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SECURITIES LAW ALERT

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This edition of the Alert discusses the oral argument before the Supreme Court in *Credit Suisse v. Simmonds*, a case concerning whether and when the statute of limitations for Section 16(b) "short-swing" trading claims may be tolled. We also address the Ninth Circuit's revival of the Alchemix action based on the Supreme Court's decision in *Merck v. Reynolds*, which addresses when the statute of limitations for a Section 10(b) claim begins to run.

In addition, we discuss a ruling from the Southern District of New York rejecting the SEC's proposed consent judgment with Citigroup, as well as a decision from the District of New Mexico holding that the First Amendment does not protect credit ratings disseminated only to a limited group of investors.

Happy holidays! We look forward to reporting on more securities law developments in the new year.

The Supreme Court Hears Oral Argument on Tolling the Statute of Limitations for Section 16(b) "Short-Swing" Trading Claims

On November 29, 2011, the Supreme Court heard oral argument in *Credit Suisse v. Simmonds*, No. 10-1261, a case concerning whether and under what circumstances the two-year statute of limitations for bringing a Section 16(b) "short-swing" trading claim is subject to equitable tolling.

Background

Section 16(b) "bars a defined set of corporate insiders from profiting from a 'short swing' purchase and sale of corporate securities within a six-month period, and allows a shareholder—after adequate demand on the corporate issuer of those securities—to bring a cause of action for disgorgement on the issuer's behalf." Petition for Writ of *Certiorari*, *Credit Suisse Sec. (USA) LLC v. Simmonds*, 2011 WL 1479066, at 1 (U.S. Apr. 15, 2011) (No. 10-1261) ("Petition for Writ of *Certiorari*"). The relevant statute of limitations provides that "no such suit shall be brought more than two years after the date such profit was realized." 15 U.S.C. § 78p(b).

In 2007, plaintiff Vanessa Simmonds brought actions under Section 16(b) to recoup profits realized by certain investment banks (the "underwriters") between 1999 and 2000 in connection with over fifty initial public offerings. In 2009, the district court dismissed her Section 16(b) suits with prejudice on the grounds that "all of the facts giving rise to Ms.

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Simmonds' complaints against the [u]nderwriter [d]efendants were known to the shareholders of the [i]ssuer [d]efendants for at least five years before these cases were filed." *In re Section 16(b) Litig.*, 602 F. Supp. 2d 1202, 1217 (W.D. Wash. 2009) (Robart, J.).

On appeal, the Ninth Circuit held that "the Section 16(b) statute of limitations is tolled until the insider discloses his transactions in a Section 16(a) filing, *regardless of whether the plaintiff knew or should have known of the conduct at issue*." *Simmonds v. Credit Suisse Sec. (USA) LLC*, 638 F.3d 1072, 1095 (9th Cir. 2011) (Smith, C.J.) (emphasis added). Because the plaintiff did not allege that the underwriters had filed Section 16(a) reports disclosing the alleged "short-swing" trades, the Ninth Circuit "conclude[d] that [her] claims [were] not time-barred." *Id.* at 1097.

Circuit Judge Smith authored the Ninth Circuit's opinion, but he also issued a separate concurrence expressing his view that "the statutory text and statutory structure [of Section 16(b)'s statute of limitations] clearly point to the repose approach." *Id.* at 1100. "Were it not for" governing Ninth Circuit precedent, Judge Smith stated that he would have held "that Section 16(b) suits may not be brought more than two years after the short-swing trades take place." *Id.* at 1100-01. (To read a complete discussion of the Ninth Circuit's decision and Judge Smith's concurrence in an earlier edition of the Alert, please click here.)

The underwriters successfully petitioned the Supreme Court for *certiorari*, citing a circuit split. In contrast to the Ninth Circuit's disclosure-based approach, the Second Circuit has held that equitable tolling of the Section 16(b) statute of limitations "ends when a potential claimant … receives sufficient notice that short-swing profits were realized by the party covered by Section 16(a)." *Litzler v. CC Invs.*, 362 F.3d 203, 205 (2d Cir. 2004) (Jacobs, C.J.). The underwriters have argued that neither approach is correct, contending instead that "Section 16(b) establishes an absolute two-year period of repose that is not subject to tolling at all." Petition for Writ of *Certiorari* at 1.

