

## ROUNDTABLE

# Securities

## EXECUTIVE SUMMARY

A slate of high-profile securities class action cases before the U.S. Supreme Court addresses legal issues that promise to have notable ripple effects on future litigation. *Erica P. John Fund, Inc. v. Halliburton Co.* (130 S.Ct. \_\_\_, 2011 WL 47984 (U.S. Jan 7, 2011) (No. 09-1403)), examines whether plaintiffs in securities fraud actions must, in addition to a rebuttable presumption of fraud on the market, establish loss causation at the class certification stage. Meanwhile, *Janus Capital Group, Inc. v. First Derivative Traders* (566 F.3d 111 (4th Cir. 2009), cert. granted, 130 S.Ct. 3499 (2010)) will determine who is considered a primary violator under the federal securities laws.

Our panel of experts discusses these cases, as well as the potential impact of the U.S. Supreme Court ruling in *Morrison v. National Australia Bank Ltd.* (130 S. Ct. 2869 (2010)), and the Dodd-Frank Wall Street Reform and Consumer Protection Act's whistleblower program. They are Tammy Albarrán and David B. Bayless of Covington & Burling; Mark Labaton of Motley Rice; Kenneth P. Herzinger and Michael Torpey of Orrick, Herrington & Sutcliffe; Mary Blasy of Scott + Scott; and Adam A. Reeves of the U.S. Attorney's Office of the Northern District of California. The roundtable was moderated by *California Lawyer* and reported by Krishanna DeRita of Barkley Court Reporters.

**MODERATOR:** What effect will the Dodd-Frank whistleblower program have on securities litigation?

**LABATON:** These provisions could have an enormous impact over time, but it will depend on a number of things, including the commitment of resources to the U.S. Securities and Exchange Commission (SEC) to implement the program. With regards to implementing regulations to the whistleblower program, Dodd-Frank (Pub.L. 111-203) left a lot of discretion and authority with the SEC. One area of controversy is whether whistleblowers will be required to exhaust internal compliance remedies prior to proceeding through the whistleblower program. The SEC's proposed regulations do not impose such a requirement, but the business community has pushed for this requirement, which I believe could be detrimental to the program.

**BAYLESS:** There was a whistleblower provision under Sarbanes-Oxley (SOX) (Pub.L. 107-204) and my sense is that the SEC and Congress were unhappy with the way that it worked—or didn't work. You had to file the complaint with the U.S. Department of Labor and the Occupational Safety and Health Administration, which would then investigate it. Well over 90 percent of the claims filed were rejected. There was also limited scope as to what the whistleblower protection covered, and the statute of limitations for retaliation

claims was narrow. Dodd-Frank addresses those issues. Under the proposed rules, a whistleblower can avoid filing an administrative action, and the scope of complaints that can be filed is broader than under SOX. Of course, the most significant thing is that there's potentially serious money that whistleblowers can get, and that can change the landscape for a company.

**HERZINGER:** Companies have created elaborate whistleblower programs under SOX, and one unintended effect that the new law may have is that whistleblowers may decide to skip the internal programs altogether because of the financial incentives provided by the government.

**ALBARRÁN:** Even if a whistleblower were to go to the company first, there's added pressure on the company to move quickly because there's a 90-day look-back period. Clearly, companies need to have procedures in place to be able to do that.

**BLASY:** As a plaintiffs lawyer who routinely deals with confidential witnesses, I don't foresee employees coming out of the woodwork. Employees are afraid of being blacklisted in their fields if they talk. I'm not sure that the prospect that the SEC may investigate a claim, may prosecute, and may actually win is enough incentive for many people to come forward and risk their livelihood.

**BAYLESS:** Much does depend on whether the SEC has the human resources to review the claims, and whether they will have the Congressional allocation of money to do it. You can have all the mechanisms for filing a complaint that you want, but if the agency doesn't have the resources to review them, they are not going anywhere. That's a practical issue in all this.

**LABATON:** The False Claims Acts (FCA) (31 U.S.C. §§ 3729-3733) may be instructive. It took a while for the program's '86 amendment to get going, but overall, it has been successful in exposing flaws related to government contracts. Unlike the FCA, the Dodd-Frank program does not provide whistleblowers the ability to pursue this action through the SEC on their own. There's every reason to believe that the SEC will be responsible and somewhat conservative in bringing cases. And they might not have the resources to bring these cases. But if there was a strong program in place, the Bernie Madoff situation might have been addressed earlier.

