

ROUNDTABLE

Securities

EXECUTIVE SUMMARY

With the recent passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the landscape of securities litigation and enforcement promises to shift dramatically. The legislation provides the U.S. Securities and Exchange Commission (SEC) with new enforcement tools and wider jurisdiction, including the ability to bring aiding and abetting claims, and the right to rely on control person liability theory. The new law also increases whistleblower incentives and broadens clawback provisions. The U.S. Supreme Court has also returned notable decisions in *Merck v. Reynolds*, which held that the statute of limitations in securities cases does not

start until an investor receives evidence of scienter, and *Morrison v. National Australia Bank*, which provides a new test as to when a securities case involving foreign entities, exchanges, and litigants can proceed in U.S. courts.

Our panel of experts discusses these topics, as well as additional trends and decisions affecting their practice. They are Tammy Albarrán and David Bayless of Covington & Burling; Richard M. Heimann of Lief Cabraser Heimann & Bernstein; Thad A. Davis and Michael Li-Ming Wong of Ropes & Gray; and Amy M. Ross and Michael D. Torpey of Orrick, Herrington & Sutcliffe. *California Lawyer* moderated the roundtable, which was reported by Krishanna DeRita of Barkley Court Reporters.

MODERATOR: What trends in litigation and enforcement do you anticipate will result from Dodd-Frank?

BAYLESS: In terms of enforcement, it gives the SEC new causes of action and new remedies, and it broadens the agency's jurisdiction. It also gives the SEC the ability in civil litigation to obtain nationwide service of trial subpoenas so they can now force people across the country to appear in federal court. Most significantly, in addition to the SEC's current right to bring aiding and abetting claims under the Securities Exchange Act of 1934 (15 U.S.C. §§ 78a-78u), the Dodd-Frank Act (formally titled the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (Pub. Law No. 111-203)) gives the SEC the right to bring an aiding and abetting claim under the Securities Act of 1933 (15 U.S.C. §§ 77a-77aa), as well as the Investment Advisers Act of 1940 (15 U.S.C. §§ 80b-1-80b-21). And previously, where the state of mind requirement was proof of actual knowledge for such a claim, now the SEC only has to prove recklessness.

Additionally and for the first time, the SEC can seek monetary penalties against a public company and its officers and directors in an administrative proceeding. Currently, public companies and their executives get an Article III judge, the right to discovery, and a jury trial. With the administrative route, an SEC employee serves as the judge and there's no

real discovery to speak of. I question whether this is constitutional. I don't see how the right to a jury trial, discovery, or an Article III judge can be taken away.

WONG: We're seeing a movement toward watering down the government's mens rea burdens in enforcement actions. Another area we're seeing this happening is control person liability, which Dodd-Frank specifically authorizes. Those of us in the Foreign Corrupt Practices Act (FCPA) bar noted with some alarm that even before Dodd-Frank, the SEC had already advanced a control person liability theory in *Nature's Sunshine Products (SEC v. Nature's Sunshine Products, Inc. No. 09-CV-00672 (D. Utah complaint filed and judgment entered July 31, 2009))*. There, the SEC brought an enforcement action against the CEO and the CFO in connection with allegations that the company bribed Brazilian customs officials. The SEC made no allegation that the executives ordered the bribes, or even knew about them. Rather, the theory was that the executives inadequately supervised their subordinates. Dodd-Frank specifically gives the green light to such enforcement actions.

ROSS: Overlaying all of this is the fact that the SEC's budget is going to double over the next five years from \$1.3 billion in 2011 to \$2.25 billion in 2015. Not only will the SEC now have broader jurisdiction, and access to new remedies and new venues, but the agency is also going to have double the money to

hire more staff to review matters and bring cases.

TORPEY: A ramification of the change to the mental state requirement under Dodd-Frank for aiding and abetting is that it will be easier for officers and directors to access their insurance coverage. This lower threshold will mean that conduct will fall within coverage where intentional conduct did not previously.

BAYLESS: There will be more litigation, at least with the SEC. They have more funding now, which means they will investigate matters that they wouldn't currently investigate. That also means they will propose additional enforcement actions, and that's going to lead to a stiffening of the spine. As Mike [Torpey] points out, if a director or officer is charged with aiding and abetting, it'll likely be covered by insurance. So if you are an individual, you have indemnification coverage, and the SEC action is on the margin, why not litigate?

