies. And Janus Management, acting through those employees, carries out the Fund's daily activities.

Rule 10b-5 says in relevant part that it is unlawful for “any person, directly or indirectly . . . [t]o make any untrue statement of a material fact” in connection with the purchase or sale of securities. . . . The specific legal question before us is whether Janus Management can be held responsible under the Rule for having “ma[d]e” certain false statements about the Janus Fund's activities. The statements in question appear in the Janus Fund's prospectuses.

The Court holds that only the Janus Fund, not Janus Management, could have “ma[d]e” those statements. The majority points out that the Janus Fund's board of trustees has “ultimate authority” over the content of the statements in a Fund prospectus. And in the majority's view, only “the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it” can “make” a statement within the terms of Rule 10b-5.

In my view, however, the majority has incorrectly interpreted the Rule's word “make.” Neither common English nor this Court's earlier cases limit the scope of that word to those with “ultimate authority” over a statement's content. To the contrary, both language and case law indicate that, depending upon the circumstances, a management company, a board of trustees, individual company officers, or others, separately or together, might “make” statements contained in a firm's prospectus — even if a board of directors has ultimate content-related responsibility. And the circumstances here are such that a court could find that Janus Management made the statements in question.

I

Respondent's complaint sets forth the basic elements of a typical Rule 10b-5 "fraud on the market" claim. It alleges that Janus Management made statements that "created the misleading impression that" it "would implement measures to curb" a trading strategy called "market timing." . . . The complaint adds that Janus Management knew that these "market timing" statements were false; that the statements were material; that the market, in pricing securities (including related securities) relied upon the statements; that as a result, when the truth came out (that Janus Management indeed permitted "market timing" in the Janus Fund), the price of relevant shares fell; and the false statements thereby caused respondent significant economic losses. . . .

The majority finds the complaint fatally flawed, however, because (1) Rule 10b-5 says that no "person" shall "directly or indirectly . . . *make* any untrue statement of a material fact," (2) the statements at issue appeared in the *Janus Fund's* prospectuses, and (3) only "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it" can "make" a false statement.

But where can the majority find legal support for the rule that it enunciates? The English language does not impose upon the word "make" boundaries of the kind the majority finds determinative. Every day, hosts of corporate officials make statements with content that more senior officials or the board of directors have "ultimate authority" to control. So do cabinet officials make statements about matters that the Constitution places within the ultimate authority of the President. So do thousands, perhaps millions, of other employees make statements that, as to content, form, or timing, are subject to the control of another.

Nothing in the English language prevents one from saying that several different individuals, separately or together, "make" a statement that each has a hand in producing. For example, as a matter of English, one can say that a national political party has made a statement even if the only written communication consists of uniform press releases issued in the name of local party branches; one can say that one foreign nation has made a statement even when the officials of a different nation (subject to its influence) speak about the matter; and one can say that the President has made a statement even if his press officer issues a communication, sometimes in the press officer's own name. Practical matters related to context, including control, participation, and relevant audience, help determine who "makes" a statement and to whom that statement may properly be "attributed," — at least as far as ordinary English is concerned.

Neither can the majority find support in any relevant precedent. The majority says that its rule "follows from *Central Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A.*, 511 U. S. 164 (1994)," in which the Court "held that Rule 10b-5's private right of action does not include suits against aiders and abettors." . . . But *Central Bank* concerns a different matter. And it no more requires the majority's rule than free air travel for small children requires free air travel for adults.

Central Bank is a case about *secondary* liability, liability attaching, not to an

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individual making a false statement, but to an individual helping *someone else* do so. *Central Bank* involved a bond issuer accused of having made materially false statements, which overstated the values of property that backed the bonds. *Central Bank* also involved a defendant that was a bank, serving as indenture trustee, which was supposed to check the bond issuer's valuations. The plaintiffs claimed that the bank delayed its valuation checks and thereby *helped* the issuer make its false statements credible. The question before the Court concerned the bank's liability—a *secondary* liability for “aiding and abetting” the bond issuer, who (on the theory set forth) was primarily liable.

The Court made this clear. The question presented was “whether private civil liability under § 10(b) extends . . . to those *who do not engage in the manipulative or deceptive practice*, but who aid and abet the violation.” . . . The Court wrote that “aiding and abetting liability reaches persons *who do not engage in the proscribed activities at all*, but who give a degree of aid to those who do.” . . . The Court described civil law “aiding and abetting” as “know[ing] that *the other's conduct constitutes a breach of duty* and giv[ing] substantial assistance or encouragement to the other” . . . And it reviewed a Court of Appeals decision that had defined the elements of aiding and abetting as “(1) *a primary violation of § 10(b)*; (2) *recklessness by the aider and abettor as to the existence of the primary violation*; and (3) *substantial assistance given to the primary violator by the aider and abettor*.” . . . Faced with this question, the Court answered that § 10(b) and Rule 10b-5 do not provide for this kind of “aiding and abetting” liability in private suits.

By way of contrast, the present case is about *primary* liability—about individuals who allegedly themselves “make” materially false statements, not about those who help *others* to do so. The question is whether Janus Management is *primarily* liable for violating the Act, not whether it simply helped others violate the Act. The *Central Bank* defendant concededly did *not* make the false statements in question (others did), while here the defendants allegedly *did* make those statements. And a rule (the majority's rule) absolving those who allegedly *did* make false statements does not “follow from” a rule (*Central Bank's* rule) absolving those who concededly did *not* do so.

The majority adds that to interpret the word “make” as including those “without ultimate control over the content of a statement” would “substantially undermine” *Central Bank's* holding. Would it? The Court in *Central Bank* specifically wrote that its holding did

not mean that secondary actors in the securities markets are always free from liability under the securities Acts. *Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.* . . .

Thus, as far as *Central Bank* is concerned, depending upon the circumstances, board members, senior firm officials, officials tasked to develop a marketing document, large investors, or others (taken together or separately) all might “make” materially false statements subjecting themselves to primary liability. The

majority's rule does not protect, it *extends*, *Central Bank's* holding of no liability into new territory that *Central Bank* explicitly placed outside that holding. And by ignoring the language in which *Central Bank* did so, the majority's rule itself undermines *Central Bank*. Where is the legal support for the majority's "draw[ing] a clean line" that so seriously conflicts with *Central Bank*? Indeed, where is the legal support for the majority's suggestion that plaintiffs must show some kind of "attribution" of a statement to a defendant, — if it means plaintiffs must show, not only that the defendant "ma[d]e" the statement, but something more?

The majority also refers to *Stoneridge*, but that case offers it no help. In *Stoneridge*, firms that supplied electronic equipment to a cable television company agreed with the cable television company to enter into a series of fraudulent sales and purchases, for example, a sale at an unusually high price, thereby providing funds which the suppliers would use to buy advertising from the cable television company. These arrangements enabled the cable television company to fool its accountants (and ultimately the public) into believing that it had more revenue (for example, advertising revenue) than it really had. As part of the agreement, the companies exchanged letters and backdated contracts to conceal the fraud. Investors subsequently sued the cable television company, some of its officers, its auditors, and the equipment suppliers, as well, claiming that all of them had engaged in a scheme to defraud securities purchasers. In respect to most of the defendants, investors identified allegedly materially false statements contained in the cable television company's financial statements or similar documents. But in respect to the equipment suppliers, investors claimed that the relevant deceptive conduct was in the letters, backdated contracts, and related oral conversations about the scheme. The investors argued that the equipment suppliers, "by participating in the transactions," violated § 10(b) and Rule 10b-5. . . .

The Court held that the equipment suppliers could not be found liable for securities fraud in a private suit under § 10(b). But in doing so, it did not deny that the equipment suppliers *had made* the false statements contained in the letters, contracts, and conversations. Rather, the Court said the issue in the case was whether "any deceptive statement or act respondents made was not actionable because it did not have the requisite *proximate relation* to the investors' harm." . . .

And it held that these deceptive statements or actions could not provide a basis for liability because the investors could not prove sufficient *reliance* upon the particular false statements that the equipment suppliers had made.

The Court pointed out that the equipment suppliers "had no duty to disclose; and their deceptive acts were not communicated to the public." . . . And the Court went on to say that "as a result," the investors "cannot show reliance upon any" of the equipment suppliers' actions, "except in an indirect chain that we find too remote for liability." The Court concluded,

[the equipment suppliers'] deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance. It was [the cable company], not [the equipment suppliers], that misled its auditor and filed fraudulent financial statements; nothing [the equipment suppliers] did made it necessary or inevitable for [the cable company] to record the transactions as it did. . . .

Insofar as the equipment suppliers' conduct was at issue, the fraudulent "arrangement . . . took place in the marketplace for goods and services, not in the investment sphere." . . .

It is difficult for me to see how *Stoneridge* "support[s]" the majority's rule. No one in *Stoneridge* disputed the *making* of the relevant statements, the fraudulent contracts and the like. And no one in *Stoneridge* contended that the equipment suppliers were, in fact, the *makers* of the cable company's misstatements. Rather, *Stoneridge* was concerned with whether the equipment suppliers' *separate* statements were sufficiently disclosed in the securities marketplace so as to be the basis for investor reliance. They were not. But this is a different inquiry than whether statements acknowledged to have been disclosed in the securities marketplace and ripe for reliance can be said to have been "ma[d]e" by one or another actor. How then does *Stoneridge* support the majority's new rule?

The majority adds that its rule is necessary to avoid "a theory of liability similar to — but broader in application than" — § 20(a)'s liability, for "[e]very person who, directly or indirectly, controls any person liable" for violations of the securities laws. . . . But that is not so. This Court has explained that the possibility of an express remedy under the securities laws does not preclude a claim under § 10(b). *Herman & MacLean v. Huddleston*, 459 U. S. 375, 388 (1983).

More importantly, a person who is liable under § 20(a) controls another "*person*" who is "*liable*" for a securities violation. . . . We here examine whether a person is primarily liable whether they do, or they do not, control another person who is *liable*. That is to say, here, the liability of some "other person" is not at issue.

And there is at least one significant category of cases that § 10(b) may address that derivative forms of liability, such as under § 20(a), cannot, namely, cases in which one actor exploits another as an innocent intermediary for its misstatements. Here, it may well be that the Fund's board of trustees knew nothing about the falsity of the prospectuses. . . . And if so, § 20(a) would not apply.

The possibility of guilty management and innocent board is the 13th stroke of the new rule's clock. What is to happen when guilty management writes a prospectus (for the board) containing materially false statements and fools both board and public into believing they are true? Apparently under the majority's rule, in such circumstances *no one* could be found to have "ma[d]e" a materially false statement — even though under the common law the managers would likely have been guilty or liable (in analogous circumstances) for doing so as *principals* (and not as aiders and abettors). . . .

Indeed, under the majority's rule it seems unlikely that the SEC itself in such circumstances could exercise the authority Congress has granted it to pursue primary violators who "make" false statements or the authority that Congress has specifically provided to prosecute aiders and abettors to securities violations. . . . That is because the managers, not having "ma[d]e" the statement, would not be liable as principals and there would be no other primary violator they might have tried to "aid" or "abet." [See] *SEC v. DiBella*, 587 F.3d 553, 566 (CA2 2009) (prosecution for aiding and abetting requires primary violation to which offender gave "substantial assistance" (internal quotation marks omitted)).

If the majority believes, as its footnote hints, that § 20(b) could provide a basis for liability in this case, then it should remand the case for possible amendment of the complaint. “There is a dearth of authority construing Section 20(b),” which has been thought largely “superfluous in 10b-5 cases.” . . . Hence respondent, who reasonably thought that it referred to the proper securities law provision, is faultless for failing to mention § 20(b) as well.

In sum, I can find nothing in § 10(b) or in Rule 10b-5, its language, its history, or in precedent suggesting that Congress, in enacting the securities laws, intended a loophole of the kind that the majority’s rule may well create.

II

Rejecting the majority’s rule, of course, does not decide the question before us. We must still determine whether, in light of the complaint’s allegations, Janus Management could have “ma[d]e” the false statements in the prospectuses at issue. In my view, the answer to this question is “Yes.” The specific relationships alleged among Janus Management, the Janus Fund, and the prospectus statements warrant the conclusion that Janus Management did “make” those statements.

In part, my conclusion reflects the fact that this Court and lower courts have made clear that at least *sometimes* corporate officials and others can be held liable under Rule 10b-5 for having “ma[d]e” a materially false statement even when that statement appears in a document (or is made by a third person) that the officials do not legally control. In *Herman & MacLean*, for example, this Court pointed out that “certain individuals who play a part in preparing the registration statement,” including corporate officers, lawyers, and accountants, may be primarily liable even where “they are not named as having prepared or certified” the registration statement. . . . And as I have already pointed out, this Court wrote in *Central Bank* that a “lawyer, accountant, or bank, who . . . makes a material misstatement (or omission) on which a purchaser or seller of securities relies *may be liable as a primary violator under 10b-5*, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.” . . .

Given the statements in our opinions, it is not surprising that lower courts have found primary liability for actors without “ultimate authority” over issued statements. One court, for example, concluded that an accountant could be primarily liable for having “ma[d]e” false statements, where he issued fraudulent opinion and certification letters reproduced in prospectuses, annual reports, and other corporate materials for which he was not ultimately responsible. *Anixter v. Home-Stake Production Co.*, 77 F.3d 1215, 1225–1227 (CA10 1996). In a later case postdating *Stoneridge*, that court reaffirmed that an outside consultant could be primarily liable for having “ma[d]e” false statements, where he drafted fraudulent quarterly and annual filing statements later reviewed and certified by the firm’s auditor, officers, and counsel. *SEC v. Wolfson*, 539 F.3d 1249, 1261 (CA10 2008). And another court found that a corporation’s chief financial officer could be held primarily liable as having “ma[d]e” misstatements that appeared in a form 10-K that she prepared but did not sign or file. *McConville v. SEC*, 465 F.3d 780, 787 (CA7 2006).

One can also easily find lower court cases explaining that corporate officials may

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be liable for having “ma[d]e” false statements where those officials use innocent persons as conduits through which the false statements reach the public (without necessarily attributing the false statements to the officials). See, e.g., *In re Navarre Corp. Securities Litigation*, 299 F.3d 735, 743 (CA8 2002) (liability may be premised on use of analysts as a conduit to communicate false statements to market); *In re Cabletron Systems, Inc.*, 311 F.3d 11, 38 (CA1 2002) (rejecting a test requiring legal “control” over third parties making statements as giving “company officials too much leeway to commit fraud on the market by using analysts as their mouthpieces”). . . .

My conclusion also reflects the particular circumstances that the complaint alleges. The complaint states that “Janus Management, as investment advisor to the funds, is responsible for the day-to-day management of its investment portfolio and other business affairs of the funds. Janus Management furnishes advice and recommendations concerning the funds’ investments, as well as administrative, compliance and accounting services for the funds.” Each of the Fund’s 17 officers was a vice president of Janus Management. The Fund has “no assets separate and apart from those they hold for shareholders.” . . . Janus Management disseminated the fund prospectuses through its parent company’s Web site. Janus Management employees drafted and reviewed the Fund prospectuses, including language about “market timing.” . . . And Janus Management may well have kept the trustees in the dark about the true “market timing” facts. . . .

Given these circumstances, as long as some managers, sometimes, can be held to have “ma[d]e” a materially false statement, Janus Management can be held to have done so on the facts alleged here. The relationship between Janus Management and the Fund could hardly have been closer. Janus Management’s involvement in preparing and writing the relevant statements could hardly have been greater. And there is a serious suggestion that the board itself knew little or nothing about the falsity of what was said. Unless we adopt a formal rule (as the majority here has done) that would arbitrarily exclude from the scope of the word “make” those who manage a firm — even when those managers perpetrate a fraud through an unknowing intermediary — the management company at issue here falls within that scope. We should hold the allegations in the complaint in this respect legally sufficient.

With respect, I dissent.

Chapter 11

ISSUER AFFIRMATIVE DISCLOSURE OBLIGATIONS

§ 11.01 OVERVIEW

Page 607: add:

A more recent decision agrees with the First Circuit's approach. *J&R Marketing, SEP v. General Motors Corp.*, 549 F.3d 384, 396-397 (6th Cir. 2008):

Plaintiffs urge us to impose upon issuers the same duty faced by those who engage in insider trading. When an insider trades in his company's stock, he has a duty to disclose any nonpublic, material information he knows about the company before trading. *See Chiarella v. United States*, 445 U.S. 222 (1980). Plaintiffs claim that we are faced with a similar scenario, where a "person," in this case GMAC, has far superior knowledge and is taking advantage of an uninformed investor.

We reject plaintiffs' invitation to create such a duty on issuers for three reasons. First, the law makes clear what is required. Section 11 and Section 12 impose liability only on those who mislead or misstate in the statements they choose to make. The only duty to speak absent pure silence comes from Section 11 which imposes liability for an issuer's failure to include information "required to be stated" in its registration statement. Plaintiffs have failed to point us to any regulation or statute requiring GMAC to include all nonpublic, material information in its registration statement.

Second, plaintiffs' only case regarding insider trading duties applying to issuers does not hold what plaintiffs request we hold. *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194 (1st Cir. 1996) did say that it was "helpful to conceptualize . . . the corporate issuer[] as an individual insider transacting in the company's securities, and to examine the disclosure obligations that would then arise." 82 F.3d at 1203. Despite such helpfulness, however, the First Circuit went on to do what we have done above: look to the statutes and regulations detailing what must be included in a registration statement and determine whether the information plaintiffs claim should have been included falls under those rules. *See id.* at 1207 ("We ask, then, whether there was a duty to disclose such information in the registration statement and prospectus under the rubric of 'material changes' under Item 11(a) of Form S-3.").

Third, we have previously rejected such a wide-ranging duty. We have said, "[t]here is no general duty on the part of a company to provided the public with all material information." *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 669 (6th Cir. 2005) (quoting *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1432 (3d Cir. 1997)). Indeed, there needs to be "healthy limits" on the duty to disclose. Those

“healthy limits” are determined by Congress and the SEC. We are not authorized to impose a wide-ranging duty to disclose anything that a person can allege was nonpublic, material information. Pursuant to the above analysis, therefore, plaintiffs have no remaining claims for material omissions.

Chapter 12

INSIDER TRADING

§ 12.06 THE “MISAPPROPRIATION” THEORY

Page 690: add:

SECURITIES AND EXCHANGE COMMISSION v. CUBAN

United States Court of Appeals, Fifth Circuit
620 F.3d 551 (2010)

HIGGINBOTHAM, CIRCUIT JUDGE:

This case raises questions of the scope of liability under the misappropriation theory of insider trading. Taking a different view from our able district court brother of the allegations of the complaint, we are persuaded that the case should not have been dismissed . . . and must proceed to discovery.

Mark Cuban is a well known entrepreneur and current owner of the Dallas Mavericks and Landmark theaters, among other businesses. The SEC brought this suit against Cuban alleging he violated [the federal securities laws] by trading in Mamma.com stock in breach of his duty to the CEO and Mamma.com — amounting to insider trading under the misappropriation theory of liability. The core allegation is that Cuban received confidential information from the CEO of Mamma.com, a Canadian search engine company in which Cuban was a large minority stakeholder, agreed to keep the information confidential, and acknowledged he could not trade on the information. The SEC alleges that, armed with the inside information regarding a private investment of public equity (PIPE) offering, Cuban sold his stake in the company in an effort to avoid losses from the inevitable fall in Mamma.com’s share price when the offering was announced.

Cuban moved to dismiss the action. The district court found that, at most, the complaint alleged an agreement to keep the information confidential, but did not include an agreement not to trade. Finding a simple confidentiality agreement to be insufficient to create a duty to disclose or abstain from trading under the securities laws, the court granted Cuban’s motion to dismiss. The SEC appeals, arguing that a confidentiality agreement creates a duty to disclose or abstain and that, regardless, the confidentiality agreement alleged in the complaint also contained an agreement not to trade on the information and that agreement would create such a duty.

. . . .

The SEC alleges that Cuban’s trading constituted insider trading The Supreme Court has interpreted section 10(b) [of the Securities Exchange Act] to prohibit insider trading under two complementary theories, the “classical theory” and the “misappropriation theory.”

The classical theory of insider trading prohibits a “corporate insider” from trading on material nonpublic information obtained from his position within the corporation without disclosing the information. According to this theory, there exists “a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.” Trading on such confidential information qualifies as a “deceptive device” under section 10(b) because by using that information for his own personal benefit, the corporate insider breaches his duty to the shareholders. The corporate insider is under a duty to “disclose or abstain” — he must tell the shareholders of his knowledge and intention to trade or abstain from trading altogether.