In response, the plaintiff has asked the Court to affirm the Ninth Circuit's disclosure-based approach. The United States, as amicus curiae, has urged the Court to hold that "Section 16(b)'s two-year limitations period is equitably tolled until a reasonably diligent security holder knows or should know the facts underlying his claim." Brief for the United States as Amicus Curiae Supporting Neither Party at 9, *Credit Suisse Sec. (USA) LLC v. Simmonds*, 2011 WL 3780721 (U.S. Aug. 25, 2011) (No. 10-1261).

Highlights from the Oral Argument

At oral argument, the underwriters contended that in accordance with the Supreme Court's decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 360 n.5 (1991), the Section 16(b) statute of limitations is "best read as a period of repose that can't be extended at all." Transcript of Oral Argument at 3, *Credit Suisse Sec. (USA) LLC, v. Simmonds*, 2011 WL 3780721 (U.S. Aug. 25, 2011) (No. 10-1261). Justice Ginsburg found that unlike the two-pronged statute of limitations at issue in *Lampf*, the Section 16(b) statute of limitations "seems to [her] a plain vanilla statute of limitations that is traditionally subject to equitable tolling." *Id.* at 4. Justice Kagan echoed this view, noting that she "[did] not understand[ ] why … one would think of [the Section 16(b) statute of limitations] as anything other than an ordinary statute of

limitations." *Id*. at 6.

Justice Sotomayor suggested that tolling would make sense in cases where an insider fails to file the required Section 16(a) disclosures. "[I]f Congress understood that some [alleged insiders] wouldn't [fulfill] the statutory requirement and file in a timely manner," she posited, "why wouldn't equitable tolling be a more appropriate way to look at this?" *Id*. at 10. Nonetheless, she later acknowledged the "very strong argument" that if Congress can "create[] a statute of repose for intentional conduct like fraud, why should they not create a statute of repose for what is a strict liability statute?" *Id*. at 37.

In Justice Alito's view, "[Section 16(b)] tells you exactly when the time is supposed to begin to run … from the realization of the profit. … [I]t doesn't begin [ ] to run from … the point when some other completely different external event occurs." *Id*. at 32. However, he did raise a practical concern regarding the feasibility of discovering potential Section 16(b) violations absent 16(a) disclosures: "[I]f 16(a) reports are not filed, how likely is it that a potential 16(b) plaintiff will find out within the 2-year period that there were these trades?" *Id*. at 14. The underwriters answered that potential plaintiffs "can find out in … the same ways that any other securities plaintiff … can find out," such as by examining corporate books and records or reviewing SEC filings. *Id*.

Justice Scalia noted that the statute provides that "you have 2 years after the … transaction that … was failed to be reported." *Id*. at 45. However, the plaintiff "want[s] to say … you have 2 years from the time it *was* reported." *Id*. (emphasis added). He explained that if Congress had meant for the Section 16(b) statute of limitations to run from the time of a Section 16(a) disclosure, "Congress would have said that. It's so easy to say that. Two years from the reporting." *Id*.

We will report on the *Simmonds* decision when it is issued.

The Ninth Circuit Revives the *Alchemix* Action Based on the Supreme Court's Decision in *Merck v. Reynolds*

On December 2, 2011, the Ninth Circuit revived a securities fraud action against Alchemix Corporation that the District of Arizona had previously found to be time-barred. *Strategic Diversity, Inc. v. Alchemix Corp*., 2011 WL 6004607 (9th Cir. Dec. 2, 2011) (Hug, J.) (*Alchemix II*). The Ninth Circuit remanded the case "for consideration in light of" the Supreme Court's intervening decision in *Merck & Co., Inc. v. Reynolds*, 130 S. Ct. 1784 (2010) (Breyer, J.). *Id*. at *10.