**REEVES:** I would like to make clear that I'm speaking in my personal capacity today and not on behalf of the government. I agree with Mark [Labaton] that it remains to be seen what the full effect of the whistleblower laws will be. As to the resources issue, and since there is no one to speak for the SEC, I would like to offer that since Madoff, I have observed a marked upswing in its efforts to move cases more

quickly in the many cases I have with the SEC. Over the past year, I have been impressed by the SEC's ability to accelerate a wide variety of complex investigations. So if the cases come, I would expect the SEC to handle them well. Second, it's important to recognize that all it takes is a few good cases of the worst conduct for the law to begin to have the deterrent effect that Congress intended and to motivate better overall compliance among public companies.

**TORPEY:** Let's assume that the SEC does not include a provision that requires whistleblowers to go to the company first. Do you advise companies to do something differently?

**LABATON:** What companies can do differently is provide a culture where whistleblowers will not be punished. The SEC is encouraging the whistleblower to come to the company first—the proposed regulations state that whistleblowers, at the discretion of the SEC, could get additional credit for going to the company first. There are employees who want to blow the whistle, and who also want to remain on good terms within their company. A compliance program could take that into account.

**HERZINGER:** Another unintended impact of the new law is that it creates an interesting conflict for confidential witnesses because they have to decide whether to go to a private plaintiffs firm or to the government, which will provide them with a financial reward. To recover an award, a whistleblower must present the government with original information that is not public, and by going to a plaintiffs attorney first and filing a complaint, that will put the previously original information out in the public domain and the whistleblower may jeopardize his or her recovery. There are also new rules for confidentiality and representation for these witnesses. I'm curious as to whether members of the plaintiffs bar think that the new whistleblower rules will increase or decrease the number of confidential witnesses.

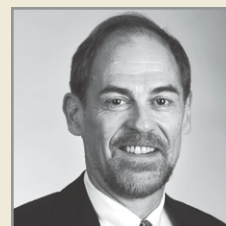
**BLASY:** After the Supreme Court decisions in *Bell Atlantic Corp. v. Twombly* (550 U.S. 544 (2007)) and *Ashcroft v. Iqbal* (129 S. Ct. 1937 (2009)), I need all of the confidential witnesses I can get to meet the high pleading standards. But they cannot come to me too early, before the fraud has been revealed and the stock price is still inflated. There's nothing I can do with their information until the fraud is publicly revealed and the stock has crashed. At that point, it's going to be public anyway.

## PARTICIPANTS



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**TORPEY:** The accountants are the constituency they could report to that could make the most of things, and whom nobody thinks about. If a whistleblower sends a letter that had any substance to it to the accounting firm, it would have a massive impact on the company. The accountants would make the company get to the bottom of things quickly.

**MODERATOR:** What are the legal questions arising from the government's recent enforcement focus on insider trading?

**REEVES:** Insider trading has always been a priority for the U.S. Department of Justice (DOJ) and the SEC. But the full context of the question seems to seek a reaction to the Galleon insider trading case (*United States v. Raj Rajaratnam et al.*, 09 Cr. 1184 (S.D.N.Y.

superceding indictment filed Feb. 9, 2010)). What strikes me most is the potential scale of the case. Rather than a few corporate insiders who are privy to inside information and misusing it, this case reveals what may be a systematic trafficking in confidential information. My concern is that when you have a situation like that, some other hedge funds may resort to similar criminal means to compete and keep up with Galleon.

**BAYLESS:** During my days at the SEC, insider trading was always a priority, but it's true that these were typically one-off cases. That is, one person on the inside passed information to his friend or relative. What is alleged in Galleon is a systemic insider trading ring. For better or worse, this mirrors a view that can be found among many people in the general population

who think the securities markets are fixed against the little guy. This case—if proven—is an important move on the part of the government to restore confidence because if people continue to think the markets are fixed, then they are going to stay out of them.

**TORPEY:** The government has taken tactics associated with organized crime, and used them in connection with insider trading. In Galleon, there was extensive wiretapping by the government, a new phenomenon that sent chills through the business community. The way that people are getting turned is also new. There are people who have pled guilty whose testimony is going up the line, which is also more typical of an organized crime approach because it is more systematic.

The government is also taking an aggressive position on what is material. Historically, insider trading cases involved an individual who obtains sensitive, non-public financial information before it is publicly released, calls a relative or friend, and then that person buys or sells based on that information. In contrast, an array of information is in these new cases, some of which was already public. Good research analysts are typically boxing in the company's activity by calling vendors and customers for information that tells them in an indirect but reliable way what's happening with that company. This raises questions about whether some of this information is really material, non-public information or whether it's aggressive fact finding. Those trafficking the information are also not the people who you would normally see in insider trading cases. It all has to do, apparently, with people who have relationships but are otherwise unconnected to one another.