There are at least two important variations of the classical theory of insider trading. The first is that even an individual who does not qualify as a traditional insider may become a “temporary insider” if by entering “into a special confidential relationship in the conduct of the business of the enterprise [he/she is] given access to information solely for corporate purposes.” Thus underwriters, accountants, lawyers, or consultants are all considered corporate insiders when by virtue of their professional relationship with the corporation they are given access to confidential information. The second variation is that an individual who receives information from a corporate insider may be, but is not always, prohibited from trading on that information as a tippee. “[T]he tippee’s duty to disclose or abstain is derivative from that of the insider’s duty” and the tippee’s obligation arises “from his role as a participant after the fact in the insider’s breach of a fiduciary duty.” Crucially, “a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know there has been a breach.” The insider breaches his fiduciary duty when he receives a “direct or indirect personal benefit from the disclosure.”

Both the temporary-insider and tippee twists on the classical theory retain its core principle that the duty to disclose or abstain is derived from the corporate insider’s duty to his shareholders. The misappropriation theory does not rest on this duty. It rather holds that a person violates section 10(b) “when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.” The Supreme Court first adopted this theory in *United States v. O’Hagan*. There, a lawyer traded the securities of a company his client was targeting for a takeover. O’Hagan could not be liable under the classical theory as he owed no duty to the shareholders of the target company. Nevertheless, the court found O’Hagan violated section 10(b). The Court held that in trading the target company’s securities, O’Hagan misappropriated the confidential information regarding the planned corporate takeover, breaching “a duty of trust and confidence” he owed to his law firm and client. Trading on such information “involves feigning fidelity to the source of information and thus utilizes a ‘deceptive device’ as required by section 10(b).” The Court stated that while there is “no general duty between all participants in market transactions to forgo actions based on material nonpublic information,” the breach of a duty to the source of the information is sufficient to give rise to insider trading liability. . . . Because the

duty flows to the source of the information and not to shareholders “if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no “deceptive device” and thus no § 10(b) violation.”

While *O'Hagan* did not set the contours of a relationship of “trust and confidence” giving rise to the duty to disclose or abstain and misappropriation liability, we are tasked to determine whether Cuban had such a relationship with Mamma.com. The SEC seeks to rely on Rule 10b5-2(b)(1), which states that a person has “a duty of trust and confidence” for purposes of misappropriation liability when that person “agrees to maintain information in confidence.” In dismissing the case, the district court read the complaint to allege that Cuban agreed not to disclose any confidential information but did not agree not to trade, that such a confidentiality agreement was insufficient to create a duty to disclose or abstain from trading under the misappropriation theory, and that the SEC overstepped its authority under section 10(b) in issuing Rule 10b5-2(b)(1). We differ from the district court in reading the complaint and need not reach the latter issues.

The complaint alleges that, in March 2004, Cuban acquired 600,000 shares, a 6.3% stake, of Mamma.com. Later that spring, Mamma.com decided to raise capital through a PIPE offering on the advice of the investment bank Merriman Curhan Ford & Co. At the end of June, at Merriman’s suggestion, Mamma.com decided to invite Cuban to participate in the PIPE offering. “The CEO was instructed to contact Cuban and to preface the conversation by informing Cuban that he had confidential information to convey to him in order to make sure that Cuban understood — before the information was conveyed to him — that he would have to keep the information confidential.” [SEC Complaint at Paragraph 12]

After getting in touch with Cuban on June 28, Mamma.com’s CEO told Cuban he had confidential information for him and Cuban agreed to keep whatever information the CEO shared confidential. The CEO then told Cuban about the PIPE offering. Cuban became very upset “and said, among other things, that he did not like PIPEs because they dilute the existing shareholders.” “At the end of the call, Cuban told the CEO ‘Well, now I’m screwed. I can’t sell.’” [SEC Complaint at Paragraph 14]

The CEO told the company’s executive chairman about the conversation with Cuban. The executive chairman sent an email to the other Mamma.com board members updating them on the PIPE offering, [stating:]

Today, after much discussion, [the CEO] spoke to Mark Cuban about this equity raise [the PIPE OFFERING] and whether or not he would be interested in participating. As anticipated he initially “flew off the handle” and said he would sell his shares (recognizing that he was not able to do anything until we announce the [offering]) but then asked to see the terms and conditions which we have arranged for him to receive from one of the participating investor groups with which he has dealt in the past.

The CEO then sent Cuban a follow up email, writing “ [i]f you want more details about the private placement please contact . . . [Merriman].’ ”

Cuban called the Merriman representative and they spoke for eight minutes.

“During that call, the salesman supplied Cuban with additional confidential details about the PIPE. In response to Cuban’s questions, the salesman told him that the PIPE was being sold at a discount to the market price and that the offering included other incentives for the PIPE investors.” It is a plausible inference that Cuban learned the off-market prices available to him and other PIPE participants.

With that information and one minute after speaking with the Merriman representative, Cuban called his broker and instructed him to sell his entire stake in the company. Cuban sold 10,000 shares during the evening of June 28, 2004, and the remainder during regular trading the next day.

That day, the executive chairman sent another email to the board, updating them on the previous day’s discussions with Cuban, stating, “‘we did speak to Mark Cuban ([the CEO] and, subsequently, our investment banker) to find out if he had any interest in participating to the extent of maintaining his interest. His answers were: he would not invest, he does not want the company to make acquisitions, he will sell his shares which he can not do until after we announce [the PIPE offering].’”

After the markets closed on June 29, Mamma.com announced the PIPE offering. The next day, Mamma.com’s stock price fell 8.5% and continued to decline over the next week, eventually closing down 39% from the June 29 closing price. By selling his shares when he did, Cuban avoided over \$750,000 in losses. Cuban notified the SEC that he had sold his stake in the company and publically stated that he sold his shares because Mamma.com “was conducting a PIPE, which issued shares at a discount to the prevailing market price and also would have caused his ownership position to be diluted.”

In reading the complaint to allege only an agreement of confidentiality, the [district] court held that Cuban’s statement that he was “screwed” because he “[could not] sell” “appears to express his belief, at least at that time, that it would be illegal for him to sell his Mamma.com shares based on the information the CEO provided.” But the court stated that this statement “cannot reasonably be understood as an agreement not to sell based on the information.” The court found “the complaint asserts no facts that reasonably suggest that the CEO intended to obtain from Cuban an agreement to refrain from trading on the information as opposed to an agreement merely to keep it confidential.” Finally, the court stated that “the CEO’s expectation that Cuban would not sell was also insufficient” to allege any further agreement.

Reading the complaint in the light most favorable to the SEC, we reach a different conclusion. In isolation, the statement “Well, now I’m screwed. I can’t sell” can plausibly be read to express Cuban’s view that learning the confidences regarding the PIPE forbade his selling his stock before the offering but to express no agreement not to do so. However, after Cuban expressed to the CEO the view that he could not sell, he gained access to the confidences of the PIPE offering. According to the complaint’s recounting of the executive chairman’s email to the board, during his short conversation with the CEO regarding the planned PIPE offering, Cuban requested the terms and conditions of the offering. Based on this request, the CEO sent Cuban a follow up email providing the contact information for Merriman. Cuban called the salesman, who told Cuban “that the PIPE was

being sold at a discount to the market price and that the offering included other incentives for the PIPE investors.” Only after Cuban reached out to obtain this additional information, following the statement of his understanding that he could not sell, did Cuban contact his broker and sell his stake in the company.

The allegations, taken in their entirety, provide more than a plausible basis to find that the understanding between the CEO and Cuban was that he was not to trade, that it was more than a simple confidentiality agreement. By contacting the sales representative to obtain the pricing information, Cuban was able to evaluate his potential losses or gains from his decision to either participate or refrain from participating in the PIPE offering. It is at least plausible that each of the parties understood, if only implicitly, that Mamma.com would only provide the terms and conditions of the offering to Cuban for the purpose of evaluating whether he would participate in the offering, and that Cuban could not use the information for his own personal benefit.³³ It would require additional facts that have not been put before us for us to conclude that the parties could not plausibly have reached this shared understanding. Under Cuban’s reading, he was allowed to trade on the information but prohibited from telling others — in effect providing him an exclusive license to trade on the material nonpublic information. Perhaps this was the understanding, or perhaps Cuban misled the CEO regarding the timing of his sale in order to obtain a confidential look at the details of the PIPE. We say only that on this factually sparse record, it is at least equally plausible that all sides understood there was to be no trading before the PIPE.³⁴ That both Cuban and the CEO expressed the belief that Cuban could not trade appears to reinforce the plausibility of this reading.

Given the paucity of jurisprudence on the question of what constitutes a relationship of “trust and confidence” and the inherently fact-bound nature of determining whether such a duty exists, we decline to first determine or place our thumb on the scale in the district court’s determination of its presence or to now draw the contours of any liability that it might bring, including the force of Rule 10b5-2(b)(1). Rather, we VACATE the judgment dismissing the case and REMAND to the court of first instance for further proceedings including discovery, consideration of summary judgment, and trial, if reached.

³³ [37] The parties dispute Mamma.com’s motive in providing the information to Cuban. Cuban contends that the offering was already oversubscribed and that this demonstrates the sole purpose of the phone call was to prevent Cuban from trading ahead of the offering. We express no opinion on this factual dispute or the potential implications of Cuban’s allegations if they are true. At the motion-to-dismiss stage we must view all the facts in light most favorable to the SEC and assume that Mamma.com had a legitimate reason for contacting Cuban.

³⁴ [38] Such an arrangement would raise serious tipper/tippee liability concerns were it explicit. If the CEO knowingly gave Cuban material nonpublic information and arranged so he could trade on it, it would not be difficult for a court to infer that the CEO must have done so for some personal benefit — e.g., goodwill from a wealthy investor and large minority stakeholder. “A reputational benefit that translates into future earnings, a quid pro quo, or a gift to a trading friend or relative all could suffice to show the tipper personally benefitted.” *SEC v Yun*, 327 F.3d 1263, 1277 (11th Cir. 2003). This of course is not to suggest any such improprieties occurred; rather, it simply reinforces the plausibility of the interpretation of the alleged facts as evidencing an understanding that the agreement included an agreement by Cuban not to trade.

Chapter 14

CORPORATE CONTROL ACQUISITIONS AND CONTESTS

§ 14.04 TENDER OFFERS

[F] Legitimacy of Defensive Tactics

[3] State Common Law

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VERSATA ENTERPRISES, INC. v. SELECTICA, INC.
Delaware Supreme Court
5 A.3d 586 (2010)

HOLLAND, JUSTICE:

This is an appeal from a final judgment entered by the Court of Chancery. On November 16, 2008 the Board of Directors of Selectica, Inc. (“Selectica”) reduced the trigger of its “poison pill” Shareholder Rights Plan from 15% to 4.99% of Selectica’s outstanding shares and capped existing shareholders who held a 5% or more interest to a further increase of only 0.5% (the “NOL Poison Pill”). Selectica’s reason for taking such action was to protect the company’s net operating loss carry forwards (“NOLs”). When Trilogy, Inc. (“Trilogy”) subsequently purchased shares above this cap, Selectica filed suit in the Court of Chancery on December 21, 2008, seeking a declaration that the NOL Poison Pill was valid and enforceable. On January 2, 2009, Selectica implemented the dilutive exchange provision (the “Exchange”) of the NOL Poison Pill, which reduced Trilogy’s interest from 6.7% to 3.3%, and adopted another Rights Plan with a 4.99% trigger (the “Reloaded NOL Poison Pill”). Selectica then amended its complaint to seek a declaration that the Exchange and the Reloaded NOL Poison Pill were valid.

Trilogy and its subsidiary Versata Enterprises, Inc. (“Versata”) counterclaimed that the NOL Poison Pill, the Reloaded NOL Poison Pill, and the Exchange were unlawful on the grounds that, before acting, the Board failed to consider that its NOLs were unusable or that the two NOL poison pills were unnecessary given Selectica’s unbroken history of losses and doubtful prospects of annual profits. Trilogy and Versata also asserted that the NOL Poison Pill and the Reloaded NOL Poison Pill were impermissibly preclusive of a successful proxy contest for Board control, particularly when combined with Selectica’s staggered director terms. After trial, the Court of Chancery held that the NOL Poison Pill, the Reloaded NOL Poison Pill, and the Exchange were all valid under Delaware law.

Trilogy and Versata now appeal and assert two claims of error. First, they

contend that the Court of Chancery erred in applying the *Unocal* test for enhanced judicial scrutiny when confronting what they frame as a question of first impression. The issue (as framed by them) is: “what are the minimum requirements for a reasonable investigation before the board of a never-profitable company may adopt a [Rights Plan with a 4.99% trigger] for the ostensible purpose of protecting NOLs from an ‘ownership change’ under Section 382 of the Internal Revenue Code?” Second, they submit that the Court of Chancery erred in holding that the two NOL poison pills, either individually or in combination with a charter-based classified Board, did not have a preclusive effect on the shareholders’ ability to pursue a successful proxy contest for control of the Company’s board. We conclude that both arguments are without merit.

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Facts

The Court of Chancery described this as a case about the value of net operating loss carryforwards (“NOLs”) to a currently profitless corporation, and the extent to which such a corporation may fight to preserve those NOLs. The Court of Chancery also provided a helpful overview of the concepts surrounding NOLs, their calculation, and possible impairment.

NOLs are tax losses, realized and accumulated by a corporation, that can be used to shelter future (or immediate past) income from taxation. (NOLs may be carried backward two years and carried forward twenty years.) If taxable profit has been realized, the NOLs operate either to provide a refund of prior taxes paid or to reduce the amount of future income tax owed. Thus, NOLs can be a valuable asset, as a means of lowering tax payments and producing positive cash flow. NOLs are considered a contingent asset, their value being contingent upon the firm’s reporting a future profit or having an immediate past profit.

Should the firm fail to realize a profit during the lifetime of the NOL (twenty years), the NOL expires. The precise value of a given NOL is usually impossible to determine since its ultimate use is subject to the timing and amount of recognized profit at the firm. If the firm never realizes taxable income, at dissolution its NOLs, regardless of their amount, would have zero value.

In order to prevent corporate taxpayers from benefiting from NOLs generated by other entities, Internal Revenue Code Section 382 establishes limitations on the use of NOLs in periods following an “ownership change.” If Section 382 is triggered, the law restricts the amount of prior NOLs that can be used in subsequent years to reduce the firm’s tax obligations. Once NOLs are so impaired, a substantial portion of their value is lost.

The precise definition of an “ownership change” under Section 382 is rather complex. At its most basic, an ownership change occurs when more than 50% of a firm’s stock ownership changes over a three-year period. Specific provisions in Section 382 define the precise manner by which this determination is made. Most importantly for purposes of this case, the only shareholders considered when calculating an ownership change under Section 382 are those who hold, or have

obtained during the testing period, a 5% or greater block of the corporation's shares outstanding.

The Parties

Selectica, Inc. ("Selectica" or the "Company") is a Delaware corporation, headquartered in California and listed on the NASDAQ Global Market. It provides enterprise software solutions for contract management and sales configuration systems. Selectica is a micro-cap company with a concentrated shareholder base: the Company's seven largest investors own a majority of the stock, while fewer than twenty-five investors hold nearly two-thirds of the stock. (However, because of the Shareholder Rights Plan first instituted in 2003, no stockholder holds more than 15% of the outstanding shares.)

Trilogy, Inc. ("Trilogy") is a Delaware corporation also specializing in enterprise software solutions. Trilogy stock is not publicly traded, and its founder, Joseph Liemandt, holds over 85% of the stock. Versata Enterprises, Inc. ("Versata"), a Delaware corporation and a subsidiary of Trilogy, provides technology powered business services to clients.

Before the events giving rise to this action, Versata and Trilogy beneficially owned 6.7% of Selectica's common stock. After they intentionally triggered Selectica's Shareholder Rights Plan through the purchase of additional shares, Versata's and Trilogy's joint beneficial ownership was diluted from 6.7% to approximately 3.3%.

James Arnold, Alan B. Howe, Lloyd Sems, Jim Thanos, and Brenda Zawatski are members of the Selectica Board of Directors (the "Board"). Zawatski and Thanos also served as Co-Chairs of the Board during the events at issue in the case. In this role, they handled the day-to-day operations of the Company, as Selectica had been without a Chief Executive Officer since June 30, 2008.

Selectica's Historical Operating Difficulties

Since it became a public company in March 2000, Selectica has lost a substantial amount of money and failed to turn an annual profit, despite routinely projecting near-term profitability. Its IPO price of \$30 per share has steadily fallen and now languishes below \$1 per share, placing Selectica's market capitalization at roughly \$23 million as of the end of March 2009. By Selectica's own admission, its value today "consists primarily in its cash reserves, its intellectual property portfolio, its customer and revenue base, and its accumulated NOLs." By consistently failing to achieve positive net income, Selectica has generated an estimated \$160 million in NOLs for federal tax purposes over the past several years.

Selectica's Relationship with Trilogy

Selectica has had a complicated and often adversarial relationship with Trilogy, stretching back at least five years. Both companies compete in the relatively narrow market space of contract management and sales configuration. In April 2004, a Trilogy affiliate sued Selectica for patent infringement and secured a

judgment that required Selectica, among other things, to pay Trilogy \$7.5 million. While their suit was pending, in January 2005 Trilogy made an offer to buy Selectica for \$4 per share in cash — a 20% premium above the then-trading price — which Selectica's Board rejected. Nevertheless, during March and April of that year, a Trilogy affiliate acquired nearly 7% of Selectica's common stock through open market trades. In early fall 2005, Trilogy made another offer for Selectica's shares at a 16%-23% premium, which was also rejected.

In September 2006, a Trilogy-affiliated holder of Selectica stock sent a letter to the Board questioning whether certain stock option grants had been backdated.³⁵ The following month, Trilogy filed another patent infringement lawsuit against Selectica. That action was settled in October 2007, when Selectica agreed to a one-time payment of \$10 million, plus an additional amount of not more than \$7.5 million in subsequent payments to be made quarterly. In late fall 2006, Trilogy sold down its holdings in Selectica.

Steel Partners

Steel Partners is a private equity fund that has been a Selectica shareholder since at least 2006 and is currently its largest shareholder. One of Steel Partners' apparent investment strategies is to invest in small companies with large NOLs with the intent to pair the failing company with a profitable business in order to reap the tax benefits of the NOLs. Steel Partners has actively worked with Selectica to calculate and monitor the Company's NOLs since the time of its original investment.

By early 2008, Steel Partners was advocating a quick sale of Selectica's assets, leaving a NOL shell that could be merged with a profitable operating company in order to shelter the profits of the operating company. In October 2008, Steel Partners informed members of Selectica's Board that it planned to increase its ownership position to 14.9% just below the 15% trigger of the 2003 Rights Plan, which it later did. Jack Howard, President of Steel Partners, lobbied for a Board seat twice in 2008, citing his experience dealing with NOLs, but was rebuffed.

Selectica Investigates Its NOLs

In 2006, at the urging of Steel Partners, Selectica directed Alan Chinn, its outside tax adviser, to perform a high-level analysis into whether its NOLs were subject to any limitations under Section 382 of the Internal Revenue Code. Chinn concluded that five prior changes in ownership had caused the forfeiture of approximately \$24.6 million in NOLs. Selectica provided the results of this study to Steel Partners, although not to any other Selectica shareholder.

³⁵ [7] A special committee empanelled by the Board ultimately concluded that certain options had, in fact, been backdated. Consequently, Selectica was required to restate its financial statements to record additional stock-based compensation and related tax effects for past option grants and incurred fees associated with the investigation in excess of \$6.2 million. This episode also led to the resignation of Selectica's then-Chairmen and Chief Executive Officer Stephen Bannion (who had been the Company's Chief Financial Officer at the time of the grants of question) and the appointment of then-Director Robert Jurkowski to the Chief Executive and Chair position.

In March 2007, again at Steel Partner's recommendation, Selectica retained a second accountant who specialized in NOL calculations, John Brogan of Burr Pilger & Mayer, LLP, to analyze the Company's NOLs more carefully and report on Chinn's Section 382 analysis. Brogan had previously analyzed the NOLs at other Steel Partners ventures. Brogan ultimately determined that Chinn's conclusions were erroneous.

