CORPORATE LAW AND PRACTICE
Course Handbook Series
Number B-2475

Securities Litigation 2019:

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After the Fall—A Plaintiff's Perspective (January 2019)

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A sharp drop in the price of a company's stock is often newsworthy and troubling to companies and their investors. However, from the plaintiffs' perspective, while the sharp decline may catch their attention, the determination of whether a particular set of facts gives rise to a potentially viable claim under the federal securities laws requires careful analysis and review of the relevant facts and law. A good way for plaintiffs to begin the investigation is by asking and answering the following questions:

- Was the stock drop significant – that is, a large percentage drop over the previous day's price resulting in a large loss of market capitalization?
- Did the drop follow the company's release of negative news such as loss of a key customer, or failure of a previously touted acquisition or merger, or reported revenues and profits dramatically lower than previous guidance?
- Was the stock drop consistent with general market trends that day (for example in reaction to some news report)?
- Was the stock drop consistent with the stock of other companies in its industry peer group or was the drop specific to that company?
- Is the company's stock historically volatile, or is the drop sudden and uncharacteristically steep?
- Did the price of the stock rebound in the days immediately following the sudden decline, or did the price remain depressed?
- Did the company file a restatement of financial data with the SEC or announce that the company's financials could no longer be relied upon?
- Did the company (or other reliable source) disclose that it was the target of an investigation by the SEC, Justice Department, FDA or some other regulatory agency, or that the company was initiating an internal investigation into its business practices?
- Was there insider trading by any company officers or directors that differed markedly from their previous trading patterns and, in particular, were there large insider sales in the period prior to announcements of bad news?

Although a sudden dramatic drop in the stock price can trigger plaintiffs' investigation, it should be viewed in the context of general market and industry trends. For example, plaintiffs should compare the company's stock price with indices such as the NASDAQ Composite Index and the NASDAQ Industrial Index and the indices of companies in the same industry as the company being investigated, focusing on the period preceding and following the disclosure of bad news. Evidence that the company's stock price diverged meaningfully from general market and industry peers arguably indicates that the company's stock price was influenced by circumstances concerning that specific company, confirming that further investigation of the facts is warranted. In addition, it is important to track the price of the stock in the days following the decline. If the stock quickly rebounds to pre-disclosure prices, it is quite possible that the decline was a "blip" and that the market did not consider the disclosure all that material. On the other hand, a massive one-day loss in market capitalization can result in heavy investor losses, even if the stock rebounds. There is no single formula. The amount and duration of the stock decline must be considered on a case-by-case basis, together with other facts described further below, in plaintiffs' pre-filing investigation of a potential securities case.

INVESTIGATING THE POTENTIAL SECURITIES CLASS ACTION CLAIM

It bears emphasizing that even if an announcement or event causes the company's stock price to drop and investors sustain substantial losses, and there are indicia of violations of the securities laws, plaintiffs who seek to bring a securities class action are faced with a difficult task in investigating the facts and drafting an initial complaint. All plaintiffs are required to investigate claims thoroughly before filing a complaint and to plead facts with some degree of particularity. *See Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009); *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 555 (2007). But plaintiffs investigating a class action to be brought under the securities laws face a uniquely difficult pre-filing burden in investigating the claims and drafting a complaint, because such plaintiffs must comply with the requirements of the Private Securities Litigation Reform Act (the "PSLRA"). The PSLRA was enacted by Congress in 1995 to discourage what were perceived as unwarranted and frivolous private securities fraud class actions. Among key provisions, the PSLRA imposes, with limited exception, an *automatic stay on all* discovery until the motion to dismiss is decided.[2] At

2. The PSLRA amended the provisions applicable to private class actions under both the Securities Exchange Act of 1934 (the "Exchange Act"), at Section 21D, 15 U.S.C. § 78u-4, and the Securities Act of 1933 (the "Securities Act"), at Section 27, 15 U.S.C. § 77z-1. Key PSLRA provisions are appointment of lead plaintiff and the imposition of an automatic stay of discovery during the pendency of the motion to dismiss. The discovery stay provision states: "In any private action arising under this Act, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that

the same time, the PSLRA imposes heightened pleading requirements for establishing the elements of a securities fraud claim under the Exchange Act, most frequently, the anti-fraud provisions of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5.[3] Without discovery, it is often challenging for plaintiffs to find and allege evidence to support their allegations, while defendants and third parties have access to that evidence.

Indeed, the Ninth Circuit, in a recent decision, explicitly noted the unfair advantage enjoyed by defendants over plaintiffs due to the PSLRA's automatic stay of discovery, and attempted to remedy it by limiting defendants' use of documents outside the pleadings in defendants' motion to dismiss a securities complaint. *Khoja v. Orexigen Therapeutics, Inc.*, 899 F. 3d 988 (9th Cir. 2018). In *Khoja*, a case in which plaintiffs alleged that a biotech company failed to disclose the truth and/or adverse material information about the drug study involving its primary drug candidate, the Ninth Circuit reversed in part the district court's dismissal of the plaintiff's claim under Section 10(b) and Rule 10b-5, because the Appeals Court found that the district court abused its discretion by improperly considering certain material outside the complaint at the motion to dismiss stage. *Id.* at 1000-1001. At the outset of its opinion, the Ninth Circuit court noted a "concerning pattern in securities cases like this one: exploiting these [incorporation-by reference and judicial notice] procedures improperly to defeat what would otherwise constitute adequately stated claims at the pleading stage." *Id.* at 998. The Court warned that the "[t]he overuse and improper application of judicial notice and the incorporation-by-reference doctrine… can lead to unintended and harmful results…. [T]he unscrupulous use of extrinsic

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particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party." 15 U.S.C. § 78u-4(b)(3)(B); 15 U.S.C. § 77z-1(b)(1).

3. The elements of a private action under Section 10(b) are "(1) a material misrepresentation or omission by the defendants; (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). To adequately plead falsity under the PSLRA, "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." Exchange Act, 15 U.S.C. § 78u-4(b)(1). To adequately plead scienter under the PSLRA "the complaint shall, with respect to each act or omission alleged to violate this Act, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2)(A).

documents to resolve competing theories against the complaint risks premature dismissals of plausible claims that may turn out to be valid after discovery." *Id.* "*This risk is especially significant in SEC fraud matters, where there is already a heightened pleading standard and the defendants possess materials to which the plaintiffs do not yet have access.*" *Id.* (emphasis added) (collecting cases).

In short, when evaluating a set of events or facts to determine whether to file a complaint under the securities laws, and what claims to prosecute, plaintiffs' counsel must determine, as best as possible within the constraints of the PSLRA, whether facts exist to adequately plead the elements of the claim, and to determine the appropriate class period, and where to file the claims. Still, even without the normal avenues of discovery, a number of excellent sources of information are available to plaintiffs that enable plaintiffs to evaluate whether a particular set of facts gives rise to liability under the securities laws and to draft a complaint that meets the PSLRA stringent pleading requirements that will survive a motion to dismiss (at which point the stay on discovery is lifted). The following are useful sources of information:

- **The company's public statements**

Defendants will rarely, if ever, admit outright that they lied to investors. However, a careful and exhaustive review of defendants' own previous public statements concerning the facts revealed in the curative disclosure often provide useful information to adequately plead that the company misrepresented or omitted to disclose a material fact that it was required to disclose to investors earlier than it did, thereby artificially inflating the price of the shares and causing investors' losses when the stock price dropped upon disclosure of the truth.

First, plaintiffs should analyze the company's own statements and any other publicly available facts. The goal is to compare the statement that led the stock price to drop with the company's prior public statements. Was the disclosure inconsistent with the company's prior statements? Did the disclosure reveal a sudden problem, or a longstanding problem that the company should have been expected to know at the time it issued its prior statements? For example, if the disclosure was that the company had lost its most important customer, causing material loss of future revenue and earnings, and that the company had known about the probable loss for months, the likelihood of establishing falsity and scienter is strengthened.

