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Securities Update and Sarbanes-Oxley Related Developments

**Joseph W. Anthony
Anthony Ostlund & Baer, P.A.**

I. Securities Update—2003

In a year filled with massive class actions and even more massive penalty awards in SEC actions, a few themes emerge for 2003. First, it is a dangerous time to be an investment banker or corporate executive involved in the telecommunications industry or responsible for taking companies public from 1999-2002. Second, bankruptcy courts are beginning to play an increasingly large role in securities litigation, impacting the size of penalty awards given in SEC enforcement actions and controlling the question of whether securities class actions may be brought against companies in Chapter 11 bankruptcy. Third, although the abuses that occur when investment companies serve as both the investment bankers and research analysts for their clients was insufficient to support a 10b-5 claim, they were sufficient to result in substantial penalties in SEC actions, and demands for material changes in corporate governance related to conflicts of interest.

A. Case Studies: Lessons Learned from Selected Litigation in 2003.

1. SEC v. WorldCom, Inc.— A Massive Award and a Preview of Bankruptcy Issues to Come.

Improper accounting practices from 1999 through the first quarter of 2002 led to WorldCom overstating its income by approximately \$11 billion and overstating its balance sheet by as much as \$200 billion. As a result, shareholders of the company lost billions, and the SEC filed suit against WorldCom. On July 7, 2003, District Judge Jed S. Rakoff issued an Opinion and Order approving the SEC's settlement with WorldCom, Inc. The civil penalty, entered in the amount of \$2.25 billion, will equate to roughly 750 million with the bankruptcy discount. Although the penalty is 75 times greater than any previous penalty assessed in a similar case, Judge Rakoff felt the need to defend the size of the award:

Undoubtedly the settlement will be criticized by, among others, those shareholders unfamiliar with the severe limits imposed on their recovery by the bankruptcy laws, those competitors whose own self-interest blinds them to the broader range of public policies that such a settlement implicates, and those professed pundits and ideologues for whom anything less than a corporate death penalty constitutes an ‘outrage.’ But the Court is convinced, for the reasons already outlined above, that the proposed settlement is not only fair and reasonable but as good an outcome as anyone could reasonably expect in these difficult circumstances.

SEC v. WorldCom, Inc., 2003 U.S. Dist. LEXIS 11394, *16 (S.D.N.Y. July 7, 2003).

Important developments unrelated to the size of the award can be extracted from the litigation:

a) Liquidation Disfavored.

Although the SEC and the District Court had the power to, they declined to force WorldCom into liquidation bankruptcy. Judge Rakoff ruled that the loss of jobs for 50,000 innocent employees, and the harm to the telecommunications market that would result from removing a major competitor outweighed the value of issuing WorldCom “the death penalty.”

b) Corporate Monitor Granted Extraordinary Authority.

The court-appointed Corporate Monitor in WorldCom was given the power to watch over the company’s finances, change the company’s internal controls, alter their corporate governance structure, and control the hiring and firing of corporate executives. All of this authority was granted by the federal district court, independent of the bankruptcy court. Although the Corporate Monitor has extraordinary powers, he is still required to follow the mandates issued by the Bankruptcy Court.

c) The Interaction of Bankruptcy Law with the Sarbanes-Oxley Act (“SOXA”).

In the classic bankruptcy hierarchy, shareholders normally lose their entire investment, receiving none of the bankruptcy proceeds that are consumed by attorneys' fees, secured creditors, and unsecured creditors. The Sarbanes-Oxley Act may provide an alternative means for shareholders to receive compensation for fraudulent acts that harm the value of their investment. Under § 308(a) of SOXA, the Commission is given the discretion to pay any penalty it recovers to shareholder victims rather than the U.S. Treasury. Therefore, under SOXA, shareholders may essentially move ahead in the line of creditors by receiving an allocation from the award given to the SEC, an unsecured creditor.

d) The Power of the Bankruptcy Court.