DAVIS: There are also new whistleblower incentives made available through Dodd-Frank, which allow the SEC to further leverage their efforts and rely on private individuals to inform the SEC of potential claims. The SEC has had the power to award a bounty to whistleblowers since the '80s in the insider trading context, but Dodd-Frank expands this ability to other enforcement actions, and provides a higher ceiling for potential payouts, to 10 to 30 percent of amounts

recovered over \$1 million. We expect this to be a significant game changer, with immediate impact on, for example, the dynamics of internal investigations and restatements as individuals contemplate trying to profit from these situations.

WONG: Dodd-Frank only expands whistleblower provisions with respect to enforcement actions brought by the SEC, and not private rights of action. This points to a broader trend in securities law made apparent in Dodd-Frank, which is a heavier reliance on government enforcement of securities laws.

ALBARRÁN: The Dodd-Frank bill did, however, direct the SEC to “conduct a study” to see whether private plaintiffs should be allowed to sue aiders and abettors, so this may change in the future.

With respect to whistleblowers, they do have expanded protections. They now can bring a private lawsuit against their employers in federal court for adverse actions that result from their coming forward to the SEC, and they can seek double back pay, attorneys fees and costs. They also can remain anonymous throughout the entire process. This will drastically change the dynamics of how attorneys representing the various individuals involved interact with each other, and how much information they share.

Additionally, the Sarbanes-Oxley clawback provision (15 U.S.C. § 7243) has been broadened. Under the new rule, companies must implement a policy whereby any current or former executive must forfeit certain bonuses following a restated financial statement. The look-back period was only a year, but it's now been extended to three years. Dodd-Frank has broadened the impact of this provision on public companies.

ROSS: Interestingly, Dodd-Frank broadens the time-frame of the clawback and the list of executives from whom funds can be clawed back, but limits the portion of the bonus that must be returned in the case of a restatement. Only the difference between what was awarded originally and the amount that would have been awarded under the restated numbers needs to be returned.

WONG: Pending actions will also be handled with increased speed. The legislation has a specific requirement that aims to reduce the SEC's backlog by requiring that the SEC make a charge or no-charge decision on all pending actions within 180 days of the Wells Notice.

DAVIS: However, the SEC can game things a bit as to when a Wells Notice is issued. The 180-day trigger may not apply to “complex” cases, and it's not clear what that will mean. The director of enforcement can also grant extensions of the 180-day period under certain circumstances. But the institutional imperative for speed is there.

TORPEY: Another interesting and unintended consequence is that defense representations will split more often, and earlier in each case. Every individual is going to have his or her own lawyer from the outset, particularly in light of the whistleblower statute, and the fact that SEC Director of Enforcement Robert Khuzami is modeling the agency after the U.S. Attorney's office. It's clear that the first guy in the door will be afforded a break. These situations will drive the defense bar to more frequently separate representations.

ROSS: With the whistleblower bounty, you are going to see whistleblowers with their own lawyers. This has not necessarily been the case in the past, and it could change the way the SEC views and handles whistleblowers. It's more likely that a whistleblower who's being represented by counsel will be taken seriously

Because of the specter of control person liability and other developments that do away with the requirements of actual knowledge, we are advising clients that they have to be proactive, especially on the FCPA front. The consequences of non-compliance these days can even include jail time, as we are seeing in the Frederick Bourke case (*United States v. Viktor Kozeny*, No. 05-CR-518-SAS (S.D.N.Y. indictment filed May 5, 2005)).

HEIMANN: Frankly, I don't see much in the bill for private investor actions and I don't have much faith in the additional study being done on a private right of action related to aiding and abetting. That is such a politically charged arena, and that's really what determines whether any changes will be made. I don't see any pendulum swing in favor of private investor actions in the foreseeable future.

MODERATOR: How will the U.S. Supreme Court decision in *Merck v. Reynolds* (130 S.Ct. 1784 (2010)) affect securities litigation?

HEIMANN: *Merck* revolves around the drug Vioxx and involved claims that it was unduly risky and could cause heart attacks. It was the subject of con-

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—David Bayless

by the SEC, and with the additional resources and staff that the SEC will have in the coming years, the claims are likely to be pursued more frequently.

