The New Term: The Supreme Court Faces Conflicting Currents in Securities Litigation

BY THOMAS O. GORMAN

Thomas O. Gorman is a partner in the Washington, D.C. office of Dorsey & Whitney LLP. This article was based on a September 30 post on Mr. Gorman's blog, "SEC Actions" (http://www.secactions.com). Contact: gorman.tom@DORSEY.com.

The first Monday in October is historically the opening day of the new Supreme Court term. In recent years the Court has heard a number of securities cases, considering issues regarding class certification in *Erica P. John Fund v. Halliburton*,[1] materiality in *Matrixx Initiatives Inc. v. Siracusano*[2] and primary liability in *Janus Capital Group, Inc. v. First Derivative Traders.*[3]

This term the Court has agreed to hear two significant securities cases. One, *Gabelli v. SEC*,[4] centers on when the five-year statute of limitations for bringing a penalty claim begins running for the U.S. Securities and Exchange Commission (SEC) and other government enforcement actions. The other, *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*,[5] focus on whether the plaintiff in a securities fraud class action must establish materiality at the class certification stage in a fraud-on-the-market case. Each presents the High Court with conflicting themes. [For more on the *Amgen* case, see the September 2012 issue of *Wall Street Lawyer* (vol. 16, No. 9)].

Gabelli & the Statute of Limitations

The *Gabelli* case presents Chief Justice John G. Robert's Court with a conflict between its favored strict statutory construction approach and law enforcement. The case turns on when the statute of limitations in Section 2442 of Title 28 begins. That Section provides for a five-year statute of limitations for penalties, specifying that "except as otherwise provided by Act of Congress" any penalty action brought by the government must be "commenced within five years from the date when the claim first accrued."

The underlying SEC enforcement action charged Marc *Gabelli*, a former portfolio manager at *Gabelli* Funds LLC, of making fraudulent statements and concealment in a market timing case. The U.S. Court of Appeals for the Second Circuit concluded that the five-year limitation period did not begin to run until the fraud was discovered or reasonably could have been discovered. That ruling preserved the SEC's claim, brought in April 2008 based on conduct that occurred from 1999 through 2002.

Petitioners in *Gabelli* rely primarily on the plain language of the statute, a favored approach of the conservative wing of the High Court. That language specifies that the five years begins when the claim "accrues," that is, when the events occurred. Nothing in the statute authorizes a delay in commencing the time period until some later date such as when the SEC or another government agency discovers the claim.

There is significant support for the Petitioner's position. Not only does the Court favor the "plain language" approach, but four circuit courts have utilized it to reject efforts to read a discovery rule into Section 2462, according to Petitioners. Typical of those decisions is the recent ruling by the Fifth Circuit in *SEC v. Bartek*.[6] There, the Fifth Circuit concluded in the context of an option backdating case, the cause of action "accrued" within the meaning of Section 2462, or when it happened. It rejected the SEC's claim that the time clock began when the claim was discovered. In reaching this conclusion the Fifth Circuit distinguished *Gabelli* since it was based on conduct that is inherently self-concealing. The Court concluded by rejecting the SEC's requests for an injunction and an officer and director bar as punitive—and thus, also a penalty—and time-barred.

The SEC, in contrast, argues that the High Court has uniformly utilized a discovery rule when applying the statute of limitations in fraud actions:

This Court has repeatedly recognized that, unless Congress specifies a different rule, the limitations period in the suit for fraud does not begin to run until the plaintiff discovers, or in the exercise of reasonable diligence could have discovered, the facts underlying his claim. That rule derives from the equitable maxim that a party should not be permitted to benefit from its own misconduct.

In effect the Commission's argument is the mirror image of the Petitioners—the discovery rule is inherent in every statute of limitations, imbedded in the word "accrue," meaning the claim does not accrue under Section 2462 unless and until it can reasonably be discovered by the agency.

The cross currents in *Gabelli* present a difficult dilemma for the High Court. On the one hand, its long-used textual approach consistently reflects the Court's conservative philosophy. On the other hand, adherence to that strict approach will have a significant impact on the SEC and federal law enforcement since it would significantly delimit agencies' ability to impose civil penalties and, as *Bartek* demonstrates, at times other remedies.