As WorldCom indicates, the Trustee in Bankruptcy has powers independent of the court-appointed Corporate Monitor to control a corporation in Chapter 11, and the Corporate Monitor must abide by the decisions of the Trustee in Bankruptcy and the Bankruptcy Court. The Trustee also has the power to enjoin class action plaintiffs from prosecuting their suit, and to prohibit them from making attempts to obtain possession of or control over the proceeds of the director/officer liability insurance policies, using the theory that such claims, if denied, would ultimately result in the class members seeking recovery from the same pool of assets used to reorganize the company in Chapter 11. Megliola v. Maxwell, 2003 U.S. Dist. LEXIS 8776, *5-8 (E.D. Ill. May 27, 2003). The original ruling by the Bankruptcy Court to enjoin the class action according to its authority under Section 105(a) of the Bankruptcy Code was upheld by the Illinois District Court. Id. at *17. As more large companies seek bankruptcy protection in response to the ramifications of widespread securities and accounting fraud perpetrated by their

officers, the power of the Bankruptcy Court to control the assets of companies in Chapter 11 will have an increasingly large impact on securities class action lawsuits.

2. In re Merrill Lynch & Co.—Conflicts of Interest Between Brokerage Firms, Investment Bankers, and Research Analysts.

Plaintiff, a shareholder in the Merrill Lynch Global Technology Fund, brought an action against the Fund, its directors, its investment advisor and affiliates, the adviser's corporate parent, Merrill Lynch & Co., Inc., and broker-dealer affiliate. Plaintiff alleges that the Fund's Registration Statements and Prospectuses failed to disclose several material facts, including: (1) the Fund invested in the securities of companies with which the Fund's broker-dealer affiliate sought investment banking business; (2) the broker-dealer affiliate used misleading research reports on many of the securities in the Fund; and (3) the Fund invested in companies at market prices inflated by the misleading research reports to enhance the ability of the affiliate to obtain investment banking business from those companies, without concern for the quality of the investment for Fund participants.

The court held that the complaint failed: (a) to allege any facts giving rise to a duty to disclose under 10b-5; (b) to plead loss causation; and (c) to allege facts suggesting that the fund knew of any misleading reports. Therefore, the court granted the motion to dismiss.

a) No Duty to Disclose Relationships between the Broker-Dealer Affiliate and Companies in which the Fund Invested.

To state a claim under the '33 Act, a plaintiff must allege that the defendants had a legal obligation to disclose the omitted information. The court held that the plaintiffs failed to establish such an obligation on the part of Merrill Lynch to disclose that the Fund's broker-dealer provided investment banking services to companies in which the Fund invested for the

following reasons: (1) such information was not included in the SEC Form N-1A as a required disclosure; (2) it is a well-recognized fact that such affiliations are commonplace; and (3) the relationship between the investment bankers and the companies is public information that does not require disclosure.

b) No Duty to Disclose that the Affiliate Issued Purportedly Misleading Reports about Securities in the Fund.

Interestingly, the court held that because the conflict of interest between underwriting and analysts in brokerage firms is so pervasive and commonplace it qualifies as public knowledge, and Merrill Lynch had no duty to disclose its potential conflict. The inherent conflict stems from the dilemma that analysts run the risk of downgrading one of their company's best investment-banking clients when they issue a "sell" order. As a result very few, if any, sell orders are issued by analysts.

c) No Duty to Disclose that the Fund Invested in Companies to Aid Investment Banking Business for Merrill Lynch.

The investment banking arm of Merrill Lynch provided investment banking services and/or issued research reports for 80-90% of the companies held in the fund. However, that fact, combined with Plaintiff's vague assertion that the overlap suggests an improper motive, was not enough to support a Section 11 claim.

d) Compare: SEC Release April 28, 2003: Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking.

The SEC brought enforcement actions against **Bear, Stearns & Co, Inc., Credit Suisse First Boston LLC, Goldman, Sachs & Co., Lehman Brothers Inc., J.P. Morgan Securities Inc., Merrill Lynch, Pierce, Fenner & Smith, Incorporated, Citigroup Global Markets Inc.,**

UBS Warburg LLC, and U.S. Bancorp Piper Jaffray. Pursuant to the enforcement actions, the ten firms will pay a total of \$875 million in penalties and disgorgement. The \$875 figure includes Merrill Lynch's previous payment of \$100 million in connection with its prior settlement relating to conflicts of interest. The individual penalties are some of the highest ever imposed in a civil enforcement action under securities laws. Penalties have been assessed against the companies for conflict of interest problems identical to those described above, namely the conflict between the research analyst and investment banking arms of the corporations. In addition to the monetary payments, the firms are required to reform their future practices, including separating research and investment banking departments, and making independent research available to investors. The settlement suggests that although the plaintiff in Merrill Lynch did not sustain the burden of proving each element of a 10b-5 claim, the inherent conflict in the research and investment banking areas of many investment firms and resulting misrepresentations were sufficient to warrant severe penalties by the SEC.

