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TRENDS IN SECURITIES LAW AND CORPORATE GOVERNANCE

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Law360 Names Cohen Milstein's Antitrust/Competition Practice Among the Best in the Nation

In In January 2014, Law360 announced the winners of its Practice Groups of the Year awards, given to firms that excelled at getting the job done for clients in litigation and deals in 2013. Cohen Milstein's Antitrust Group was selected as a top practice by the publication and is the only plaintiffs' firm whose antitrust practice received this honor.

More information about **Cohen Milstein's Securities Fraud/Investor Protection Practice** can be found here, or call (202) 408-4600.

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Spotlight Interview with Ann Yerger, Executive Director of the Council of Institutional Investors

The Council of Institutional Investors ("CII") is a nonprofit association of pension funds, other employee benefit funds, endowments and foundations with combined assets that exceed $3 trillion. Founded in 1985, CII is a leading voice for effective corporate governance and strong shareowner rights. Ann Yerger has served as executive director of CII since 2005. She is a member of the Investor Advisory Group of the Public Company Accounting Oversight Board, the Investor Advisory Committee of the Securities and Exchange Commission, Weinberg Center for Corporate Governance Advisory Board and the Nasdaq Listing and Hearing Review Council. Ms. Yerger earned an A.B. from Duke University and an M.B.A. from Tulane University, and is a Certified Financial Analyst ("CFA") charter holder. Suzanne M. Dugan, who leads Cohen Milstein's Ethics and Fiduciary Counseling practice, recently sat down to discuss CII's activities with Ms. Yerger.

Suzanne M. Dugan ("SMD"): *CII is a leading voice for strong shareowner rights and effective corporate governance. What are CII's current priorities?*

Ann Yerger ("AY"): CII's overarching priorities are to educate our members on corporate governance issues and rules and regulations impacting their rights and protections as investors and to advocate reforms on highest priority corporate governance issues.

On the educational front we host semi-annual meetings and regular webinars and teleconferences featuring top experts. Teleconferences focus on proposed or pending rulemaking affecting institutional investors under the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Jumpstart Our Business Startups Act. Upcoming webinars will focus on the impact on investors of rulings from the U.S. Supreme Court and Delaware Chancery Court. We also publish a weekly e-newsletter highlighting the hottest issues and trends, along with a library of plain-English reference guides covering corporate governance basics such as proxy voting and securities litigation.

CII continues to focus its advocacy work on ensuring that shareholders can exercise their most basic rights to elect and remove directors. That is why our top-priority reform is majority voting for directors. We believe that if a director is not supported by a majority of the votes cast, he/she should not serve on the board. After several years of trying futilely to convince the Delaware Bar Association and the American Bar Association to set majority voting as the standard in Delaware General Corporation Law and the Model Business Corporation Act, CII is now pressing the U.S. stock exchanges to adopt listing standards mandating majority voting for directors.

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Looking ahead, CII will be petitioning the U.S. Securities and Exchange Commission to amend rules to provide for a universal proxy ballot that would enable shareholders to split their votes as they see fit between company and challenger candidates.

SMD: *You serve on the Investor Advisory Committee of the Securities and Exchange Commission, which was established by section 911 of the Dodd-Frank Act. Can you tell us about this committee and its role to advise the SEC?*

AY: The SEC's Investor Advisory Committee was formally established by Section 911 of the Dodd-Frank Act. It consists of 21 members, including several CII members. It is mandated to advise and consult with the Commission on issues ranging from regulatory priorities to initiatives to protect investors and promote investor confidence and the integrity of the securities markets.

Since its first meeting in June 2012, the Investor Advisory Committee has approved unanimously several recommendations, including those affecting data tagging and Regulation D offerings. Its four subcommittees are continuously evaluating other issues.

SMD: *The recent proxy season shows some success in board governance reform, with approvals, for example, to declassify boards and change supermajority voting, while seeing less success with say on pay proposals, yet it is the latter that gets so much attention and has had some success in Europe. What do you see in the future for board governance reform, and how can CII help facilitate these reforms?*

AY: I believe the corporate governance world has changed tremendously—in a positive way—over the nearly 30 years since CII was founded. Structures advocated by CII more than 25 years ago, such as majority independent boards and annual election of directors, are now mainstream. CII policies are now widely practiced by companies and consistent with policies adopted by organizations such as the Business Roundtable. "Traditional" asset managers are now engaged and involved; they are speaking out and are dedicating staff and resources to corporate governance issues. The dialogue with companies is far less hostile. "Engagement" is the new catchphrase. Companies and directors are increasingly reaching out to their investors to discuss corporate governance issues, and companies—large and small—are more responsive to shareholder concerns.