Amgen & Materiality

Amgen presents the Court with equally important issues and conflicting currents. The issue here is at the intersection of Rule 23 of the Federal Rules of Civil Procedure, and the Supreme Court's holding in *Basic Inc. v. Levinson*,[7] which adopted the fraud-on-the-market theory in securities fraud class actions. In the underlying case, the Ninth Circuit affirmed a ruling by a U.S. District Court, holding that the plaintiffs did not have to establish materiality to prevail on a Rule 23 motion for class certification. Rather, the question of materiality, necessary to the invocation of the *Basic* presumption, is reserved for the merits phase of the case. At the certification stage, it is sufficient to "take a peek at the merits" by ensuring that materiality is plausibly pleaded. This approach to Rule 23 is consistent with the Supreme Court's recent applications of that Rule in *Halliburton* and *Dukes v. Wal-Mart Stores, Inc.*[8]

The Petitioners' argument hews closely to the text of Rule 23 and the requirements outlined in *Basic*. Rule 23 requires in part that the securities class action plaintiffs demonstrate that there are common issues of law or fact which predominate over individual ones. The predicate to this point is frequently reliance, Petitioner argued. *Basic* substitutes a presumption for that element when the information is material and the market is efficient. Thus, the critical Rule 23 determination hinges on the application of the materiality according to Petitioners:

This Court has explained that in securities-fraud cases, the answer to the predominance question frequently turns on the reliance element. But the required predominance finding can be made as to reliance (and hence overall) only through the fraud-on-the-market theory. Unless that theory can properly be invoked, therefore, certification cannot be granted. The theory cannot properly be involved, however, unless all of its predicates—including the materiality of the alleged misstatement—have first been established.

Respondents also ground their position in the text of Rule 23, arguing that it does not specify that materiality be assessed at the class certification stage:

A suit that meets the criteria of Rule 23 may proceed as a class action. Courts are not free to impose requirements of class certification that go beyond Rule 23.

Acknowledging that the Rule requires that there be common questions of law or fact, Petitioners note that "[p]roof of materiality at the class-certification stage is therefore only required if, absent such proof, individual questions would predominate over common ones." This position is consistent with rulings by the First, Second and Fifth Circuits.

© 2012 THOMSON REUTERS

Conclusion

Amgen, like *Gabelli*, presents conflicting currents for the High Court. Here its "plain language" approach is at issue with the pro-business tendencies of the Court. On one side, the approach of the Ninth Circuit and Respondents tends to ease class certification, cutting against the Court's pro-business bent. As Respondents correctly point out, most class actions settle. The pressure of a certification ruling significantly increases those prospects meaning that if the *Basic* materiality issues are postponed until later in the proceeding they may never be reached.

Such an expansive ruling also runs counter to the Court's often stated view that since the cause of action under Rule 10(b)-5 is court made, it should be carefully circumscribed. On the other hand, imposing a materiality requirement on Rule 23 can be seen as a deviation from the "plain text" approach and the conservative method of analysis preferred by the Court.

The resolution of the conflicts in *Gabelli* and *Amgen* will come later this term.

NOTES

1. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 180 L. Ed. 2d 24, Fed. Sec. L. Rep. (CCH) P 96323, 79 Fed. R. Serv. 3d 945 (2011).
2. *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 179 L. Ed. 2d 398, Fed. Sec. L. Rep. (CCH) P 96249, 62 A.L.R. Fed. 2d 737 (2011).
3. *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 180 L. Ed. 2d 166, Fed. Sec. L. Rep. (CCH) P 96327 (2011).
4. *Gabelli v. SEC*, Docket No. 11-1274.
5. *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, Docket No. 11-1085.
6. *SEC v. Bartek*, No. 11-10594 (5th Cir. Decided Aug. 7, 2012).
7. *Basic Inc. v. Levinson*, 485 U.S. 224, 108 S. Ct. 978, 99 L. Ed. 2d 194, Fed. Sec. L. Rep. (CCH) P 93645, 24 Fed. R. Evid. Serv. 961, 10 Fed. R. Serv. 3d 308 (1988).
8. *Dukes v. Wal-Mart Stores, Inc.*, 659 F.3d 801, 113 Fair Empl. Prac. Cas. (BNA) 928 (9th Cir. 2011).

Notable

ISS Releases Draft of 2013 Proxy Voting Policies

BY GIBSON, DUNN & CRUTCHER LLP

The following memo was released by Gibson, Dunn & Crutcher LLP on Oct. 16 in response to the unveiling of Institutional Shareholder Services (ISS) always-anticipated changes to its proxy voting policies. The memo is available at http://www.gibsondunn.com/publications/pages/ISS-Draft2013ProxyVotingPolicies.aspx.

On October 15, Institutional Shareholder Services (ISS), a leading proxy advisory firm, issued for comment certain proposed 2013 proxy voting policy changes. ISS has requested comments on the proposed changes via e-mail submissions to policy@issgovernance.com by October 31, 2012 and will take the comments into account when issuing its 2013 proxy voting policies, which are expected to be released in November. Companies should pay particular attention to the proposed policy change relating to majority votes on shareholder proposals and consider commenting. The proposed policy updates, which are available at http://issgovernance.com/policycomment2013, address the following topics.

Board Response to Majority-Supported Shareholder Proposals

Noting that companies "have been increasingly responding to shareholders proposals that received only one year of a majority of votes cast," ISS proposes to revise its existing policy regarding board responsiveness to shareholder proposals to

© 2012 THOMSON REUTERS