B. Selected Recent Regulations and Proposed Regulations: SEC and NASD.

1. NASD Proposes Disclosure of Mutual Fund Compensation Arrangements.

On August 7, 2003, the NASD proposed for comment a rule that would expand disclosure of the types of compensation paid for the sale of mutual fund shares to better inform investors about the financial incentives that brokerage firms and their representatives have to recommend particular funds. The proposed change reflects the heightened scrutiny and high number of disciplinary actions in the area of mutual funds and variable annuities since 2001. The proposal would disclose the two types of compensation paid for the sale of mutual fund shares: (a) cash payments to brokerage firms in return for shelf space; and (b) payment of a

higher compensation rate to registered representatives for selling certain funds. Firms would be required to disclose in writing the nature of the compensation arrangement to the customer either when the customer first opens an account or purchases mutual fund shares.

2. SEC Will No Longer Allow Respondents to “Neither Admit Nor Deny” the Allegations that Result in a Successful Injunction.

In their Opinion issued on July 25, 2003, In the Matter of Marshall E. Melton and Asset Management & Research, Inc., the SEC redefined their policy on administrative disciplinary proceedings based on consent injunctions. “For purposes of consent injunctions that are agreed to and entered by a court after issuance of this opinion, we will construe the ‘neither admit nor deny’ language as precluding a person who has consented to an injunction in a Commission enforcement action from denying the factual allegations of the injunctive complaint in a follow-on proceeding before this agency.” Now, respondents who consent to an injunction may not later deny the factual allegations of the injunctive complaint in a follow-on proceeding, thus paving the way for SEC enforcement actions.

3. Forms U-4 and U-5 Changed, Effective July 14, 2003.

The SEC approved the following changes to the Forms U-4 and U-5: (a) new disclosure questions to the “Regulatory Disciplinary Actions” subsection of Section 14 (Disclosure) and a new corresponding Disclosure Reporting Page to gather information about events that might cause a person to be disqualified as a result of the Sarbanes-Oxley Act; (b) add new disclosure questions to the Form U-5 to mirror the Form U-4 relating to terminations for cause; and (c) streamline the language associated with the U-4 questions relating to fingerprinting, along with other technical corrections and revisions.

4. SEC Approves the Amendment to Rule 3070 that Requires Filing with the NASD of Civil and Criminal Complaints and Arbitration Claims.

On March 3, 2003, the SEC approved the NASD's proposal that required members to file with the NASD copies of criminal and civil complaints and arbitration claims that name a member or associated person as defendant or respondent. The NASD plans to use these filings to better protect investors by quickly detecting patterns of broker misconduct. Members are required to file with the NASD copies of: (a) any indictment, information, or other criminal complaint or plea agreement; (b) any complaint in which a member is named as a defendant or respondent in any securities or commodities-related private civil litigation; (c) any securities or commodities-related arbitration claim filed against a member in any forum other than the NASD Dispute Resolution form; and (d) any indictment, information or other criminal complaint, any plea agreement, or any private civil complaint or arbitration claim against a person associated with a member that is reportable under question 14 on Form U-4. The new regulations do not require duplicative filing if the documents have already been subject to a request by the NASD.