Plaintiffs should carefully review the company's statements in press releases, conference calls with analysts, presentations at industry events, and other publicly available statements prior to the disclosure. Plaintiffs should also review the company's filings with the Securities and Exchange Commission ("SEC"), including sections enumerating "risk factors" and "management's discussion and analysis ("MD&A"). The "risk factors" are especially important and should be read closely in the pre-filing investigation, with an eye to considering whether they were mere boilerplate, or whether they in fact disclosed the "true" facts to investors with the same intensity as the undisclosed facts. Such considerations are essential because if a complaint is filed, defendants may attempt to assert a "truth-on-the-market" defense – arguing that they disclosed the risks that later materialized throughout the alleged class period.

- **Analyst reports**

Reports by analysts covering the company at issue and analyst conference calls at which analysts question the company officers are extremely valuable sources of information for plaintiffs investigating potential securities claims. Plaintiffs should obtain and review as many analyst reports and conference call transcripts as possible. Analysts are well-versed in the industry and the company, and they are perceptive and ask the "right" questions. It is well worth reviewing the Q&A sections of conference calls. The questions that analysts ask company officers during conference calls usually target the issues that concern them and that are most important to investors. As a result, any statements or omissions on those issues by defendants that are later revealed to be misleading are arguably "material." Even more useful are analyst reports that analysts file after a conference call in which the analysts typically summarize their "key takeaways" from the call, and then rate the stock. Not surprisingly, the price of a stock often rises during the period of alleged false statements when analysts react positively to the company's financial or other statements, releases, and reports.

The most helpful analyst reports are often those issued by the analysts *after* defendants' disclosure of the bad news. In those reports, analysts often express opinions that can plausibly support allegations that defendants knew, or recklessly disregarded, material facts which were not disclosed during the class period, or that the prospectus and registration statement in connection with an offering of a company's securities contained materially false and misleading statements or omissions. For example, analysts may express surprise and disappointment that the company was not candid in their prior statements and assurances that the company's financials were complete and accurate, that its business operations were on solid footing, and that prospects for future revenues and earnings were strong. Analysts may complain that the company has not been "transparent" with investors or that its "credibility" has been badly damaged. These negative comments can arguably indicate that the analysts felt that the company had hidden material information in previous statements and that the sudden disclosure of the truth was more than "mismanagement." Further, analysts may identify "red flags" that were present all along and that, in retrospect, were material information that should have been disclosed to investors. In addition, plaintiffs can cite analysts' statements that the analysts were downgrading the company's stock based upon their reaction to the company's disclosures as compelling proof that the stock drop was caused by the disclosure of previously undisclosed material information.[4]

- **Former employees**

Former employees of the defendant company are often useful sources of information about the company's practices that can confirm whether or not the case has merit, primarily to help establish scienter and falsity. Former employees can be cited in the complaint anonymously, without revealing their names, as confidential witnesses ("CWs"). CWs can play an important role in securities class action litigation. It has been noted that "[g]iven the obstacles imposed by the PSLRA, the opportunity to use CWs often represents the only viable opportunity for plaintiffs to survive a motion to dismiss." *See* Gideon Mark, *Confidential Witness Interviews in Securities Litigation*, 96 N.C. L. Rev. 789, 822 (2018).

- **Government regulatory actions and significant news events**

A company's disclosure that it is the subject of an investigation by the SEC, Justice Department, FDA, or other federal or state regulator, or even foreign regulator, can trigger a significant drop in the company's

4. These analysts' opinions are relevant for claims under both the Exchange Act and the Securities Act. Plaintiffs must affirmatively plead "loss causation" as a prima facie element of a securities fraud claim under the Exchange Act,15 U.S.C. § 78u-4(b)(4). While loss causation is not a required element for a false registration statement or prospectus claim under Section 11 and 12(a)(2) of the Securities Act, loss causation is an affirmative defense against those claims, by defendant proving that "any portion or all" of the alleged damages were not caused by the alleged violations. 15 U.S.C. §§ 77k(e), 77l(b).

share price. For example, a company may announce that it received a subpoena from the US Attorney's office or the SEC requesting documents about the company's accounting practices or its compliance with ethical or other business standards. Actions against newly-public or established pharmaceutical companies are frequently triggered by steep drops in the stock price and massive loss of market capitalization following an announcement that an important drug trial failed to achieve anticipated results or that the FDA refused to approve or recalled the company's primary drug or device. In some cases, the SEC or some other regulator may have already brought an action against the company. Pleadings and other documents in those actions are often public and can provide a wealth of facts that plaintiffs can review to evaluate whether to bring a private securities action.

Recently, many securities cases have been investigated and filed in the immediate aftermath of a major news event, such as a massive data breach, a natural disaster, or a whistleblower's accusations against a company or particular employees. Here too, plaintiffs should search for news articles, press releases, pleadings, transcripts, or other documents that may have been filed by any private or government entity who may be investigating or already prosecuting claims against companies in the wake of these events. Review of these documents can help plaintiffs determine whether to bring a securities case in these circumstances.

- **<u>Consultation with experts</u>**

Consultation with experts is a potentially worthwhile part of the pre-filing investigation to help plaintiffs determine whether a set of facts constitutes actionable violations of the securities laws. For example, plaintiffs often find it useful to consult with an accounting expert when a company announces a restatement or other serious financial problems such as failure to take adequate reserves or failure to timely write down an important asset. The expert can provide insight into such questions as whether the restatement is material, whether the company should have corrected the financials earlier, and whether accounting standards were breached. Expert opinions are also helpful where the disclosure involves technical issues, such as failure of a drug trial, or recall of a product or medical device. Often, such expert opinions help plaintiffs determine whether the problems were due to entirely unanticipated events, or general market conditions, or mere mismanagement, or some other factors, rather than actionable fraud.

THE PROPOSED CLASS PERIOD

During the pre-filing investigation, plaintiffs should determine the class period that will be asserted in the initial complaint. The class period at the initial stage of the litigation will be the basis to calculate plaintiffs' losses for those who file motions for appointment as lead plaintiff, and will be the basis for the court's determination of the plaintiff with the "largest financial interest" in the litigation.[5]

Another consideration when determining the class period is the statute of limitations and statute of repose imposed by the securities laws. The Exchange Act has a two-year statute of limitations and a five-year statute of repose. 28 U.S.C.A. § 1658(b); *Merck & Co. v. Reynolds*, 559 U.S. 633, 638 (2010). Claims under Section 11 and 12(a)(2) of the Securities Act have a one-year statute of limitations and a three-year statute of repose. Securities Act, Section 13, 15 U.S.C.A. § 77m.[6]

POTENTIAL DEFENDANTS

Potential defendants will often include the company and its chief officers, primarily the CEO and CFO. In cases where the stock falls following the company's announcement of a restatement, or potential accounting irregularities, or failure of internal financial controls, plaintiffs may consider naming the company's auditor. Where the claims are brought under the

5. *See* Exchange Act, 15 U.S.C. § 78u-4(a)(3)(B)(iii); Securities Act, 15 U.S.C. § 77z-1(a)(3)(B)(iii).
6. Plaintiffs should be aware of the caselaw interpreting these statutes, including what gives rise to "discovery" of the alleged violation to trigger the statute of limitations. *See, e.g.*, *Merck & Co., Inc. v. Reynolds,* 559 U.S. 633, 637, 649 (2010) (construing "2 years after the discovery of the facts constituting the [section 10(b)] violation" to mean that a cause of action accrues "when the plaintiff did in fact discover" or "when a reasonably diligent plaintiff would have discovered" the facts constituting the violation, whichever comes first, and include the facts showing scienter). In addition, the Supreme Court recently held that the 3-year time limit in Section 13 of the Securities Act is a "statute of repose" which "on its face creates a fixed bar against future liability" and is "not subject to equitable tolling." *California Public Employees' Retirement System v. ANZ*, 137 S. Ct. 2042, 2049, 2051 (2017). Although the Supreme Court has not explicitly applied *ANZ's* holding to the Exchange Act, at least one district court has done so, reasoning that "[c]ourts routinely characterize the Exchange Act's five-year statutory time restriction as a 'statute of repose.'" *In re BP p.l.c. Secs. Litig.,* 341 F. Supp. 3d 698, 704 (S.D. Tex. 2018)(citing, *e.g.*, *Merck*, 559 U.S. at 650, in which the Supreme Court noted that § 1658(b)(2)'s "unqualified bar on actions instituted '5 years after such violation' giv[es] defendants total repose after five years"). Thus, the *BP* court concluded, "the five-year bar is a statute of repose, not subject to equitable tolling." *BP,* 341 F. Supp. 3d at 705.