Background

On May 7, 2007, Kenneth Weiss and his wholly-owned corporation, Strategic Diversity, Inc., brought suit in connection with a loan made by Strategic to Alchemix Corporation. According to the complaint, the plaintiffs were "induced … to accept repayment of the [l]oan and purchase $250,000 worth of Alchemix stock" based on "alleged misrepresentations and omissions" made by Robert R. Horton, Alchemix's founder and Chief Executive Officer. *Strategic Diversity, Inc. v. Alchemix Corp*., 2010 WL 94122, at *5 (Jan. 5, 2010) (Snow, J.) (*Alchemix I*). The plaintiffs asserted Section

10(b) claims, as well as state securities fraud and common law claims.

On January 5, 2010, the District of Arizona granted summary judgment in the defendants' favor on, *inter alia*, statute of limitations grounds. The applicable statute of limitations provides that Section 10(b) claims "may be brought not later than the earlier of … 2 years after the discovery of facts constituting the violation; or … 5 years after such violation." 28 U.S.C.A. § 1658(b). The district court held that the plaintiffs' Section 10(b) claims were time-barred in view of a memorandum provided by Horton to Weiss on June 18, 2002 (the "Western Memo"). Finding that the Western Memo "created 'sufficient suspicion of fraud to cause a reasonable investor to investigate the matter further,'" the district court determined that the plaintiffs "were on inquiry notice of the alleged wrongdoing" nearly five years prior to the commencement of the action. *Alchemix I*, 2010 WL 94122, at *7 (Jan. 5, 2010). The court also found that if the plaintiffs "had exercised reasonable diligence [after receiving the Western Memo], they would have discovered the alleged fraud." *Id.*

Several months after the district court's ruling, the Supreme Court issued its decision in *Merck*. The *Merck* Court held that the limitations period for a Section 10(b) action "does not begin to run until the plaintiff thereafter discovers or a reasonably diligent plaintiff would have discovered 'the facts constituting the violation,' including scienter—irrespective of whether the actual plaintiff undertook a reasonably diligent investigation." 130 S. Ct. at 1798.

The Ninth Circuit Vacates the District Court's Decision and Remands for Further Consideration in View of *Merck*

On appeal, "[t]he parties agree[d] that the suit was filed within the five-year limitation" but "disagree[d] as to whether Weiss should have known of the claims more than two years prior to filing his complaint." *Alchemix II*, 2011 WL 6004607, at *5. "If the facts conclusively determine[d] that Weiss should have discovered the facts of his claim prior to May 7, 2005," the Ninth Circuit explained that "the claims [would be] time-barred." *Id.*

"Here, operating without the benefit of the Supreme Court's ruling in *Merck & Co.*, the district court found that the Western Memo [had] put Weiss on 'inquiry notice,' and it marked the time of the commencement of the statute of limitations at the time of inquiry notice, *i.e.*, June 2002." *Id.* at *6. However, in *Merck*, the Court held that "the 'discovery' of facts that put a plaintiff on 'inquiry' notice does not automatically begin the running of the limitations period." *Merck*, 130 S.Ct. at 1798. The Court stated that "terms such as 'inquiry notice' and 'storm warnings' may be useful to the extent that they identify a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating." *Id.* The Ninth Circuit noted that under *Merck*, "the ultimate burden is on the defendant to demonstrate that a reasonably diligent plaintiff would have *discovered* the facts constituting the violation." *Alchemix II*, 2011 WL 6004607, at *5 (emphasis in original) (citing *Merk*, 130 S.Ct. at 1799).

Applying the *Merck* standard, the Ninth Circuit determined that the defendants had not met their "burden of showing that the claims are time barred." *Id.* at *6. "Even assuming that [the plaintiffs were] on inquiry notice in 2002," the Ninth Circuit found that the

defendants had not "demonstrate[d] how a reasonably diligent plaintiff from that point forward would have discovered the violations." *Id.* The *Alchemix II* court emphasized that under *Merck*, "[t]he limitations period does not begin to run until *discovery*, 'irrespective of whether the actual plaintiff undertook a reasonably diligent investigation.'" *Id.* (emphasis in original).