C. The Next Wave of Class Actions: "Hot" IPO Allocation.

Brokerage firms and investment banks that were bringing companies public during the boom of 1998-2000 began allocating large blocks of the "hot" IPO stock to certain institutional investors who would then in turn share the profit with the brokerage firm by paying unusually large commissions on secondary trades in highly liquid securities. These commissions were in some instances 4,000% higher than the typical \$.06 per share commission on secondary trades. The institutional investor benefitted from this by having the "hot" IPO stock when it hit the market and skyrocketed, allowing them quick profit when they almost immediately sold the IPO stock back to the investment brokerage firm. The firm would benefit by receiving huge

commissions which were in essence kickbacks for allowing the institutional investors first crack at the new IPOs. The companies going public and their non-institutional stockholders suffered, however, when the value of the stock skyrocketed and then plummeted shortly after the company went public. Litigation over this practice has begun to intensify in 2003, with investment brokerage firms such as **Robertson Stephens** paying large civil penalties to the SEC, and class actions brought by purchasers of the IPO stock against IPO underwriters. See description of Robertson Stephens SEC settlement described below; see also In re: Public Offering Fee Antitrust Litigation; In Re: Issuer Plaintiff Initial Public Offering Antitrust Litigation, 2003 U.S. Dist. LEXIS 10984 (S.D.N.Y. June 27, 2003).

D. Selected People (natural and artificial) You Don't Want to be in 2003.

Henry Blodget: This former managing director of Merrill Lynch and senior research analyst will be censured and permanently barred from the securities industry, in addition to paying more than \$4 million to settle the charges against him. Blodget issued fraudulent research under Merrill Lynch's name, including reports that exaggerated the value and marketability of several Internet companies. The entire penalty will be put in a fund for Merrill Lynch investors.

Nathan A. Chapman, Jr. (and his companies): On June 26, 2003, the SEC filed securities fraud charges against Nathan Chapman, three of his companies and three of his associates in connection with the initial public offering and secondary market trading in the common stock of eChapman.com. The SEC action is based upon fraudulent conduct that Chapman and his cohorts engaged in to try to save their failing IPO.

Chan Desai goudar: The SEC won a large award against Chan Desai goudar, chief executive officer and chairman of the board of directors of California Micro Devices (CMD), on July 31, 2003. Desai goudar made several misrepresentations consistent with the company's campaign to artificially inflate the company's financial status to outside investors. His misrepresentations and omissions included: false press releases about company revenue, allowing a false 10-K to be submitted, falsely attributing product revenue write-offs to strengthening distributor relationships abroad, and recklessly signing materially false or misleading representation letter to CMD's outside auditors. After a criminal conviction for insider trading, the SEC brought this action in September, 1998, seeking civil penalties to recover additional funds for distribution to investors harmed by CMD's inflated share price from May 4, 1994 to January 5, 1995. Desai goudar transferred over 1 million shares of CMD stock for distribution to the class of harmed investors, and provided them with further compensation for his unjust enrichment. The

court also held him in violation of Section 10(b) of the Exchange Act and Rule 10b-5 for his materially false or misleading statements. Next, as a deterrent to others who might engage in such violations, the court imposed civil penalties totaling \$1,381,424.66 against Desiagoudar pursuant to § 308 of the Sarbanes-Oxley Act of 2002. The additional penalties went into the disgorgement fund to benefit the victims of the securities violations. Finally, the court permanently prohibited him from acting as an officer or director of any public corporation.

Enron Executives: It should come as no surprise that Enron is included in the list of people you would rather not be in 2003. Specifically, **Kenneth D. Rice, Joseph Hirko, Kevin P. Hannon, Rex T. Shelby, and F. Scott Yeager** were charged with violating the antifraud provisions of federal securities laws and personally taking more than \$150 million in unlawful profits. The complaint filed by the SEC concerns the false and misleading statements the individuals made about the technology, financial condition, performance, and value of Enron Broadband Services, Inc. to artificially inflate the value of the stock. Each defendant benefitted from their false and misleading statements by selling the artificially inflated stock, netting profits that ranged from \$9.0 million to \$53 million. The SEC is seeking disgorgement and civil penalties.

Gemstar-TV Guide International, Inc: The SEC filed securities fraud charges against the former CEO and CFO of Gemstar on June 19, 2003. The charges are a result of the role that the two officers played in a scheme to inflate Gemstar's licensing and advertising revenues. **Henry C. Yuen and Elsie M. Leung** will have to disgorge their salaries, bonuses, and proceeds from the sale of stock during the period of the fraud, in addition to suffering civil penalties, if the SEC's action is successful. Yuen and Leung overstated Gemstar's revenues by over \$223 million from March 2000 to September 2002 to meet its unrealistic revenue growth projections.