I attribute this progress to a variety of factors, including shareholder proposals and say-on-pay votes. Over the years CII members have sponsored a significant number of the shareholder resolutions addressing a range corporate governance issues. These resolutions have been an extremely effective tool for changing boardroom performance and motivating important reforms to the U.S. corporate governance model. And I believe say on pay has been a game changer when it comes to corporate governance. Not only has say on pay served as a wake-up call to directors and a catalyst for engagement, these votes have forced companies to sharpen their focus on pay for performance. As a result, many

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have improved their pay disclosures and eliminated benefits—such as golden coffins and gross-ups—that institutional investors have long opposed.

Despite this significant progress, plenty of work remains. Some companies resist adopting best practices. CII will continue to publicize their names and press them to change. The U.S. remains a global laggard when it comes to investor rights and protections. CII will continue to press for reforms such as majority voting for directors, proxy access and universal ballots that enhance the rights and protections of investors in the U.S. The courts are eroding investor remedies. CII will continue to monitor pending court cases for possible involvement and will keep members informed of the latest from the judiciary.

SMD: *The regulations mandated in Dodd-Frank are finally moving toward conclusion, and the challenges have begun with mixed results in the courts. How does CII track these developments and can you foresee any trends?*

AY: The regulators still have a long way to go before completing the many regulations mandated in Dodd-Frank and the JOBS Acts. As a result, CII will continue to host regular teleconferences and webinars featuring the top experts on pending and proposed rules, and it will continue to comment, as consistent with CII policies, on proposed changes. In 2014 CII will commission "plain English" briefs focusing on final or pending reforms—including derivatives and credit rating agencies—of greatest potential impact to CII members and summarizing their potential impact institutional investors. Our goal is to ensure that CII members are "in the know" on the regulatory reform activities impacting them as institutional investors.

SMD: *CII is uniquely positioned to focus attention on the issues that concern institutional investors, bringing together members from the public, private and other sectors. How do you manage to maintain coherence among these different groups?*

AY: Institutional investors are very diverse, and so is CII! It was founded to focus on the many "big tent" issues of interest to the bulk of the membership, and this remains CII's goal. Thanks to CII's strong board, engaged membership and a governance model requiring member input and approval of all CII policies, the organization has a history of successfully focusing on issues involving transparency, accountability and fairness.

SMD: *How do you see CII evolving over the next few years to ensure it maintains its important role as a leading voice for effective corporate governance and strong shareowner rights and in providing assistance to the institutional investor community?*

AY: CII's greatest strength is its members. Our members are increasingly engaged on governance and willing to speak up. That will strengthen CII's efforts to work for effective corporate governance. We hope to continue to grow and remain the leading voice for corporate governance in the U.S.

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The Second Circuit Changes the Rule on Tolling and Statutes of Repose: What It Means for Investors

Just a few months ago, the Court of Appeals for the Second Circuit issued a decision in *Police and Fire Retirement System of the City of Detroit v. Indymac MBS, Inc.* ("*Indymac*"), 721 F.3d 95 (2d Cir. 2013),[1] in which it held that the three-year statute of repose under Section 13 of the Securities Act of 1933 cannot be tolled for any reason.[2] Specifically, the Second Circuit held that statutes of repose could not be tolled by the filing of putative class actions covering the claim – despite the fact that the Supreme Court long ago held that this situation merited a tolling of statutes of limitation in *American Pipe Construction Co. v. Utah*, 414 U.S. 538 (1974) ("*American Pipe*"). The Second Circuit based its decision on its determination that statutes of limitation and statutes of repose were conceptually different creatures, with statutes of repose being far more absolute and less subject to tolling.