TORPEY: The immediate issues companies will need to address are the disclosure provisions in Dodd-Frank that will apply to the 2011 proxies. The biggest issue will be the “say on pay” disclosure and shareholder vote requirements. These new rules will require public companies to hold a non-binding shareholder vote regarding the compensation for the top executives. There are going to be situations where the companies don't get shareholder approval for the proposed compensation, and it's unclear what happens next. Is there a lawsuit if you continue to pay the executives when the shareholders have effectively said no, even though it's a non-binding vote?

WONG: On the compliance front, the control person liability clarifications are already having an impact.

siderable tort litigation. The securities litigation was filed some time later, and the question was raised as to whether or not the securities claims had been filed outside the statute of limitations. The Court held that the statute of limitations on the securities claims did not begin to run until the plaintiff's discovery of the facts constituting the violation, including facts suggesting scienter, an essential element of a Section 10(b) securities fraud claim. The court also held that facts that tend to show a materially false or misleading statement are not necessarily sufficient to show scienter.

From the plaintiff's perspective, this has an enormous impact on when cases should be filed and what the prospects are of sustaining a claim, given the significant pleading hurdles that both Congress and the courts have imposed on plaintiffs in securities fraud cases. As a result, a case that had been previously dismissed on grounds of inadequate allegations of scienter might be resuscitated

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when subsequent information is made available. An example is the ongoing class action against Diebold (*Louisiana Mun. Police Employees Ret. Sys. v. KPMG LLP*, No. 10-CV-01461 (N.D. Ohio complaint filed June 30, 2010)).

ROSS: *Merck* is interesting, and it's certainly exciting for the plaintiffs bar. The Court goes out of its way to make the point that Richard [Heimann] just made, which is that inquiry notice is not enough. Instead, until the plaintiff knew or should have known what was in the mind of the speaker, the statute is not triggered. This changes the whole ball game, and in many cases, it will effectively do away with the two-year statute altogether. Now, private plaintiffs counsel could potentially wait until an SEC investigation is over to file a case—notice of the investigation is no longer enough to trigger the statute. Even if the SEC investigation takes five years, it's only at the time that the scienter evidence collected by the SEC becomes available that plaintiffs could know what was in the mind of the speaker making the alleged false statement, and only at that point will the statute begin to run.

ALBARRÁN: Securities fraud defendants should assume that their conduct is subject to a five-year statute of limitations. Even then, *Merck* makes it almost impossible, as a practical matter, to win on a statute of limitations defense because it's difficult to show exactly when a plaintiff knew, or should have known, the defendant's state of mind.

WONG: From the defense perspective, what we worry about are stale claims being brought against our clients. The two-year statute is effectively gone, which deprives companies of the benefits of limitations statutes: certainty and repose. As time passes, memories fade, documents get lost or destroyed pursuant to corporate retention policies, personnel turns over, and witnesses become unavailable. This will make litigation more difficult and costly.

DAVIS: What Justices Clarence Thomas and Antonin Scalia did in the concurring opinion was attempt to follow the statutory text which they typically purport to do, and proposed an even more narrow, actual knowledge standard. But more interestingly, the majority was attempting to reconcile the tension in these types of cases with strict pleading standards and the statute of limitations. Plaintiffs face strict pleading standards with the Private Securities Litigation Reform Act (PSLRA (Pub.Law No. 104-67)), and

the *Tellabs* (*Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007)) and *Twombly* (*Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007)) decisions, which state that plaintiffs have to put forth substantial facts—“strong inferences” not just conjecture—in class action cases generally and in securities cases, in particular, to survive motions to dismiss. Reconciling that with a strict reading of the statute could essentially hamper plaintiffs severely, so that was part of what was animating the *Merck* decision.

HEIMANN: One question to pose is, “Will defendants want the class to be certified before the court rules on motions to dismiss so that the class is bound by the order on the dismissal motions?”

TORPEY: The downside to moving forward with class certification first is that, in all likelihood, we would lose the discovery stay. The difference between what it costs to get through a motion to dismiss versus the class certification is substantial. Moreover, the defense bar wins a high percentage of motions to dismiss. So, I don’t see the defense bar changing the order of the process. That’s why the strategy you mentioned earlier—a plaintiff loses on a motion to dismiss initially, but then plaintiffs counsel re-pleads with a new plaintiff once more scien-ter evidence is available—is an interesting one.