Jack Grubman: On April 28, 2003 the SEC, NY AG, NASD, and NYSE announced that Jack Grubman would be censured and permanently barred from the securities industry. Grubman, a former manager of Salomon Smith Barney Inc., and the lead research analyst for SSB's telecommunications sector, issued fraudulent and flawed research reports under SSB's name. Grubman has been ordered to pay \$15 million, \$7.5 million of which will be added to a distribution fund for SSB customers, and the other \$7.5 million of which will be paid to the New York Attorney General. Grubman will not be indemnified or seek tax deductions for the penalty.

KPMG: On January 29, 2003 the SEC sued KPMG LLP and four KPMG partners in connection with their audits of Xerox Corp. from 1997-2000. The SEC alleges that KPMG and partners permitted Xerox to manipulate its accounting practices to close a 'gap' between actual operating results and results reported to the public, a 'gap' of approximately \$3 billion. The four KPMG partners named are **Michael A. Conway, Joseph T. Boyle, Anthony P. Dolanski, and Ronald A. Safran**. In a related action, Xerox consented to paying \$10 million to the SEC in civil penalties without admitting or denying the allegations in the SEC's complaint.

PricewaterhouseCoopers LLP: The SEC announced a settled enforcement action against PricewaterhouseCoopers LLP for improper professional conduct on May 22, 2003. The improper conduct claims stem from its audit of SmarTalk TeleServices, Inc's year-end 1997

financial statements. PwC was censured under Rule 102(e) of the SEC's Rules of Practice for its failure to adequately audit a \$25 million restructuring reserve established by SmarTalk at fiscal year-end 1997. PwC did not admit or deny the allegations, and agreed to pay \$1 million. It also agreed to establish and maintain policies and procedures to preserve working papers intact and to retain an independent consultant to review PwC's software designed to meet the objectives of the policies and procedures agreed upon by the SEC.

Prudential Securities: On July 10, 2003, the SEC announced two enforcement actions involving the sale of mutual funds shared by Prudential Securities, Inc. The first is a settled action, where the SEC found that Prudential had inadequate systems in place to monitor and enforces its policies and procedures relating to sales of different classes of mutual funds. Prudential will pay a \$300,000 civil penalty and \$82,000 in disgorgement for the settled action. In the action that has not yet been resolved, **Robert Ostrowski** and **Rees T. Harris** are charged with violating antifraud provisions of securities laws by not disclosing material facts about Class B shares in a mutual fund to purchasing investors. As a result, Ostrowski received excess commissions, Harris failed to supervise Ostrowski, and Prudential received almost \$63,000 in excess commissions.

Qwest: On February 25, 2003 the SEC filed civil fraud charges against eight current and former officers and employees of Qwest Communications Int'l, Inc., alleging that they inflated the company's revenue by approximately \$144 million in 2000 and 2001 to meet earnings projections and revenue expectations. Defendants artificially inflated Qwest's recognition of revenue in two equipment sale transactions to bridge the gap between actual revenue and revenue targets for the quarters ending in June, 2001 and September, 2000.

Robertson Stephens, Inc: The SEC filed a civil action against Robertson Stephens Inc. on January 9, 2003 for violations of NASD Conduct rules that prohibit profit sharing in customer accounts relating to the firm's allocation of shares in Initial Public Offerings (IPOs) during 1999 and 2000. Robertson Stephens would allocate shares of "hot" IPOs to customers in exchange for excessive commissions or markdowns. Robertson Stephens agreed to pay \$28 million to resolve the Commission's action and a related action brought by the NASD, \$23 million in disgorgement and \$5 million in civil penalty.

In another Robertson Stephens matter, **Paul Johnson**, a former employee, was sued by the SEC individually for failing to disclose a serious conflict of interest that resulted in a personal multimillion dollar windfall. Johnson, a senior research analyst at Robertson Stephens, praised two private companies that were going to merge with public companies, failing to disclose that he owned stock in both private companies and would gain millions of dollars worth of publicly-traded stock if the mergers were successful.