The Company engaged Brogan to perform additional work on the topic of NOLs in June 2007. One of Steel Partners's employees, Avi Goodman, worked closely with Brogan on the matter, although Brogan was working for and being paid by Selectica and received no compensation from Steel Partners. Brogan's draft letter opinion, concluding that the Company had not undergone an "ownership change" for Section 382 purposes since 1999, was shared with Steel Partners, although again not with any other outside investors.

In the fall of 2007, Brogan proposed a third, more detailed, Section 382 study, which Selectica's then-CEO, Robert Jurkowski, opposed. In February 2008, the Board voted against spending \$40,000-\$50,000 to fund this Section 382 study. By July, however, the Board asked Brogan to update his study. Brogan delivered the draft opinion that, as of March 31, 2008, the Company had approximately \$165 million in NOLs. Brogan was later asked to advise the Board in the fall of 2008 on the updated status of its NOLs when the Board moved to amend its Rights Plan.

Lloyd Sems Elected Director

In April 2008, the Board began interviewing candidates for an open board seat, giving preference to the Company's large stockholders. Selectica investor Lloyd Sems had previously expressed interest in joining the Board and had sought support from certain shareholders, including Steel Partners, through Howard, and Lloyd Miller, another large Selectica shareholder not affiliated with Steel Partners. Both Miller and Howard wrote to the Board in support of Sems's appointment, although Sems was already favored by the Board by that time. In June 2008, Sems was appointed to the Board.

As large shareholders, Sems, Howard, and Miller had periodically discussed Selectica as early as October 2007. At that time, Sems had emailed Howard, stating, "I wanted to get your opinion of how or if you would like me to proceed with [Selectica]." Howard replied, "Lloyd [Miller] said he would call you about [Selectica]." Both before and after his appointment to the Board, Sems discussed with Howard and Miller a number of the proposals that Sems ultimately advocated as a director, including that Selectica should buy back its stock, that Selectica should consider selling its businesses, that the NOLs were important and should be preserved through the adoption of a Rights Plan with a 5% trigger, and that Jurkowski should be removed as CEO.

Selectica Restructures and Explores Alternatives

In early July 2008, after determining that the Company needed to change course, the Board terminated Jurkowski as CEO and eliminated several management positions in the sales configuration business. Later that month,

prompted by the receipt of five unsolicited acquisition offers over the span of a few weeks, the Board announced that it was in the process of selecting an investment banker (ultimately, Jim Reilly of Needham & Company) to evaluate strategic alternatives for the Company and to assist with a process that ultimately might result in the Company's sale. In view of the potential sale, the Board decided to forgo the expense of replacing Jurkowski and, instead, asked Zawatski and Thanos jointly to assume the title of Co-Chair and to perform operational oversight roles on an interim basis.

The Needham Process

Needham has actively carried out its task of evaluating Selectica's strategic options since its selection by the Board. Needham first discussed with the Board the various strategic choices that the Company could take. These included a merger of equals with a public company, a reverse IPO or other going-private transaction, the sale of certain assets, and the use of cash to acquire another company, as well as stock repurchases or the issuance of dividends if Selectica decided to continue as an independent public company in the absence of sufficient market interest for an acquisition.

In October 2008, Needham prepared an Executive Summary of the assets and operations of Selectica and subsequently reached out to potential buyers, keeping in touch with various interested parties throughout the remainder of the year and into the first part of 2009. By February 2009, at least half a dozen parties had come forward with letters of intent and were in the process of meeting with Selectica management and conducting due diligence in the Company, with Needham evaluating their various proposals for the purchase of all or part of Selectica's operations. As of April 2009, Selectica, through Needham, had signed a letter of intent and entered into exclusive negotiations with a potential buyer.

Trilogy's Offers Rejected

On July 15, 2008, Trilogy's President, Joseph Liemandt, called Zawatski to inquire generally about the possibility of an acquisition of Selectica by Trilogy. On July 29, Trilogy Chief Financial Officer Sean Fallon, Trilogy Director of Finance Andrew Price, and Versata Chief Executive Officer Randy Jacops participated in a conference call with Selectica Co-Chairs Zawatski and Thanos on the same topic. During the call, Thanos inquired as to how Trilogy would calculate a value for the Company's NOLs. Fallon replied that Trilogy, "really [did not] pursue them with as much vigor as other[s] might since that is not our core strategy."

The following evening, Fallon contacted Zawatski and outlined two proposals for Trilogy to acquire Selectica's business: (1) Trilogy's purchase of all of the assets of Selectica's sales configuration business in exchange for the cancellation of the \$7.1 million in debt Selectica still owed under the October 2007 settlement with Trilogy; or (2) Trilogy's purchase of Selectica's entire operations for the cancellation of the debt plus an additional \$6 million in cash. Fallon subsequently followed up with an email reiterating both proposals and suggesting that either proposal would allow Selectica to still make use of its NOLs through the later sale of its corporate entity.

Shortly thereafter, the Board rejected both proposals, made no counterproposal, and there were no follow-up discussions. On October 9, 2008, Trilogy made a second bid to acquire all of the Selectica's assets for \$10 million in cash plus the cancellation of the debt, which the Board also rejected. Although Trilogy was invited to participate in the sale process being overseen by Needham, Trilogy was apparently unwilling to sign a non-disclosure agreement, which was a prerequisite for participation. Around this same time, Trilogy had begun making open-market purchases for Selectica stock, although the Board apparently was not aware of this fact at the time.

Trilogy Buys Selectica Stock

On the evening of November 10, Fallon contacted Zawatski and informed her that Trilogy had purchased more than 5% of Selectica's outstanding stock and would be filing a Schedule 13D shortly, which it did on November 13. On a subsequent call with Zawatski and Reilly, Fallon explained that Trilogy had begun buying because it believed that "the company should work quickly to preserve whatever shareholder value remained and that we were interested in seeing this process that they announced with Needham, that we were interested in seeing that accelerate . . ." Within four days of its 13D filing, Trilogy had acquired more than 320,000 additional shares, representing an additional 1% of the Company's outstanding shares.

NOL Poison Pill Adopted

In the wake of Trilogy's decision to begin acquiring Selectica shares, the Board took actions to gauge the impact of these acquisitions, if any, on the Company's NOLs, and to determine whether anything needed to be done to mitigate their effects. Sems immediately asked Brogan to revise his Section 382 analysis — which had not been formally updated since July — to take into account the recent purchases. The revised analysis was delivered to Sems and the Company's new CFO, Richard Heaps, on November 15. It showed that the cumulative acquisition of stock by shareholders over the past three years stood at 40%, which was roughly unchanged from the previous calculation, due to some double counting that occurred in the July analysis.

The Board met on November 16 to discuss the situation and to consider amending Selectica's Shareholder Rights Plan, which had been in place since February 2003. As with many Rights Plans employed as protection devices against hostile takeovers, Selectica's Rights Plan had a 15% trigger. The Board considered an amendment that would reduce that threshold trigger to 4.99% in order to prevent additional 5% owners from emerging and potentially causing a change-in-control event, thereby devaluing Selectica's NOLs. Also present at the meeting were Heaps, Brogan, and Reilly, along with Delaware counsel.

Heaps gave an overview of the Company's existing Shareholder Rights Plan and reviewed the stock price activity since Trilogy had filed its Schedule 13D, noting that shares totaling approximately 2.3% of the Company had changed hands in the two days following the filing. Brogan reviewed the Section 382 ownership analysis

that his firm had undertaken on behalf of the Company, noting that additional acquisitions of roughly 10% of the float by new or existing 5% holders would “result in a permanent limitation on use of the Company’s net operating loss carryforwards and that, once an ownership change occurred, there would be no way to cure the use limitation on the net operating loss carryforwards.” He further advised the Board that “net operating loss carryforwards were a significant asset” and that he generally advises companies to consider steps to protect their NOLs when they experience a 30% or greater change in beneficial ownership. Lastly, Brogan noted that, while he believed that the cumulative ownership change calculations would decline significantly over the next twelve months, “it would decline only modestly, if at all, over the next three to four months,” meaning that “the Company would continue to be at risk of an ownership change over the near term.”

Reilly discussed the Company’s strategic alternatives and noted that Steel Partners and other parties had expressed interest in pursuing a transaction that would realize the value of Selectica’s NOLs. He also reviewed potential transaction structures in which the Company might be able to utilize its NOLs. Responding to questions from the Board, Reilly noted that “it is difficult to value the Company’s net operating loss carryforwards with greater precision, because their value depends, among other things, on the ability of the Company to generate profits.” He confirmed that “existing stockholders may realize significant potential value” from the utilization of the Company’s NOLs, which would be “significantly impaired” if a Section 382 ownership change occurred.

At the request of the Board, Delaware counsel reviewed the Delaware law standards that apply for adopting and implementing measures that have an anti-takeover effect. The Board then discussed amending the existing Shareholder Rights Plan, and the possible terms of such an amendment. These included: the pros and cons of providing a cushion for preexisting 5% holders, the appropriate effective date of the new Shareholder Rights Plan, whether the Board should have authority to exclude purchases by specific stockholders from triggering the Rights Plan, and whether a review process should be implemented to determine periodically whether the Rights Plan should remain in effect.

The Board then unanimously passed a resolution amending Selectica’s Shareholder Rights Plan, by decreasing the beneficial ownership trigger from 15% to 4.99%, while grandfathering in existing 5% shareholders and permitting them to acquire up to an additional 0.5% (subject to the original 15% cap) without triggering the NOL Poison Pill.

The Board resolution also established an Independent Director Evaluation Committee (the “Committee”) as a standing committee of the Board to review periodically the rights agreement at the behest of the Board and to “determine whether the Rights [Plan] continues to be in the best interest of the Corporation and its stockholders.” The Committee was also directed to review “the appropriate trigger percentage” of the Rights Plan based on corporate and shareholder developments, any broader developments relating to rights plans generally — including academic studies of rights plans and contests for corporate control — and any other factors it deems relevant. The Board set April 30, 2009, as the first

date that the Committee should report its findings.

Trilogy Triggers NOL Poison Pill

The Board publicly announced the amendment of Selectica's Rights Plan on Monday, November 17. Early the following morning, Fallon emailed Trilogy's broker, saying "[W]e need to stop buying SLTC. They announced a new pill and we need to understand it." Fallon also sent Liemandt a copy of Selectica's 8-K containing the amended language of the NOL Poison Pill. Trilogy immediately sought legal advice about the NOL Poison Pill. The following morning, Liemandt e-mailed Price, with a copy to Fallon, asking, "What percentage of [Selectica] would we need to buy to ruin the tax attributes that [S]teel [P]artners is looking for?" They concluded that they would need to acquire 23% to trigger a change-in-control event.

Later that week, Trilogy sent Selectica a letter asserting that a Selectica contract with Sun Microsystems constituted a breach of the October 2007 settlement and seeking an immediate meeting with Selectica purportedly to discuss the breach, even though members of Trilogy's management had been on notice of the contract as early as July. Fallon, Liemandt, and Jacops from Trilogy, along with Zawatski, Thanos, and Heaps from Selectica met on December 17. The parties' discussions at this meeting are protected by a confidentiality agreement that had been circulated in advance. However, Selectica contends that "based solely on statements and conduct outside that meeting, it is evident that Trilogy threatened to trigger the NOL Poison Pill deliberately unless Selectica agreed to Trilogy's renewed efforts to extract money from the Company."

On December 18, Trilogy purchased an additional 30,000 Selectica shares, and Trilogy management verified with Liemandt his intention to proceed with "buying through" the NOL Poison Pill. The following morning, Trilogy purchased an additional 124,061 shares of Selectica, bringing its ownership share to 6.7% and thereby becoming an "Acquiring Person" under the NOL Poison Pill. Liemandt testified that the rationale behind triggering the pill was to "bring accountability" to the Board and "expose" what Liemandt characterized as "illegal behavior" by the Board in adopting a pill with such a low trigger. Fallon asserted that the reason for triggering the NOL Poison Pill was to "bring some clarity and urgency" to their discussions with Selectica about the two parties' somewhat complicated relationship by "setting a time frame that might help accelerate discussions" on the direction of the business.

Fallon placed a telephone call to Zawatski on December 19 to advise her that Trilogy had bought through the NOL Poison Pill. During a return call by Zawatski later that evening, Fallon indicated that Trilogy felt, based on the conversations from December 17, that Selectica no longer wanted Trilogy as a shareholder or creditor. He then proposed that Selectica repurchase Trilogy's shares, accelerate the payment of its debt, terminate its license with Sun, and make a payment to Trilogy of \$5 million "for settlement of basically all outstanding issues between our companies." Zawatski recalled that Fallon told her that Trilogy had triggered the pill "to get our attention and create a sense of urgency;" that, since the Board

would have ten days to determine how to react to the pill trigger, “it would force the board to make a decision.”

Board Considers Options and Requests a Standstill

The Selectica Board had a telephonic meeting on Saturday, December 20, to discuss Trilogy’s demands and an appropriate response. The Board discussed “the desirability of taking steps to ensure the validity of the Shareholder Rights Plan,” and ultimately passed a resolution authorizing the filing of this lawsuit, which occurred the following day. On December 22, Trilogy filed an amended Schedule 13D disclosing its ownership percentage and again the Selectica Board met telephonically to discuss the litigation. It eventually agreed to have a representative contact Trilogy to seek a standstill on any additional open market purchases while the Board used the ten-day clock under the NOL Poison Pill to determine whether to consider Trilogy’s purchases “exempt” under the Rights Plan, and if not, how Selectica would go about implementing the pill.

The amended Rights Plan allowed the Board to declare Trilogy an “Exempt Person” during the ten-day period following the trigger, if the Board determined that Trilogy would not “jeopardize or endanger the availability to the Company of the NOLs” The Board could also decide during this window to exchange the rights (other than those held by Trilogy) for shares of common stock. If the Board did nothing, then after ten days the rights would “flip in” automatically, becoming exercisable for \$36 worth of newly-issued common stock at a price of \$18 per right.

The Board met again by telephone the following day, December 23, to discuss the progress of the litigation and to consider the potential impact of the various alternatives under the NOL Poison Pill. The Board agreed to meet in person the following Monday, December 29, along with the Company’s financial, legal, and accounting advisors, to evaluate further the available options. The Board also voted to reduce the number of authorized directors from seven to five.

On Wednesday, December 24, the Board met once again by telephone upon learning that the Company’s counsel had not succeeded in convincing Trilogy to agree to a standstill. The Board resolved that Zawatski should call Fallon to determine whether Trilogy was willing “to negotiate a standstill agreement that might make triggering the remedies available under the Shareholder Rights Plan, as amended, unnecessary at this time.” Zawatski spoke with Fallon on the morning of December 26. Fallon stated that Trilogy did not want to agree to a standstill, that relief from the NOL Poison Pill was not Trilogy’s goal, and that Trilogy expected that the NOL Poison Pill would apply to it. Fallon reiterated that the ten-day window would help “speed [the] course” towards a resolution of their claims.

The Board and its advisors met again on December 29. Thanos provided an update on recent developments at the Company, including financial results, management changes, and the Needham Process, as well as an overview of the make-up of the Company’s shareholder base. Reilly then provided a more detailed report on the status of the Needham Process. Thereafter, Brogan presented his firm’s updated analysis of Selectica’s NOLs, which found that the Company had at least \$160 million in NOLs and that there had been a roughly 40% ownership

change by 5% holders over the three-year testing period. Since those were not expected to “roll off” in the near term, there was “a significant risk of a Section 382 ownership change.”

Brogan subsequently discussed the possible consequences of the two principal mechanisms for implementing the triggered NOL Poison Pill to the change-in-control analysis. He stated that employing a share exchange would not likely have a materially negative impact on the Section 382 analysis. He expressed concern, however, about the uncertain effect of a flip-in pill on subsequent ownership levels (specifically, the possibility that a flip-in pill would, itself, trigger a Section 382 ownership change). Reilly once again addressed the Board to explain the ways he believed the NOLs would be valuable to the Company in its ongoing exploration of strategic alternatives, and reiterated his opinion that an ownership change would “reduce the value of the Company.”

The Board also discussed Trilogy’s settlement demands. It found them “highly unreasonable” and “lack[ing] any reasonable basis in fact,” and that “it [was] not in the best interests of the Company and its stockholders to accept Trilogy/Versata’s settlement demands relating to entirely separate intellectual property disputes as a precondition to negotiating a standstill agreement to resolve this dispute.” The Board discussed Trilogy’s actions at some length, ultimately concluding that they “were very harmful to the Company in a number of respects,” and that “implementing the exchange was reasonable in relation to the threat imposed by Trilogy.” In particular, that was because (1) the NOLs were seen as “an important corporate asset that could significantly enhance stockholder value,” and (2) Trilogy had intentionally triggered the NOL Poison Pill, publicly suggested it might purchase additional stock, and had refused to negotiate a standstill agreement, even though an additional 10% acquisition by a 5% shareholder would likely trigger an ownership change under Section 382.

The Board then authorized Delaware counsel to contact Trilogy in writing, one final time, to seek a standstill agreement. It also passed resolutions delegating the full power of the Board to the Committee to determine whether or not to treat Trilogy or its acquisition as “exempt,” and nominating Alan Howe as a new member of the Board. On the evening of December 29, Selectica’s Delaware counsel e-mailed Trilogy’s trial counsel at the Board’s instruction, seeking a standstill agreement “so that the Board could consider either declaring them an ‘Exempt Person’ under the Rights Plan . . . or alternatively, settle the litigation altogether in exchange for a long term agreement relating to your clients’ ownership of additional shares.” The following afternoon, Trilogy’s counsel responded that Trilogy was not willing to agree to the proposed standstill.

Two days later, on December 31, the Board met telephonically and was informed of Trilogy’s latest rejection of a standstill agreement. The Board discussed its options with its legal advisors and ultimately concluded that the NOL Poison Pill should go into effect and that an exchange was the best alternative and should be implemented as soon as possible in order to protect the NOLs, even at the risk of disrupting common stock trading. The Board directed advisers to prepare a technical amendment to the NOL Poison Pill to clarify the time at which the exchange would become effective.

Board Adopts Reloaded Pill and Dilutes Trilogy Holdings

On January 2, the Board met telephonically once more, reiterating its delegation of authority to the Committee to make recommendations regarding the implementation of the NOL Poison Pill. The Board also passed a resolution expressly confirming that the Board's delegation of authority to the Committee included the power to effect an exchange of the rights under the NOL Poison Pill and to declare a new dividend of rights under an amended Rights Plan (the "Reloaded NOL Poison Pill"). The Board then adjourned and the Committee — comprised of Sems and Arnold — met with legal and financial advisors, who confirmed that there had been no new agreement with representatives from Trilogy, reiterated that the NOLs remained "a valuable corporate asset of the Company in connection with the Company's ongoing exploration of strategic alternatives," and advised the Committee members of their fiduciary obligations under Delaware law.

Reilly presented information to the Committee about the current takeover environment and the use of Rights Plans (specifically, the types of pills commonly employed and their triggering thresholds), and reviewed the Company's then-current anti-takeover defenses compared with those of other public companies. Reilly stated that "a so-called NOL rights plan with a 4.99% trigger threshold is designed to help protect against stock accumulations that would trigger an 'ownership change,'" and that "implementing appropriate protections of the Company's net operating loss carryforwards was especially important at present," given Trilogy's recent share acquisitions superimposed on the Company's existing Section 382 ownership levels. Finally, Reilly reviewed the proposed terms and conditions of the Reloaded NOL Poison Pill, discussed the methodology for determining the exercise price of the new rights, and made recommendations. The Committee sought and obtained reconfirmed assurances by its financial and legal advisors that the NOLs were a valuable corporate asset and that they remained at a significant risk of being impaired.

The Committee concluded that Trilogy should not be deemed an "Exempt Person," that its purchase of additional shares should not be deemed an "Exempt Transaction," that an exchange of rights for common stock (the "Exchange") should occur, and that a new rights dividend on substantially similar terms should be adopted. The Committee passed resolutions implementing those conclusions, thereby adopting the Reloaded NOL Poison Pill and instituting the Exchange.

The Exchange doubled the number of shares of Selectica common stock owned by each shareholder of record, other than Trilogy or Versata, thereby reducing their beneficial holdings from 6.7% to 3.3%. The implementation of the Exchange led to a freeze in the trading of Selectica stock from January 5, 2009 until February 4, 2009, with the stock price frozen at \$0.69. The Reloaded NOL Poison Pill will expire on January 2, 2012, unless the expiration date is advanced or extended, or unless these rights are exchanged or redeemed by the Board some time before.