DAVIS: Also, for whistleblowers to get paid, they have to come forward with something new. So to that extent—although it’s not always the case that the plaintiffs bar necessarily has access to the whistleblowers—that scenario might be a countervailing pressure toward more quick dissemination of scien-ter-related evidence if there’s a time pressure on the whistleblower to get out in front. This type of revelatory information, if plaintiffs do get access to it, could make the statute of limitations issue less relevant. Of course, under Dodd-Frank, the whistleblower can remain anonymous until the payout, so it would be a question of the whistleblower’s counsel reaching out to private plaintiffs counsel.

TORPEY: If the existence of a whistleblower becomes known to the company, there’s likely going to be an internal investigation. It doesn’t take very much for people to get terminated, and that will be another source of information for the plaintiffs bar.

ROSS: Even if the whistleblower doesn’t become known to the company until a case is actually filed, in light of the new 180-day rule, companies

will know about them much sooner than under prior SEC timetables.

MODERATOR: What other recent cases or decisions will have ripple effects on your practice?

WONG: It will be interesting to see what the U.S. Supreme Court does in the *Janus* case (*Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525 (certiorari granted, 130 S.Ct. 3499 (2010), opinion below sub. nom. *In Re Mutual Funds Inv. Litig.*, 566 F.3d 111 (4th Cir. 2009)), which raises the possibility of back-dooring in what seems like secondary liability by potentially expanding the universe of players who would be considered primary violators for Section 10(b) purposes. The Court’s ruling could

potentially have significant implications for collateral participants in securities transactions, including investment managers, officers and directors, lawyers, and accountants.

Another trend is the increasing use of law enforcement techniques, including undercover stings and wiretaps, which we are now seeing in securities matters.

BAYLESS: There’s also the SEC’s increasing use of the prosecutor technique where the first guy in the door gets a break. That has never been the case at the SEC—if you were first in the door, last in the door, it didn’t matter. Now it does. That can break up the solidarity of the defense, which makes it easier for the government.

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ROSS: It will be interesting to see how the “first in the door” policy works. In instances where the lead wrong-doer, the “big guy” if you will, is the first in the door, will that mean that the SEC will treat him or her more favorably than the myriad “smaller” or lower-level wrong-doers? By this policy, it seems the SEC intends to convey that nobody—even the little guys—should think they are above the law. It will be interesting to see how this policy plays out in practice.

ALBARRÁN: I’m interested in the SEC’s insider trading case against Mark Cuban (*SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009)). The SEC alleged that Cuban received a phone call from a company where he was a 6.3 percent shareholder, asking him to participate in a PIPE transaction, and he didn’t like the idea. Prior to receiving this information, he agreed to keep the information confidential. After he hung up the phone, he called his broker and sold all of his stock. Cuban argued to the district court that while the SEC alleged he agreed to confidentiality, he never agreed to *not* use it for his personal benefit. The district court agreed and said that under the antifraud provisions, there is deception only if there is both an agreement to confidentiality *and* an agreement to not trade on that information. The Fifth Circuit recently heard arguments in the case.

Another interesting trend is the aggressiveness of the SEC. For example, in *SEC v. Jenkins* (2010 WL 2347020 (D. Ariz.)), the SEC brought a lawsuit against an executive for failing to reimburse the company for bonuses that were paid during a year that the financial statements were wrong. Here, the court said it doesn’t have to be the CEO or the CFO who engaged in the misconduct that led to the restatement. Prior to this case, the SEC used that particular Sarbanes-Oxley provision as a remedy, and now it’s using it as a cause of action. The SEC has taken very aggressive positions in many cases.

BAYLESS: That’s the result of the pressure that the SEC’s been under. The perception is that they’ve been asleep at the switch and now they are being aggressive, extending claims to conduct that courts have had to shoot down.