This decision constituted a sharp reversal of prevailing case law on this issue. Specifically, during a period of over 40 years, at least 17 different decisions by federal courts (including the Tenth Circuit), all reached the opposite conclusion and concluded that *American Pipe* tolling applied to statutes of repose as well as statutes of limitations. *See, e.g., Joseph v. Wiles*, 223 F.3d 1155, 1166-67 (10th Cir. 2000) (applying *American Pipe* to Section 13 of the Securities Act); *Pub. Emps.' Ret. Sys. of Miss. v. Merrill Lynch* & Co., No. 08 Civ. 10841 (JSR), 2011 U.S. Dist. LEXIS 93222 (S.D.N.Y. August 22, 2011) (*American Pipe* tolled the statute of repose for Securities Act claims as of the date such claims were first asserted in a complaint).

The *Indymac* case itself consisted of two consolidated class action cases where plaintiffs asserted claims under the Securities Act with regard to 106 different mortgage-backed securities offerings issued pursuant to three registration statements. When the two cases were consolidated in 2009, only one originally-named plaintiff remained as lead plaintiff, while the plaintiff in the other case – ousted, by statute, through the lead plaintiff appointment process under the PSLRA – became part of what the court referred to as "asserted" or putative plaintiffs. In 2010, the District Court then dismissed certain claims from the case based on lack of standing by the remaining and solely-named plaintiff which had not itself purchased the securities that the dismissed plaintiff had purchased. For that reason, the plaintiff originally named in the pre-consolidated cases sought to intervene as a named plaintiff and cure the standing deficiency identified by the district court.

[1] For brevity, all citations omit internal references and quotations.
[2] Under 15 U.S.C. 77m, plaintiffs must bring their claims within one year of discovery (a statute of limitation) or within three years from the underlying event (a statute of repose) giving rise to their claims. *Indymac*, 721 F.3d at 107.

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By this time, however, the three-year statute of repose under Section 13 had run, and defendants in the case requested that the court deny the motion to intervene. The intervening plaintiff opposed, arguing that the putative class action had covered its claim until the District Court's dismissal on standing grounds and this fact should toll the statute of repose. Yet the District Court agreed with the defendants, holding that "neither *American Pipe* nor any other form of tolling may be invoked to avoid the three year statute of repose set forth in Section 13 of the Securities Act of 1933." *In re IndyMac Mortg.-Backed Sec. Litig*., 793 F. Supp. 2d 637, 642 (S.D.N.Y. 2011). In short, this decision meant that investors who had purchased those securities timely named in both the pre-consolidated complaint as well as the consolidated amended complaint had not only been excluded from the case, but would be forever barred from pursuing relief or seeking damages at all. Plaintiffs appealed this decision to the Second Circuit.

The Second Circuit's *Indymac* Decision

Despite the court's admission that "statues of repose and statutes of limitations are often confused," as well as the concession that even the Supreme Court of the United States has referred to both inclusively as statutes of limitation, the Court of Appeals declined to toll the three-year deadline under Section 13. Instead, it held that a statute of repose is qualitatively different and cannot be tolled in the same way as a statute of limitation. *Indymac*, 721 F.3d at 106 & n.13, 109. The difference, the court explained, is that a statute of limitation cuts-off a plaintiff's access to certain remedies while having no effect on the accessibility of the underlying right. *Id.* at 106. For this reason, statutes of limitation are subject to equitable considerations and may be tolled. *Id.* Yet the "most important" feature of statutes of repose is that they can only be tolled by "legislatively created exceptions" – otherwise called "legal" tolling. *Id.* at 106-07. The court held that the stricter nature of statutes of repose is due to the fact that they "affect the underlying right, not just the remedy, and thus they run without interruption once the necessary triggering event has occurred." *Id.* 106. The court went on to hold that – even if *American Pipe* tolling could somehow be construed as legal tolling (and not equitable) – the Rules Enabling Act conferring exclusivity on the Supreme Court in the design of rules of practice and procedure would bar construing the statute of repose under Section 13 as affected by even arguably "legal" tolling under *American Pipe*. Therefore, despite the plaintiffs' vigilance in identifying and naming certain securities from the outset of the lawsuit, those claims were summarily dismissed from the litigation in favor of defendants.

