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Securities Law Alert

In This Edition:

- D.C. Circuit: Rejecting a Constitutional Challenge to the SEC's In-House Courts, the D.C. Circuit Holds SEC Administrative Law Judges Are Not "Officers of the United States" Subject to the Appointments Clause
- Third Circuit: Speaker's State of Mind Is Irrelevant for Purposes of the PSLRA's Safe Harbor Provided the Forward-Looking Statement Is Accompanied by Meaningful Cautionary Statements
- Seventh Circuit: Court Applies the Delaware Chancery Court's *Trulia* Decision and Rejects a Disclosure-Only Settlement
- Ninth Circuit: (1) Rule 13a-14 Provides the SEC with a Cause of Action Against Executives Who Certify False or Misleading Statements, and (2) SOX 304's Disgorgement Provisions Require Only Issuer Misconduct, Not Personal Misconduct by the CEO or CFO
- Tenth Circuit: SEC Claims for Disgorgement and Injunctive Relief Are Not Subject to Section 2462's Five-Year Limitations Period

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– Chambers USA 2016
(quoting a client)

D.C. Circuit: Rejecting a Constitutional Challenge to the SEC's In-House Courts, the D.C. Circuit Holds SEC Administrative Law Judges Are Not "Officers of the United States" Subject to the Appointments Clause

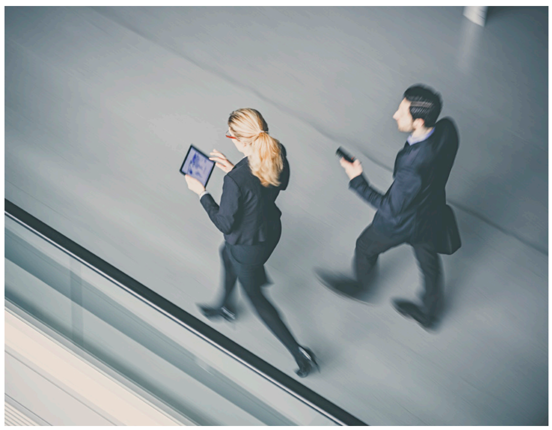
On August 9, 2016, in the first circuit court opinion to consider a constitutional challenge to the SEC's in-house administrative enforcement tribunals, the D.C. Circuit affirmed the constitutionality of the SEC's appointment of administrative law judges ("ALJs"). *Raymond J. Lucia Cos. v. SEC*, 2016 WL 4191191 (D.C. Cir. 2016) (Rogers, J.) (*Raymond Lucia*). The D.C. Circuit held the SEC's ALJs are not "Officers of the United States" subject to the Appointments Clause of the United States Constitution because "no initial decision of [the SEC's] ALJs is independently final" under the SEC's regulatory framework.

SEC ALJs Are Not "Officers of the United States" for Purposes of the Appointments Clause Because They Lack the Authority to Issue Final SEC Decisions

The Appointments Clause states that the President "shall nominate, and by and with the Advice and Consent of the Senate, shall appoint . . . Officers of the United States." U.S. Const. art. II, § 2, cl. 2.[1] The D.C. Circuit explained that "[o]nly those deemed to be employees or other 'lesser functionaries' need not be selected in compliance with the strict requirements of Article II." *Raymond Lucia*, 2016 WL 4191191.

1. The Appointments Clause further states that "Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments." U.S. Const. art. II, § 2, cl. 2.

As a general rule, "an appointee is an Officer, and not an employee who falls beyond the reach of the [Appointments] Clause, if the appointee exercises 'significant authority pursuant to the laws of the United States.'" *Id.* (quoting *Buckley v. Valeo*, 424 U.S. 1 (1976)). The D.C. Circuit stated that under its precedent, "the main criteria for drawing the line between inferior Officers and employees not covered by the [Appointments] Clause are (1) the significance of the matters resolved by the officials, (2) the discretion they exercise in reaching their decisions, and (3) the finality of those decisions." *Id.* (quoting *Tucker v. Comm'r of Internal Revenue*, 676 F.3d 1129 (D.C. Cir. 2012)).