ANALYSIS

Unocal Standard Applies

In *Unocal* [, 493 A.2d 946 (Del. 1985)], this Court recognized that “our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs.” [In this litigation,] [t]he Court of Chancery concluded that the protection of company NOLs may be an appropriate corporate policy that merits a defensive response when they are threatened. We agree.

The *Unocal* two part test is useful as a judicial analytical tool because of the flexibility of its application in a variety of fact scenarios. Delaware courts have approved the adoption of a Shareholder Rights Plan as an antitakeover device, and have applied the *Unocal* test to analyze a board’s response to an actual or potential hostile takeover threat. Any NOL poison pill’s principal intent, however, is to prevent the inadvertent forfeiture of potentially valuable assets, not to protect against hostile takeover attempts. Even so, any Shareholder Rights Plan, by its nature, operates as an antitakeover device. Consequently, notwithstanding its primary purpose, a NOL poison pill must also be analyzed under *Unocal* because of its effect and its direct implications for hostile takeovers.

Threat Reasonably Identified

The first part of *Unocal* review requires a board to show that it had reasonable grounds for concluding that a threat to the corporate enterprise existed. The Selectica Board concluded that the NOLs were an asset worth preserving and that their protection was an important corporate objective. Trilogy contends that the Board failed to demonstrate that it conducted a reasonable investigation before determining that the NOLs were an asset worth protecting. We disagree.

The record reflects that the Selectica Board met for more than two and a half hours on November 16. The Court of Chancery heard testimony from all four directors and from Brogan, Reilly, and Heaps, who also attended that meeting and advised the Board. The record shows that the Board first analyzed the NOLs in September 2006, and sought updated Section 382 analyses from Brogan in March 2007, June 2007, and July 2008. At the November 16 meeting, Brogan advised the Board that the NOLs were a “significant asset” based on his recently updated calculations of the NOLs’ magnitude. Reilly, an investment banker, similarly advised the Board that the NOLs were worth protecting given the possibility of a sale of Selectica or its assets. Accordingly, the record supports the Court of Chancery’s factual finding that the Board acted in good faith reliance on the advice of experts in concluding that “the NOLs were an asset worth protecting and thus, that their preservation was an important corporate objective.”

The record also supports the reasonableness of the Board’s decision to act promptly by reducing the trigger on Selectica’s Rights Plan from 15% to 4.99%. At the November 16 meeting, Brogan advised the Board that the change-of-ownership calculation under Section 382 stood at approximately 40%. Trilogy’s ownership had climbed to over 5% in just over a month, and Trilogy intended to continue buying more stock. There was nothing to stop others from acquiring stock up to the 15%

trigger in the Company's existing Rights Plan. Once the Section 382 limitation was tripped, the Board was advised it could not be undone.

At the November 16 meeting, the Board voted to amend Selectica's existing Rights Plan to protect the NOLs against a potential Section 382 "change of ownership." It reduced the trigger of its Shareholders Rights Plan from 15% to 4.99% and provided that existing shareholders who held in excess of 4.99% would be subject to dilutive consequences if they increased their holdings by 0.5%. The Board also created the Review Committee (Arnold and Sems) with a mandate to conduct a periodic review of the continuing appropriateness of the NOL Poison Pill.

The Court of Chancery found the record "replete with evidence" that, based upon the expert advice it received, the Board was reasonable in concluding that Selectica's NOLs were worth preserving and that Trilogy's actions presented a serious threat of their impairment. The Court of Chancery explained those findings, as follows:

The threat posed by Trilogy was reasonably viewed as qualitatively different from the normal corporate control dispute that leads to the adoption of a shareholder rights plan. In this instance, Trilogy, a competitor with a contentious history, recognized that harm would befall its rival if it purchase sufficient shares of Selectica stock, and Trilogy proceeded to act accordingly. It was reasonable for the Board to respond, and the timing of Trilogy's campaign required the Board to act promptly. Moreover, the 4.99% threshold for the NOL Poison Pill was driven by our tax laws and regulations; the threshold, low as it is, was measured by reference to an external standard, one created neither by the Board nor by the Court [of Chancery]. Within this context, it is not for the Court [of Chancery] to second-guess the Board's efforts to protect Selectica's NOLs.

Those findings are not clearly erroneous. They are supported by the record and the result of a logical deductive reasoning process. Accordingly, we hold that the Selectica directors satisfied the first part of the *Unocal* test by showing "that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership."

Selectica Defenses Not Preclusive

The second part of the *Unocal* test requires an initial evaluation of whether a board's defensive response to the threat was preclusive or coercive and, if neither, whether the response was "reasonable in relation to the threat" identified. Under *Unitrin*, a defensive measure is disproportionate and unreasonable *per se* if it is draconian by being either coercive or preclusive. A coercive response is one that is "aimed at 'cramming down' on its shareholders a management-sponsored alternative."

A defensive measure is preclusive where it "makes a bidder's ability to wage a successful proxy contest and gain control either 'mathematically impossible' or 'realistically unattainable.'" A successful proxy contest that is mathematically impossible is, *ipso facto*, realistically unattainable. Because the "mathematically

impossible” formulation in *Unitrin* is subsumed within the category of preclusivity described as “realistically unattainable,” there is, analytically speaking, only one test of preclusivity: “realistically unattainable.”

Trilogy claims that a Rights Plan with a 4.99% trigger renders the possibility of an effective proxy contest realistically unattainable. In support of that position, Trilogy argues that, because a proxy contest can only be successful where the challenger has sufficient credibility, the 4.99% pill trigger prevents a potential dissident from signaling its financial commitment to the company so as to establish such credibility. In addition, Professor Ferrell, Trilogy’s expert witness, testified that the 5% cap on ownership exacerbates the free rider problem already experienced by investors considering fielding an insurgent slate of directors, and makes initiating a proxy fight an economically unattractive proposition.³⁶

This Court first examined the validity of a Shareholder Rights Plan in *Moran v. Household International, Inc.* [500 A.2d 1346 (Del. 1985).] In *Moran* the Rights Plan at issue had a 20% trigger. We recognized that, while a Rights Plan “does deter the formation of proxy efforts of a certain magnitude, it does not limit the voting power of individual shares.” In *Moran*, we concluded that the assertion that a Rights Plan would frustrate proxy fights was “highly conjectural” and pointed to “recent corporate takeover battles in which insurgents holding less than 10% stock ownership were able to secure corporate control through a proxy contest or the threat of one.”

The 5% trigger that is necessary for a NOL poison pill to serve its primary objective imposes a lower threshold than the Rights Plan thresholds that have traditionally been adopted and upheld as acceptable anti-takeover defenses by Delaware courts. Selectica submits that the distinguishing feature of the NOL Poison Pill and Reloaded NOL Poison Pill — the 5% trigger — is not enough to differentiate them from other Rights Plans previously upheld by Delaware courts, and that there is no evidence that a challenger starting below 5% could not realistically hope to prevail in a proxy contest at Selectica. In support of those arguments Selectica presented expert testimony from Professor John C. Coates IV and Peter C. Harkins.

Professor Coates identified more than fifty publicly held companies that have implemented NOL poison pills with triggers at roughly 5%, including several large, well-known corporations, some among the Fortune 1000. Professor Coates noted that 5% Rights Plans are customarily adopted where issuers have “ownership controlled” assets, such as the NOLs at issue in this case. Professor Coates also testified that Selectica’s 5% Rights Plan trigger was narrowly tailored to protect the NOLs because the relevant tax law, Section 382, measures ownership changes based on shareholders who own 5% or more of the outstanding stock.

³⁶ [24] According to Professor Ferrell, the free rider problem is that, even if an investor believes that replacing the board would result in a material benefit to shareholders, the investor has to bear the full cost of a proxy fight while only receiving her proportionate fraction of the benefit bestowed upon shareholders. Professor Ferrell testified that, along with the reduced likelihood of success at a 5% position, the capped position would mean that the challenger would be unable to internalize more of the benefits by increasing her share ownership.

Moreover, and as the Court of Chancery noted, shareholder advisory firm RiskMetrics Group now supports Rights Plans with a trigger below 5% on a case-by-case basis if adopted for the stated purpose of preserving a company's net operating losses. The factors RiskMetrics will consider in determining whether to support a management proposal to adopt a NOL poison pill are the pill's trigger, the value of the NOLs, the term of the pill, and any corresponding shareholder protection mechanisms in place, such as a sunset provision causing the pill to expire upon exhaustion or expiration of the NOLs.

Selectica expert witness Harkins of the D.F. King & Co. proxy solicitation firm analyzed proxy contests over the three-year period ending December 31, 2008. He found that of the fifteen proxy contests that occurred in micro-cap companies where the challenger controlled less than 5.49% of the outstanding shares, the challenger successfully obtained board seats in ten contests, five of which involved companies with classified boards. Harkins opined that Selectica's unique shareholder profile would considerably reduce the costs associated with a proxy fight, since seven shareholders controlled 55% of Selectica's shares, and twenty-two shareholders controlled 62%. Harkins testified that "if you have a compelling platform, which is critical, it would be easy from a logistical perspective; and from a cost perspective, it would be *de minimis* expense to communicate with those investors, among others." Harkins noted that to win a proxy contest at Selectica, one would need to gain only the support of owners of 43.2% plus one share.

The Court of Chancery concluded that the NOL Poison Pill and Reloaded NOL Poison Pill were not preclusive. For a measure to be preclusive, it must render a successful proxy contest realistically unattainable given the specific factual context. The record supports the Court of Chancery's factual determination and legal conclusion that Selectica's NOL Poison Pill and Reloaded NOL Poison Pill do not meet that preclusivity standard.

Our observation in *Unitrin* is also applicable here: "[I]t is hard to imagine a company more readily susceptible to a proxy contest concerning a pure issue of dollars." The key variable in a proxy contest would be the merit of the bidder's proposal and not the magnitude of its stockholdings. The record reflects that Selectica's adoption of a 4.99% trigger for its Rights Plan would not preclude a hostile bidder's ability to marshal enough shareholder votes to win a proxy contest.

Trilogy argues that, even if a 4.99% shareholder could realistically win a proxy contest "the preclusiveness question focuses on whether a challenger could realistically attain sufficient board control to remove the pill." Here, Trilogy contends, Selectica's charter-based classified board effectively forecloses a bid conditioned upon a redemption of the NOL Poison Pill, because it requires a proxy challenger to launch and complete two successful proxy contests in order to change control. Therefore, Trilogy argues that even if a less than 5% shareholder could win a proxy contest, Selectica's Rights Plan with a 4.99% trigger in combination with Selectica's charter-based classified board, makes a successful proxy contest for control of the board "realistically unattainable."

Trilogy's preclusivity argument conflates two distinct questions: first, is a successful proxy contest realistically attainable; and second, will a successful proxy contest result in gaining control of the board at the next election? Trilogy argues

that unless both questions can be answered affirmatively, a Rights Plan and a classified board, viewed collectively, are preclusive. If that preclusivity argument is correct, then it would apply whenever a corporation has both a classified board and a Rights Plan, irrespective whether the trigger is 4.99%, 20%, or anywhere in between those thresholds.

Classified boards are authorized by statute and are adopted for a variety of business purposes. Any classified board also operates as an antitakeover defense by preventing an insurgent from obtaining control of the board in one election. More than a decade ago, in *Carmody* [, 723 A.2d 1180, 1186 n. 17 (Del. Ch. 1998)], the Court of Chancery noted “because only one third of a classified board would stand for election each year, a classified board would *delay-but not prevent-a hostile acquiror from obtaining control of the board*, since a determined acquiror could wage a proxy contest and obtain control of two thirds of the target board over a two year period, as opposed to seizing control in a single election.” The fact that a combination of defensive measures makes it more difficult for an acquirer to obtain control of a board does not make such measures realistically unattainable, i.e., preclusive.

In *Moran*, we rejected the contention “that the Rights Plan strips stockholders of their rights to receive tender offers, and that the Rights Plan fundamentally restricts proxy contests.” [500 A.2d at 1357.] We explained that “the Rights Plan will not have a severe impact upon proxy contests and it will not *preclude* all hostile acquisitions of Household.” In this case, we hold that the combination of a classified board and a Rights Plan do not constitute a preclusive defense.³⁷

Range of Reasonableness

If a defensive measure is neither coercive nor preclusive, the *Unocal* proportionality test “requires the focus of enhanced judicial scrutiny to shift to ‘the range of reasonableness.’” Where all of the defenses “are inextricably related, the principles of *Unocal* require that such actions be scrutinized collectively as a unitary response to the perceived threat.” Trilogy asserts that the NOL Poison Pill, the Exchange, and the Reloaded NOL Poison Pill were not a reasonable collective response to the threat of the impairment of Selectica’s NOLs.

The critical facts do not support that assertion. On November 20, within days of learning of the NOL Poison Pill, Trilogy sent Selectica a letter, demanding a conference to discuss an alleged breach of a patent settlement agreement between the parties. The parties met on December 17, and the following day, Trilogy resumed its purchases of Selectica stock.

Fallon testified that he and Liemandt had a discussion wherein Fallon advised Liemandt that Trilogy had purchased additional shares, but not enough to trigger the NOL Poison Pill. Fallon then asked if Liemandt really wanted to trigger the pill,

³⁷ [41] We note that Selectica no longer has a classified Board. After trial, the Selectica Board amended its charter to eliminate its staggered board structure. On October 15, 2009 the Court of Chancery granted Trilogy’s Second Motion for Judicial Notice, which requested the court to take judicial notice of the Selectica proxy statement that referenced the foregoing charter amendment eliminating the staggered board terms.

and Liemandt expressly directed Fallon to proceed. On December 19, 2008, Trilogy bought a sufficient number of shares to become an “Acquiring Person” under the NOL Poison Pill. According to Fallon, this was done to “‘bring some clarity and urgency’ to Trilogy’s discussions with Selectica about the two parties’ somewhat complicated relationship by ‘setting a time frame that might help accelerate discussions’ on the direction of the business.”

Fallon described Trilogy’s relationship with Selectica as a “three-legged stool,” referring to Trilogy’s status as a competitor, a creditor, and a stockholder of Selectica. The two companies had settled prior patent disputes in 2007 under terms that included a cross-license of intellectual property and quarterly payments from Selectica to Trilogy based on Selectica’s revenues from certain products. Selectica argues that Trilogy took the unprecedented step of deliberately triggering the NOL Poison Pill — exposing its equity investment of under \$2 million to dilution — primarily to extract substantially more value for the other two “legs” of the stool.

Trilogy’s deliberate trigger started a ten business day clock under the terms of the NOL Poison Pill. *If the Board took no action during that time, then the rights (other than those belonging to Trilogy) would “flip-in” and become exercisable for deeply discounted common stock. Alternatively, the Board had the power to exchange the rights (other than those belonging to Trilogy) for newly-issued common stock, or to grant Trilogy an exemption.* Three times in the two weeks following the triggering, Selectica offered Trilogy an exemption in exchange for an agreement to stand still and to withdraw its threat to impair the value and usability of Selectica’s NOLs. Three times Trilogy refused and insisted instead that Selectica repurchase its stock, terminate a license agreement with an important client, sign over intellectual property, and pay Trilogy millions of dollars. After three failed attempts to negotiate with Trilogy, it was reasonable for the Board to determine that they had no other option than to implement the NOL Poison Pill.

The Exchange employed by the Board was a more proportionate response than the “flip-in” mechanism traditionally envisioned for a Rights Plan. Because the Board opted to use the Exchange instead of the traditional “flip-in” mechanism, Trilogy experienced less dilution of its position than a Rights Plan is traditionally designed to achieve.

The implementation of the Reloaded NOL Poison Pill was also a reasonable response. The Reloaded NOL Poison Pill was considered a necessary defensive measure because, although the NOL Poison Pill and the Exchange effectively thwarted Trilogy’s immediate threat to Selectica’s NOLs, they did not eliminate the general threat of a Section 382 change-in-control. Following implementation of the Exchange, Selectica still had a roughly 40% ownership change for Section 382 purposes and there was no longer a Rights Plan in place to discourage additional acquisitions by 5% holders. Selectica argues that the decision to adopt the Reloaded NOL Poison Pill was reasonable under those circumstances. We agree.

The record indicates that the Board was presented with expert advice that supported its ultimate findings that the NOLs were a corporate asset worth protecting, that the NOLs were at risk as a result of Trilogy’s actions, and that the steps that the Board ultimately took were reasonable in relation to that threat. Outside experts were present and advised the Board on these matters at both the

November 16 meeting at which the NOL Poison Pill was adopted and at the Board's December 29 meeting. The Committee also heard from expert advisers a third time at the January 2 meeting prior to instituting the Exchange and adopting the Reloaded NOL Poison Pill.

Under part two of the *Unocal* test, the Court of Chancery found that the combination of the NOL Poison Pill, the Exchange, and the Reloaded NOL Poison Pill was a proportionate response to the threatened loss of Selectica's NOLs. Those findings are not clearly erroneous. They are supported by the record and the result of a logical deductive reasoning process. Accordingly, we hold that the Selectica directors satisfied the second part of the *Unocal* test by showing that their defensive response was proportionate by being "reasonable in relation to the threat" identified.

Context Determines Reasonableness

Under a *Unocal* analysis, the reasonableness of a board's response is determined in relation to the "specific threat," at the time it was identified. Thus, it is the specific nature of the threat that "sets the parameters for the range of permissible defensive tactics" at any given time. The record demonstrates that a longtime competitor sought to increase the percentage of its stock ownership, not for the purpose of conducting a hostile takeover but, to intentionally impair corporate assets, or else coerce Selectica into meeting certain business demands under the threat of such impairment. Only in relation to that specific threat have the Court of Chancery and this Court considered the reasonableness of Selectica's response.

The Selectica Board carried its burden of proof under both parts of the *Unocal* test. Therefore, at this time, the Selectica Board has withstood the enhanced judicial scrutiny required by the two part *Unocal* test. That does not, however, end the matter.

As we held in *Moran*, the adoption of a Rights Plan is not absolute. In other cases, we have upheld the adoption of Rights Plans in specific defensive circumstances while simultaneously holding that it may be inappropriate for a Rights Plan to remain in place when those specific circumstances change dramatically. The fact that the NOL Poison Pill was reasonable under the specific facts and circumstances of this case, should not be construed as generally approving the reasonableness of a 4.99% trigger in the Rights Plan of a corporation with or without NOLs.

To reiterate *Moran*, "the ultimate response to an actual takeover bid must be judged by the Directors' actions at that time." If and when the Selectica Board "is faced with a tender offer and a request to redeem the [Reloaded NOL Poison Pill], they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism." The Selectica Board has no more discretion in refusing to redeem the Rights Plan than it does in enacting any defensive mechanism." [*Moran*, 500 A.2d at 1354, 1357.] Therefore, the Selectica Board's future use of the Reloaded NOL Poison Pill must be evaluated if and when that issue arises.

. . . .

[Affirmed.]

Chapter 15

SECURITIES LAW ENFORCEMENT

Page 882: add new § 15.07A:

§ 15.07A DODD-FRANK ENHANCED ENFORCEMENT

The Dodd-Frank Act, enacted in 2010, enhanced SEC enforcement in significant ways. The following discussion summarizes these key additions.

First, in administrative cease and desist proceedings, the SEC may impose civil money penalties upon any violator. This money penalty may be levied based on violation of any provision of the securities acts, including where the defendant engages in negligent conduct. The amount of the penalty ordered is structured in three tiers, with more severe money penalties levied against those who engaged in fraud and whose conduct resulted in (or created a significant risk of) significant pecuniary harm.

Second, the SEC may pursue aiders and abettors not only for violations of the Securities Exchange Act and Investment Advisers Act, but now also under the Securities Act and the Investment Company Act. The requisite mental state for the imposition of aider and abettor liability is knowing or reckless misconduct.

Third, the SEC may invoke Section 20(a) of the Securities Exchange Act to bring enforcement actions against “control persons.” Prior to this clarification, the lower federal courts were divided regarding whether the SEC had this authority to use Section 20(a) or whether the statute was solely applicable in private litigation.

Fourth, the Commission now may impose collateral bars in its administrative enforcement proceedings. An associated person who violates the securities laws is now subject to a bar from associating with any regulated entity, such as a broker-dealer or investment adviser. Prior to this clarification, there was uncertainty whether the Commission’s bar authority was limited to the profession in which the violator engaged in the misconduct (such as whether a registered broker not only could be barred from associating with any broker-dealer firm but also from associating with any investment adviser firm).