Securities Act alleging a false or misleading registration statement and/or prospectus, potential defendants may include the company's directors and underwriters in addition to the company and its top officers, or others enumerated in the Statute.[7]

Although beyond the scope of this article, it should be noted that when evaluating and drafting claims under the Exchange Act, plaintiffs should review the most recent caselaw addressing the questions of who is a primary violator and who "made" the alleged false statements, to be subject to liability in a private action, in contrast to one who is arguably a mere "aider and abettor."[8]

NON-US COMPANIES

Frequently, potential claims arise against a foreign company which trades its shares on the exchange of a foreign country and offers only American Depositary Receipts ("ADRs") or American Depository Shares ("ADSs") to U.S. investors. In those cases, U.S. plaintiffs who purchased ADRs or ADSs are faced with the question of whether they can bring a securities class action against the non-U.S. company without running afoul of the Supreme Court's decision in *Morrison v. National Australia Bank, Ltd*., 561 U.S. 247 (2010). *Morrison* held that Section 10(b) did not apply extraterritorially, but is only applicable (1) in connection with the purchases or sale of any securities registered on a national securities exchange or (2) domestic transactions in other securities not so registered. *Id*. at 265-266.

Recently, the ability for U.S. purchasers of unsponsored ADRs to bring a class action against a foreign company under the Exchange Act post-*Morrison* was significantly improved by a Ninth Circuit decision, *Stoyas v. Toshiba Corp*., 896 F. 3d 933 (9th Cir. 2018). In *Stoyas,* the Ninth Circuit reversed the lower court's dismissal of plaintiffs-pension funds' securities class action complaint filed on behalf of purchasers of ADRs of Toshiba Corporation, a Japanese Corporation whose common stock is publicly traded

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7. *See* Securities Act Sections 11, Section 12(a)(2), and Section 15 enumerating those who may be sued under those sections.
8. For example, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver N.A*., 511 U.S. 164, 191 (1994), the Supreme Court held that only the SEC, not private parties, can bring an action under Section 10(b) based on an aiding and abetting theory. In *Janus Capital Group v. First Derivative Traders*, 564 U.S. 135, 142 (2011), the Supreme Court held that "[f]or 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."

on the Tokyo Stock Exchange and not listed directly on any US exchange.[9] The plaintiffs-funds had alleged that defendants had violated Section 10(b) based on the company's "now-admitted fraudulent accounting practices that caused hundreds of millions of dollars in loss to U.S. investors." *Id*. at 937. The district court had dismissed the case with prejudice on the grounds that the over-the-counter ("OTC") market on which Toshiba's ADRs are sold was not a "national exchange" within the meaning of *Morrison*, and that there was no "domestic transaction" between the ADR purchasers and Toshiba, *i.e.,* the complaint failed to allege Toshiba's involvement in the ADR transactions at issue. *Id*. at 937-938.

On *de novo* review, the Ninth Circuit held that the district court had "misapplied *Morrison.*" The Ninth Circuit reversed and remanded to allow the plaintiffs to amend their complaint to allege that the plaintiffs' ADR purchases on the over-the-counter market were "domestic purchases" of securities and that the alleged fraud was in connection with the purchase of those securities. *Id.* at 952.

The Ninth Circuit held that the Exchange Act applied to the Toshiba ADR transactions because *"Toshiba ADRs are 'securities' under the Exchange Act*." *Id*. at 939 (emphasis added). "Toshiba ADRs fit comfortably within the Exchange Act's definition of 'security,' specifically as 'stock,'" sharing "many of the five significant characteristics typically associated with common stock," including negotiability and the capacity to appreciate in value. *Id*. at 939-941. Further, while the over-the-counter market is not an "exchange," the "Exchange Act regulates over-the-counter markets." *Id*. at 947.

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9. ADRs "allow U.S. investors to invest in non-U.S. companies and give non-U.S. companies easier access to U.S. capital markets." *Stoyas*, 896 F. 3d at 940 (citation omitted). "Specifically, ADRs are negotiable certificates issued by a United States depositary institution, typically banks, and they represent a beneficial interest in, but not legal title of, a specified number of shares of a non-United States company. The depositary institution itself maintains custody over the foreign company's shares." *Id.* The Court explained that "Toshiba ADRs are *unsponsored* which means that the depositary institutions each filed Form F-6 with the SEC without Toshiba's 'formal participation' and possibly without its acquiescence." *Id*. at 941 (citation omitted). Thus, when an investor purchases an unsponsored ADR, as plaintiff did with Toshiba's ADRs, it enters into "essentially a two-party contract" with the depositary institution. "In contrast, ADRs are sponsored when a depositary institution and the foreign company jointly file Form F-6 to register the ADRs. Accordingly, purchasers of sponsored ADRs enter into essentially a three-party contract with the depositary and the foreign company." *Id*. at 941 & n. 8 (citation omitted).

Next, the Ninth Circuit held that *plaintiffs' "purchase of Toshiba ADRs on the over-the-counter market is a domestic 'purchase or sale of ... any security not' registered on a national securities exchange."* *Id*. at 939 (emphasis added) (citing 15 U.S.C. § 78j(b)); *Morrison,* 561 U.S. at 269-70. The Ninth Circuit adopted and applied the "irrevocable liability" test articulated by courts since *Morrison* to determine whether the plaintiffs' transactions in Toshiba's ADRs were a "domestic transaction in other securities" under *Morrison* to fit within Section 10(b). *Id*. at 948 (citations omitted). Under that test, the key question is *where* investors bought and sold the securities not whether the foreign company issued or authorized the ADRs. "[A] plaintiff must plausibly allege 'that the purchaser incurred irrevocable liability within the United States to take and pay for a security, or that the seller incurred irrevocable liability within the United States to deliver a security.'" *Id*. (citation omitted). "Looking to where purchasers incurred the liability to take and pay for securities, and where sellers incurred the liability to deliver securities, hews to Section 10(b)'s focus on transactions and *Morrison*'s instruction that purchases and sales constitute transactions." *Id.* at 949. Thus, "factual allegations concerning contract formation, placement of purchase orders, passing of title, and the exchange of money are directly related to the consummation of a securities transaction*." Id.* In the case at hand, for instance, plaintiffs alleged that the Toshiba ADRs were purchased in the United States, and that Bank of New York, one of the depositary institutions, sold Toshiba ADRs in the U.S., and the four Toshiba ADR depositary banks' principal executive offices and offices where ADR holders can exchange their ADRs for Toshiba common stock are all in New York. *Id.* The court permitted amendment to supply "specific facts regarding where the parties to the transaction incurred irrevocable liability," and anticipated that "an amended complaint could almost certainly allege sufficient facts to establish that [the plaintiff fund] purchased its Toshiba ADRs in a *domestic transaction*." *Id*. (emphasis added).

In addition, the appellate court made clear that plaintiffs would also have to amend their complaint before the court could determine whether the alleged fraud was "in connection with the purchase or sale of a security" to sufficiently plead an Exchange Act claim. *Id.* at 950. The court cautioned that "[f]irst and foremost, sufficiently pleading Toshiba's connection to the ADR transactions requires clearly setting forth the transactions" and requires amendment to provide "basic details" about the ADRs, and "factual allegations" about the over-the-counter market where Toshibas

ADRs are listed, and to provide missing detail about plaintiffs' purchase of the Toshiba ADRs, including how the purchase was made and which depository institution holds the corresponding Toshiba common stock. *Id.* at 951. Second, the court noted that the complaint lacked facts supporting plaintiffs' argument that Toshiba was "indeed involved in the establishment" of the ADRs, and permitted plaintiffs to amend to supply these facts. *Id*. at 952.

The key takeaway from the Ninth Circuit analysis and ruling in *Toshiba* that the Exchange Act can apply to Toshiba's ADR transactions under *Morrison*, is that non-U.S. companies may be more likely to face U.S. securities fraud claims. As a practical matter for plaintiffs, the description of the type of details about the ADRs and U.S. contacts that the Ninth Circuit required plaintiffs to plead offer instructive features for plaintiffs to look for when analyzing the nature of both sponsored and unsponsored ADRs of foreign companies bought by U.S. investors where there appear to be meritorious securities claims.