The D.C. Circuit noted that in *Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000), it held that ALJs of the Federal Deposit Insurance Corporation ("FDIC") were not Officers for purposes of the Appointments Clause "because their authority was limited by FDIC regulations to recommending decisions that the FDIC Board of Directors might issue." *Raymond Lucia*, 2016 WL 4191191. Applying *Landry*, the D.C. Circuit determined the key question was whether SEC ALJs "issue final decisions" of the SEC. *Id.*

The D.C. Circuit found that pursuant to the governing statutory scheme, the SEC has a discretionary right to review the action of any ALJ as it sees fit, either on its own initiative or upon a petition for review filed by a party or aggrieved person. *Id.* (citing 15 U.S.C. § 78d-1(a)-(b)). The SEC has the authority to "review[ ] an ALJ's decision *de novo*" and "may make any findings or conclusions that in its judgment are proper and on the basis of the record." *Id.* (citing 17 C.F.R. § 201.411(a)). In the event that "no review of the initial decision is sought or ordered," then the SEC will issue an order stating that it has declined review and specifying the date that the ALJ's sanctions, if any, will take effect. The ALJ's initial decision becomes final *only* upon issuance of the SEC's order.

The D.C. Circuit deemed it significant that the SEC "must affirmatively act—by issuing the order—in every case." The court explained that the SEC's "final action is either in the form of a new decision after *de novo* review or, by declining to grant or order review, its embrace of the ALJ's initial decision as its own." The court emphasized that the SEC "retain[s] full decision-making powers" over cases heard by the ALJs. The D.C. Circuit determined that the SEC's ALJs "neither have been delegated sovereign authority to act independently of the [SEC] nor, by other means established by Congress, do they have the power to bind third parties, or the government itself, for the public benefit."

Finding the SEC ALJ's decisions to be "no more final than the recommended decisions issued by the FDIC ALJs" in *Landry*, the D.C. Circuit concluded that SEC ALJs are not "Officers of the United States" subject to the Appointments Clause.

Third Circuit: Speaker's State of Mind Is Irrelevant for Purposes of the PSLRA's Safe Harbor Provided the Forward-Looking Statement Is Accompanied by Meaningful Cautionary Statements

On August 22, 2016, the Third Circuit held that if a forward-looking statement is accompanied by meaningful cautionary statements, then "the state of mind of the individual making the statement is irrelevant" for purposes of the safe-harbor provisions of the Private Securities Litigation Reform Act ("PSLRA"). *OFI Asset Mgmt. v. Cooper Tire & Rubber*, 2016 WL 4434404 (3d Cir. 2016) (Jordan, J.).

The Third Circuit explained that the PSLRA's "safe harbor" provisions establish a "disjunctive statutory test" for immunizing certain forward-looking statements from Section 10(b) liability. Under the first prong of the test, the safe harbor applies if the "forward-looking statement is identified as such, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." *Id.* (quoting 15 U.S.C. § 78u-5(c)(1)). Under the second prong of the test, the PSLRA's safe harbor applies if "the plaintiff fails to prove the forward-looking statement was made with actual knowledge by the speaker that the statement was false or misleading." *Id.* (quoting 15 U.S.C. § 78u-5(c)(1)). The Third Circuit found the PSLRA "provides two distinct entrances to the safe harbor" pursuant to which "any forward-looking statement is protected if it is either accompanied by substantive and tailored cautionary statements or if the plaintiff fails to show actual knowledge of falsehood."

In the case before the court, plaintiff contended that a forward-looking statement concerning the effect of a strike on a planned merger was not protected under the PSLRA's safe harbor despite the presence of meaningful cautionary statements. Plaintiff argued the safe harbor did not apply because the speakers "could not . . . have believed" their stated expectation "that the strike would not impede the closing of the merger." The Third Circuit found plaintiff's argument rested on a "misread[ing of] the law." The court determined that in light of the "disjunctive" nature of the safe harbor test, the question of whether the speakers actually believed the forward-looking statement at the time it was made was "irrelevant" because "there was sufficient meaningful cautionary language." The Third Circuit held that "where a future-looking statement is accompanied by sufficient cautions, then . . . the statement is not actionable regardless of the plaintiff's showing of scienter."