DAVIS: We haven’t given much attention to M&A deals and litigation in the state courts. In a number of instances—the Green Mountain Coffee’s acquisition of Diedrich Coffee, Shiseido’s acquisition of Bare Escentuals, as well as the Bioform-Merz acquisition being litigated in San Mateo—California Superior Court judges are applying Delaware law in a disci-

plined fashion. So they are not granting expedited discovery if the case is inadequately pled, or makes conclusory allegations about required disclosures that allegedly benefit the shareholders in the deal. They are not granting temporary restraining orders or preliminary injunctions absent proper pleadings and real showings of threat of harm to shareholders and material nondisclosures. They appear to be following precedents set by Vice Chancellor Leo E. Strine Jr. and the trends coming out of the Delaware courts, where cases get a hard look right out of the gate, which is gratifying for defense firms.

TORPEY: *Morrison v. National Australia Bank* (130 S.Ct. 2869 (2010)) was recently decided by the U.S. Supreme Court. It involved an Australian company that did not trade its stock on U.S. exchanges, but had some commercial activity in the United States. The lower courts applied the conduct and effects test, which courts have used since the 1960s to determine whether the case could proceed in U.S. courts. The Court ultimately decided that the lower courts applied the wrong test; to determine whether a lawsuit could be brought in the United States, the Court looked to where the transaction occurred. I don’t think this case means that fewer cases can be brought, but rather that for cases to be brought, the purchase or sale must take place in the United States.

WONG: Dodd-Frank explicitly restored the conduct and effects test that the *Morrison* Court killed—but only in actions brought by the SEC and DOJ, not in private plaintiff actions.

HEIMANN: From the plaintiff’s perspective, the impact of *Morrison* is on the reduction in the size of the cases in a class context. The *Toyota* case (*Stackhouse v. Toyota Motor Corp.*, No. 10-CV-922 (C.D. Cal. complaint filed Feb. 8, 2010)) is a good example. Toyota is the subject of securities class actions arising from its alleged concealment of defects in certain automobiles. A Maryland pension fund, one of the applicants for lead plaintiff, claimed approximately \$15 million in losses associated with its purchases of Toyota stock. When it reassessed those losses in view of the district court’s decision that the court would only look to purchases made on U.S. exchanges, Maryland’s losses went from \$15 million to \$200,000. So a case potentially worth hundreds of millions of dollars is now worth a fraction of that.

However, *Morrison* did not hold that the federal courts do not have jurisdiction over those claims,

but rather that the plaintiffs did not state a claim under the federal securities laws. This implies that one is free to bring common law claims arising out of those transactions. I anticipate an imaginative plaintiffs lawyer advancing that theory in jurisdictions where he or she thinks they have a chance of persuading the courts to apply the fraud-on-the-market doctrine to prove reliance. That ties in with a recent decision in *Anwar v. Fairfield Greenwich Ltd.* (2010 WL 3022848 (S.D.N.Y.)), a Madoff-related litigation holding that, contrary to law that’s been established for more than a decade, New York’s Martin Act does not preempt common law claims in connection with securities transactions.

WONG: The SEC has been recently re-organized by Khuzami, and there’s now a dedicated unit within the SEC for FCPA investigations. The DOJ has announced publicly that FCPA and anti-corruption enforcement is the number-two priority, second only to terrorism. The agencies have clearly shifted to high gear in FCPA investigations.

TORPEY: One trend that we haven’t discussed is the decrease in the number of cases brought by private plaintiffs, and the increasing number of cases won on a motion to dismiss, which has put enormous pressure on the defense bar. There’s going to be significant consolidation in the defense bar over the next five years.

HEIMANN: On the plaintiff’s side of securities litigation, most firms have become highly selective in the cases they file, which accounts, to a large degree, for the decline in the number of cases.

BAYLESS: But there’s certainly going to be more action on the SEC front. Law firms don’t staff SEC investigations like they staff big, private cases, so it may ultimately impact firms and the way they are structured.

Overall, it’s interesting to see how the pendulum moves. When I was at the SEC, there was a move to restrict the SEC’s enforcement authority and private rights of action, which led to the PSLRA. Today we have a statute that’s probably the most far-reaching financial services statute since the ‘30s, and it’s moving the other way. There was a view in Congress 15 years ago toward relying on market-based solutions, and now there’s a recognition that anything that human beings do can be problematic, whether it’s market based or not, and you need regulation to address it. That’s what we see in Dodd-Frank. ■