"Because the district court did not have the benefit" of the Supreme Court's guidance in *Merck*, the Ninth Circuit vacated the district court's ruling and remanded the case for further consideration. *Id.* at *6.

The Southern District of New York Rejects the SEC's Settlement with Citigroup

On November 28, 2011, the Southern District of New York refused to approve a proposed consent judgment in the SEC's action against Citigroup Global Markets Inc. ("Citigroup"). *U.S. Securities and Exchange Commission v. Citigroup Global Markets Inc.*, 2011 WL 5903733 (S.D.N.Y. Nov. 28, 2011) (Rakoff, J.). The court found that "the proposed [c]onsent [j]udgment [was] neither fair, nor reasonable, nor adequate, nor in the public interest." *Id.* at *4.

Background

On October 19, 2011, the SEC filed suit "accusing [Citigroup] … of a substantial securities fraud." *Id.* at *1. The SEC alleged that Citigroup had "created a billion-dollar [f]und" and had misrepresented to investors that "the [f]und's assets were attractive investments rigorously selected by an independent investment adviser." *Id.* According to the SEC's complaint, "Citigroup had [instead] arranged to include in the portfolio a substantial percentage of negatively projected assets and had then taken a short position in those very assets it had helped select." *Id.* The SEC alleged that Citigroup realized net profits of approximately $160 million in connection with the transaction, while investors "lost more than $700 million." *Id.*

The same day that the SEC filed its complaint against Citigroup, the SEC presented a proposed consent judgment for the court's approval. In addition to injunctive relief, the proposed consent judgment provided that Citigroup would disgorge to the SEC $160 million in profits, plus $30 million in interest; and pay a civil penalty to the SEC in the amount of $95 million.

On October 27, 2011, the court "put some questions to the parties concerning the proposed [c]onsent [j]udgment, to which the parties responded both in writing" and at a hearing held on November 9, 2011. *Id.* at *2.

The Southern District of New York Holds That Courts Must Consider the Public Interest When Deciding Whether to Approve Proposed Consent Judgments

In evaluating the proposed consent judgment, the court "turn[ed] first to the standard of review." *Id.* The SEC argued that "while [a] [c]onsent [j]udgment must … be shown to be fair, adequate, and reasonable, 'the public interest … is not part of [the] applicable standard of judicial review.'" *Id.* The Southern District of New York rejected the SEC's position as "erroneous," explaining that "a court cannot grant the extraordinary remedy of injunctive relief without considering the public interest." *Id.*

The SEC also argued that "if the public interest must be taken into account, the [SEC] is the sole determiner of what is in the public interest in regard to [c]onsent [j]udgments settling [SEC] cases." *Id.* at *3. The Southern District of New York found this contention similarly unavailing. Although the court recognized that it must "giv[e] substantial deference to the views of an administrative body vested with authority over

a particular area," the Southern District of New York determined that a court "must still exercise a modicum of independent judgment in determining whether the requested deployment of its injunctive powers will serve, or disserve, the public interest." *Id*. A court must "be satisfied that it is not being used as a tool to enforce an agreement that is unfair, unreasonable, inadequate, or in contravention of the public interest." *Id*.

The Southern District of New York held that the proposed Citigroup consent judgment "does not serve the public interest, because it asks the [c]ourt to employ its power and assert its authority when it does not know the facts." *Id*. at *6. "Purely private parties can settle a case without ever agreeing on the facts." *Id*. at *4. However, "when a public agency asks a court to become its partner in enforcement by imposing wide-ranging injunctive remedies on a defendant, enforced by the formidable judicial power of contempt, the court, and the public, need some knowledge of what the underlying facts are." *Id*. "[O]therwise, the court becomes a mere handmaiden to a settlement privately negotiated on the basis of unknown facts, while the public is deprived of ever knowing the truth …." *Id*. "In any case like this that touches on the transparency of financial markets," the court found that there is an "overriding public interest in knowing the truth." *Id*. at *6.