**ALBARRÁN:** Another new tactic is the SEC's introduction of formal cooperation agreements that give leniency to some individuals in exchange for information. There are about sixteen formal cooperation agreements that have been entered into, and the SEC has confirmed that some of those agreements involved insider trading probes. We are seeing the SEC make use of a tactic that wasn't available in the past.

**LABATON:** On a broader level, what this indicates is that there are newer segments of the financial community that have never been well regulated, like hedge funds and derivative traders. Dodd-Frank tried to deal with this disconnect.

**HERZINGER:** The SEC has created the Asset Management Unit to drill down into this area because it

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**MARY BLASY** has prosecuted securities and shareholder derivative actions since 2000 and joined the San Diego office of Scott + Scott in 2009. Her clients range from individual investors to some of the nation's largest public pension funds. Ms. Blasy has recovered hundreds of millions of dollars for investors in class actions, including Sprint, Coca-Cola, Reliance Acceptance and Martha Stewart Omnimedia. Through shareholder derivative litigation, she has obtained corporate governance enhancements valued by the market at billions of dollars. [mblasy@scott-scott.com](mailto:mblasy@scott-scott.com)



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has been largely unregulated in the past. One of the unit's priorities is to examine hedge funds with abnormal returns. So essentially, if a portfolio manager out-performs his or her peers in the market, then perhaps they are committing fraud, which I suppose in some cases may be true. But this obviously creates concern for our clients. If you have a good year, it does not automatically mean that you have engaged in fraud. But it is an interesting and new technique.

**ALBARRÁN:** A lot of these funds now have to ensure that their compliance programs are robust, and that the analysts understand the contours of insider trading law. If not, you are going to run into a problem where there is a question as to whether the information that the analyst is getting is material, non-public information and whether you should be acting on it.

**BLASY:** The SEC needs to go higher up the food chain and reinvigorate Rule FD (Fair Disclosure). The information is just too valuable. I frequently read transcripts of conference calls where analysts ask questions about certain topics, but they take that part of the conversation offline, and then it later turns out that the subject matter taken offline was being fraudulently misrepresented. Analysts selectively disclose. With the high loss-causation pleading standards private litigants face, information leaks don't just provide unfair advantages to certain traders; they make it difficult to recover on behalf of defrauded investors.

**MODERATOR:** What are the legal issues raised in *Halliburton*?

**BLASY:** The Fifth Circuit, unlike other circuits, allows defendants to factually rebut a plaintiff's fraud-on-the-market presumption of reliance at class certification by making them prove loss causation (See *Oscar Private Equity Inv. v. Allegiance Telecom Inc.*, 487 F.3d 261 (5th Cir. 2007)). The problem with *Oscar*, which the Supreme Court is reviewing in *Halliburton*, is that defendants can use facts known only to them to defeat class certification before plaintiffs are afforded discovery. Some judges are using *Oscar* to manage their dockets, dismissing meritorious cases. Hopefully, the Supreme Court overturns *Oscar*. The Solicitor General put in a strong amicus in support of reversal, confirming it was wrong for the district court to resolve loss causation at class certification, and that the issue has to go to the jury.

Here's why *Oscar* is problematic. Some judges want a mirror disclosure—whatever the false statement was,

they want a revelation of the falsity of that very same statement to have caused the stock price to decline, but it's not that neat. They also want an instantaneous price decline. I don't want to lay out a blueprint to fraud, but if you put out other bad news with your fraud revelation, it's difficult for an expert, especially without the benefit of discovery, to precisely assign all or part of the decline to a particular revelation.

**LABATON:** I put together the original complaints in *Oscar*, but didn't litigate this case beyond that. The Fifth Circuit decision is out of whack with other district courts, and the SEC and the solicitor general have criticized it. One critique is that it conflated the requirements of reliance and loss causation.

**HERZINGER:** The Supreme Court could opt to split the difference between the positions asserted by the parties, and create a rule that comes down somewhere in between. Other circuits have criticized *Oscar* as being an outlier for requiring plaintiffs to prove loss causation at the class certification stage by a preponderance of the evidence. The criticisms of the Fifth Circuit have been that you cannot find that requirement in Federal Rule of Civil Procedure 23. But you cannot find the fraud-on-the-market doctrine in Rule 23 either, so if the courts are going to give the plaintiffs the benefit of the fraud-on-the-market construct from *Basic Inc. v. Levinson* (485 U.S. 224 (1988)), then they must follow the rest of *Basic*'s holding, which says the defendant can rebut the doctrine by showing the plaintiff did not rely on the price, or by showing the fraud did not actually distort the market price, and that is loss causation.