Seventh Circuit: Court Applies the Delaware Chancery Court's *Trulia* Decision and Rejects a Disclosure-Only Settlement

Earlier this year, the Delaware Chancery Court indicated that disclosure-only settlements would likely be met with continued disfavor "unless the supplemental disclosures address a plainly material misrepresentation or omission." *In re Trulia, Inc. Stockholder Litig.*, 129 A.3d 884 (Del. Ch. 2016).[2]

On August 10, 2016, the Seventh Circuit explicitly "endorse[d], and appl[ied]" the Delaware Chancery Court's decision in *Trulia* to reverse district court approval of a disclosure-only settlement where the supplemental disclosures provided "nonexistent" benefits to the class, in the Seventh Circuit's view. *In re Walgreen Co. Stockholder Litig.*, 2016 WL 4207962 (7th Cir. 2016) (Posner, J.). The Seventh Circuit stated that supplemental disclosures must not only "address the misrepresentation or omissions" but also "must correct them" for a disclosure-only settlement to merit court approval.

In the case before the Seventh Circuit, the district court approved a disclosure-only settlement of shareholder litigation arising out of Walgreen Co.'s agreement to acquire the outstanding stock of Alliance Boots and create the Walgreens Boots Alliance. Defendants agreed to six additional disclosures, amounting to a total of "fewer than 800 new words," as well as the payment of $370,000 in attorneys' fees to

2. Please click here to read our prior discussion of the *Trulia* decision.

class counsel. The district court expressed doubt concerning the added value of these disclosures, but ultimately concluded that at least certain of the supplemental disclosures "*may have* mattered to a reasonable investor." *Id.* (emphasis added by the Seventh Circuit). A Walgreens shareholder objected to the settlement and appealed the district court's decision.

On appeal, the Seventh Circuit held the district court had erred in considering whether the supplemental disclosures "*may have* mattered to a reasonable investor," finding this standard "not good enough." The Seventh Circuit determined the proper standard is whether the supplemental disclosures "*would* be *likely* to matter to a reasonable investor." The court reasoned that "[d]isclosures are meaningful only if they can be expected to affect the votes of a nontrivial fraction of the shareholders."

The Seventh Circuit emphasized that "[n]o class action settlement that yields zero benefits for the class should be approved, and a class action that seeks only worthless benefits for the class should be dismissed out of hand." Here, the Seventh Circuit found the disclosure-only settlement did not merit court approval because the supplemental disclosures "contained no new information that a reasonable investor would have found significant."

In so holding, the Seventh Circuit adopted the standard for reviewing disclosure-only settlements set forth by the Delaware Chancery Court in *Trulia*. The *Trulia* court stated that such settlements "are likely to be met with . . . disfavor . . . unless the supplemental disclosures address a plainly material misrepresentation or omission." *Trulia*, 129 A.3d 884. The *Trulia* court explained that the term "plainly material" means that "it should not be a close call that the supplemental information is material as that term is defined under Delaware law." In endorsing the *Trulia* decision, the Seventh Circuit "add[ed] that it's not enough that the disclosures address the misrepresentation or omissions: they must [also] correct them." *Walgreen*, 2016 WL 4207962.

Ninth Circuit: (1) Rule 13a-14 Provides the SEC with a Cause of Action Against Executives Who Certify False or Misleading Statements, and (2) SOX 304's Disgorgement Provisions Require Only Issuer Misconduct, Not Personal Misconduct by the CEO or CFO

Pursuant to Rule 13a-14 of the Securities Exchange Act,[3] an issuer's CEO and CFO must certify the accuracy of the issuer's financial reports filed with the SEC. On August 31, 2016, the Ninth Circuit held Rule 13a-14 "provides the SEC with a cause of action not only against CEOs and CFOs who do not file the required certifications, but also against CEOs and CFOs who certify false or misleading statements." *SEC v. Jensen*, 2016 WL 4537377 (9th Cir. 2016) (Clifton, J.).

The Ninth Circuit also considered the reach of Section 304 of the Sarbanes-Oxley Act ("SOX 304"),[4] which permits the SEC to seek disgorgement of certain CEO and CFO compensation and stock sale profits when the issuer is required to prepare an accounting restatement "as a result of misconduct." The Ninth Circuit held SOX 304's disgorgement remedy "applies regardless of whether a restatement was caused by the personal misconduct of an issuer's CEO and CFO or by other issuer misconduct." *Jensen*, 2016 WL 4537377.