The court noted that the SEC's "long-standing policy … of allowing defendants to enter into [c]onsent [j]udgments without admitting or denying the underlying allegations, deprives the [c]ourt of

even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact." *Id*. at *4. "As a matter of law, an allegation that is neither admitted nor denied … has no evidentiary value and no collateral estoppel effect." *Id*. "As for common experience, a consent judgment that does not involve any admissions and that results in only very modest penalties is just as frequently viewed, particularly in the business community, as a cost of doing business imposed by having to maintain a working relationship with a regulatory agency, rather than as any indication of where the real truth lies." *Id*. at *5. Here, the court noted that there was "little real doubt that Citigroup contests the factual allegations of the [c]omplaint." *Id*.

Turning to the specific terms of the consent judgment, the court found it significant that the agreement "does not commit the [SEC] to returning any of the total of $285 million obtained from Citigroup to the defrauded investors but only suggests that the [SEC] 'may' do so." *Id*. at *5. "[T]his still leaves the defrauded investors substantially short-changed." *Id*. Moreover, "in terms of deterrence," the court noted that "the $95 million civil penalty that the [c]onsent [j]udgment proposes is pocket change to any entity as large as Citigroup." *Id*.

The court also questioned why the SEC had opted to charge Citigroup only with negligence, rather than scienter. In the court's view, "[t]he combination of charging Citigroup only with negligence and then permitting Citigroup to settle without either admitting or denying the allegations deals a double blow to any assistance the defrauded investors might seek to derive from the [SEC] litigation in attempting to recoup their losses through private litigation, since private investors not only cannot bring securities claims based on negligence, but also cannot derive any collateral estoppel assistance from Citigroup's non-admission/non-denial of the [SEC]'s allegations." *Id*. (citations omitted).

Rather than approving the proposed consent judgment, the court consolidated the SEC's action

against Citigroup with a parallel action against Brian Stoker, a Citigroup employee, and set a trial date of July 16, 2012. *Id.* at *6. On December 15, 2011, the SEC filed a notice of appeal.

The District of New Mexico Holds That the First Amendment Does Not Protect Credit Ratings Disseminated Only to a Limited Group of Investors

On November 12, 2011, the District of New Mexico held that the First Amendment does not protect credit ratings for mortgage-backed securities ("MBS") offered only to select institutional investors. *Genesee County Employees Retirement System v. Thornburg Mortgage Securities Trust 2006-3*, 2011 WL 5840482 (D.N.M. Nov. 12, 2011) (Browning, J.) (*Thornburg*). The court explained that the credit ratings at issue "impacted only the limited group of investors who received the offering documents, the Thornburg Trusts, and the companies involved with those Thornburg Trusts as opposed to the public at large." *Id.* at *129.

Background

Investors in mortgage pass-through certificates issued by the Thornburg Trusts brought suit against Moody's Corp.; Moody's Investors Services, Inc.; McGraw Hill-Companies, Inc.; Standard & Poor's Rating Services; Fitch, Inc.; and Fitch Ratings (collectively, the "Rating Agency Defendants"). The plaintiffs alleged that the Rating Agency Defendants had been "substantial participants in creating each of the Thornburg Trusts and in drafting and disseminating the offering documents for the certificates." *Id.* at *5.

The certificates at issue were allegedly "designed … to ensure that they received the highest [credit] ratings." *Id.* at *6. According to the complaint, "the Rating Agency Defendants shared their methodologies and models with the underwriters … to structure the Thornburg Trusts to achieve the desired investment-grade ratings." *Id.* at *14. The fee arrangement provided that "[t]he Rating Agency Defendants would only receive compensation if they provided [an investment-grade] rating …." *Id.* at *12.

The plaintiffs contended that "[t]he investment-grade ratings that the Rating Agency Defendants assigned to the certificates issued by the … Thornburg Trusts did not represent the true risk of the certificates." *Id.* at *13. In the plaintiffs' view, the "ratings assigned to these certificates (i) did not reflect the true likelihood of the receipt of payments on the underlying loans; (ii) misrepresented that the ratings were based on the actual credit quality of the loans; and (iii) misrepresented that certain certificates were investment-grade when they should have been classified as below investment-grade, in accordance with the Rating Agency Defendants' pre-established rating guidelines." *Id.* at *12.