WHERE TO FILE

Under Section 27(a) of the Exchange Act, 15 U.S.C. § 78aa(a), federal district courts of the U.S. have "exclusive jurisdiction" over any cases brought under the Exchange Act. Further, as to venue, Section 27(a) provides that a suit under the Exchange Act "may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business." The Securities Act, Section 22, 15 U.S.C. § 77v has a similar venue provision which provides that any suit under the Securities Act "may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein."[10] In addition, the "general"

10. "Courts have interpreted this statutory language to mean that the commission of any non-trivial act in the district establishes venue for an Exchange Act claim, even if this act does not go to the core of the alleged violation*." Ato Ram II, Ltd. v. SMC Multimedia Corp*., 2004 WL 744792, at *3 (S.D.N.Y. April 7, 2004) (collecting cases). "The act or transaction committed within the district need not constitute the core of the violation, but should be an important step in the fraudulent scheme." *SEC v. Contrarian* Press*, LLC*, 2017 WL 4351525, at *2 (S.D.N.Y. Sept. 29, 2017). Further, "[i]f there is proper venue under [either the Securities or Exchange Acts], venue is also proper for a claim arising under [the other.]." *Id*. (citation omitted).

venue statute, 28 U.S.C.A. § 1391, applies to the "the venue of all civil actions brought in district courts of the United States" (§ 1391(a)(1)), which includes those brought under the federal securities laws.[11] Plaintiffs frequently file in the district where the defendant company has its headquarters or principal executive offices. *See Ahrens v. Cti Biopharma Corp.*, 2016 WL 2932170, at *3-4 (S.D.N.Y. May 19, 2016) (on balance, Western District of Washington was proper venue where defendant company was incorporated under laws of Washington State, maintains its headquarters, principal place of business and sole U.S. office in Seattle, and issued its allegedly false financial statements and SEC filings from that office, particularly viewed in the context of a stockholder class action, where members of the class are dispersed throughout the nation).

Importantly, while suits alleging securities fraud claims under the *Exchange Act* must be brought in *federal* court under Exchange Act Section 27's "exclusive jurisdiction" language, in contrast, a plaintiff may file claims under the *Securities Act* in *state court as well as federal court* under the "concurrent" jurisdiction provision of the Securities Act, Section 22, 15 U.S.C. § 77v(a). Recently, the U.S. Supreme Court, in a recent unanimous decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund*, 138 S. Ct. 1061 (2018), affirmed that investors have the right to bring claims under the Securities Act *in state or federal court*, notwithstanding SLUSA. Specifically, in *Cyan,* the Court held that the Securities Litigation Uniform Standards Act of 1998 "(SLUSA") does not strip state courts of their "longstanding jurisdiction" to adjudicate class actions alleging only violations of the federal *Securities Act* (regulating securities offerings). Second, the Court held that "neither did SLUSA authorize removing such suits from state to federal court." *Id.* at 1078.

The practical result of *Cyan* is that if a plaintiff brings a class action alleging only claims under the Securities Act against a company in *state* court, the company cannot argue that SLUSA bars the state court suit, and cannot remove the state court suit to federal court, even if there is a parallel or even identical action in *federal* court. *Cyan* was a significant victory for plaintiffs since it now clearly enables plaintiffs to choose to litigate claims under the Securities Act, arising from allegedly false or misleading statements in a registration statement or prospectus, against defendants in a state forum without facing removal. For defendants, on the other hand, the

11. Among the provisions of § 1391, venue is proper in the judicial district "in which a substantial part of the events or omissions giving rise to the claim occurred…" 28 U.S.C.A. § 1391(b)(2).

decision means that they now face the possibility of having to litigate multiple such lawsuits in multiple jurisdictions based on the same set of events.[12]

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12. *Cyan*'s ruling affirming the "concurrent jurisdiction" of state and federal courts over Securities Act claims refers to the courts' jurisdiction over the claims, *i.e.*, subject matter jurisdiction. Although beyond the scope of this article, plaintiffs -- especially when suing in state court -- should also be aware of recent decisions by the Supreme Court that address the issue of "personal jurisdiction," which hold that, under the 14th Amendment due process clause, courts may only exercise personal jurisdiction over an out-of-state defendant who has certain minimum contacts with the State such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice. *BNSF Ry. Co. v. Tyrrell*, 137 S. Ct. 1549, 1557-1558 (2017). That clause "does not permit a State to hale an out-of-state corporation before its courts when the corporation is not 'at home' in the State and the episode-in-suit occurred elsewhere." *Id.* at 1554 (citing *Daimler AG v. Bauman*, 571 U.S. 117, 127 (2014)). "The Fourteenth Amendment due process constraint described in *Daimler*… applies to all state-court assertions of general jurisdiction [an "all purpose" type of personal jurisdiction] over nonresident defendants; *the constraint does not vary with the type of claim asserted or business enterprise sued.*" *BNSF*, 137 S. Ct. at 1558-59 (emphasis added). In *Daimler,* Argentinian residents brought suit in California federal district court against German corporation Daimler under the Alien Tort Statute as well as state law. The Supreme Court held that due process did not permit exercise of general jurisdiction over Daimler in California for injuries that took place outside the U.S. since there was no evidence that Daimler's affiliations with the State are so "continuous and systematic" as to render Daimler "essentially at home" in California. *Daimler*, 571 U.S. at 122, 127. The "paradigm forum" for exercise of general jurisdiction over a corporation is the "corporation's place of incorporation and principal place of business," where "a corporate defendant may be sued on any and all claims." *Id.* at 137.

    It is not clear the extent to which *Daimler* and the other Supreme Court cases on personal jurisdiction apply to cases filed under the federal securities laws, in particular those brought in *federal* court, since courts have held that where a court exercises jurisdiction based on "federal question jurisdiction," such as the Exchange Act and the Securities Act, as opposed to diversity jurisdiction, and where the federal statute confers nationwide service of process, "the issue for due process purposes is whether the party has sufficient contacts *with the United States*, not any particular state." *SEC v Lyndon*, 27 F. Supp. 3d 1062, 1068-69 (D. Hawaii, 2014) (citing *Securities Investor Protection Corp. v. Vigman,* 764 F. 2d 1309, 1315-16 (9th Cir. 1985) (emphasis added) (district court may exercise personal jurisdiction over § 10(b) claim if defendant has minimum contacts with the United States). *Lyndon* held that since both Section 27 of the Exchange Act, § 78aa and Section 22 of the Securities Act, § 77v, allow for "nationwide service of process," the court has personal jurisdiction over the defendant so long has he has "minimum contacts with the United States." *Id.* at 1069-1070. *Kammona v. Onteco Corp.,* 587 Fed. Appx. 575, 580

FILING THE LEAD PLAINTIFF MOTION AND CALCULATING CLIENT LOSSES

Under the PSLRA provisions applicable to both the Securities Act and the Exchange Act, plaintiffs who file a class action must comply with the Lead Plaintiff provisions of those Acts.[13] These provisions include requiring the plaintiff filing the first complaint to file early notice to class members, and appointment of a lead plaintiff. The "rebuttable presumption" that the "most adequate plaintiff" is the "person or group of persons" that the court determines to have "the largest financial interest" is the basis of most lead plaintiff contests. A substantial body of caselaw has developed interpreting the terms "largest financial interest," and other language of the Lead Plaintiff provisions.

While the PSLRA does not specify a method by which to determine which movant has the largest financial interest, for purposes of computing losses, courts frequently apply the four "*Lax* factors" adopted in *Lax v First Merchants Acceptance Corp.,* 1997 WL 461036 (N.D. Ill. Aug. 11, 1997). These factors include (1) total number of shares purchased during the class period; (2) net shares purchased during the class period; (3) net funds expended during the class period; and (4) the approximate financial losses suffered. *See McKenna v. Dick's Sporting Goods, Inc.*, 2018 WL 1083971, at *4 (S.D.N.Y. Feb. 27, 2018) (collecting cases applying the *Lax* test). "Financial loss is the factor typically given the most weight." *Id.* Plaintiffs can calculate losses using both "first-in-first-out" ("FIFO") and "last-in-first-out" ("LIFO") methods. *Id*. "The majority view seems to be that approximate losses should be calculated using the LIFO method." *Strong v. AthroCare Corp.*, 2008 WL 11334942, at *6 (W.D. Tex. Dec. 10, 2008) (collecting cases). "Many courts have followed this preference for the LIFO method of accounting over the FIFO method in securities fraud cases, as 'the inflation of stock prices over the course of the class period may have resulted in gains accrued to plaintiffs… FIFO may overstate actual

(11th Cir. 2014)(because § 78aa authorizes nationwide service of process in securities-fraud cases, the district court incorrectly analyzed defendants' minimum contacts in the context of the forum state of Florida, as opposed to contacts with the United States as a whole).