3. 17 C.F.R. § 240.13a-14. Under Rule 13a-14 and related provisions, an issuer's CEO and CFO must certify that they have established and maintained internal controls pursuant to which they are made aware of material information concerning the company. The executives must also certify that based on their knowledge, the company's SEC filings do "not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading." *Jensen*, 2016 WL 4537377 (quoting Section 302 of the Sarbanes-Oxley Act).

4. 15 U.S.C. § 7243. SOX 304 provides in relevant part that "[i]f an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws," the CEO and CFO "shall reimburse the issuer" for certain compensation and profits from the sale of issuer stock during the preceding twelve month period.

Rule 13a-14 Includes an Implicit Truthfulness Requirement for CEO and CFO Certifications of Issuer Financial Statements

The Ninth Circuit held that "Rule 13a-14, like other rules promulgated under Section 13 of the Exchange Act, includes an implicit truthfulness requirement." Relying on the dictionary definition of the word "certify," the court determined "one cannot certify a fact about which one is ignorant or which one knows is false." The court also reasoned that "[s]igners of documents should be held responsible for the statements in the document."

The Ninth Circuit found "a mere signature is not enough for compliance" with Rule 13a-14. The court stated that CEOs and CFOs cannot simply "sign their names to a document certifying that SEC filings include no material misstatements or omissions without a sufficient basis to believe that the certification is accurate."

The Ninth Circuit concluded Rule 13a-14 creates a cause of action against CEOs and CFOs who certify false or misleading statements, as well as a claim against CEOs and CFOs who do not sign or file the required certifications.

SOX 304's Disgorgement Remedy Applies Whenever the Issuer's Misconduct Triggers a Restatement

The Ninth Circuit then considered the reach of SOX 304, which permits the SEC to seek disgorgement of certain CEO and CFO compensation and profits from the sale of issuer stock if a restatement is required "as a result of misconduct, with any financial reporting requirement under the securities laws." The court held "SOX 304 allows the SEC to seek disgorgement from CEOs and CFOs even if the triggering restatement did not result from misconduct on the part of those officers."

The Ninth Circuit determined that "the plain language of the statute" supported its interpretation. The court explained that "[t]he clause 'as a result of misconduct' modifies the phrase 'the material noncompliance of the issuer,' suggesting that it is the issuer's misconduct that matters, and not the personal misconduct of the CEO or CFO."

The Ninth Circuit found its interpretation "bolstered by the history of the statute," which was designed "to craft a broad remedy that focused on disgorging unearned profits rather than punishing individual wrongdoing." Finally, the Ninth Circuit observed that most district courts to consider the issue have similarly concluded that SOX 304 "does not require CEOs or CFOs to have personally engaged in misconduct before they are required to disgorge profits."

Tenth Circuit: SEC Claims for Disgorgement and Injunctive Relief Are Not Subject to Section 2462's Five-Year Limitations Period

Pursuant to 28 U.S.C. § 2462, the SEC and other federal government entities may not bring any "action, suit, or proceeding for the enforcement of any civil fine, penalty, or forfeiture" more than five years after the claim first accrued.

On August 23, 2016, the Tenth Circuit held Section 2462's limitations period does not apply to SEC claims for disgorgement or injunctive relief. *SEC v. Kokesh*, 2016 WL 4437585 (10th Cir. 2016) (Hartz, J.). The Tenth Circuit's decision deepened a circuit split on the question of whether disgorgement is a type of "forfeiture" within the meaning of Section 2462.

Tenth Circuit Holds Disgorgement Is Not a "Forfeiture" for Section 2462 Purposes

The Tenth Circuit stated that "[d]isgorgement consists of factfinding by a district court to determine the amount of money acquired through wrongdoing . . . and an order compelling the wrongdoer to pay that amount plus interest to the court." *Kokesh*, 2016 WL 4437585. The Tenth Circuit noted that it has previously held that "disgorgement is not a penalty under § 2462 because it is remedial" in nature. The court observed that when "[p]roperly applied, the disgorgement remedy does not inflict punishment" but instead "leaves the wrongdoer in the position he would have occupied had there been no misconduct."