Fifth, the clawback provision, enacted pursuant to the Sarbanes-Oxley Act of 2002 (SOX), is no longer limited to a subject reporting company’s CEO and CFO. If an executive received unjust enrichment based on the company’s inaccurate financial statements which have been restated, the company may recover such excessive incentive-based compensation from the executive without any showing of fault being necessary.

Sixth, the SEC has the authority to suspend or revoke the registration of a nationally recognized statistical rating agency (NRSRO) in regard to a specified class (or subclass) of securities if the NRSRO fails to establish and maintain sufficient resources for determining credit ratings in an acceptable manner.

Seventh, the SEC now has discretion to allocate money penalties paid by defendants in SEC enforcement actions to Fair Funds, irrespective whether disgorgement of ill-gotten gains has been obtained by the SEC. Prior to this

amendment, civil money penalties could only be allocated to Fair Funds under SOX's Fair Fund Provision if an order of disgorgement (even as little as \$1) was procured.

Eighth, the SEC now has authority to award whistleblowers monetary awards of ten to thirty percent where a money penalty over \$1 million is levied if such whistleblower provided the SEC with "original information" (meaning information that is independent and not known by the Commission by any other means).

Ninth, the Supreme Court's restrictive decision in *Morrison v. National Australia Bank* (contained in Section 8.13 herein) is nullified in the U.S. government enforcement context. As now set forth, the SEC and the U.S. Department of Justice may bring government actions, even if the transactions did not occur in this country and did not harm U.S. citizens, if the "conduct and effects" test is met.

Page 904: add new § 15.11:

§ 15.11 THE MADOFF SCANDAL

SENTENCING HEARING

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

UNITED STATES OF AMERICA
v.
BERNARD L. MADOFF

} 09 CR 213 (DC)

New York, N.Y.
June 29, 2009
10:00 a.m.

Before:

HON. DENNY CHIN,
District Judge

(In open court)

(Case called)

THE COURT:

Please be seated. Good morning. Mr. Madoff, would you please stand.

Mr. Madoff, you pled guilty on March 12th, 2009 to 11 counts of securities fraud, investment advisor fraud, wire and mail fraud, money laundering, making false statements, perjury, filing false documents with the SEC and theft from employee benefit funds. You are here this morning to be sentenced for those crimes.

Have you reviewed the presentence report?

THE
DEFENDANT:

Yes, I have, your Honor.

§ 15.11

THE MADOFF SCANDAL

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THE COURT: Did you discuss it with your lawyers?

THE DEFENDANT: I have.

THE COURT: Mr. Sorkin, have you reviewed the presentence report and discussed it with your client?

MR. SORKIN: Yes, your Honor, we have.

THE COURT: Do you or your client have any objections to the factual recitations or the guidelines calculations?

MR. SORKIN: We do not, your Honor.

THE COURT: Thank you. You can be seated.

Ms. Baroni, does the government have any objections to the presentence report?

MS. BARONI: No, your Honor.

THE COURT: Thank you.

I accept and adopt the factual recitations set forth in the presentence report. I accept and adopt the guidelines calculation set forth in the presentence report with one clarification which I will discuss in a moment.

The total offense level is 52, the criminal history category is I. The PSR concludes that the guideline range is life imprisonment. That is not quite accurate, however, because the guidelines range cannot be life imprisonment as no count carries the possibility of a life sentence. Rather the most serious counts carry a maximum of 20 years' imprisonment.

I look then to Section 5G1.2(d) of the guidelines, which tells us that where there are multiple counts, and the guideline range exceeds the statutory maximum for the most serious count, the court must impose consecutive terms of imprisonment to the extent necessary to achieve the total punishment.

There is a little bit of ambiguity, however, as to what is meant by "total punishment" where the guideline calculation calls for life imprisonment, but Second Circuit case law makes clear that in such a situation, the district court is to stack or add up the maximum sentences for all the counts.

In *United States v. Evans*, for example, 352 F.3d 65, where the guideline calculation called for life imprisonment but no count carried a life sentence, the court held that the guideline range is 240 years, the maximum sentences for all the counts added together.

Accordingly, here the guideline range is not life imprisonment, but 150 years, the maximum sentences for each of the 11 counts added together. Of course, in light of *Booker* [, 543 U.S. 220 (2005),] and the case law that followed, the guideline range is advisory only. While I must give the guideline range fair and respectful consideration, I am not bound by it. In fact, the Probation Department recommends a sentence of 50 years. Instead I must make an individualized assessment based on all the facts and circumstances, including the factors set forth in the statute. In the end, I must impose a sentence that is reasonable.

We will proceed as follows:

First we will hear from the victims. Then Mr. Sorkin will speak on behalf of Mr. Madoff. Next Mr. Madoff may speak if he wishes. Finally, I will hear from the government.

First the victims. I have received several hundred written statements from victims including the e-mails and letters submitted back in March. Every victim who made a timed request to speak will be permitted to speak today except in two instances. Two members of the same family asked to speak, and we will permit one person to speak on behalf of the family. Two victims have now withdrawn their request. Accordingly, we will hear from 9 victims today.

First we will hear from Mr. and Mrs. Ambrosino. The Ambrosinos can step up to the microphone. Go ahead. Mr. Ambrosino, go ahead. Come up to the microphone so everyone can hear you.

MR. AMBROSINO: Thank you, your Honor. My name is Dominic Ambrosino.

THE COURT: Sir, just keep your voice up.

MR. AMBROSINO: I thank the court for allowing me to speak today. As a retired New York City Correction Officer, I am very familiar with the inside of a courtroom. However, I never in my wildest dreams ever expected to be sitting in one as a victim of an indescribably heinous crime —

THE COURT: Mr. Ambrosino, slow down a touch so our Court Reporter can transcribe what you're saying.

MR. AMBROSINO: That dream came true on March 12th as I watched Bernie Madoff stand and be cuffed. However, the dream really started as a nightmare on December 11th. I can remember the exact second my wife told me the news. I immediately knew all the ramifications, but I don't think she did. The fallout from having your entire life savings drop right out from under your nose is truly like nothing you can ever describe. As first it was the obvious, and how will we pay our bills? How can someone do this to us?

We worked honestly and we worked so hard. This can't be real. We did nothing wrong.

I don't know if anyone other than another victim can explain what the less obvious effects are, how every decision directly and indirectly hinged on the fact that we had the security of our savings. When I was able to leave the job, we bought a motor home to travel the country. We took out a mortgage since it was better to keep our savings in Madoff. We sold the house my wife lived in for 27 years and also put all those profits — and they were high — into our Madoff account. We trusted that the saving and planning would see us through our retirement.

We had ideas of traveling the country. It all stopped abruptly on December 11th. As a result, we are left with no permanent house, a depreciating motor home, we are upside down on the loan and an income from my pension that is our life. This pension used to be perceived as spending money before December 11th, and now although it doesn't cover our monthly expenses, we rely on it fully. It is all we have.

I sustained a 52 percent hearing loss on my job, and at 49 years's old I can't go back to my previous career so I have taken on a job this summer in Arizona as a construction project coordinator. The job will only last until August. Then I don't know what I am going to do.

My wife's foot was run over by a van while in New York City. There was a plea hearing in March. She had a job lined up before the trip. The expenses of the trip were given to us and we had to let it go since she was in a cast for eight weeks. She is now rehabilitating and still feels pain when she stands for long periods of time.

With that background as to who I am, I would like to share some of the specific problems Madoff's crime brought to us. My pension distribution, a one-time decision, were based on the fact that we had savings and security with Madoff. If I should die, my wife is left without my income or health insurance.

We sold our home in New York with the expectation that someday we would have the finances to purchase another one. We have no credit now and can't get a mortgage. We have been forced to take care of people's homes while they are traveling for the summer, as we used to do prior to December 11th.

We have through the generosity of friends been able to stay rent free on the RV lots of other people in the community. This will come to a screeching halt in October when the owners return for the winter season. We don't know where we'll go at that time. We don't have enough income from my pension to pay monthly rent.

The most devastating to us is we lost our freedom. We lost the ability to share our life every day as we explore the country every day. We lost the time to hold hands as we walked. As they say in the commercial, this is priceless.

In closing, I would like to say, Judge Chin, sentencing Bernard L. Madoff to the fullest extent will certainly not eliminate any of the issues I wrote about. It probably won't even gain me satisfaction. As the guard who used to be on the right side of the prison bars, I'll know what Mr. Madoff's experience will be and will know that he is in prison in much the same way he imprisoned us as well as others.

He took from us the freedom that we held so precious close to our lives, the very thing I always valued and never took for granted. In a sense, I would like someone in the court today to tell me how long is my sentence.

Thank you very much.

THE COURT:

Thank you. Next we'll hear from Mr. and Mrs. FitzMaurice.

MS. EBEL:

No, Judge Chin. I am next.

THE COURT: I saw the gentleman standing up next and I thought you were Maureen Ebel.

MS. EBEL: Yes, I am. I am here with my brother, William Thomas McDonough.

THE COURT: All right.

MS. EBEL: My name is Maureen Ebel and I am a victim of Bernard L. Madoff.

I have lost all of my life's hard-earned savings. I have lost my life savings because of our government has failed me and thousands and thousands of other citizens. There are many levels of government complicity in this crime. The Securities and Exchange Commission, by its total incompetence and criminal negligence, has allowed a psychopath to steal from me and steal from the world.

I am a 61-year-old widow and I am now working full time. I have done many things to survive since December 11th, including selling a lot of my possessions and working three jobs at the same time. I have lost a home that my husband and I had owned for 25 years because of this theft.

I have lost my ability to care for myself in my old age. I have lost the ability to donate to charity, especially the Leukemia and Lymphoma Society. I have lost the ability to donate my time working for the charity as I had done in the past because now I must work full time in order to eat.

I have lost the ability to help future generations of my family get an education. I have lost the ability to help them with their housing needs. It pains me so much to remember my husband getting up in the middle of the night. He was a very fine physician. He would get up in the middle of the night year after year in all kinds of weather to go to the hospital to save someone's life in rain, ice and snow.

He would save someone's life so that Bernie Madoff could buy his wife another party rock. I have lost the ability to move around the world freely at this state in my life using the money my husband and I have worked so hard to earn. We had worked, saved and planned for our old age so that we could leave something behind and not be a burden when we became sick and old.

The emotional toll that this has taken on me has been devastating. I have had great pain and suffering at the hands of Bernie Madoff. My health deteriorated rapidly after December 11th. I could not eat or sleep. I was very agitated and hyperactive. I had all the signs and symptoms of someone undergoing great stress. I suffered rapid weight loss, rapid heart rate, sweating, insomnia and sometimes spells.

I had the horrible feeling that I had been pushed into the great black abyss, but I could not indulge these paralyzing feelings too long. I had work to do. While experiencing all these symptoms, I had to sell my home of 25 years, sell my car, sell my possessions and go to work full time. I accepted gifts of money from family and friends to pay for heat, electricity, gasoline and food.

I was the recipient of so many kindnesses and saw so much goodness in people. Goodness in people is something that you, Mr. Madoff, have been blind to your whole life, and that goodness is better than all the yachts and all the French homes in all the world put together.

Sadly, Mr. Madoff not only defrauded thousands of investors, he mastered the art of manipulating our government. FINRA and the Securities and Exchange Commission became his tools. They were willing to relax all regulations that would have uncovered his fraud. The justification for relaxing the regulations was to ease the burden on Wall Street firms, the very firm that bankrupted the world economy.

THE COURT: Ms. Ebel, this is not the time to criticize the agencies. That is not before me. What is before me is what sentence to impose, so if you would address that, please.

MS. EBEL: I will, Judge Chin.

Mr. Madoff, I have read you will be making a statement about your guilt and shame. I do not believe you. Judge Chin, Mr. Madoff should stay in jail until every person who enabled him to cause such a massive devastation is brought to justice. He should stay in jail until the families of every one of his victims are able to restore their financial stability. That could easily take 150 years. Thank you.

THE COURT: Thank you. Next we'll hear from Mr. and Mrs. FitzMaurice.

MR FITZMAURICE: Thank you, Judge Chin, for allowing us to be heard in your courtroom today.

My wife and I here are today representing the thousands of Madoff victims. We have all suffered extensively as a result of his actions. It has been well chronicled that Madoff did not limit his treachery to a few. He stole from the rich, he stole from the poor and he stole from the in-between. He had no boundaries. He stole from individuals as well as charitable organizations of all types and denominations.

My wife and I are not millionaires. He has taken our entire life savings. We have not been overlooked just as many of his other victims. We have worked hard, long and hard for all of our lives to provide for our family and to be in a position to retire someday. I am now forced to work three jobs. My wife is working a full-time job only to make ends meet, to allow us to pay our mortgage and put food on the table.

We are 63 years' old. It will be no retirement for us in the next two or three years. There will be no trips to California to visit our one-year-old grandson. There will be no vacations of any type. Again we are too old to recoup the monies that he has taken from us. We can only work as long as our health will hold up and then we will have to sell our home and hope to survive on social security alone.

Madoff has shown no remorse. Please do not confuse his prepared statement as remorse. His crime was premeditated and calculated. He was attempting to scam investors only days before his arrest. If he had the opportunity, he would still be stealing from innocent investors. He has not truly cooperated with the authorities to recover the money that rightfully belongs to his investors, whom we are now known as victims.

He cheated his victims out of their money so that he and his wife Ruth and their two sons could live a life of luxury beyond belief. This life is normally reserved for royalty, not for common thieves.

Your Honor, we implore you to give him the maximum sentence at a maximum prison for this evil lowlife. This would be true justice. Minimum security prison would only allow Madoff too many freedoms that he does not deserve. He would be leading a life better than a lot of his victims. That is not true justice. His was a violent crime without the use of a tangible weapon.

His attorney will argue for a lenient sentence of up to twelve years. That is both insulting and another example of Madoff's arrogance. The scope of the devastation he has wreaked is unparalleled. It is impossible to compare his crime to any past criminal act. The pain he has inflicted will continue for many years. My life will never be the same. I am financially ruined and will worry every day about how I will take care of my wife.

Where will we be able to live? How will we pay our bills? How will we get medical insurance?

All of his victims worldwide will be waiting to see that true justice is served. True justice is a maximum sentence in a maximum security prison. I have a quotation from my wife, since only one of us could speak. She wants to say:

"I cry every day when I see the look of pain and despair in my husband's eyes. I cry for the life we once had before that monster took it away. Our two sons and daughter-in-law have rallied with constant love and support. You, on the other hand, Mr. Madoff, have two sons that despise you. Your wife, rightfully so, has been vilified and shunned by her friends in the community. You have left your children a legacy of shame. I have a marriage made in heaven. You have a marriage made in hell, and that is where you, Mr. Madoff, are going to return. May God spare you no mercy."

THE COURT:

Thank you.

Next we will hear from Carla Hirschhorn.

MS.
HIRSCHIHORN:

Good morning and thank you, your Honor, for allowing me to address you.

My husband and I write to you to explain the devastation caused by Bernard L. Madoff to our lives. Since 1992 we were invested with Bernard L. Madoff Investment Securities. We have never been rich people. We have worked throughout all our adult lives. Over the years my husband has worked hard to learn a trade as a glazer which afforded him the opportunity to start a small business. I have been a physical therapist and worked through to the day I was graduated from college in 1980. We have both diligently saved our hard-earned money to invest with Bernard Madoff over the years. We used our money to raise our children, purchase our home and put our savings in Bernard Madoff Securities.

Since December 11th, 2008 life has been a living hell. It feels like a nightmare that we can't wake up from. I am so thankful that my father died two years ago and was spared from having to live in his terminal condition without the money to provide him 24/7 health care which allowed him to die with dignity.

My father died and left my mother believing she would be able to live a safe and secure life with the money in her Bernard Madoff accounts. Now all she has to live on is a sparse social security check and a small pension which will last less than one year. She may not have enough money to maintain her home and living expenses.

It is our hope and in our prayers she does not become ill and require extraordinary means to sustain her. Our daughter who sits in this courtroom today to witness this horrific event is a junior at college and has worked two jobs since our Madoff accounts were stolen while going to school full time. The stress and worry about her family's financial situation and health of her parents has been devastating to her. We have no idea how we will continue to pay for college without it being a terrible financial burden and worry on all of us.

Immediately after hearing the news of the ponzi scheme, we filed papers for financial aid to sustain our daughter through college. We were informed we were not eligible for any grant money, that our only hope would be to take out loans. However, in this financial environment, without SIPIC insurance and with concern about claw-back litigation, we can't possibly take loans out to send our daughter to college. The turmoil caused by our financial devastation has caused us serious physical and emotional problems from which we need medical treatment.

Your Honor, please understand that we, the investors, have been punished by Madoff's crime. We were devastated by the SEC's failure to uncover Madoff's fraud and its continued stamp of approval behind Madoff over the decades of his crime. We have been abandoned by our elected officials which refuse to require the SEC to find income. We have been betrayed by SIPIC, which in order to save money, has invented a new definition of net equity to deprive us of the \$500,000 of insurance which we were assured.

Please, your Honor, do not fail us. Please assure that Madoff is sentenced with the maximum possible time and he is required to serve his sentence in a maximum security prison. This is not a man who deserves a federal country club.

Respectfully, Carla Hirschhorn.

THE COURT:

Thank you.

It is not up to me, by the way, where Mr. Madoff will be designated. A number of people have made that suggestion, but it is up to the Bureau of Prisons.

Next we'll hear from Sharon Lissauer.

MS.
LISSAUER:

My name is Sharon Lissauer. Thank you, your Honor, for letting me speak. I am very emotional, so please bear with me if I break down into tears. As everyone knows, this nightmare has begun six and a half months ago and yet it seems like a lifetime.

I keep on thinking I am going to wake up from it. It keeps on getting worse. My life and my future have been ruined. I was always so careful with my money, but I entrusted everything I had to Mr. Madoff, my whole life savings from modeling and the inheritance of my mom. She just died last year, and as soon as I got the money, because I just miss her and I trusted Mr. Madoff so much, I gave it all to him, but now I don't have my mom or the money.

I know I am not alone. I know he has ruined thousands of people's lives. In the March hearing he said that he was truly sorry, which I don't really believe, but even if it is a little bit true, then I am not asking him, I am begging him, if he has any money from the offshore accounts or his family has any money obtained from this horrible fraud, that they disgorge it and give it back to the victims so they can have a little bit of their lives back.

With respect to his sentencing, I used to think that it didn't matter if he got 150 years, what would that do for the victims? It wouldn't get their money back. But now upon reflection, I think he should spend his whole life in jail because of what he has done is just despicable. He has ruined so many people's lives. He killed my spirit and shattered my dreams. He destroyed my trust in people. He destroyed my life, and I have no other assets. I make very little money from modeling and he left me in a very difficult position to pay my bills and support myself. For the first time in my life I am very, very frightened of my future.

Thank you, your Honor.

THE COURT:

Thank you.

Next we'll hear from Burt Ross. Mr. Ross.

MR. ROSS:

Your honor, my name is Burt Ross and my wife Joan and I lost \$5 million because of the criminal acts of Bernard Madoff. Not only have I lost the inheritance of my father who worked for his entire life so that his children and his children's children can leave a better life, I have lost our retirement accounts and funds in trust for our children.

The fact is though we are one of the fortunate ones because we still have a roof over our heads, food on our table, unlike so many others who have been forced to sell their homes, who have been forced to sell their homes and pick up the pieces of their lives.

Years ago I attended a Friends secondary school where we thought that in each person there was an inner light, that of God and everyone. For the life of me, as far as I have searched, I cannot find that inner light in Bernard Madoff.

What can we possibly say about Madoff, that he was a philanthropist, when the money he gave to charities he stole from the very same charities he ultimately devastated; that he was a good family man when he leaves his grandchildren a name that mortifies them, a name which they will live in infamy; that he is genuinely remorseful for his conduct when the statement he read in this very court was totally without emotion, when even after confessing he fought to keep assets away from those he hurt, when we all know his only regret was getting caught.

Can we say Madoff was a righteous Jew who served on the boards of Jewish institutions when he sank so low, when he sank so low as to steal from Elie Weisel, as if Weisel hasn't already suffered enough in his lifetime.

A righteous Jew, when in reality nobody has done more to reinforce the ugly stereotype that all we care about is money the fact is there are no people on this earth more charitable? But we will survive. We have survived worse than Madoff.