13. *See* Exchange Act Section 21D(a)(3), 15 U.S.C. § 78u-4(a)(3); Securities Act Section 27, 15 U.S.C. § 77z-1(a)(3).

losses suffered by stockholders, whereas LIFO takes into account these gains.'" *Id.*[14]

Another point to consider is that a plaintiff who purchased one type of security, for example, common stock, can be appointed lead plaintiff – and his counsel appointed as lead counsel – to represent putative class members who purchased different type of securities, such as bonds. "[T]he weight of the caselaw is that securities cases should be consolidated under a single lead plaintiff even when the cases involve different types of securities." *In re CenturyLink Sales Practices and Secs. Litig*., 2018 WL 1902725, at *4 (D. Minn. April 20, 2018). "[C]ourts have repeatedly concluded that stock purchasers can represent purchasers of debt instruments." *Id*. (citing *In re Enron Corp. Sec. Litig*., 206 F.R.D. 427, 455 (S.D. Tex. 2002).[15]

A final observation: Despite plaintiff's diligent pre-filing investigation and drafting of the initial complaint, it is of course quite possible that the competitive and usually hotly-contested lead plaintiff motion process will produce a lead plaintiff and lead counsel who were not the ones who filed

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14. As the court in *Strong* further explained, LIFO is preferred to calculate losses for lead plaintiff motions in securities class actions because "LIFO offsets gains accrued to the plaintiffs due to the inflation of stock prices during the class period…excludes 'in-and-out' transactions during the class period [and] takes into account gains and can disregard losses that are not causally related to the misstatement claims." *Strong*, 2008 WL 11334942, at *6. *Mckenna,* 2018 WL 1083971, at *4 (courts in the Southern District of New York "have a very strong preference for the LIFO method" for calculating loss, "because LIFO accounts for gains accrued to plaintiffs during the class period due to the inflation of the stock price." (citations omitted). In contrast, the other method, first-in-first-out ("FIFO") "ignores sales occurring during the class period and hence may exaggerate losses." *Id*. at*4 n.4 (citation omitted).

    Other issues can arise when computing losses of institutional investors or other large holders of multiple funds. For example, gains in one account may offset losses in another. Or, a potential plaintiff may be a "net seller." These factors may not be disqualifying if the plaintiff has the largest financial loss. "Financial loss is the factor typically given the most weight; therefore, [m]ost courts agree that the largest loss is the critical ingredient in determining the largest financial interest and outweighs net shares purchased and net expenditures." *McKenna,* 2018 WL 1083971, at *4 (citation omitted) (collecting cases). *See also In re Audioeye, Inc. Sec. Litig.,* 2015 WL 13654027, at *5 (D. Ariz. Aug. 3, 2015) ("courts in the Ninth Circuit and elsewhere have repeatedly held that a 'net seller' can be a lead plaintiff or class representative, as long as it has a recoverable loss."). These factors, and others, must be carefully analyzed, when computing and presenting clients' trading information on the lead plaintiff motion.
15. The court explained that choosing one lead plaintiff to represent different securities comports with the goals of the PSLRA: "The PSLRA intended to centralize decision-making into the hands of one lead-plaintiff or plaintiffs' group in order to avoid waste and empower investors. Requiring a separate lead plaintiff for every type of security would contradict these purposes." *CenturyLink,* 2018 WL 1902725 at *4.

the first complaint and disseminated notice to the class. Instead, the first-filing plaintiff will remain in the case as an absent class member. That is simply how Congress intended the PSLRA to work.

RECENT NOTABLE DEVELOPMENTS IN SECURITIES LAW:

(1) **Supreme Court holds that SLUSA does not bar filing Securities Act class actions in state courts as well as federal courts, under the "concurrent" jurisdiction provision of the Securities Act, expanding plaintiffs' ability to choose state courts as the appropriate forum for such claims and increasing potential for parallel actions in federal and state courts**

- ***Cyan, Inc. v. Beaver County Employees Retirement Fund***, 138 S. Ct. 1061 (March 20, 2018). A unanimous decision by the Supreme Court, delivered by Justice Kagan, held that state courts retain concurrent jurisdiction with federal courts over class actions alleging only 1933 Act Claims (pertaining to securities offerings) and that they cannot be removed to federal court. Specifically, SLUSA (the Securities Litigation Uniform Standards Act of 1998), "did nothing to strip state courts of their longstanding jurisdiction to adjudicate class actions alleging only 1933 Act violations. Neither did SLUSA authorize removing such suits from state to federal court." *Id*. at 1078.

  Investors had bought shares of stock in Cyan's IPO and, after the stock declined in value, brought a class action against Cyan in state court alleging 1933 Act violations, and no claims based on state law. *Id*. at 1068. Cyan moved to dismiss for lack of subject matter jurisdiction on the grounds that state courts have no jurisdiction over '33 Act claims in "covered class actions." Investors argued that SLUSLA left intact covered class actions alleging *only federal* '33 Act claims. *Id.* The California Superior Court agreed with the investors. The Supreme Court granted Cyan's petition for certiorari. The Court also agreed to consider whether SLUSA enabled defendants to remove 1933 Act class actions from state to federal court. *Id*. at 1069.

  The Court framed the question as whether SLUSA's text, at Securities Act Section 16, 15 U.S.C.§ 77p, *limits* state court jurisdiction over class actions brought under the 1933 Act, and is therefore in conflict with Section 22, which grants state court jurisdiction. *Id*. at 1069. The Court held that it does not. Rather,

§77p only bars certain securities action based on *state* law, and authorizes their removal to federal court. But, §77p "says nothing, and so does nothing, to deprive state courts of jurisdiction over class actions based on *federal* law. That means the background rule of § 77v(a) – under which a state court may hear the investors' 1933 Act suit – continues to govern." *Id.* (emphasis in original). Finding that the California Superior Court had jurisdiction over investors' claims, the Supreme Court affirmed the judgment of the California Superior Court. *Id*. at 1078.

The Supreme Court's instruction in *Cyan* that SLUSA did nothing to strip state courts of their concurrent jurisdiction over Securities Act claims, and that defendants cannot remove state actions to federal court, was recently cited in ***Sciabacucchi v. Salzberg***, 2018 WL 6719718 (Del. Ch. Dec. 19, 2018). The Delaware Court of Chancery held that a Delaware Corporation cannot compel shareholders to litigate Securities Act claims in *federal* court via a forum selection clause in its corporate charter. *Id.* at *3. The Delaware court noted that "[c]orporations and their advisors preferred federal court," and had begun adopting forum-selection provisions that specified federal courts as the exclusive forum for 1933 Act claims when the 1998 SLUSA cast doubt on the federal/state allocation of jurisdiction. *Id*. at *6. The Delaware Court held that such "Federal Forum Provisions" in corporate bylaws are "ineffective and invalid" as contrary to the federal scheme governing the Securities Act Statute. *Id*. at *3. When enacting the Securities Act in 1933, Congress explicitly gave state and federal courts "concurrent jurisdiction over claims by private plaintiffs and barred defendants from removing actions filed in state court to federal court," as confirmed by the Supreme Court in *Cyan v. Beaver City*. *Id.* at *1 & n.1.

The Delaware Chancery court explained that a corporation's bylaws can only govern the forum in which parties bring claims affecting its own "internal affairs." In contrast a "Delaware corporation cannot use it charter or bylaws to regulate the forum in which parties bring 'external claims, such as federal securities law claims.'" *Id*. at *18 (citing *Boilermakers Local 154 Ret. Fund v. Chevron Corp*., 73 A. 3d 934 (Del. Ch. 2013). "[A] federal claim under the 1933 Act is a clear example of an external claim. The plaintiff is a purchaser of securities, and the source of the cause of action is the sale of a security that violates the federal regulatory regime*."* *Id.* at *22.