Why the *Indymac* Ruling is Important to Investors

The *Indymac* decision is a highly significant boon to defendants in securities litigation because it extinguishes the claims of any potential securities claimant after the statute of repose expires unless their

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claim is covered by a class definition certified by the court or they have brought an individual claim. For Securities Act claims, as discussed above, this is a three-year period and for claims brought under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78a, it is a five year statute of repose period.

Practically speaking, this means that investors with significant losses may have to file prophylactic individual claims prior to the expiration of the statute of repose -- even if a putative class action covers their claims -- to guard against the possibility that the district court will deny certification of the putative class action. Otherwise, if the class does not get certified for whatever reason, they will have no recourse at all. To prevent this from happening, investors or their representatives should carefully monitor cases where they have significant losses and, if a class has not been certified by the time the statute of repose could arguably run, they should consider filing individual cases.

The *Indymac* decision could, however, ironically prove beneficial for the certification of certain classes where otherwise the statute of limitations would have run. This is because the superiority requirement of Rule 23(b)(3) -- which requires that a putative class representative demonstrate that a class action is superior to individual actions -- should be easily satisfied in cases where the comparison is between a viable class action and time barred individual claims.

The plaintiffs in *Indymac* are in the process of petitioning the United States Supreme Court for *certiorari* in hopes of overturning the Second Circuit's decision. Unless this occurs, however, investors must remain vigilant and they and their representatives should closely monitor the potential impact of statutes of repose on their claims.

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When a Good Plan Goes Bad: The Exploitation of Loopholes in the Rules Governing 10b5-1 Trading Plans

Introduction

Rule 10b5-1 Trading Plans can, and often do, serve as an affirmative defense to allegations of illegal insider trading. However, increased scrutiny has demonstrated that the Plans are ripe for abuse and in some instances have the perverse effect of providing a formidable shield for corporate wrongdoers who engage in illegal insider trading. The Securities and Exchange Commission ("SEC") and the United States Attorney's Office for the Southern District of New York have launched investigations into the alleged abuses of the Plans. In January 2013, the Council of Institutional Investors wrote to the SEC to express their "concerns with the potential misuse" of 10b5-1 Trading Plans, and to ask for "clear guidelines regarding the circumstances in which a 10b5-1 Plan may be adopted, modified, or canceled." [3] We think it is important for you to understand the structure of 10b5-1 Plans, their potential abuses, and how they can play a critical role for plaintiffs in securities fraud litigation.

Background

The SEC adopted Rule 10b5-1 in August 2000 to clarify the standard for federal insider trading liability. Prior to the adoption of Rule 10b5-1 it was unclear whether an insider must have "used" material non-public information in connection with the purchase or sale of a security, or whether the insider must have merely "knowingly possessed" such information in order for insider trading liability to attach. Rule 10b5-1 addressed this issue by codifying the "knowingly possessed" standard—meaning insiders are subject to insider trading liability if they execute insider trades while in knowing possession of material non-public information. Because the SEC acknowledged that this broad standard carried with it the potential for significantly increased exposure to insider trading liability, it also created an affirmative defense for corporate insiders – the 10b5-1 Trading Plan.

A 10b5-1 Trading plan is a predetermined plan for selling or trading Company stock. The Plan may be designed a couple of different ways. For example, the plan may require sales of a certain number of shares on a certain day, or may allow for trades any time the stock hits a preset price. Under no circumstances, however, can executives be aware of material non-public information at the time the plan is adopted, and the plan must be adopted in good faith. If these requirements are met, the fact that an

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[3] Council of Institutional Investors, Request for Rulemaking Concerning Amending Rule 10b5-1 or Further Interpretive Guidance Regarding the Circumstances under which Rule 10b5-1 Trading Plans May be Adopted, Modified, or Cancelled (Jan. 2, 2013) *available at* http://www.sec.gov/rules/petitions/2013/petn4-658.pdf.

executive made trades based on a pre-established plan provides a strong defense in the face of insider trading allegations.

Potential for Abuse and Increased Scrutiny

While the concept underlying the 10b5-1 Trading Plan system is sound, the rules (or lack thereof) governing the system are riddled with shortcomings which can have the practical effect of eviscerating any exculpatory presumption in favor of executives trading under the plans. To begin with, there is an utter lack of transparency. Executives are not required to file the plans with any federal agency, nor are they required to disclose if they change, cancel, or amend the plans.