The Tenth Circuit determined that disgorgement is also not a "forfeiture" within the meaning of Section 2462. The court acknowledged that "in common English the words *forfeit* and *disgorge* . . . capture similar concepts." However, the Tenth Circuit found "[t]he word *forfeiture* in § 2462 must be read in the context of government causes of action." The court explained that historically, "[f]orfeiture was an in rem procedure to take tangible property used in criminal activity." The Tenth Circuit found that "[w]hen the term *forfeiture* is linked in § 2462 to the undoubtedly punitive actions for a *civil fine* or *penalty*, it seems apparent that Congress was contemplating the meaning of *forfeiture* in this historical sense." The court reasoned that "[t]he nonpunitive remedy of disgorgement does not fit in that company."

The Tenth Circuit "recognize[d] that in recent years some federal forfeiture statutes have been expanded to include disgorgement-type remedies." However, the court found that "this expansion should not expand the meaning of the word *forfeiture* in § 2462 to encompass traditional disgorgement remedies outside those forfeiture statutes." The Tenth Circuit explained that words in statutes must "be interpreted as taking their ordinary, contemporary, common meaning at the time Congress enacted the statute." Moreover, the court emphasized that statutes of limitation must be "interpreted narrowly in the government's favor." The court reasoned that it "should not strain to expand the meaning of [§ 2462's] language to restrict the government" from bringing suit.

Notably, the Tenth Circuit expressly disagreed with the Eleventh Circuit's decision in *SEC v. Graham*, 823 F.3d 1357 (11th Cir. 2016).[5] The *Graham* court found "no meaningful difference in the definitions of disgorgement and forfeiture," and concluded that disgorgement is a type of "forfeiture" subject to Section 2462's limitations period.

Tenth Circuit Finds Injunctive Relief Is Not a "Penalty" Subject to Section 2462's Limitations Period

The Tenth Circuit further held that an SEC order permanently enjoining a defendant from violating certain provisions of the securities laws is not a "penalty" for purposes of Section 2462's limitations period. The court reasoned that "an order to obey the law" is not designed to "penalize [a d]efendant" but rather, "to protect the public by giving [the d]efendant an added incentive to conduct himself in accordance with the securities laws." The Tenth Circuit stated that courts have long recognized that an order to obey the law "is purely remedial and preventative" and not punitive in nature.

5. Please click here to read our prior discussion of the Eleventh Circuit's decision in *Graham*.

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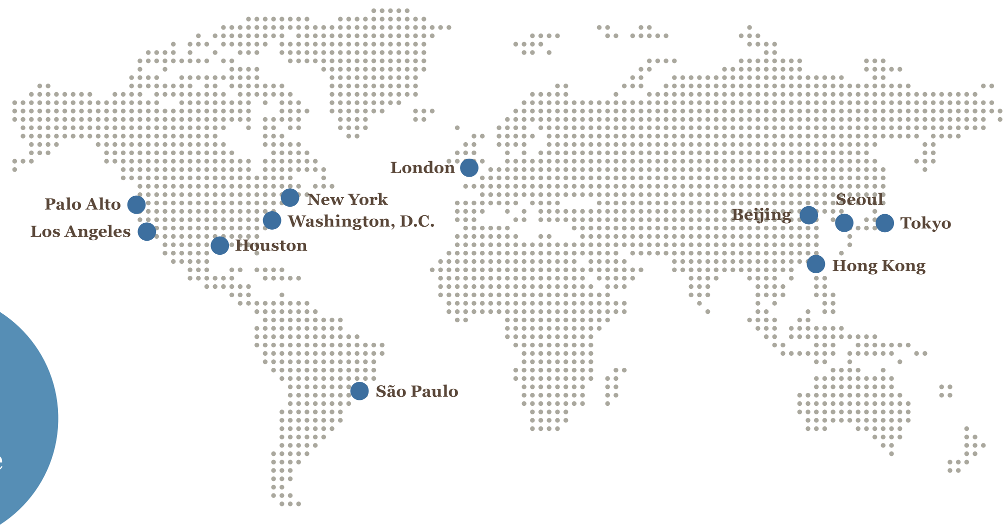

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