(2) **Supreme Court holds that the statute of limitations cannot be tolled under *American Pipe* for absent class members who bring successive *class* actions outside the applicable limitations period**

- ***China Agritech, Inc. v. Michael H. Resh***, 138 S. Ct. 1800 (June 11, 2018). In an 8-1 decision delivered by Justice Ginsburg, the Supreme Court held that upon denial of class certification, a putative class member, in lieu of promptly joining an existing suit or promptly filing an individual action, may not commence a class action beyond the time allowed by the applicable statute of limitations.

  The Court clarified that *American Pipe and Crown Construction Co. v. Utah*, 414 U.S. 538 (1974) only "tolls the statute of limitations during the pendency of a putative class action, allowing unnamed class members to join the action *individually* or file *individual claims* if the class fails. But *American Pipe* does not permit the maintenance of a follow-on class action past expiration of the statute of limitations." *Id.* at 1804 (emphasis added).

  Plaintiffs had sued China Agritech under Section 10(b) of the Exchange Act for allegedly engaging in fraud and misleading business practices, causing the company's stock price to plummet when the misconduct was reported. The first complaint was filed at the start of the Exchange Act's two year limitation period in February 2011; the court subsequently denied plaintiffs' motion for class certification in May 2012. On June 30, 2014, plaintiff Resh filed a class action, a year and a half after the Exchange Act's statute of limitations expired. The district court dismissed the complaint as untimely, but the Ninth Circuit reversed. *Id.* at 1805. Because of the circuit split on the issue, the Supreme Court granted certiorari. The Court held that considerations of efficiency dictate that a class action may not be filed after the expiration of the statute of limitations following a denial of class certification, stating as follows:

  > We hold that *American Pipe* does not permit a plaintiff who waits out the statute of limitations to piggyback on an earlier, timely filed class action. The "efficiency and economy of litigation" that support tolling of individual claims do not support maintenance of untimely successive class actions; any additional *class* filings should be made early on, soon after the commencement of the first action seeking class certification.

  Id. at 1806 (emphasis in original) (citing *American Pipe*, 414 U.S. at 553).

Further, the Court pointed out that Rule 23 indicates a preference for barring untimely successive class actions by "instructing that class certification should be resolved early on." *Id*. at 1807. Similarly, the PSLRA evinces a preference for early resolution of class certification by "grouping class-representative filings at the outset of litigation*." Id.*

(3) **Ninth Circuit limits defendants' use of judicial notice and incorporation-by-reference doctrines at motion to dismiss stage**

- ***Khoja v. Orexigen Therapeutics, Inc.***, 899 F. 3d 988 (9th Cir. 2018). Plaintiffs alleged that a biotech company failed to disclose the truth and/or adverse material information about the drug study involving its primary drug candidate. The Ninth Circuit reversed the district court's dismissal of the plaintiff's claim under §10(b) and Rule 10b-5, finding that the district court abused its discretion by improperly considering material outside the complaint on the motion to dismiss stage. The Appeals Court found that defendants' practice was a "concerning pattern in securities cases" by "exploiting these procedures improperly to defeat what would otherwise constitute adequately stated claims at the pleading stage." 899 F. 3d at 998. *The risk of abuse and unfairness leading to "premature dismissals of plausible claims that may turn out to be valid after discovery" is "especially significant in SEC fraud matters, where there is already a heightened pleading standard and the defendants possess materials to which the plaintiffs do not yet have access." Id.* (emphasis added).

  While the Ninth Circuit did not entirely bar the use of judicial notice and incorporation-by-reference, the Court "clarified" that "a court cannot take judicial notice of *disputed* facts contained in [] public records" without converting the motion to dismiss into a motion for summary judgment. *Khoja*, 899 F. 3d at 999 (emphasis added). Applying that rule, the court found the district court abused its discretion by judicially noticing certain documents, including a transcript of an investor conference call that defendants submitted with their motion to dismiss to show that they had previously disclosed the true facts about the drug trial to investors who, therefore, could not have been misled. *Id*. at 1000. The Ninth Circuit found that "[i]t is improper to judicially notice a transcript when the substance of the transcript 'is subject to varying interpretations, and there is a reasonable dispute as to what the [transcript] establishes.'" *Khoja*, 899 F. 3d at 1000 (citation omitted).

(4) **Ninth Circuit states that the less restrictive "general proximate cause" is the correct test to establish the element of loss causation under the Exchange Act under *Dura:* thus, a plaintiff may prove loss causation by showing that the stock price fell upon revelation of an earnings miss, even if the fraud was not affirmatively revealed to the market prior to the claimed loss**

- ***Mineworkers' Pension Scheme v. First Solar Inc.***, 881 F. 3d 750 (9th Cir. 2018). Investors brought a § 10(b) case against producer of photovoltaic solar panel modules, alleging defendants issued financial statements which concealed product manufacturing and design defects, and that the company's stock price fell when the company disclosed the defects and attendant financial liabilities to the market. *Id*. at 752. After defendants filed a motion for summary judgment, which the court granted and denied in larger part, the court then stayed the action to seek interlocutory appeal from the Ninth Circuit to resolve a perceived conflict in two competing lines of case law in the Ninth Circuit regarding loss causation – one that requires plaintiff to show causal connection between the *very facts* misrepresented or omitted and the plaintiff's loss; and the second "more restrictive view" requiring that the *market must have actually learned* of defendants' fraudulent practices and reacted to the fraud itself. *Id.* at 752-53.

  In its response, the Ninth Circuit resolved the ambiguity by confirming the first less restrictive test for loss causation, affirming the Supreme Court's holding in *Dura*, which instructed that the inquiry "requires no more than the familiar test for proximate cause." *Id.* at 753 (citing *Dura Pharm. Inc. v. Broudo*, 544 U.S. 336, 346 (2005). "To prove loss causation, plaintiffs need only show a 'causal connection' between the fraud and the loss, by tracing the loss back to 'the 'very facts about which the defendant lied.' '***Disclosure of the fraud is not a sine qua non of loss causation, which may be shown even where the alleged fraud is not necessarily revealed prior to the economic loss***.'" *Id*. (emphasis added) (internal citations omitted). The Court explained that there is an "infinite variety" of ways that loss causation can be shown in a 10(b) case; revelation of the actual fraud in the marketplace is only one way. But, not the only way – disclosure of an earnings miss by itself is another way to show loss causation even without revelation of the reason for the miss. "***A plaintiff may also prove loss causation by showing that the stock price fell upon the revelation of an earnings miss, <u>even if the market was unaware at the time</u> that fraud had concealed the miss***." *Id.* at 754 (emphasis added). The fact that the stock price drop comes immediately *after* the revelation of fraud helps rule out alternative causes, but that sequence is not a *condition* of loss causation. *Id.*

In short, since the element of loss causation is simply a variant of the traditional "proximate cause" test, "the ultimate issue is whether the defendant's misstatement, as opposed to some other fact, foreseeably caused the plaintiff's loss." *Id.* at 753 (citing *Dura*, 544 U.S. at 343-46). The Ninth Circuit found that the district court had applied the correct "general proximate cause" test when it found that plaintiffs had proven the element of loss causation. *Id.* at 754.

(5) **Southern District of New York, on remand, holds that defendants bear the burden of "preponderance of the evidence" in order to show lack of price impact in order to rebut the *Basic* presumption of classwide "reliance" on a motion for class certification**

- ***In re Goldman Sachs Group, Inc. Sec. Litig.,*** 2018 WL 3854757 (S.D.N.Y. Aug. 14, 2018). Investors filed a suit alleging Goldman Sachs violated § 10(b) and Rule 10b-5 by issuing misstatements about Goldman's conflicts of interest policies and business practices, revealed by reports by government investigations. The class was certified, but defendants filed an interlocutory appeal. The Second Circuit vacated the class certification and remanded the case for further proceedings, directing the district court to reconsider whether defendants had rebutted the *Basic* presumption of reliance by a preponderance of the evidence. *Id.* at *1. After holding an evidentiary hearing, at which defendants' expert testified that the alleged misstatements had no price impact, the district court determined that defendants "have not rebutted the *Basic* presumption [of plaintiffs' reliance under the fraud-on-the-market theory] by a preponderance of the evidence" and granted class certification to plaintiffs. *Id.* at *2.