What Bernard L. Madoff did far transcends the loss of money. It involves his betrayal of the virtues people hold dearest — love, friendship, trust — and all so he can eat at the finest restaurants, stay at the most luxurious resorts, and travel on yachts and private jets. He has truly earned his reputation for being the most despised person to be in America today.

Several hundred years ago the Italian poet Dante in his “The Divine Comedy” recognized fraud as the worst of sins, the ultimate evil more than any other act contrary to God’s greatest gift to mankind — love. In fact, he placed the perpetrators of fraud in the lowest depths of hell, even below those who had committed violent acts. And those who betrayed their benefactors were the worst sinners of all, so in the three mouths of Satan struggle Judas for betraying Jesus Christ, and Brutus and Cassius for betraying Julius Caesar.

Please allow me to take a liberty now by speaking for many of those victims who because of frailty, privacy, distance, or other reasons are unable to bear witness today. We urge your Honor to commit Madoff to prison for the remainder of his natural life, and when he leaves this earth virtually unmourned, may Satan grow a fourth mouth where Bernard L. Madoff deserves to spend the rest of eternity.

Thank you.

THE COURT:

Thank you. Next we’ll hear from Michael Schwartz.

MR.
SCHWARTZ:

Can everyone hear me?

My name is Michael Schwartz. I am 33 years’ old. It was my family’s trust fund that helped fund the money for Bernard Madoff’s organization. Since I was a teenager, I invested into what I thought was a forthright and legitimate investment firm. During this time I made sure I lived well within my means, nothing extravagant. I viewed my investment as a safety net in case I should hit hard times or perhaps face medical issues.

Unfortunately, several months ago, my job was regionalized, eliminated. I was handed a letter of recommendation and sent on my way. It didn’t hit me until I got home that the company that you ran had already taken my life savings. At 33, I was wiped out.

I am one of the lucky ones by far. I have my health. I am young, I have great friends, got a loving wife. Unfortunately, the money you took from other members of my family wasn’t a minor setback. It was quite a bit more. Your Honor, part of the trust fund wasn’t set aside for a house in the Hamptons, a large yacht or box seat to the Mets. No, part of that money was set aside to take care of my twin brother who is mentally disabled, who at 33, he lives at home with my parents and will need care and supervision for the rest of his life.

In the final analysis, my family wants to remember that in addition to stealing from retirees, veterans, widows, Bernard Madoff stole from the disabled. Every time he cashed a check and paid for his family’s decadent lifestyle, he killed dreams. My parents had a simple dream for my brother, a week at summer camp, someday being able to live in a good group home. Thanks to Bernard Madoff’s greed, complete lack of ethics, that dream will be delayed.

At the end of the day my twin brother will be taken care of. My family is strong enough to weather this storm but, your Honor, I say this without any malice, Bernard Madoff should no longer be allowed back in society. I only hope that his prison sentence is long enough so that his jail cell becomes his coffin. Thank you.

THE COURT: Thank you.

We'll hear next from Miriam Siegman.

MS. SIEGMAN: I was born a few blocks from this courthouse. I still live here. On a cold winter's day just before my 65th birthday, the man sitting in front of me announced to the world that he had stolen everything I had. After that he refused to say another word to his victims. I am here today to bear witness for myself and others, silent victims.

The streets of my childhood felt safe. The streets I wander now feel threatening. The man sitting in this courtroom robbed me. In an instant his words and deeds beat me to near senselessness. He discarded me like road kill. Victims became the byproduct of his greed. We are what is left over, the remnants of stunning indifference and that of politicians and bureaucrats.

Six months have passed. I manage on food stamps. At the end of the month I sometimes scavenge in dumpsters. I cannot afford new eyeglasses. I long to go to a concert, but I never do. Sometimes my heartbeats erratically for lack of medication when I cannot pay for it.

I shine my shoes each night, afraid they will wear out. My laundry is done by hand in the kitchen sink. I have collected empty cans and dragged them to the redemption centers.

I do this now. People ask how are you? My answer always is I'm fine, but it is not always true. I have lived with fear. It strikes me at all hours. I calculate again and again how long I can hold out.

It is only a matter of time. I will be unable to meet my own basic needs, food, shelter, medicine. I feel grief at no longer being able to help support my beloved sister. I feel shame and humiliation asking for help.

I also feel overwhelming sadness. I know that another human being did this to me and to all the victims, but I don't know why. What I do understand frightens me. The man who did this had deep contempt for his victims.

There are many victims including those we never hear from or see; union members, pipe-fitters, laborers, women who work in nursing homes, bricklayers, firemen, working people. One victim shot himself. The inquest informs us he was a highly decorated former soldier who could not face the shame of his ruin, his last words on a humanitarian mission in Afghanistan. By self-admission, this thief among us knew his victims were facing a kind of death at his hands, yet he continued to play with us as a cat would with a mouse.

What shall be the punishment for such a man? What sentence? Carry the burden we carry, feel his shame, humiliation and isolation as I do. Feel it each day wherever you are until life ends.

Face and acknowledge the murderous effects of your life's work. I long for the truth that might become of a trial and hope justice had placed a higher premium on truth and expediency. Forgiveness for now, it will have to come from someone other than me.

THE COURT: Thank you. Finally we'll hear from Sheryl Weinstein.

MS. Hello, your Honor.

WEINSTEIN:

THE COURT: Good morning.

MS.

WEINSTEIN:

I was introduced to Bernard Madoff 21 years ago at a business meeting. At the time I was the chief financial officer of Hadassah, a charitable women's organization. I now view that day as perhaps the unluckiest day of my life because of the many events set into motion that would eventually have the most profound and devastating effect on me, my husband, my child, my parents, my in-laws and all those who depended upon us for their liveliness.

You have read and you appear from many of us, the old, the young, the healthy and infirm about the unimaginable extent of human tragedy and devastation. According to a Time Magazine article, there are over 3 million individuals worldwide who have been directly or indirectly affected. They, the press and the media, speak of us as being greedy and rich. Most of us are just ordinary working people, worker bees, as I like to refer to us.

My husband and I are not both in our 60's and have been married for 37 years. We have saved for most of our lives by living beneath our means in order to provide for our retirement. This past Thursday at 2:00 o'clock my husband and I sold our home of 20 years. People are always asking how much did we lose? My reply is that when you lose everything, it really doesn't matter because you have nothing left, and we have lost everything.

Many have told us we were lucky — I no longer know — to be able to sell in this depressed market although at a greatly reduced amount. We had to sell because four years ago we refinanced our mortgage and gave the excess cash to Bernie Madoff. There was very little left over after all was said and done at the closing.

It is difficult to describe how it feels due to circumstances outside of your control to be virtually forced out of your home, to leave unwillingly. Last Tuesday I walked out following the movers with a thought I would be back before the closing, but knowing in the back of my mind that I wouldn't.

My husband was the last to be in our home. He shared with me his hesitation of not wanting to leave, of wanting to remain, but realizing that staying was no longer an option. We chose not to go to the closing because it would have been too difficult and painful for either of us to be there. For months after December 11th I would wake in the dark hours of the night and early morning and to my horror realize that there was no calming, soothing words I could say to myself because it wasn't a dream. The monster who visited me was true, a reality. Those same thoughts would occur to me upon waking in the morning and during the day and a deep, heavy depression would surround me and not lift.

This went on for many months. I went on after bad dreams, virtually not unable to eat. The sight of food was making me feel sick, unable to escape the reality of my personal devastation. At times I could not even bear to be alone. I would ask my friends to either stay with me at the office even if there was very little work to do. It would prompt me to pick up the phone to call my husband to be reassured I was not alone.

This continued until March 12th when Madoff entered his plea of guilty. I began to speak out to the media, and the helpless and hopeless feelings began to retreat and I began to feel empowered. It came together for me while being interviewed by Katie Couric. She asked me wasn't I embarrassed being a CPA losing all my money? At that moment I realized and responded no, I am not embarrassed because I did not lose my money. My money was stolen from me.

Ms. Couric said to me you sound angry, and I said yes, you're right. When someone steals from you, you get angry. That was the beginning of my healing process.

I felt it was important for somebody who is personally acquainted with Madoff to speak. My family and I are not anonymous people to him. He knows my husband's name is Rob and my son's name is Eric. In fact, Eric worked for him one summer while in college many years ago. Eric would continue to call him over the years to ask for his advice and input. Eric entrusted him with his money that he worked and saved. A few months before all this happened Eric had spoken to him and thanked him for doing such a good job.

I would now like to have the opportunity to share with you my personal feelings about Madoff and to speak to his sentencing.

I remember when my son was perhaps a few weeks' old and I would watch him as he slept and he would whimper, not a cry of hunger, but a whimper. Even at a few weeks's old there was something about his subconscious that could frighten him. It amazed me such a young child, an infant can have nightmares.

All of us from our earliest ages remember those times when the terror, the monsters and goblins would come visit us in those dark hours. Eventually we would be so frightened that we would awake sometimes calling out to our parents because of the fear.

It was calming to have our parents remind us it was only a dream. As we got older, we could wake ourselves and self-assure ourselves it was only a dream. That terror, that monster, that horror, that beast has a name to me, and it is Bernard L. Madoff. I will now attempt to explain to you the nature of this beast who I call Madoff.

He walks among us. He dresses like us. He drives and eats and drinks and speaks. Under the facade there is truly a beast. He is a beast that has stolen for his own needs the livelihoods, savings, lives, hopes and dreams and futures of others in total disregard. He has fed upon us to satisfy his own needs. No matter how much he takes and from whom he takes, he is never satisfied. He is an equal opportunity destroyer.

I felt it important for you to know in appearance, he would be just like everybody else and it is for this reason I am asking your Honor to keep him in a cage behind bars because he has lost the privilege of walking and being among us mortal human beings. He should not be given the opportunity to walk into our society again.

I would like to suggest that while any man, woman or child that has been affected by his heinous crime still walks this earth, Madoff the beast should not be free to walk among them. You should protect society from the likes of him. I have reread Madoff's March 12th statement to you. Certain quotes jumped out at me. His continuing self-serving references, and I quote, that his proprietary trading in the market making business managed by his brother and two sons was legitimate, profitable and successful in all respects, or that he felt, "compelled to satisfy my clients' expectations at any cost."

It sounds as if he is laying the blame on his clients' expectations and never admitting the truth he was stealing from these clients and the lives he ruined. If he was attempting to protect his family, he should not be given that opportunity because we, the victims, did not have the same opportunity to protect our families. Madoff the beast has stolen our ability to protect our loved ones away from us. He should have no opportunity to protect his family.

We, the victims, are greatly disappointed by those agencies that were set up to protect us. SIPIC has now redefined what we are entitled to. The IRS approved their office request to be a custodian of our IRSs and pension funds and the SEC appears to have looked the other way on numerous occasions. This is a human tragedy of historic proportions and we ask — no, we implore — that those whose agencies may have failed us in the past through acts of omissions, step up to the plate, fulfill their responsibilities. I thank your Honor for your indulgence and I feel comfortable you will make sure justice is served.

Thank you.

THE COURT: Thank you.

Thanks to all the victims who spoke today and to all those who wrote. I appreciate hearing your views.

Mr. Sorkin.

MR. SORKIN: Good morning, your Honor.

THE COURT: Good morning.

MR. SORKIN: Before I speak, would your Honor respectfully acknowledge you have received both the government's sentencing memorandum and two responses?

THE COURT: Yes, I have your initial letter I received yesterday and your brief reply. I have the government's memorandum as well.

MR. SORKIN: Thank you.

THE COURT: I have read them all.

MR. SORKIN: Thank you, your Honor.

THE COURT: Yes.

MR. SORKIN:

Your Honor, I know I speak on behalf of all Mr. Madoff's counsel as well as Mr. Madoff who will speak. We cannot be unmoved by what we heard. There is no way that we cannot be insensitive to the victims' suffering.

This is a tragedy as some of the victims have said at every level. There is no doubt Mr. Madoff will speak. We represent a deeply flawed individual, be we represent, your Honor, a human being. We don't represent a statistic. We don't represent a number. We speak to the victims. We have heard what they've had to say and we can only imagine, your Honor, what we would have heard from others.

I say again, forgive me for being redundant, we represent a very flawed individual, an individual who appears before this court facing a sentence that is sufficient but not unreasonably necessary to carry out the mandate that this court has to carry out.

The magnificence of our legal system, your Honor, is that we do not seek an eye for an eye. To be sure, if it is any consolation to the victims, we have worked hopefully diligently with the U.S. Attorney's Office in an atmosphere of trying to recover assets. To that extent, your Honor, we have provided the government with what we believe to be the assets that Mr. Madoff has gathered over the years which the victims have referred to, and again if it is any consolation to them, to the extent that the government has left him and his family, his wife impoverished, we are just about there with respect to everything the government believes it can show in order to obtain the appropriate assets for forfeiture.

Vengeance is not the goal of punishment. Our system of justice, your Honor, has recognized that justice is and must always be blind and fair — not blind to the criminal acts that Mr. Madoff pleaded guilty to and certainly not blind to the suffering of the victims, but blind to the extent that it will achieve a sentence that has been set out over the years in the guidelines and the cases interpreting the guidelines, and the guidelines and the courts and the statutes, your Honor, do not speak of vengeance and revenge.

There is something bordering on the absurd, and we cited United States versus Ellison on this point, your Honor. For the government to ask for 150 years so that Mr. Madoff gets out of jail at the age of 221 because he is 71 now, he will face supervised release. By the same token, your Honor, it defies reason for the Probation Department to suggest that he be sentenced to 50 years in prison for the very same reasons.

I point out to the court, and forgive me, your Honor, for repeating what is in the letter we sent you most recently, that Mr. Madoff, as he pleaded to, as appears in the presentence report and appears in the information in which the government agrees, for most of the period of time that Mr. Madoff is alleged to have engaged in this ponzi scheme and, in fact, it was a ponzi scheme, it was money in and money out.

Most of the money went for redemptions. People who invested money were given back money. To be sure, it was fraud. To be sure, it was a ponzi scheme. To be sure, it was a crime, but nevertheless, your Honor, I point out, and in response respectfully to some of the victims, I think it is common knowledge in the industry that Mr. Madoff built up this firm on the proprietary trading side to the point in 1991, as the presentence report points out, the proprietary trading side which at the point of his arrest had approximately 200 employees separate and apart from the fraudulent advisory business, a hundred traders making markets and in 1991, your Honor, accounted for almost 10 percent of all transactions on the New York Stock Exchange.

Sufficient to provide revenue at the same time Mr. Madoff engaged in taking money in and taking money out, most of that money went for redemptions. As we point out in our letter of yesterday, and as the government notes, the loans, the commingling, and we do dispute this with the government, but I don't think it is a relevant issue, the commingling, the loans.

MR. SORKIN:

The loans, the commingling, commenced within the last eight to ten years. And as Mr. Madoff will say, things began to collapse. And then there was commingling with \$250 million over the last eight or so years, of advisory money, as well as money in, money out of investments.

I think it's important to note, your Honor, again that Mr. Madoff stepped forward. He chose not to flee. He chose not to hide money. To the extent money is overseas, we are still actively engaged — we, his defense counsel — in assisting the government, at the request of the government, to obtain assets located overseas, as we speak, and we submitted that voluntarily, and we have been trying to help, with Mr. Madoff's authorization, permission, and blessing.

Mr. Madoff is 71 years old, your Honor. Based upon his health, his family history, his life expectancy, that is why we ask for a sentence of 12 years, just short, based upon the statistics that we have, of a life sentence.

We also said, if your Honor is inclined, your Honor obviously makes the decision, 15 to 20 years. So that if Mr. Madoff ever sees the light of day, in his 90s, impoverished and alone, he will have paid a terrible price. He expects, your Honor, to live out his years in prison.

Your Honor, as we noted in our letter to you, that the loss in this case is \$13,226,000,000. What has not been heard publicly, your Honor, is the fact that over \$1,276,000,000 is held by the SIPC trustee, and we have no control over how that money is disbursed. And I say this for the victims we have heard. Again, we have no control over what the SIPC trustee does with the money that he obtains, nor do we have any control over what the SEC will do, nor do we have any control as to how the government to whom we have forfeited all of the assets but a few, which the government and we have agreed were weighed against the risk of litigation, we have no control how that money is disbursed.

Additionally to the \$1,276,000,000, the SIPC trustee has recovered \$1,225,000,000, has sent demand letters to individuals for 735 million, and has commenced litigation to seek a clawback from some very large funds to obtain redemptions and interest payments in the amount of \$10,100,000,000. It is our hope, your Honor, our sincerest hope, that all the money is collected, in an amount in excess of \$13,226,000,000, that that will be provided to investors.

The frenzy, the media excitement, that Mr. Madoff engaged in a Ponzi scheme involving \$65 billion and that he has ferreted money away, as far as we know, your Honor, that is simply not true, and it is not borne out by the government.

In closing, your Honor, there is no question that this case has taken an enormous toll, not only on Mr. Madoff and his family, but to the victims to be sure. But it has also taken a toll, your Honor, as Mr. Madoff will say, on the industry that he helped revolutionize, that he helped grow, and now has become the object of disrespect and abomination, and that is a tragedy as well.

We ask only, your Honor, that Mr. Madoff be given understanding and fairness, within the parameters of our legal system, and that the sentence that he be given be sufficient, but not greater than necessary, to carry out what this Court must carry out under the rules, statutes and guidelines.

Thank you, your Honor.

THE COURT:

Thank you.

Mr. Madoff, if you would like to speak, now is the time.

THE
DEFENDANT:

Your Honor, I cannot offer you an excuse for my behavior. How do you excuse betraying thousands of investors who entrusted me with their life savings? How do you excuse deceiving 200 employees who have spent most of their working life working for me? How do you excuse lying to your brother and two sons who spent their whole adult life helping to build a successful and respectful business? How do you excuse lying and deceiving a wife who stood by you for 50 years, and still stands by you? And how do you excuse deceiving an industry that you spent a better part of your life trying to improve? There is no excuse for that, and I don't ask any forgiveness.

Although I may not have intended any harm, I did a great deal of harm. I believed when I started this problem, this crime, that it would be something I would be able to work my way out of, but that became impossible. As hard as I tried, the deeper I dug myself into a hole. I made a terrible mistake, but it wasn't the kind of mistake that I had made time and time again, which is a trading mistake. In my business, when you make a trading error, you're expected to make a trading error, it's accepted. My error was much more serious. I made an error of judgment. I refused to accept the fact, could not accept the fact, that for once in my life I failed. I couldn't admit that failure and that was a tragic mistake.

I am responsible for a great deal of suffering and pain. I understand that. I live in a tormented state now knowing all of the pain and suffering that I have created. I have left a legacy of shame, as some of my victims have pointed out, to my family and my grandchildren. That's something I will live with for the rest of my life.

People have accused me of being silent and not being sympathetic. That is not true. They have accused my wife of being silent and not being sympathetic. Nothing could be further from the truth. She cries herself to sleep every night knowing all of the pain and suffering I have caused, and I am tormented by that as well. She was advised to not speak publicly until after my sentencing by our attorneys, and she complied with that. Today she will make a statement about how she feels about my crimes. I ask you to listen to that. She is sincere and all I ask you is to listen to her.

Apologizing and saying I am sorry, that's not enough. Nothing I can say will correct the things that I have done. I feel terrible that an industry I spent my life trying to improve is being criticized terribly now, that regulators who I helped work with over the years are being criticized by what I have done. That is a horrible guilt to live with. There is nothing I can do that will make anyone feel better for the pain and suffering I caused them, but I will live with this pain, with this torment for the rest of my life.

I apologize to my victims. I will turn and face you. I am sorry. I know that doesn't help you.

Your Honor, thank you for listening to me.

THE COURT: Thank you.

Mr. Sorkin, did I understand Mr. Madoff to say that Mrs. Madoff wanted to speak?

MR. SORKIN: No, your Honor. Mrs. Madoff after the sentencing will be giving a statement. And I add what Mr. Madoff said about belaboring it, that she was advised by counsel to wait until after sentence.

THE COURT: I thought he was saying she wanted to speak. Thank you.

I will hear from the government.

MS. BARONI: This defendant carried out a fraud of unprecedented proportion over the course of more than a generation. For more than 20 years he stole ruthlessly and without remorse. Thousands of people placed their trust in him and he lied repeatedly to all of them. And as the Court heard from all of the victims, in their words and in the letters, he destroyed a lifetime of hard work of thousands of victims. And he used that victims' money to enrich himself and his family, with an opulent lifestyle, homes around the world, yachts, private jets, and tens of millions of dollars of loans to his family, loans of investors' money that has never been repaid.

