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SPECIAL FEATURE

The Search for Truth in the Securities Marketplace

By Stephen M. Honig

The U.S. Supreme Court's recent ruling in *Matrixx Initiatives, Inc. v. Siracusano* held that a company could be liable for a material misstatement that might have affected the "total mix" of information in the marketplace, even when that misstatement lacked "statistical significance."

Earlier this month, the Supreme Court's holding in *Erica P. John Fund Co. v. Halliburton* made life even easier for plaintiffs' lawyers seeking to establish class action certification for misrepresentation.

In *Halliburton*, the court unanimously determined that plaintiffs could establish a claim for alleged misrepresentations about revenue projections and potential liability for asbestos lawsuits, by company executives seeking to inflate stock prices.

The case was determined on what appears to be technical grounds, but careful reading suggests that important legal principles are being parsed.

What is fraud?

Both the U.S. District Court and the 5th U.S. Circuit Court of Appeals in *Halliburton* had dismissed the class action, ruling it was necessary for the plaintiff investors to prove "loss causation" (a connection between the alleged misrepresentation, the market price of the stock and the resultant economic loss) in order to establish a "fraud on the market."

Chief Justice John G. Roberts, Jr. made a fine but vital distinction. It is *not* necessary to prove loss causation in order to establish a prima facie case of fraud on the market for material misrepresentation; to get to a jury, you must allege a material misrepresentation, and you must establish that "common questions of law or fact predominate."

The court observed that the seminal Supreme Court case of *Basic v. Levinson*, upon which the court relied in *Matrixx*, did not even mention "loss causation" as a precondition for creating the rebuttable presumption of investor reliance on the misrepresentation.

Rather, loss causation addresses a matter different from whether an investor relied on a misrepresentation. Loss causation "requires a plaintiff to show that a misrepresentation that affected the integrity of the market price *also* caused a subsequent economic loss" (emphasis in original).

It would be possible, consequently, for the marketplace to have been aware of the misrepresentation (thereby creating a basis for a fraud on the marketplace claim), and yet, later at trial, it might be established that the mispricing of the securities was *not caused* by those misstatements. Rather, the misstatements and the economic loss were merely coincidental.

Putting *Halliburton* together with *Matrixx,* it now seems clear under recent decisions of the Supreme Court that investors may bring a class action for material misstatements that are without statistical significance but which a reasonable investor might consider to be of importance, without necessity of showing at the pleading stage that those material misstatements, in fact, caused a pricing anomaly that triggered the investor loss.

Liar, liar

Companies are not the only players in the securities marketplace taking heat for lack of candor.

In a remarkable speech in early June, Robert S. Khuzumi, director of the SEC's Division of Enforcement, delivered a scathing indictment of lawyers representing clients before the commission. Citing James Stewart's new book entitled "Tangled Web," which, in turn, highlights a growing wave of lying in the marketplace (making reference to Martha Stewart and Bernie Madoff among others), Khuzumi excoriated the bar with a list of what the SEC considers to be improper defense tactics:

- multiple representation of witnesses whose interests are adverse;
- representing multiple witnesses, all of whom consistently put forward implausible explanations;
- counseling witnesses to answer "I don't recall" even with respect to matters clearly within their knowledge;
- sending signals to clients; and
- complicating and delaying document production and internal investigations.

After recognizing the obligation of defense lawyers to be "zealous and aggressive," and thanking the defense bar for helping the SEC "make fair and informed enforcement decisions" (although many defense counsel would question that point), Khuzumi got very specific.

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The commission is troubled when both a company and numerous of its employees (some of whom may have legal exposure) are represented by the same counsel. The SEC's newly inaugurated "Cooperation Program" makes multiple representation riskier; the program provides for reduced sanctions in exchange for assistance given to SEC investigations, but Khuzumi suggested that the level of requisite assistance could not possibly be given by a client represented by counsel who in turn is serving the interests of multiple clients.

Although acknowledging that "memories do fade over time," the director objected to "I don't recall" responses "about nearly everything of substance, including the most basic facts, such as their own job responsibilities." When contemporaneous documents wholly fail to refresh witness recollection with respect to almost anything, the SEC must "draw the most negative inferences from the evidence," he said.

The most tantalizing part of his speech related to the ways in which lawyers send signals to their clients: the long lawyer's objection that breaks the chain of testimony is a tactic perhaps well-known to trial counsel, but how many of us would signal our clients by systematically touching the foot of a witness under the table?

With respect to internal investigations, Khuzumi noted that counsel sometimes interview multiple witnesses together, or scapegoat lower-level employees, or fail to advise the commission of constraints placed on the scope of their inquiry.

What happens when lawyers undertake those tactics?

First, when multiple representation is broken because conflicts arise, the SEC is now resisting the grant of time extensions in order to bring in separate counsel.

Further, practitioners can be suspended or barred from practice before the commission, and "we can and will increase referrals to the Department of Justice for witnesses who engage in obstruction and perjury, including false claims of a lack of recollection," Khuzumi said.

Finally, Khuzumi made reference to the SEC's Dodd-Frank whistleblower rules, enacted on May 25 after extensive commentary from businesses and the bar. The whistleblower program rewards persons who voluntarily provide original information to the SEC leading to successful monetary enforcement. The program will increase the chances that an insider with "intimate knowledge of wrongdoing may well emerge" and blow the cover of a client's evasive testimony, opening the client to severe liability, he said.

It looks like a pretty good time to be practicing on the plaintiffs' side of the class action arena, which also means lots of work for the defense bar.

New whistleblower rules

The primary objections to the proposed rules were premised on the fear that whistleblowers, in order to receive a bounty of a percentage of the money recovered by the SEC in cases over $1 million, would be incentivized to undertake direct communication with the SEC rather than complying with extensive company policies for internal reporting.

The final rules, which become effective Aug. 12, split numerous hairs in order to encourage the bounty system and yet preserve corporate reporting programs. (The rules are not comprehensively summarized here.)

One interesting point about the whistleblower program is how it fits into the SEC's regulatory approach to lawyers.

The SEC has long tried to make the securities bar the "traffic cops" for front-end prevention of fraud. Theoretically recognizing the obligation of the lawyer to zealously represent, as did Khuzumi in his speech, the SEC nonetheless has periodically sued counsel on dubious grounds and come close to requiring lawyers to disclose their client confidences in enacting Part 205, Title 17 of CFR (which requires in-house and outside counsel to pursue investigations of possible client wrongdoing).

We now learn from Khuzumi that the whistleblower program may increase the likelihood that zealous lawyer representation may backfire, because whistleblowers presumably will force the truth out into the open.

The final whistleblower rules disqualify a lawyer from receiving a bounty for blowing the whistle on a client, except in cases that would permit a lawyer to reveal privileged information under the American Bar Association Model Rule of Professional Conduct ("to prevent, mitigate or rectify substantive injury to the financial interests or property of another").

Lawyer disqualification from receipt of a bounty, suggested by numerous pre-adoption commentators and by two SEC commissioners, seems appropriate, but merely mirrors the preexisting ethical obligation of counsel.

Even if the whistleblower program had not disqualified bounties to attorneys providing disclosures to the SEC, the Rules of Professional Conduct would still prohibit lawyers from making such disclosures in most cases.

Conclusion

The financial world seems awash in fraud. Reacting against the evils that Dodd-Frank was purportedly designed to prevent, and to the distrust of financial markets that comes from numerous Ponzi schemes, courts and government agencies are attempting to craft appropriate protections for disillusioned investors.

And for lawyers? It looks like a pretty good time to be practicing on the plaintiffs' side of the class action arena, which also means lots of work for the defense bar.

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