**BLASY:** Agreed, but you can't get to a balancing of the evidence without discovery.

**ALBARRÁN:** Depending on what the Supreme Court decides, class cert can become a big event for defendants, much like the motion to dismiss stage. Since these Fifth Circuit cases, when plaintiffs counsel asks us to stipulate to class certification, we see no reason to. It could be that now, as opposed to merely taking the deposition of the named plaintiffs, you'll need some expert discovery. So class certification may not happen as early in the litigation as it has in the past.

**MODERATOR:** What impact could *Morrison* have on securities cases?

**TORPEY:** It's going to have a big impact. In *Morrison*,

the Supreme Court decided that the test for determining whether or not a foreign private issuer can be sued in a securities fraud class action in the United States is contrary to an established line of thinking based on a jurisdictional analysis; it is instead determined by a transaction-based analysis and the transaction has to occur in the U.S. This leads to a different set of results as to which foreign private issuers can be sued in the U.S., and which cannot. For the private bar, it is going to impact the whole shape of a case. It is not going to have an impact on the SEC or the DOJ because there is a provision in Dodd-Frank that reserves extraterritorial jurisdiction for the government when it chooses to bring an action. And it is possible that the attention that has been brought here will cause the SEC to bring more, not fewer, enforcement actions against foreign private issuers.

**BAYLESS:** This situation creates an opportunity for the SEC to bring actions that the private bar cannot, in a way similar to how the SEC can bring aiding and abetting claims, but the private bar can't. The government brings a lot of aiding and abetting cases because it knows it is the only game in town, and I expect that to happen here too, combined with more cooperation between the SEC and foreign regulatory counterparts.

**BLASY:** What the Supreme Court had before it was a classic F-cubed situation: a foreigner buying a foreign issuer's stock on a foreign exchange. But *Morrison* is now being applied to F-squared situations, where a U.S. citizen buys a foreign issuer's stock on a foreign exchange, and even to purchases on U.S. exchanges. These issues weren't briefed or argued before the Supreme Court, so it's beyond what the court contemplated. If folks want a bright-line rule, it should be based on the citizenship of the investor, not the exchange transacted on.

**LABATON:** American Depository Receipts (ADR) do seem to give some assurances and protection, but ADRs have high transactional costs. We'll see greater purchases of ADRs, and movement in some European countries to develop their own systems of compensating investors in securities actions.

**BLASY:** The U.S. Supreme Court recently held in *Shady Grove Orthopedic Assocs. v. Allstate Ins. Co.* (130 S. Ct. 1431 (2010)) that Rule 23 governs procedure in all federal class actions, regardless of what substantive law applies. And all of the countries

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where these foreign private issuers are located have securities laws prohibiting fraud. There's nothing that says you can't bring a securities fraud action based on English or French law here in the U.S. as long as you are applying their law. *Morrison* only affects the extraterritorial reach of the U.S. securities laws.

**REEVES:** Recently, DOJ filed an insider trading-related indictment for obstruction that was the result of parallel investigations with both the SEC and the Financial Services Authority in London. That was a first for DOJ. Based on my involvement in that case, I see an interest in the United Kingdom in enforcing its insider trading laws in a more dynamic way, and I expect that there will be future cooperation between U.S. and European law enforcement agencies with respect to financial fraud prosecutions. There are aspects of the *Morrison* decision that make it clear that criminal prosecutions wouldn't be precluded when there's evidence that defendants are intentionally using a foreign jurisdiction to conceal a domestic violation. If *Morrison* did somehow impose a bar to an insider trading prosecution, I would consider using the wire fraud statute instead, a technique the government used effectively in the Galleon case. I'd go to a different tool in the toolbox.

**ALBARRÁN:** In addition to the dismissals of F-cubed and F-squared cases based on *Morrison*, we are also seeing challenges post-verdict, like in *Vivendi* (*In re Vivendi Univ., S.A. Sec. Litig.*, No. 02-5571 (S.D.N.Y.)). The estimated damages are about \$9 billion and if *Vivendi* wins on this issue, then damages could be significantly reduced. In SEC enforcement actions, such as the one against Fabrice Tourre of Goldman Sachs, *Morrison* has been raised as a defense. Tourre didn't win his motion for judgment on the pleadings, but the SEC did have to amend its complaint to plead around *Morrison*. In December, again relying on *Morrison*, Tourre filed a motion to dismiss the amended complaint.