The guideline sentence in this case, as your Honor knows, is 150 years and the government respectfully submits that a sentence of 150 years or a substantial term of imprisonment that will ensure that he spends the rest of his life in jail is appropriate in this case.

This was not a crime born of any financial distress or market pressures. It was a calculated, well orchestrated, long-term fraud, that this defendant carried out month after month, year after year, decade after decade. He created literally hundreds and hundreds of thousands of fake documents every year. Every time he told his clients that he was making trades for them he sent them trade confirmations filled with lies. At every month end he sent them account statements that were nothing but lies. And the defendant knew that his clients made critically important life decisions, as your Honor heard today, based on these lies. Decisions about their children's education, their retirement, how to care for elderly relatives, and how to provide for their families. He knew this, and he stole from them anyway.

In doing so, he drove charities, companies, pension plans and families to economic ruin. And even on the most dispassionate view of the evidence, the scale of the fraud, which is at a conservative estimate, your Honor, \$13 billion, when you look at the duration of the fraud, which is more than 20 years, when you look at the fact that the defendant could have stopped this fraud and saved the victims' losses, all of these facts justify a guideline sentence of 150 years.

And to address briefly some of Mr. Sorkin's arguments, despite Mr. Sorkin's arguments, the defendant here deserves no leniency and certainly does not deserve a sentence of 12 years' imprisonment.

Mr. Sorkin tries to argue that the loss amount is actually going to be less than 13 billion because the trustee may recover some assets in clawback proceedings. As your Honor knows, that has nothing to do with the loss amount in this case. Further, the defendant shouldn't get any credit for anything the government or the trustee does after the fraud to recover money.

In asking for 12 years, your Honor, the defendant is asking you to impose a sentence that a defendant would receive in a garden variety fraud case in this district, a case with about \$20 million of losses and far fewer victims. In imposing a 12 year sentence in this case, on the facts and circumstances here, would be profoundly unfair. Not only would it not reflect the seriousness and the scope of the defendant's crimes, but, also, it would not promote the goals of general deterrence going forward.

Mr. Sorkin's argument that the defendant should get some credit for coming forward and turning himself in is also entirely meritless. The defendant continued his fraud scheme until the very end, when he knew the scheme was days away from collapse, when he was almost out of money and when he was faced with redemption requests from clients that he knew he could not meet. And even at that point, rather than turning himself in, he tried to take the last of his victims' money. He prepared \$173 million in checks that he planned to give to his family, his friends, and some preferred clients. It was his final effort to put his interests above those of his clients, and had the FBI not arrested him when they did, he might well have succeeded.

Your Honor, in sum, for running an investment advisory business that was a complete fraud, for betraying his clients for decades, and for repeatedly lying to regulators to cover up his fraud, for the staggering harm that he has inflicted on thousands of people, for all of these reasons and all of the reasons your Honor heard so eloquently from the victims, the government, respectfully requests that the Court sentence the defendant to 150 years in prison or a substantial term of imprisonment that ensures that he will spend the rest of his life in jail.

Thank you.

THE COURT:

Thank you.

I take into account what I have read in the presentence report, the parties' sentencing submissions, and the e-mails and letters from victims. I take into account what I have heard today. I also consider the statutory factors as well as all the facts and circumstances in the case.

In his initial letter on behalf of Mr. Madoff, Mr. Sorkin argues that the unified tone of the victims' letters suggests a desire for mob vengeance. He also writes that Mr. Madoff seeks neither mercy nor sympathy, but justice and objectivity.

Despite all the emotion in the air, I do not agree with the suggestion that victims and others are seeking mob vengeance. The fact that many have sounded similar themes does not mean that they are acting together as a mob. I do agree that a just and proportionate sentence must be determined, objectively, and without hysteria or undue emotion.

Objectively speaking, the fraud here was staggering. It spanned more than 20 years. Mr. Madoff argues in his reply letter that the fraud did not begin until the 1990s. I guess it's more that the commingling did not begin until the 1990s, but it is clear that the fraud began earlier. And even if it is true that it only started in the 1990s, the fraud exceeded ten years, still an extraordinarily long period of time. The fraud reached thousands of victims.

As for the amount of the monetary loss, there appears to be some disagreement. Mr. Madoff disputes that the loss amount is \$65 billion or even \$13 billion. But Mr. Madoff has now acknowledged, however, that some \$170 billion flowed into his business as a result of his fraudulent scheme. The presentence report uses a loss amount of \$13 billion, but as I understand it, that number does not include the losses from moneys invested through the feeder funds. Mr. Madoff argues that the \$13 billion amount should be reduced by the amounts that the SIPC trustee may be able to claw back, but that argument fails. Those clawbacks, if they happen, will result in others who suffered losses. Moreover, Mr. Madoff told his sons that there were \$50 billion in losses. In any event, by any of these monetary measures, the fraud here is unprecedented.

Moreover, the offense level of 52 is calculated by using a chart for loss amount that only goes up to \$400 million. By any of these measures, the loss figure here is many times that amount. It's off the chart by many fold.

Moreover, as many of the victims have pointed out, this is not just a matter of money. The breach of trust was massive. Investors — individuals, charities, pension funds, institutional clients — were repeatedly lied to, as they were told their moneys would be invested in stocks when they were not. Clients were sent these millions of pages of account statements that the government just alluded to confirming trades that were never made, attesting to balances that did not exist. As the victims' letters and e-mails demonstrate, as the statements today demonstrate, investors made important life decisions based on these fictitious account statements — when to retire, how to care for elderly parents, whether to buy a car or sell a house, how to save for their children's college tuition. Charitable organizations and pension funds made important decisions based on false information about fictitious accounts. Mr. Madoff also repeatedly lied to the SEC and the regulators, in writing and in sworn testimony, by withholding material information, by creating false documents to cover up his scheme.

It is true that Mr. Madoff used much of the money to pay back investors who asked along the way to withdraw their accounts. But large sums were also taken by him, for his personal use and the use of his family, friends, and colleagues. For example, Mr. Madoff reported adjusted gross income of more than \$250 million on his tax returns for the ten year period from 1998 through 2007. On numerous occasions, Mr. Madoff used his firm's bank accounts which contained customer funds to pay for his personal expenses and those of his family, including, for example, the purchase of a Manhattan apartment for a relative, the acquisition of two yachts, and the acquisition of four country club memberships at a cost of \$950,000. Billions of dollars more were paid to individuals who generated investments for Mr. Madoff through these feeder funds.

Mr. Madoff argues a number of mitigating factors but they are less than compelling. It is true that he essentially turned himself in and confessed to the FBI. But the fact is that with the turn in the economy, he was not able to keep up with the requests of customers to withdraw their funds, and it is apparent that he knew that he was going to be caught soon. It is true that he consented to the entry of a \$100 billion forfeiture order and has cooperated in transferring assets to the government for liquidation for the benefit of victims. But all of this was done only after he was arrested, and there is little that he could have done to fight the forfeiture of these assets. Moreover, the SIPC trustee has advised the Court Mr. Madoff has not been helpful, and I simply do not get the sense that Mr. Madoff has done all that he could or told all that he knows.

Mrs. Madoff has stipulated to the transfer of some \$80 million dollars in assets to the government for the benefit of victims, but the record also shows that as it became clear that Mr. Madoff's scheme was unraveling, he made substantial loans to family members, he transferred some \$15 million of firm funds into his wife's personal accounts, and he wrote out the checks that the government has just described.

I have taken into account the sentences imposed in other financial fraud cases in this district. But, frankly, none of these other cases is comparable to this case in terms of the scope, duration and enormity of the fraud, and the degree of the betrayal.

In terms of mitigating factors in a white-collar fraud case such as this, I would expect to see letters from family and friends and colleagues. But not a single letter has been submitted attesting to Mr. Madoff's good deeds or good character or civic or charitable activities. The absence of such support is telling.

We have heard much about a life expectancy analysis. Based on this analysis, Mr. Madoff has a life expectancy of 13 years, and he therefore asks for a sentence of 12 years or alternatively 15 to 20 years. If Mr. Sorkin's life expectancy analysis is correct, any sentence above 20 or 25 years would be largely, if not entirely, symbolic.

But the symbolism is important, for at least three reasons. First, retribution. One of the traditional notions of punishment is that an offender should be punished in proportion to his blameworthiness. Here, the message must be sent that Mr. Madoff's crimes were extraordinarily evil, and that this kind of irresponsible manipulation of the system is not merely a bloodless financial crime that takes place just on paper, but that it is instead, as we have heard, one that takes a staggering human toll. The symbolism is important because the message must be sent that in a society governed by the rule of law, Mr. Madoff will get what he deserves, and that he will be punished according to his moral culpability.

Second, deterrence. Another important goal of punishment is deterrence, and the symbolism is important here because the strongest possible message must be sent to those who would engage in similar conduct that they will be caught and that they will be punished to the fullest extent of the law.

Finally, the symbolism is also important for the victims. The victims include individuals from all walks of life. The victims include charities, both large and small, as well as academic institutions, pension funds, and other entities. Mr. Madoff's very personal betrayal struck at the rich and the not-so-rich, the elderly living on retirement funds and social security, middle class folks trying to put their kids through college, and ordinary people who worked hard to save their money and who thought they were investing it safely, for themselves and their families.

I received letters, and we have heard from for example, a retired forest worker, a corrections officer, an auto mechanic, a physical therapist, a retired New York City school secretary, who is now 86 years old and widowed, who must deal with the loss of her retirement funds. Their money is gone, leaving only a sense of betrayal.

I was particularly struck by one story that I read in the letters. A man invested his family's life savings with Mr. Madoff. Tragically, he died of a heart attack just two weeks later. The widow eventually went in to see Mr. Madoff. He put his arm around her, as she describes it, and in a kindly manner told her not to worry, the money is safe with me. And so not only did the widow leave the money with him, she eventually deposited more funds with him, her 401(k), her pension funds. Now, all the money is gone. She will have to sell her home, and she will not be able to keep her promise to help her granddaughter pay for college.

A substantial sentence will not give the victims back their retirement funds or the moneys they saved to send their children or grandchildren to college. It will not give them back their financial security or the freedom from financial worry. But more is at stake than money, as we have heard. The victims put their trust in Mr. Madoff. That trust was broken in a way that has left many — victims as well as others — doubting our financial institutions, our financial system, our government's ability to regulate and protect, and sadly, even themselves.

I do not agree that the victims are succumbing to the temptation of mob vengeance. Rather, they are doing what they are supposed to be doing — placing their trust in our system of justice. A substantial sentence, the knowledge that Mr. Madoff has been punished to the fullest extent of the law, may, in some small measure, help these victims in their healing process.

Mr. Madoff, please stand.

It is the judgment of this Court that the defendant, Bernard L. Madoff, shall be and hereby is sentenced to a term of imprisonment of 150 years, consisting of 20 years on each of Counts 1, 3, 4, 5, 6, and 10, 5 years on each of Counts 2, 8, 9, and 11, and 10 years on Count 7, all to run consecutively to each other. As a technical matter, the sentence must be expressed on the judgment in months. 150 years is equivalent to 1,800 months.

Although it is academic, for technical reasons, I must also impose supervised release. I impose a term of supervised release of 3 years on each count, all to run concurrently.

I will not impose a fine, as whatever assets Mr. Madoff has, as to whatever assets may be found, they shall be applied to restitution for the victims.

As previously ordered, I will defer the issue of restitution for 90 days.

Finally, I will impose the mandatory special assessment of \$1,100, \$100 for each count.

Mr. Sorkin, any requests?

MR. SORKIN: Yes, your Honor.

As you pointed out to one of the victims, you cannot designate a prison, but we would ask, based upon an analysis that we have done that in 75 percent of the cases recommendations made by the court are followed by the Bureau of Prisons, we respectfully request that your Honor recommend to the Bureau of Prisons that Mr. Madoff be designated to Otisville.

THE COURT: I will recommend to the Bureau of Prisons that Mr. Madoff be designated to an appropriate facility in the northeast region of the United States.

MR. SORKIN: Thank you.

THE COURT: Ms. Baroni?

§ 15.11

THE MADOFF SCANDAL

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MS. BARONI: Two issues. If you can specifically incorporate by reference the forfeiture order of Friday, pronounce it as part of the sentence.

THE COURT: The forfeiture order is hereby incorporated.

MS. BARONI: Special assessment.

THE DEFENDANT: I did the special assessment of \$1,100.

MS. BARONI: Thank you.

THE COURT: Mr. Madoff, please stand one more time.

Mr. Madoff, you have the right to appeal at least certain aspects of this judgment and conviction. If you wish to appeal, you must do so within ten days. If you cannot afford an attorney, the court will appoint one for you.

We are adjourned.

(Adjourned)

Chapter 17

SELECTED TOPICS IN SECURITIES REGULATION

§ 17.04 REGULATION OF MARKET PARTICIPANT TRADING

Page 987: add:

SEC APPROVES SHORT SELLING RESTRICTIONS SEC Press Release No. 2010-26 (2010)

Washington, D.C., Feb. 24, 2010 — The Securities and Exchange Commission today adopted a new rule to place certain restrictions on short selling when a stock is experiencing significant downward price pressure. The measure is intended to promote market stability and preserve investor confidence.

This alternative uptick rule is designed to restrict short selling from further driving down the price of a stock that has dropped more than 10 percent in one day. It will enable long sellers to stand in the front of the line and sell their shares before any short sellers once the circuit breaker is triggered.

“The rule is designed to preserve investor confidence and promote market efficiency, recognizing short selling can potentially have both a beneficial and a harmful impact on the market,” said SEC Chairman Mary L. Schapiro. “It is important for the Commission and the markets to have in place a measure that creates certainty about how trading restrictions will operate during periods of stress and volatility.”

Short selling involves the selling of a security that an investor does not own or has borrowed. When shorting a stock, the investor expects that he or she can buy back the stock at a later date for a lower price than it was sold for. Rather than buying low and selling high, the investor is hoping to sell high and then buy low. Short selling can serve useful market purposes, including providing market liquidity and pricing efficiency. However, it also may be used improperly to drive down the price of a security or to accelerate a declining market in a security.

The alternative uptick rule (Rule 201) approved today imposes restrictions on short selling only when a stock has triggered a circuit breaker by experiencing a price decline of at least 10 percent in one day. At that point, short selling would be permitted if the price of the security is above the current national best bid.

Rule 201 includes the following features:

- *Short Sale-Related Circuit Breaker:* The circuit breaker would be triggered for a security any day in which the price declines by 10 percent or more from the prior day’s closing price.
- *Duration of Price Test Restriction:* Once the circuit breaker has been triggered, the alternative uptick rule would apply to short sale orders in

that security for the remainder of the day as well as the following day.

- *Securities Covered by Price Test Restriction:* The rule generally applies to all equity securities that are listed on a national securities exchange, whether traded on an exchange or in the over-the-counter market.
- *Implementation:* The rule requires trading centers to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the execution or display of a prohibited short sale.

. . . .

Page 1010: add new §§ 17.09 and 17.10:

§ 17.09 INVESTMENT ADVISER FEES

JONES v. HARRIS ASSOCIATES L.P.

United States Supreme Court
130 S. Ct. 1418 (2010)

JUSTICE ALITO delivered the opinion of the Court.

We consider in this case what a mutual fund shareholder must prove in order to show that a mutual fund investment adviser breached the “fiduciary duty with respect to the receipt of compensation for services” that is imposed by § 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b) (hereinafter § 36(b)).

I

A

The Investment Company Act of 1940 (Act) . . . regulates investment companies, including mutual funds. “A mutual fund is a pool of assets, consisting primarily of [a] portfolio [of] securities, and belonging to the individual investors holding shares in the fund.” *Burks v. Lasker*, 441 U.S. 471, 480 (1979). The following arrangements are typical. A separate entity called an investment adviser creates the mutual fund, which may have no employees of its own. The adviser selects the fund’s directors, manages the fund’s investments, and provides other services. Because of the relationship between a mutual fund and its investment adviser, the fund often “cannot, as a practical matter sever its relationship with the adviser. Therefore the forces of arm’s-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.” . . .

“Congress adopted the [Investment Company Act of 1940] because of its concern with the potential for abuse inherent in the structure of investment companies.” *Daily Income Fund*, 464 U.S. [523, 536 (1984)]. Recognizing that the relationship between a fund and its investment adviser was “fraught with potential conflicts of interest,” the Act created protections for mutual fund shareholders.

Among other things, the Act required that no more than 60 percent of a fund's directors could be affiliated with the adviser and that fees for investment advisers be approved by the directors and the shareholders of the fund. . . .

The growth of mutual funds in the 1950's and 1960's prompted studies of the 1940 Act's effectiveness in protecting investors. Studies commissioned or authored by the Securities and Exchange Commission (SEC or Commission) identified problems relating to the independence of investment company boards and the compensation received by investment advisers. In response to such concerns, Congress amended the Act in 1970 and bolstered shareholder protection in two primary ways.

First, the amendments strengthened the "cornerstone" of the Act's efforts to check conflicts of interest, the independence of mutual fund boards of directors, which negotiate and scrutinize adviser compensation. The amendments required that no more than 60 percent of a fund's directors be "persons who are interested persons," *e.g.*, that they have no interest in or affiliation with the investment adviser.³⁸ . . . These board members are given "a host of special responsibilities." . . . In particular, they must "review and approve the contracts of the investment adviser" annually, and a majority of these directors must approve an adviser's compensation. . . . Second, § 36(b) of the Act imposed upon investment advisers a "fiduciary duty" with respect to compensation received from a mutual fund, 15 U.S.C. § 80a-35(b), and granted individual investors a private right of action for breach of that duty. . . .

The "fiduciary duty" standard contained in § 36(b) represented a delicate compromise. Prior to the adoption of the 1970 amendments, shareholders challenging investment adviser fees under state law were required to meet "common-law standards of corporate waste, under which an unreasonable or unfair fee might be approved unless the court deemed it 'unconscionable' or 'shocking,'" and "security holders challenging adviser fees under the [Investment Company Act] itself had been required to prove gross abuse of trust." *Daily Income Fund*, 464 U.S., at 540, n. 12. Aiming to give shareholders a stronger remedy, the SEC proposed a provision that would have empowered the Commission to bring actions to challenge a fee that was not "reasonable" and to intervene in any similar action brought by or on behalf of an investment company. This approach was included in a bill that passed the House. H. R. 9510, 90th Cong., 1st Sess., § 8(d) (1967); see also S. 1659, 90th Cong., 1st Sess., § 8(d) (1967). Industry representatives, however, objected to this proposal, fearing that it "might in essence provide the Commission with ratemaking authority." *Daily Income Fund*, 464 U.S., at 538.

³⁸ [1] An "affiliated person" includes (1) a person who owns, controls, or holds the power to vote 5 percent or more of the securities of the investment adviser; (2) an entity which the investment adviser owns, controls, or in which it holds the power to vote more than 5 percent of the securities; (3) any person directly or indirectly controlling, controlled by, or under common control with the investment adviser; (4) an officer, director, partner, copartner, or employee of the investment adviser; (5) an investment adviser or a member of the investment adviser's board of directors; or (6) the depositor of an unincorporated investment adviser. See § 80a-2(a)(3). The Act defines "interested person" to include not only all affiliated persons but also a wider swath of people such as the immediate family of affiliated persons, interested persons, of an underwriter or investment adviser, legal counsel for the company, and interested broker-dealers. § 80a-2(a)(19).

The provision that was ultimately enacted adopted “a different method of testing management compensation,” *id.*, at 539 (quoting S. Rep., at 5 (internal quotation marks omitted)), that was more favorable to shareholders than the previously available remedies but that did not permit a compensation agreement to be reviewed in court for “reasonableness.” This is the fiduciary duty standard in § 36(b).

B

Petitioners are shareholders in three different mutual funds managed by respondent Harris Associates L.P., an investment adviser. Petitioners filed this action in the Northern District of Illinois pursuant to § 36(b) seeking damages, an injunction, and rescission of advisory agreements between Harris Associates and the mutual funds. The complaint alleged that Harris Associates had violated § 36(b) by charging fees that were “disproportionate to the services rendered” and “not within the range of what would have been negotiated at arm’s length in light of all the surrounding circumstances.”