Additionally, executives are free to amend, cancel, or modify their existing plans at any time, thereby allowing them to exploit inside knowledge – the very thing that the Plans were intended to prevent. For example, studies show that executives often cancel their plans before positive Company news is announced – allowing them to immediately cash in on the increased stock price after the news becomes public regardless of whether they could have done so under the Plan. Indeed, a 2006 study "*Do Insiders Trade Strategically within the SEC Rule 10b5-1 Safe Harbor?"* written by Professor Alan D. Jagolinzer found that early terminations are associated with later positive performance. A follow up study by the same professor in 2009 found that 46% of early terminations of Plans requiring share sales occurred within 90 days before the Company released positive news, whereas only 11% of terminations of plans that called for share sales came before the release of negative news about the Company. Executives also opportunistically amend their plans. A recent Wall Street Journal Article highlighted how one executive's plan called for trading at $11 per share. When the stock fell well below $11, and stayed there, the executive amended his plan to permit selling at the current market price.

Executives are also free to begin trading under a plan immediately after it is adopted. The absence of a required waiting period is another loophole that permits executives to take advantage of insider knowledge while trading under the guise of a pre-determined plan. The shorter the period of time between plan adoption and first trades, the higher the specter of suspicion because it appears that the plan was adopted solely to capitalize on newly available insider information. Similarly, because there are no rules governing the duration of a trading plan, executives can enter into short-term plans that allow them to benefit from inside information but still give them the freedom to avoid being locked into a long term trading schedule. The shorter the plan period, the more prone it is to manipulation as well as allegations that it was not adopted in good faith.

Finally, the existence of a 10b5-1 Trading Plan does not prohibit an insider from executing other trades outside of the plan. Trades made outside of the plan are inherently suspicious because the plan is

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intended to provide the insider with adequate diversification and liquidity – therefore any trades outside of the plan appear like they were made with the intent to benefit improperly from insider knowledge.

Journalists and academics have started to bring these shortcomings into the spotlight of mainstream media. For example, a recent Wall Street Journal piece, "*Executives' Good Luck in Trading Own Stock*," reported that executives trading under 10b5-1 Plans "do statistically much better than we'd expect." The article included numerous anecdotes of insiders exploiting loopholes in the rules governing 10b5-1 Trading plans to generate large and favorable returns. Professor Jagolinzer has conducted two studies on trading patterns under 10b5-1 Plans and concluded that trading under the plans generates abnormally large returns. The criticisms led to increased scrutiny by the United States Attorney's Office for the Southern District of New York and the SEC, both of which have launched investigations in to the potential abuses of the plans.

Role in Securities Litigation

Insider trading allegations are often central to proving a defendant's scienter (i.e., fraudulent intent) in securities fraud actions. Plaintiffs often argue that the defendant's insider sales allowed her to benefit from the alleged fraud by selling stock at artificially inflated prices while in possession of material non-public adverse information about the Company. Since the adoption of Rule 10b5-1, Plaintiffs have further argued that trades made pursuant to a 10b5-1 Plan can buttress the inference of scienter if the trades were suspicious – i.e., if the plan was short in duration, if there was no waiting period between the adoption of the plan and the first sale, or if the Plan was adopted, modified, or cancelled while in possession of material non-public adverse information. A review of recent case law demonstrates that courts have been inconsistent with their treatment of the latter argument, with some finding that trades under 10b5-1 Plans do not indicate scienter, while others acknowledge that "[a] Rule 10b5-1 trading plan may give rise to an inference of scienter because 'a clever insider might "maximize" their gain from knowledge of an impending price drop over an extended amount of time, and seek to disguise their conduct with a 10b5-1 plan.'" *Freudenberg v. E*Trade Fin. Corp.*, 712 F. Supp. 2d 171, 200 (S.D.N.Y. 2010).

With the current heightened scrutiny into the potential abuses of 10b5-1 Plans, we expect courts to become uniformly more receptive to arguments that securities fraud defendants acted with scienter even while trading pursuant to a 10b5-1 Plan. We also believe that ongoing investigations by the United States Attorney's Office and the SEC could result in changes to the rules governing 10b5-1 Trading Plans. We will continue to monitor this area and will keep you updated on any developments.