"Following the offerings, … [a]s MBS across the country began to fail in unprecedented numbers, the Rating Agency Defendants had to adjust ratings downward …." *Id.* at *13. "[T]he certificates [at issue] received a downgrade of not just one or two grade levels, but as many as eighteen grade levels downward." *Id.* "Based on this downgrade, the certificates that the [p]laintiffs and the rest of the class purchased declined significantly in price." *Id.*

The Court Rejects the Rating Agency Defendants' First Amendment Defense

"The Rating Agency Defendants argue[d] that their credit ratings [were] protected opinions under the First Amendment." *Id.* at *126. In considering the Rating Agency's First Amendment defense, the

Thornburg court explained that "[c]redit ratings are commercial speech, and thus they receive 'reduced protection' and 'occup[y] a subordinate position in the scale of First Amendment values.'" *Id.* at *129 (quoting *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 758 n.5 (1985) (Powell, J.) (internal quotations omitted)). "[A] credit rating not addressing a matter of public concern receives no special protection when 'the speech is wholly false' …." *Id.*

Here, "[t]he Amended Complaint … asserts that the [d]efendants specifically targeted institutional investors for the [Thornburg Trust] investments." *Id.* "The [p]laintiffs [did] not allege that the Rating Agency Defendants ever published their ratings to the public at large." *Id.* Moreover, "the ratings related to statutory trusts, and not publicly traded companies, which would qualify as public figures." *Id.* Accordingly, the *Thornburg* court held that "[t]he credit ratings at issue in this case are not entitled to First Amendment protection." *Id.*

The *Thornburg* court noted that the Southern District of New York has also held that "the First Amendment does not apply when a rating agency disseminates ratings to a select group of investors and not the public at large." *Id.* at *128 (citing *Abu Dhabi Commercial Bank v. Morgan Stanley & Co., Inc.*, 651 F. Supp. 2d 155 (S.D.N.Y. 2009) (Scheindlin, J.)). In *Abu Dhabi*, the Southern District of New York explained that "under typical circumstances, the First Amendment protects rating agencies, subject to an 'actual malice' exception, from liability arising out of their issuance of ratings and reports because their ratings are considered matters of public concern." 651 F. Supp. 2d at 176. "However, where a rating agency has disseminated [its] ratings to a select group of investors rather than to the public at large, the rating agency is not afforded the same protection." *Id.* The *Abu Dhabi* court rejected the rating agencies' First Amendment defense where the ratings at issue were allegedly "never widely disseminated, but were provided instead in connection with a private placement to a select group of investors." *Id.* Similarly, the Southern District of Ohio rejected a First Amendment defense where "the only place that the ratings [were] alleged to have appeared [was] in the offering materials given to [a] select class of [institutional] investors[,]" and there was no allegation that the offering materials "were published to the investing public at large." *In re Nat'l Century Financial Enterprises Inc., Investment Litig.*, 580 F. Supp. 2d 630, 640 (S.D. Oh. 2008) (Graham J.).

Because the *Thornburg* court found that the First Amendment does not apply to the Rating Agency Defendants' credit ratings, the court held that the plaintiffs did not have to plead that the Rating Agency Defendants had "issued their credit ratings with actual malice." 2011 WL 5840482, at *130. The court explained that "[a]ctual malice protections apply only when the complained of speech at issue implicates the First Amendment." *Id.*

The *Thornburg* court nonetheless granted in part the Rating Agency Defendants' motion to dismiss, finding that the plaintiffs had "sufficiently pled allegations about material misrepresentations or omissions with respect to [d]efendants McGraw-Hill Companies, Inc. and Standard & Poor's Rating Services, but not against [d]efendants Fitch, Inc., Fitch Ratings, Moody's Corp., or Moody's Investors Services, Inc." *Id.* at *148. The court granted the plaintiffs leave to amend their complaint.

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