In reviewing the applicable law, the district court acknowledged that the Supreme Court held in *Halliburton Co. v. Erica P. John Fund, Inc.,* 1134, S. Ct. 2398 (2014) ("*Halliburton II*") that the *Basic* presumption can be rebutted at the class certification stage with evidence that defendants' misrepresentation had "no price impact." *Id.* at *2. What the district court clarified is that, in the Second Circuit, defendants "bear the burden of persuasion to rebut the *Basic* presumption by a preponderance of the evidence" standard. *Id. (citing Arkansas Teachers Ret. Sys. V. Goldman Sachs Grp., Inc.*, 879 F. 3d 474, 478 (2d Cir. 2018) (*citing Waggoner v. Barclays PLC*, 875 F, 3d 79 (2d Cir. 2017). Under that standard, defendants must demonstrate, by a preponderance of the evidence, that the alleged misstatements "had no price impact," that is, that the misstatements did not contribute to any of the price declines that followed the three alleged corrective disclosures. *Id*. at *4. Finding that defendants' failed to meet this heavy evidentiary burden of proof, and thus failed to rebut the *Basic* presumption, the district court certified the class. *Id*. at *6.

(6) **Supreme Court grants certiorari to revisit who is a "maker" of false statements under the federal securities laws in the wake of *Janus* and to decide whether to expand "scheme liability" to cover conduct barred by *Janus***

- ***Lorenzo v. Securities and Exchange Commission***, 872 F. 3d 578 (D.C. Cir. 2017), *cert. granted by Lorenzo v. S.E.C.,* 138 S. Ct. 2650 (U.S. June 18, 2018). The Supreme Court granted certiorari to consider whether a person who is not considered the "maker" of a false statement under *Janus Capital Group v. First Derivative Traders*, 564 U.S. 135 (2011) can nevertheless be liable for the alleged false statement under the "scheme liability" provisions of Rule 10b-5(a) and (c) as the SEC asserted in its complaint. The Supreme Court case has been fully briefed and oral argument held.

  In *Janus*, the Supreme Court had restrictively held that only the "maker" of an alleged misstatement can be primarily liable under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. *Id*. at 144. "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." *Id.* at 142 (emphasis added). Thus, the Court held, that because the false statements included in mutual fund prospectuses were "made" by the investment fund, the investment advisor and parent capital group could not be held liable in a private § 10(b)/Rule 10b-5 securities action for those statements. *Id.* at 141.

In *Lorenzo*, defendant, an investment banker, is appealing the D.C. Circuit's decision. The D.C. Circuit had found that Lorenzo, director of investment banking at a broker-dealer, was not liable as the "maker" of statements, as defined by *Janus*, by merely forwarding from his account allegedly misleading emails at the "behest of his boss" who drafted the emails. *Id.* at 589. However, the D.C. Circuit held that "[a]lthough Lorenzo does not qualify as the 'maker' of those [false statements] under *Janus* because he lacked ultimate authority" over their content and dissemination," Lorenzo was nevertheless liable for violating the "scheme liability" provisions of Rule 10b-5(a) and (c), through his "own active 'role in producing and sending the emails'" to investors which "constituted employing a deceptive 'device,' 'act' or 'artifice to defraud' for purposes of liability under Section 10(b), Rule 10b-5(a) and (c) and Section 17(a)(1)." *Id.* at 589. Indeed, "Lorenzo's conduct fits comfortably within the ordinary understanding of those terms," of scheme liability. *Id.* "Lorenzo, acting with scienter, (i.e., an intent to deceive or defraud, or extreme recklessness to that effect), produced email messages containing three false statements about a pending offering, sent the messages directly to potential investors, and encouraged them to contact him personally with any questions." *Id.*

The Supreme Court has heard oral arguments on *Lorenzo* and a decision can be expected this term. Although *Lorenzo* is a case brought by the SEC, the Supreme Court's ultimate decision on whether the "scheme liability" provisions of Rule 10b-5(a) and (c) should be interpreted expansively to impose liability for allegedly false statements that are not technically "made" by an actor will impact the law in private securities actions as well.

(7) **Applying *Morrison*, Ninth Circuit reverses lower court decision that U.S. securities laws do not apply to Japanese company's unsponsored ADRs; Ninth Circuit applies the "irrevocable liability" test which focuses on where the stock was bought or sold**

and allows plaintiffs to amend complaint to allege that over-the-counter ADRs are subject to US securities laws even if not traded on a U.S. "exchange"

- ***Stoyas v. Toshiba Corp.***, 896 F. 3d 933 (9th Cir. 2018). In *Stoyas,* the Ninth Circuit reversed the lower court's dismissal of plaintiffs-pension funds' securities class action complaint filed on behalf of purchasers of ADRs of Toshiba Corporation, a Japanese Corporation whose common stock is publicly traded on the Tokyo Stock Exchange and not listed directly on any U.S. exchange. The Funds had alleged that defendants had violated § 10(b) based on the company's "now-admitted fraudulent accounting practices that caused hundreds of millions of dollars in loss to U.S. investors." *Id*. at 937. The district court had dismissed the case with prejudice on the grounds that the over-the-counter ("OTC") market on which ADRs are sold was not a "national exchange" within the meaning of *Morrison*, and that there was no "domestic transaction" between ADR purchasers and Toshiba. *Id*.

  On *de novo* review, the Ninth Circuit held that the district court had "misapplied *Morrison"* and reversed and remanded to allow the plaintiffs to amend their complaint to allege that the ADR purchases on the over-the-counter market were "domestic purchases" of securities and that the alleged fraud was in connection with the purchase of those securities. *Id.* at 952. In reaching its decision, the Ninth Circuit found that the Exchange Act applied to the plaintiffs' ADR transactions because the Toshiba ADRs "fit comfortably within the Exchange Act's definition of 'security,' specifically as 'stock'" and plaintiffs' purchases of ADRs on the OTC market was a domestic "purchase or sale of … any security not" registered on a national securities exchange. *Id*. at 939 (citing 15 U.S.C. § 78j(b)); *Morrison,* 561 U.S. at 269-70. The Court agreed with the plaintiffs that the Exchange Act regulates OTC markets, even though it is not an "exchange." *Id.*

  The Ninth Circuit applied the "irrevocable liability" test articulated by courts since *Morrison* to determine whether the plaintiffs' transactions in Toshiba's ADRs was a "domestic transaction in other securities" under *Morrison* to fit within § 10(b). *Id*. at 948 (citations omitted). Under that test, the key question is *where* investors bought and sold the securities not whether the foreign company issued or authorized the ADRs. In other words, the Exchange Act applies if a plaintiff "plausibly allege[s] 'that the *purchaser incurred 'irrevocable liability within the United States to take and pay for a security, or that the seller incurred irrevocable liability within the United States to deliver a security*.'" *Id.* at 948 (citation omitted) (emphasis added). "Looking to where purchasers incurred the liability to take and pay for securities, and where sellers incurred the liability to deliver securities hews to Section 10(b)'s focus on transactions and *Morrison*'s instruction that purchases and sales constitute transactions." *Id*. at 949.

Relevant to satisfying that test, the Court noted that the complaint alleged that the Toshiba ADRs were purchased in the U.S. and that Bank of New York, one of the depository institutions, sold ADRs in the U.S., and that the four Toshiba ADR depository banks had principal executive offices are all in New York. The Ninth Circuit gave plaintiffs leave to amend the complaint with "specific factual allegations" which would almost certainly allege sufficient facts to establish "irrevocable liability" within the US. *Id*. at 949 (citing with approval *In re Petrobras Secs.,* 862 F. 3d at 263, 273 (identifying the relevant facts as including who sold the relevant securities and how those transactions were effectuated, as evidenced by documentation such as confirmation slips).

In addition, the appellate court made clear that plaintiffs would also have to amend their complaint before the court could determine whether the alleged fraud was "in connection with the purchase or sale of a security" to sufficiently plead an Exchange Act claim. *Id.* at 950. The court cautioned that "[f]irst and foremost, sufficiently pleading Toshiba's connection to the ADR transactions requires clearly setting forth the transactions" and requires amendment to provide "basic details" about the ADRs, and "factual allegations" about the over-the-counter market where Toshibas ADRs are listed, and to provide missing detail about plaintiffs' purchase of the Toshiba ADRs, including how the purchase was made and which depository institution holds the corresponding Toshiba common stock. *Id.* at 951. Second, the court noted that the complaint lacked facts supporting plaintiffs' argument that Toshiba was "indeed involved in the establishment" of the ADRs, and permitted plaintiffs to amend to supply these facts. *Id*. at 952.