Martha Stewart: Amidst jokes that Martha is going to revolutionize prison fashion and put the "café" back into cafeteria, the SEC filed securities fraud charges against Martha Stewart and her former stockbroker **Peter Bacanovic** on June 4, 2003. Stewart allegedly received an inside tip and sold her stock based upon information that ImClone Systems was going to drop due to the news that it would not be able to market a cancer drug it was developing. Stewart and

Bacanovic made matters worse by creating an alibi and concealing important facts from the SEC during criminal investigations into her trades. The SEC seeks an order requiring Stewart and Bacanovic to disgorge the losses Stewart avoided and to pay civil monetary penalties. The SEC's charges have had a negative impact on the stock price of Stewart's own company, Martha Stewart Living Omnimedia, Inc.

Richard Scrushy: The former **HealthSouth Corp.** CEO was charged by the SEC with fraudulent accounting practices that resulted in an over \$1.4 billion overestimation of company earnings (now valued at over \$2 billion). On March 19, 2003 the SEC filed a complaint that alleged that Scrushy and HealthSouth matched overstated earnings with false increases in HealthSouth's assets, leading to "cooked books" of epic proportions. Multiple parties have been indicted criminally and sued in response to the fraud on the market perpetrated by HealthSouth. Scrushy's assets have been frozen, and many of his former employees are blaming him for the fraudulent accounting practices.

Samuel Waksal: The former ImClone CEO agreed to pay more than \$800,000 in civil penalties to partially resolve the insider trading case brought against him by the SEC. In addition to paying the penalty, Waksal is barred from acting as an officer or director for public companies. The SEC action arises from Waksal's conduct upon receiving information that the FDA was planning to reject for review ImClone's pending application to market a cancer treatment drug. Using the inside information, Waksal tried to sell shares of ImClone worth nearly \$5 million, tipped a family member, directed his daughter to sell her ImClone stock, and purchased 210 ImClone put option contracts through a Swiss account. Waksal was also charged criminally for his conduct, and pled guilty.

Xerox: On June 5, 2003, the SEC charged six former senior executives of Xerox, **Paul A. Allaire, G. Richard Thoman, Barry D. Romeril, Phillip D. Fishback, Daniel S. Marchibroda, and Gregory B. Taylor**, with securities fraud and aiding and abetting Xerox's violations of federal securities laws. The six defendants will pay over \$22 million in penalties, disgorgement, and interest. The funds will be placed in a court account for the victims according to Section 308(a) of the Sarbanes-Oxley Act of 2002. The individuals have been charged as a result of their work to "polish" Xerox's reputation on Wall Street and boost the company's stock price. The polishing resulted in more than \$3 billion of overstated revenues.

II. The Sarbanes-Oxley Act

A. Background.

On June 30, 2002, President Bush signed the Sarbanes-Oxley Act of 2002 (“SOXA”), and on August 28, 2002 the Securities and Exchange Commission released its final rules implementing the civil certification requirements mandated by Section 302 of the Act. The stated purpose of the Act, “To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes,” reflects the government’s concern with investor confidence in the wake of Enron and dozens of similar corporate scandals. Although a large portion of SOXA addresses internal controls, corporate governance, and auditing procedure, two recently-addressed issues directly impact attorneys who practice securities litigation: (1) the new statute of limitations; and (2) the “reporting up the ladder” provisions applicable to all attorneys appearing or practicing before the SEC.

B. “Ratting Up the Ladder”: The SOXA Rules Governing the Conduct of Securities Lawyers Became Effective August 5, 2003.

On August 5, 2003, the rules established by the SEC to govern attorney actions when he or she is confronted with corporate wrongdoing became effective. The rules require an attorney to report evidence of a material violation of securities laws “up-the-ladder” within the company to chief legal counsel, the chief executive officer, an audit committee, or a committee of independent directors, beginning with legal counsel and continuing through the chain until a disinterested or independent party investigates the objectively reasonable suspicion. Note that this applies to any attorney who appears before the Commission, and is not limited to in-house counsel. The code provisions “allow” the attorney to reveal confidential information related to his or her representation of the issuer client to the extent that the attorney reasonably believes necessary to prevent the issuer from committing a material violation of securities law, or to rectify the consequences of a material violation in which the attorney’s services have been used.