The District Court granted summary judgment for Harris Associates. Applying the standard adopted in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F. 2d 923 (CA2 1982), the court concluded that petitioners had failed to raise a triable issue of fact as to “whether the fees charged . . . were so disproportionately large that they could not have been the result of arm’s-length bargaining.” The District Court assumed that it was relevant to compare the challenged fees with those that Harris Associates charged its other clients. But in light of those comparisons as well as comparisons with fees charged by other investment advisers to similar mutual funds, the Court held that it could not reasonably be found that the challenged fees were outside the range that could have been the product of arm’s-length bargaining.

A panel of the Seventh Circuit affirmed based on different reasoning, explicitly “disapprov[ing] the *Gartenberg* approach.” 527 F.3d 627, 632 (2008). Looking to trust law, the panel noted that, while a trustee “owes an obligation of candor in negotiation,” a trustee, at the time of the creation of a trust, “may negotiate in his own interest and accept what the settlor or governance institution agrees to pay.” *Ibid.* (citing Restatement (Second) of Trusts § 242, and Comment *f*). The panel thus reasoned that “[a] fiduciary duty differs from rate regulation. A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation.” 527 F.3d, at 632. In the panel’s view, the amount of an adviser’s compensation would be relevant only if the compensation were “so unusual” as to give rise to an inference “that deceit must have occurred, or that the persons responsible for [the] decision have abdicated.” . . .

The panel argued that this understanding of § 36(b) is consistent with the forces operating in the contemporary mutual fund market. Noting that “[t]oday thousands of mutual funds compete,” the panel concluded that “sophisticated investors” shop for the funds that produce the best overall results, “mov[e] their money elsewhere” when fees are “excessive in relation to the results,” and thus “create a competitive pressure” that generally keeps fees low. The panel faulted *Gartenberg* on the ground that it “relies too little on markets.” . . . And the panel

firmly rejected a comparison between the fees that Harris Associates charged to the funds and the fees that Harris Associates charged other types of clients, observing that “[d]ifferent clients call for different commitments of time” and that costs, such as research, that may benefit several categories of clients “make it hard to draw inferences from fee levels.” . . .

The Seventh Circuit denied rehearing en banc by an equally divided vote. 537 F.3d 728 (2008). The dissent from the denial of rehearing argued that the panel’s rejection of *Gartenberg* was based “mainly on an economic analysis that is ripe for reexamination.” 537 F.3d, at 730 (opinion of Posner, J.). Among other things, the dissent expressed concern that Harris Associates charged “its captive funds more than twice what it charges independent funds,” and the dissent questioned whether high adviser fees actually drive investors away.

We granted certiorari to resolve a split among the Courts of Appeals over the proper standard under § 36(b).

II

A

Since Congress amended the Investment Company Act in 1970, the mutual fund industry has experienced exponential growth. Assets under management increased from \$38.2 billion in 1966 to over \$9.6 trillion in 2008. The number of mutual fund investors grew from 3.5 million in 1965 to 92 million in 2008, and there are now more than 9,000 open- and closed-end funds.

During that time, the standard for an investment adviser’s fiduciary duty has remained an open question in our Court, but, until the Seventh Circuit’s decision below, something of a consensus had developed regarding the standard set forth over 25 years ago in *Gartenberg*. . . . The *Gartenberg* standard has been adopted by other federal courts, and “[t]he SEC’s regulations have recognized and formalized, *Gartenberg*-like factors.” . . . In the present case, both petitioners and respondent generally endorse the *Gartenberg* approach, although they disagree in some respects about its meaning.

In *Gartenberg*, the Second Circuit noted that Congress had not defined what it meant by a “fiduciary duty” with respect to compensation but concluded that “the test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm’s-length in the light of all the surrounding circumstances.” 694 F. 2d, at 928. The Second Circuit elaborated that, “[t]o be guilty of a violation of § 36(b), . . . the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.” . . . “To make this determination,” the Court stated, “all pertinent facts must be weighed,” and the Court specifically mentioned “the adviser-manager’s cost in providing the service, . . . the extent to which the adviser-manager realizes economies of scale as the fund grows larger, and the volume of orders with must be processed by the

manager.” *Id.*, at 930.³⁹ Observing that competition among advisers for the business of managing a fund may be “virtually non-existent,” the Court rejected the suggestion that “the principal factor to be considered in evaluating a fee’s fairness is the price charged by other similar advisers to funds managed by them,” although the Court did not suggest that this factor could not be “taken into account.” *Id.*, at 929. The Court likewise rejected the “argument that the lower fees charged by investment advisers to large pension funds should be used as a criterion for determining fair advisory fees for money market funds,” since a “pension fund does not face the myriad of daily purchases and redemptions throughout the nation which must be handled by [a money market fund].” *Id.*, at 930, n. 3.⁴⁰

B

The meaning of § 36(b)’s reference to “a fiduciary duty with respect to the receipt of compensation for services”⁴¹ is hardly pellucid, but based on the terms of that provision and the role that a shareholder action for breach of that duty plays in the overall structure of the Act, we conclude that *Gartenberg* was correct in its basic formulation of what § 36(b) requires: to face liability under § 36(b), an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s length bargaining.

1

We begin with the language of § 36(b). As noted, the Seventh Circuit panel thought that the phrase “fiduciary duty” incorporates a standard taken from the law of trusts. Petitioners agree but maintain that the panel identified the wrong trust-law standard. Instead of the standard that applies when a trustee and a settlor negotiate the trustee’s fee at the time of the creation of a trust, petitioners invoke the standard that applies when a trustee seeks compensation after the trust is created. A compensation agreement reached at that time, they point out, “will

³⁹ [5] Other factors cited by the *Gartenberg* court include (1) the nature and quality of the services provided to the fund and shareholders; (2) the profitability of the fund to the adviser; (3) any “fall-out financial benefits,” those collateral benefits that accrue to the adviser because of its relationship with the mutual fund; (4) comparative fee structure (meaning a comparison of the fees with those paid by similar funds); and (5) the independence, expertise, care, and conscientiousness of the board in evaluating adviser compensation. 694 F. 2d, at 929-932 (internal quotation marks omitted).

⁴⁰ [6] A money market fund differs from a mutual fund in both the types of investments and the frequency of redemptions. A money market fund often invests in short-term money market securities, such as short-term securities of the United States Government or its agencies, bank certificates of deposit, and commercial paper. Investors can invest in such a fund for as little as a day, so, from the investor’s perspective, the fund resembles an investment “more like a bank account than [a] traditional investment in securities.” *Id.*, at 925.

⁴¹ [7] Section 36(b) provides as follows:

“[T]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser.” 84 Stat. 1429 (codified at 15 U.S.C. § 80a-35(b)).

not bind the beneficiary' if either 'the trustee failed to make a full disclosure of all circumstances affecting the agreement' " which he knew or should have known or if the agreement is unfair to the beneficiary. . . . Respondent, on the other hand, contends that the term "fiduciary" is not exclusive to the law of trusts, that the phrase means different things in different contexts, and that there is no reason to believe that § 36(b) incorporates the specific meaning of the term in the law of trusts.

We find it unnecessary to take sides in this dispute. In *Pepper v. Litton*, 308 U.S. 295 (1939), we discussed the meaning of the concept of fiduciary duty in a context that is analogous to that presented here, and we also looked to trust law. At issue in *Pepper* was whether a bankruptcy court could disallow a dominant or controlling shareholder's claim for compensation against a bankrupt corporation. Dominant or controlling shareholders, we held, are "fiduciar[ies]" whose "powers are powers [held] in trust." *Id.*, at 306. We then explained:

"Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. . . . *The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain.* If it does not, equity will set it aside." *Id.*, at 306–307 (emphasis added; footnote omitted); see also *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921) (standard of fiduciary duty for interested directors).

We believe that this formulation expresses the meaning of the phrase "fiduciary duty" in § 36(b). The Investment Company Act modifies this duty in a significant way: it shifts the burden of proof from the fiduciary to the party claiming breach, 15 U.S.C. § 80a-35(b)(1), to show that the fee is outside the range that arm's-length bargaining would produce.

The *Gartenberg* approach fully incorporates this understanding of the fiduciary duty as set out in *Pepper* and reflects § 36(b)(1)'s imposition of the burden on the plaintiff. As noted, *Gartenberg* insists that all relevant circumstances be taken into account, see 694 F. 2d, at 929, as does § 36(b)(2), 84 Stat. 1429 ("[A]pproval by the board of directors . . . shall be given such consideration by the court as deemed appropriate under *all the circumstances*" (emphasis added)). And *Gartenberg* uses the range of fees that might result from arm's-length bargaining as the benchmark for reviewing challenged fees.

Gartenberg's approach also reflects § 36(b)'s place in the statutory scheme and, in particular, its relationship to the other protections that the Act affords investors.

Under the Act, scrutiny of investment adviser compensation by a fully informed mutual fund board is the "cornerstone of the . . . effort to control conflicts of interest within mutual funds." *Burks*, 441 U.S., at 482. The Act interposes disinterested directors as "independent watchdogs" of the relationship between a

mutual fund and its adviser. To provide these directors with the information needed to judge whether an adviser's compensation is excessive, the Act requires advisers to furnish all information "reasonably . . . necessary to evaluate the terms" of the adviser's contract, 15 U.S.C. § 80a-15(c), and gives the SEC the authority to enforce that requirement. See § 80a-41. Board scrutiny of adviser compensation and shareholder suits under § 36(b), 84 Stat. 1429, are mutually reinforcing but independent mechanisms for controlling conflicts. See *Daily Income Fund*, 464 U.S., at 541 (Congress intended for § 36(b) suits and directorial approval of adviser contracts to act as "independent checks on excessive fees"); *Kamen*, 500 U.S., at 108 ("Congress added § 36(b) to the [Act] in 1970 because it concluded that the shareholders should not have to rely solely on the fund's directors to assure reasonable adviser fees, notwithstanding the increased disinterestedness of the board" . . .).

In recognition of the role of the disinterested directors, the Act instructs courts to give board approval of an adviser's compensation "such consideration . . . as is deemed appropriate under all the circumstances." § 80a-35(b)(2). Cf. *Burks*, 441 U.S., at 485 ("[I]t would have been paradoxical for Congress to have been willing to rely largely upon [boards of directors as] 'watchdogs' to protect shareholder interest and yet, where the 'watchdogs' have done precisely that, require that they be totally muzzled").

From this formulation, two inferences may be drawn. First, a measure of deference to a board's judgment may be appropriate in some instances. Second, the appropriate measure of deference varies depending on the circumstances.

Gartenberg heeds these precepts. *Gartenberg* advises that "the expertise of the independent trustees of a fund, whether they are fully informed about all facts bearing on the [investment adviser's] service and fee, and the extent of care and conscientiousness with which they perform their duties are important factors to be considered in deciding whether they and the [investment adviser] are guilty of a breach of fiduciary duty in violation of § 36(b)." . . .

III

While both parties in this case endorse the basic *Gartenberg* approach, they disagree on several important questions that warrant discussion.

The first concerns comparisons between the fees that an adviser charges a captive mutual fund and the fees that it charges in its independent clients. As noted, the *Gartenberg* court rejected a comparison between the fees that the adviser in that case charged a money market fund and the fees that it charged a pension fund. 694 F. 2d, at 930, n. 3 (noting the "[t]he nature and extent of the services required by each type of fund differ sharply"). Petitioners contend that such a comparison is appropriate, Brief for Petitioners 30-31, but respondent disagrees. Brief for Respondent 38-44. Since the Act requires consideration of all relevant factors, 15 U.S.C. § 80a-35(b)(2), we do not think that there can be any categorical rule regarding the comparisons of the fees charged different types of clients. See *Daily Income Fund*, *supra*, at 537 (discussing concern with investment advisers' practice of charging higher fees to mutual funds than to their other clients). Instead, courts

may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require, but courts must be wary of inapt comparisons. As the panel below noted, there may be significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund which are attributable to the greater frequency of shareholder redemptions in a mutual fund, the higher turnover of mutual fund assets, the more burdensome regulatory and legal obligations, and higher marketing costs. 527 F.3d, at 634 (“Different clients call for different commitments of time”). If the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison. Even if the services provided and fees charged to an independent fund are relevant, courts should be mindful that the Act does not necessarily ensure fee parity between mutual funds and institutional clients contrary to petitioners’ contentions. . . .⁴²

By the same token, courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers. These comparisons are problematic because these fees, like those challenged, may not be the product of negotiations conducted at arm’s length. . . .

Finally, a court’s evaluation of an investment adviser’s fiduciary duty must take into account both procedure and substance. See 15 U.S.C. § 80a-35(b)(2) (requiring deference to board’s consideration “as is deemed appropriate under all the circumstances”); cf. *Daily Income Fund*, 464 U.S., at 541 (“Congress intended security holder and SEC actions under § 36(b), on the one hand, and directorial approval of adviser contracts, on the other, to act as independent checks on excessive fees”). Where a board’s process for negotiating and reviewing investment-adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process. See *Burks*, 441 U.S., at 484 (unaffiliated directors serve as “independent watchdogs”). Thus, if the disinterested directors considered the relevant factors, their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently. This is not to deny that a fee may be excessive even if it was negotiated by a board in possession of all relevant information, but such determination must be based on evidence that the fee “is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.” . . .

In contrast, where the board’s process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome. When an investment adviser fails to disclose material information to the board, greater scrutiny is justified because the withheld information might have hampered

⁴² [8] Comparisons with fees charged to institutional clients, therefore, will not “doo[m] [a]ny [f]und to [t]rial.” Brief for Respondent 49; see also *Stougo v. BEA Assocs.*, 188 F. Supp. 2d 373, 384 (SDNY 2002) (suggesting that fee comparisons, where permitted, might produce a triable issue). First, plaintiffs bear the burden in showing that fees are beyond the range of arm’s-length bargaining. § 80a-35(b)(1). Second, a showing of relevance requires courts to assess any disparity in fees in light of the different markets for advisory services. Only where plaintiffs have shown a large disparity in fees that cannot be explained by the different services in addition to other evidence that the fee is outside the arm’s-length range will trial be appropriate. . . .

the board's ability to function as "an independent check upon the management." . . . "Section 36(b) is sharply focused on the question of whether the fees themselves were excessive." *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 258 F.3d 321, 328 (CA4 2001); see also 15 U.S.C. § 80a-35(b) (imposing a "fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature" (emphasis added)). But an adviser's compliance or noncompliance with its disclosure obligations is a factor that must be considered in calibrating the degree of deference that is due a board's decision to approve an adviser's fees.

It is also important to note that the standard for fiduciary breach under § 36(b) does not call for judicial second-guessing of informed board decisions. See *Daily Income Fund, supra*, at 538; see also *Burks*, 441 U.S., at 483 ("Congress consciously chose to address the conflict-of-interest problem through the Act's independent-directors section, rather than through more drastic remedies"). "[P]otential conflicts [of interests] may justify some restraints upon the unfettered discretion of even disinterested mutual fund directors, particularly in their transactions with the investment adviser," but they do not suggest that a court may supplant the judgment of disinterested directors apprised of all relevant information, without additional evidence that the fee exceeds the arm's-length range. In reviewing compensation under § 36(b), the Act does not require courts to engage in a precise calculation of fees representative of arm's-length bargaining. . . . As recounted above, Congress rejected a "reasonableness" requirement that was criticized as charging the courts with rate-setting responsibilities. Congress' approach recognizes that courts are not well suited to make such precise calculations. . . . *Gartenberg's* "so disproportionately large" standard reflects this congressional choice to "rely largely upon [independent director] 'watchdogs' to protect shareholders interests." *Burks, supra*, at 485.

By focusing almost entirely on the element of disclosure, the Seventh Circuit panel erred. See 527 F.3d, at 632 (An investment adviser "must make full disclosure and play no tricks but is not subject to a cap on compensation"). The *Gartenberg* standard, which the panel rejected, may lack sharp analytical clarity, but we believe that it accurately reflects the compromise that is embodied in § 36(b), and it has provided a workable standard for nearly three decades. The debate between the Seventh Circuit panel and the dissent from the denial of rehearing regarding today's mutual fund market is a matter for Congress, not the courts.

IV

For the foregoing reasons, the judgment of the Court of Appeals is vacated, and the case remanded for further proceedings consistent with this opinion.

It is so ordered.

JUSTICE THOMAS, concurring.

The Court rightly affirms the careful approach to § 36(b) cases that courts have applied since (and in certain respects in spite of) *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928-930 (CA2 1982). I write separately because I

would not shortchange the Court's effort by describing it as affirmation of the "*Gartenberg* standard."

The District Court and Court of Appeals in *Gartenberg* created that standard, which emphasizes fee "fairness" and proportionality, 694 F.2d, at 929, in a manner that could be read to permit the equivalent of the judicial rate regulation the *Gartenberg* opinions disclaim, based on the Investment Company Act of 1940's "tortuous" legislative history and a handful of extrastatutory policy and market considerations. . . . Although virtually all subsequent § 36(b) cases cite *Gartenberg*, most courts have correctly declined its invitation to stray beyond statutory bounds. Instead, they have followed an approach (principally in deciding which cases may proceed past summary judgment) that defers to the informed conclusions of disinterested boards and holds plaintiffs to their heavy burden of proof in the manner the Act, and now the Court's opinion, requires. . . .

I concur in the Court's decision to affirm this approach based upon the Investment Company Act's text and our longstanding fiduciary duty precedents. But I would not say that in doing so we endorse the "*Gartenberg* standard." Whatever else might be said about today's decision, it does not countenance the free-ranging judicial "fairness" review of fees that *Gartenberg* could be read to authorize, see 694 F.2d, at 929–930, and that virtually all courts deciding § 36(b) cases since *Gartenberg* (including the Court of Appeals in this case) have wisely eschewed in the post *Gartenberg* precedents we approve.

§ 17.10 CREDIT RATING AGENCIES

The Dodd-Frank Act of 2010 made significant changes with respect to the regulation and oversight of credit rating agencies. The Joint Explanatory Statement of the Committee of Conference, Conference Committee Report No. 111-517 (2010), summarized these provisions as follows:

Subtitle C — Improvement to the Regulation of Credit Rating Agencies gives broader powers to the SEC to regulate nationally recognized statistical rating organizations ("NRSROs"). A new Office of Credit Ratings ("Office") is required to examine NRSROs at least once a year and make key findings public. The Office will write new rules, including requiring NRSROs to (1) set up internal controls over the process for determining credit ratings; (2) establish an independent board of directors; (3) make greater disclosures to the public and investors; and (4) develop universal ratings across asset classes and types off issuer. The report also gives the Office the authority to deregister an NRSRO for providing bad ratings over time. New professional standards are established that require ratings analysts to pass qualifying exams and have continuing education.

The report includes provisions to address conflicts of interest. It prohibits compliance officers from working on ratings, methodologies, or sales and prevents other employees from both marketing ratings services and performing the ratings of securities. The subtitle includes an additional conflict of interest mitigation including a new requirement for NRSROs to conduct a one-year look-back review when an NRSRO employee goes to

work for an obligor or underwriter of a security or money market instrument subject to a rating by that NRSRO; and report to the SEC when certain employees of the NRSRO go to work for an entity that the NRSRO has rated in the previous twelve months. The SEC shall make such reports publicly available.

To reduce the reliance on ratings, the report amends several statutes to remove references to credit ratings, credit rating agencies and NRSROs. The subtitle includes a requirement that all Federal agencies review their regulations, policies and practices that reference credit ratings, credit rating agencies, and NRSROs. After identifying where the agency relies on or makes these references, the agencies shall modify their regulations by striking these references and substituting a standard of creditworthiness to be established by the agencies.

New provisions address information gathering. NRSROs must consider information in their ratings that comes to their attention from a source other than the organizations being rated, if they find it credible. In addition, the subtitle includes an elimination of the credit rating agency exemption from Regulation Fair Disclosure, commonly known as Reg FD.

The report also addresses liability measures for the NRSRO. The report allows investors to bring private rights of action against credit rating agencies for a knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source. The report also nullifies Rule 436(g) which provides an exemption for credit ratings provided by NRSROs from being considered a part of the registration statement prepared or certified by a person under the "expert liability" regime of Section 7 and Section 11 of the Securities Act of 1933. The subtitle requires all references to "furnish" be replaced with the word "file" in existing law. Information that is "furnished" to the SEC is subject to a lower standard of accuracy and liability than information "filed" with the SEC.

The report also directs the SEC to establish a system that prohibits issuers of structured finance from selecting the NRSRO that will provide the initial credit rating. The system would mandate that initial rating assignments for structured finance securities be made on a random or semi-random basis, unless the SEC determines, after study, that an alternative system of assigning ratings would better protect investors and serve the public interest.