Toshiba filed a petition for certiorari with the Supreme Court on October 15, 2018. The Supreme Court has invited the U.S. Solicitor General to file briefs in the case "expressing the views of the United States." *See Toshiba Corp. v. Auto. Indus. Pension Trust Fund, et al.,* No. 18-486, –S. Ct. –, 2019 WL 177587 (Jan. 14, 2019).

(8) **Supreme Court grants certiorari to consider whether negligence is sufficient to state a claim for false statements or omissions in connection with a tender offer under Section 14(e) of the Exchange Act**

- ***Varjabedian v Emulex Corp.***, 888 F. 3d 399 (9th Cir. 2018), *cert. granted* by *Emulex Corp. v. Varjabedian*, — S. Ct. — 2019 WL 98542 (Mem. Jan. 4, 2019). The Supreme Court granted certiorari in *Emulex,* in a case that will determine what a plaintiff must plead in order to state a claim for false statement or omission in connection with a tender offer under Section14(e) of the Exchange Act. The Ninth Circuit had held that a plaintiff only needs to plead negligence, not scienter, and reversed dismissal of the complaint, and remanded the case to the district court to reconsider defendants' motion to dismiss under the negligence standard. 888 F. 3d at 401.

  Emulex is a "merger" case, brought by shareholders who complained that the offering price in the merger was inadequate. The plaintiffs alleged that defendants violated Section 14(e) of the Exchange Act the first clause of which prohibits making misleading statements or omissions in connection with any tender offer, by failing to include the Premium Analysis in its Recommendation Statement which would have disclosed that the premium offered to shareholders was below average compared to similar mergers. *Id*. at 402-403. The district court had dismissed the complaint on the basis that Section 14(e) requires a showing of scienter which plaintiffs failed to plead. On a lengthy *de novo* review, including analysis of the text of the statute, and legislative history, the Ninth Circuit interpreted Section 14(e) to require a "mere negligence" standard. *Id*. at 407-408. The Ninth Circuit conceded that its conclusion that Section 14(e) imposes a negligence standard departed from five other circuits which apply a scienter standard for misrepresentations in connection with a tender offer under Section 14(e) based on the similarity between the language of Rule 10b-5 and Section 14(e).

Id. at 409. Finding "important distinctions" between Rule 10b-5 and Section 14(e), "that strongly militate against importing the scienter requirement from the context of Rule 10b-5 to Section 14(e)," the Ninth Circuit declined to follow those other circuits. *Id*. at 405, 407. "Ultimately, because the text of the first clause of Section 14(e) is devoid of any suggestion that scienter is required, we conclude that the first clause of Section 14(e) requires a showing of only negligence, not scienter." *Id*. at 408.

The Supreme Court's ruling will be watched to determine the appropriate standard for pleading a Section 14(e) claim.

(9) **Federal courts issue recent opinions on whether cryptocurrencies are "investment contracts" and thus "securities" subject to regulation under the federal securities laws based on fact-specific analyses under the *Howey* test**

- In ***United States v. Zaslavskiy***, 2018 WL 4346339 (E.D.N.Y. Sept. 11, 2018), the United States District Court for the Eastern District of New York found that the cryptocurrencies promoted by defendants to investors constituted an "investment contract" within the definition of a "security" in both Section 3(a)(10) of the Exchange Act and Section 2(a)(1) of the Securities Act. *Id*. at *1. In *Zaslavskiy*, the district court denied defendant's motion to dismiss an indictment and allowed federal prosecutors to pursue claims against defendant Zaslavskiy for violating the Exchange Act by making false and fraudulent representations and omissions in connection with two purported virtual currency investment schemes and their related Initial Coin Offerings ("ICOs"). *Id*. at *1. Zaslavskiy and his co-conspirators were charged with promising investors that the cryptocurrency "tokens" or coins" that he offered were backed by domestic and international real estate investments and diamonds, while, in fact, no real estate or diamonds were ever purchased. *Id*. at *2. Zaslavskiy argued that the virtual currencies promoted by his activities did not qualify as an "investment contract" and thus were not "securities," as the government had charged, and thus were outside the purview of the securities laws. *Id*. The court disagreed with the defendant. The court emphasized that "[w]hether a transaction or instrument qualifies as an investment contract is a highly fact-specific inquiry." *Id*. at *4. Still, for the purpose of the motion to dismiss, the court applied the U.S. Supreme Court's multi-factor analysis in *SEC v. W.J.*

Howey Co., 328 U.S. 293 (1946) to determine whether a transaction or instrument qualifies as an "investment contract" and thus a "security" under the securities laws, and found that the facts alleged in the indictment, if proven at trial, would permit a "reasonable jury" to conclude that the investment opportunities described meet the definition of "security" under the *Howey* test. *Id.* at *5. These allegations included that individuals made an "investment of money" (and other forms of payment) in order to participate in the scheme, in exchange for investments in what they were told were investment-backed virtual tokens or coins, that investors could have reasonably had an "expectation of profits" derived solely from the managerial efforts of defendants, not any efforts of the investors themselves, and that investors pooled their assets in a "common enterprise." *Id.* at *5-7 (citing *Howey*'s three part test). The district court noted *Howey*'s instruction that the definition of a security, and therefore of an investment contract, "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* at *4 (citing *Howey*, 328 U.S. at 299). The court emphasized that "the ultimate fact-finder will be required to conduct an independent *Howey* analysis based on the evidence presented at trial." *Id.* at *5.

Further, the district court rejected defendant's argument that the securities laws were "unconstitutionally vague" as applied to cryptocurrencies. *Id.* at *8. "[C]ourts are clear that the securities laws are meant to be interpreted 'flexibly to effectuate [their] remedial purpose.'" *Id*. at *9 (citing *SEC v. Zandford*, 535 U.S. 813, 819 (2002)). The district court also cited numerous SEC releases and articles and caselaw interpreting and applying *Howey* that cautioned that simply labeling something a "currency" does not remove it from the purview of the securities laws, and that virtual currencies may have characteristics that make them "securities." *Id*. at *9. The court thus denied Zaslavkiy's motion to dismiss and ordered the case to proceed to trial.

- However, in ***SEC v Blockvest, LLC***, 2018 WL 6181408 (S.D. Cal. Nov. 27, 2018), the district court in the Southern District of California applied the *Howey* test, but concluded that the SEC had not demonstrated that the "digital asset" "or "coin" called BLV tokens that defendants Blockvest, an LLC set up to exchange cryptocurrencies, and its founder, offered in their initial coin offering ("ICO") to 32 "test" investors were "securities" as defined by the securities laws. *Id.* at *7. The SEC had charged that defendants falsely claimed their ICO had been "registered" and "approved" by the SEC and used the SEC seal on defendants' website. *Id*. at *2. The court found the "investment of money" prong of *Howey* focusing on "what the purchasers were offered or promised" was subject to dispute in the case, because *plaintiffs and defendants* "*provide starkly different facts* as to what the 32 test investors relied on, in terms of promotional materials" and "economic inducements" and other information before they purchased the BLV tokens. *Id.* at *6 (citation omitted)(emphasis added). For example, the court noted that the SEC argued that Blockvest's website and whitepaper "presented an offer of an unregistered security" – presuming, "without evidentiary support," that the 32 test investors actually reviewed the website – while defendants argued that "it was clear to the 32 testers that they were testing the platform." *Id*. at *6. Next, the court found that the SEC had not demonstrated that the 32 test investors had an "expectation of profits" to satisfy the second *Howey* prong. *Id*. at *7. The court concluded that without "full discovery" on the disputed issues of material facts, the court could not make a determination whether the BLV tokens offered to the 32 test investors was a "security." Therefore, the court found that the SEC had not demonstrated that the BLV tokens purchased by the 32 test investors were "securities" as defined under the securities laws. Consequently, the court concluded that the SEC did not make a prima facie showing that defendants had violated the Exchange Act and Securities Act. *Id*. at *7-8.

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