Originally, the Commission wanted to require an attorney to inform the SEC through “noisy withdrawal” of its decision not to continue representing a client. Attorneys objected to this proposed rule vehemently, arguing that it is not the SEC’s role to make determinations about attorney’s professional conduct. In response, the SEC proposed an alternative where it would be the responsibility of the company to inform the SEC of an attorney’s withdrawal, and an option for the attorney to do the same.

The SEC’s power to enact such rules originates in § 307 of SOXA, and the SEC’s regulations are codified in 17 CFR 205.1-205.6. Excerpts from SOXA and the CFR pertinent to the newly-enforced SEC rules are included below.

1. Section 307 of SOXA.

Not later than 180 days after the date of enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule—

(1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors comprised solely of directors not employed directly or indirectly by issuer, or to the board of directors.

2. Selections from 17 CFR 205.1-205.6.

205.1: Purpose. This set of regulations is designed to set forth the minimum standards of professional conduct for attorneys appearing and practicing before the Commission. The standards are designed to supplement applicable standards of professional conduct, but where the standards conflict, this section governs.

205.2: Appearing Before the Commission. In 205.2(a), “appearing and practicing before the Commission” is defined as: (i) transacting any business; (ii) representing an issuer in any

proceeding, investigation, inquiry, information request, or subpoena; (iii) providing advice in respect to the SEC or securities law regarding any document that will be filed or submitted to the Commission; or (iv) providing advice regarding whether any information or statement should be filed with the SEC. The SEC does not include non-appearing foreign attorneys or attorneys who conduct any of the above activities in a context other than providing legal services to the issuer.

205.2: Material Violation. “Material violation means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.”

205.3(b): Duty to Report Evidence of a Material Violation.

(1) “If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or the officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer’s chief legal officer (or the equivalent thereof) or to both the issuer’s chief legal officer and its chief executive officer (or the equivalents thereof) forthwith. By communicating such information to the issuer’s officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney’s representation of an issuer.”

(2) The chief legal officer has the responsibility to inquire into the evidence of the material violation as he or she deems it appropriate. If there is no current or pending violation, the chief legal officer will explain to the reporting attorney how that determination was made. If there is a material violation, he or she is required to take reasonable steps to cause the issuer to adopt an appropriate response.

(3) Unless the reporting attorney reasonably believes that the chief legal officer has provided the appropriate response, or if the reporting attorney believes it would be futile to report such material violations to the chief legal officer, the reporting attorney **shall report** the evidence of a material violation to: (i) the audit committee of the issuer’s board of directors; (ii) another committee of the issuer’s board consisting of persons who are not “interested” as defined in § 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19)); or (iii) the issuer’s board of directors if the issuer’s board has no committee does not have a committee of persons who are not “interested.”

(6) Subsection (6) of 205.3(b) lists the circumstances under which an attorney does not have any obligation to report evidence of a material violation. The exceptions are limited to attorneys who are hired by chief legal officers to investigate a material violation, and report their findings to the chief legal officers, or to defend the company against an alleged material violation.

205.3(c): Alternative Reporting Procedure. If an attorney is retained or employed by an issuer that has an established qualified legal compliance committee, the attorney can report suspicions of a material violation to the qualified legal compliance committee.

205.3(d): Issuer Confidentiality?

(1) “Any report under this section (or the contemporaneous record thereof) or any response thereto (or the contemporaneous record thereof) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney’s compliance with this part is in issue.”

(2) “An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer’s consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

(i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;

(ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S. C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or

(iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney’s services were used.

205.6: Sanctions and Discipline. Attorneys who violate 205.1-205.6 are subject to civil penalties and remedies under federal securities law, the disciplinary authority of the Commission, and discipline by the State Bar Association(s) where the attorney is admitted, depending upon the state disciplinary code. Again, where state disciplinary laws and this federal code conflict, the federal code governs.

C. The Impact of SOXA on Statutes of Limitations.

The passage of SOXA significantly altered the statute of limitations time period for federal causes of action. Previously, subsection (a) of 28 USC § 1658 applied to all causes of action arising under an Act of Congress. Judicial interpretation limited the applicability of 28 UCS §1658 to new causes of action passed without reference to preexisting laws, and courts have not applied 28 USC § 1658 to amended versions of laws passed prior to the statute’s enactment. Section 804(b) of SOXA gave securities claims a statute of limitations period

distinct from other federal causes of action, extending the time period in which private plaintiffs may file an action to address their grievances. After SOXA was enacted, courts have addressed a variety of issues surrounding the statute, ranging from which causes of action may use the extended statute of limitation to what falls under the definition of “proceeding” in § 804(b) of SOXA.