**MODERATOR:** What additional trends, cases, and decisions are you watching and why?

**BAYLESS:** I'm watching *Janus*, which is also before the Supreme Court—this appears to be the year of securities litigation for the U.S. Supreme Court. *Janus Capital Management*, which was the investment advisor for Janus Mutual Funds, drafted and prepared a prospectus, which the fund issues and has the fund's name on it. *Janus* addresses the issue of when someone is responsible for a statement that they drafted or

were involved in preparing, but they did not make it themselves and it is not attributed to them. The Fourth Circuit held that since the investment advisor is so closely involved with the mutual fund and its prospectus, the statements in the prospectus are actually the adviser's statement even though the adviser did not make the statement and they are not publicly attributed to the adviser. This case could result in either a strong or a weak decision. I suspect it will be the latter. The strong decision would be for the Supreme Court to say, "No private right of action for aiding and abetting, period. Liability requires that a person actually make the false statement at issue." The weak decision would be for the high court to say that this is a unique situation because we are dealing with a mutual fund and an investment advisor, and they don't exist separately as the mutual fund operates through its adviser. That would be a way of affirming what the Fourth Circuit did, but keeping it narrow. It's an important case because it goes to the decision in *Central Bank of Denver, NA v. First Interstate Bank of Denver, NA* (511 U.S. 164 (1994)), which barred private causes of action for aiding and abetting.

**ALBARRÁN:** It will be critical to see if the Supreme Court agrees with *First Derivative Traders* and, if so, how the opinion is written—whether it's written very narrowly to apply only in the mutual fund context, where you do have this unique relationship between the investment advisors and the mutual fund, or whether the opinion can be read expansively to then affect *Stoneridge Inv. Partners, LLC v. Scientific Atlanta, Inc.* (552 U.S. 148 (2008)), which none of us on the defense side want.

**TORPEY:** But it could be expansively narrowing. It could say, "You have to say or write the words." It would certainly make it harder for plaintiffs to go after an individual in a securities case if they have to find a specific statement in a transcript or a conference call, whereas now plaintiffs use statements in press releases or 10-Qs or 10-Ks. Some of this came up in *In re Vivendi Universal S.A. Securities Litigation*—who was the speaker and how do you impute mental state to the company? It is difficult to attribute scienter to a person when the plaintiff cannot attribute a statement to them. It would fundamentally change the dynamics of many civil cases if this became the rule.

**HERZINGER:** As to trends I'm watching, I'm interested in what the U.S. Commodity Futures Trading Commission (CFTC) does in the next year. Their bud-

get has been increased. They now have more jurisdiction over more instruments than they did in the past, and Dodd-Frank actually codified a provision that is similar to 10b-5 that allows the CFTC to investigate manipulative devices. According to preliminary statements, it will not be applied as broadly as 10b-5 has been by the Supreme Court, but it still remains to be seen. The agency has raised its profile in the last several years and has been more active in cases—including joint cases with the SEC and DOJ—and that will increase.

**REEVES:** I'm watching the SEC's administrative proceeding against the State of New Jersey, where it's alleged that the state made misrepresentations about the underfunding of its pension plans in connection with the sale of \$26 billion worth of municipal bonds. This is an under-investigated area of exposure for bondholders, and given the amount of money and the potential involvement of state actors, this is something that I'm sure the SEC will want to look at carefully, and so do I.

**HERZINGER:** Various news agencies have reported that CalPERS is also being investigated by the SEC. These investigations raise a series of legal and constitutional issues, and obviously a lot of money is at stake, so that will be interesting to watch.

**ALBARRÁN:** I'm curious about how many more non-prosecution agreements (NPAs) the SEC will enter into with companies. The first one was with Carter's, Inc., where the SEC actually didn't pursue a claim against the company, but it did go after the sales executive (See *SEC v. Elles*, No. 10-CV-4118 (N.D. Ga.)). In that case, it seems the conduct was isolated and just one person was involved. But it would be interesting to see what other NPAs the SEC enters into with companies, and the nature of the conduct that's involved.

**LABATON:** Dodd-Frank required the government to undertake a study for Congress regarding secondary liability in securities laws, and that's an enormous issue that *Stoneridge* took off the map for private litigants. I'm interested to see what the Government Accountability Office comes up with in that report. I doubt that Congress will restore aiding and abetting liability, but as we have seen in WorldCom and Enron and other bankruptcy cases, private causes of action can be the best means for investors to recover when companies fail, and it can serve as a major deterrent. ■