1. 28 USC § 1658: Time Limitations on the Commencement of Civil actions Arising under Acts of Congress.

(a) Except as otherwise provided by law, a civil action arising under an Act of Congress enacted after the date of the enactment of this section [enacted Dec. 1, 1990] may not be commenced later than 4 years after the cause of action accrues.

(b) Notwithstanding subsection (a), a private right of action that involves a claim of fraud, deceit, manipulation or contrivance in contravention of a regulatory requirement concerning securities laws, as defined in section 3(a)(47) of the Securities Exchange act of 1934 (15 U.S.C. 78c(a)(47)), may be brought not later than the earlier of–

- (1) 2 years after the discovery of the facts constituting the violation; or
- (2) 5 years after such violation.

2. Private Plaintiffs Seeking Recovery under SOXA are Subject to the Statute of Limitations in 28 USC § 1658(b).

A private plaintiff, unlike the SEC, is subject to the statute of limitations provision that bars their recovery on any fraudulent actions in their account. In a federal securities fraud suit, the statute of limitations begins to run upon either actual or inquiry notice of the facts constituting fraud. See Tregenza v. Great Amer. Comm. Co., 12 F.3d 717, 722 (7th Cir. 1993). In addition to extending the statute of limitations from 1 & 3 to 2 & 5 years, SOXA has created 2 private causes of action: one that involves recovery of profits from insider trading, 15 U.S.C. § 7244, and one that provides protection for whistle blowers, 18 U.S.C. § 1514A. Gideon Minerals v. J.P. Morgan Chase Bank, 2003 U.S. Dist. LEXIS 13598, *3 (S.D.N.Y. Aug. 6,

2003). Any private actions involving the '34 Act that are brought after July 30, 2002 are subject to the new statute of limitations in SOXA.

3. SOXA does not Change the Law Regarding Equitable Tolling; It Merely Extends the Number of Years a Plaintiff Can File.

With the passage of SOXA, an issue arose as to whether the Act would change the Lampf holding that inquiry notice triggers the Rule 10b-5 limitations period. Under Lampf, an action is time barred if either: (1) the events occurred more than three years prior to filing of the complaint; or (2) the plaintiff had inquiry notice of the alleged fraud for more than one year. De La Fuente v. DCI Telecommunications, 259 F. Supp. 2d 250, 258 (S.D.N.Y. 2003) (citing Lampf, Pleva Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 115 L. Ed. 2d 321, 111 S. Ct. 2773 (1991)) Because the language in SOXA tracks that of Lampf, merely extending the limitations period, most likely the inquiry notice trigger remains unaffected. Id. at 263.

4. Applicability of SOXA to Claims filed after its Passage, Concerning Events that Occurred Before its Passage.

There is no real debate about whether SOXA changes the statute of limitations for suits filed prior to the passage of the Act. Clearly, it does not affect the limitations period for actions that have already been commenced. De La Fuente v. DCI Telecommunications, 259 F.Supp. 2d 250, 263 (S.D.N.Y. 2003). However, courts are debating whether the Act allows the extended statute of limitation period to apply to events that occurred before the passage of SOXA where the actions are filed after the July 30, 2002 enactment. The plain language of the amendment provides that the extended limitations period “shall apply to all proceedings addressed by this Section that are commenced on or after the enactment of this act.” Pub. L. 107-204, Title VIII, §

804(b) (emphasis added). The language seems to presume that the Act affords redress for violations that occurred prior to the passage of SOXA on July 30, 2002. Roberts v. Dean Witter Reynolds, 2003 U.S. Dist. LEXIS 5675, *8-9 (D. Fla. March 14, 2003); Friedman v. Rayovac Corp., 2003 U.S. Dist. LEXIS 13135, *29 (D. Wisc. May 29, 2003).

In Roberts, the plaintiff brought claims after the passage of SOXA that would have been time barred under Lampf, but were within the limitations period under SOXA. The defendants brought a motion to dismiss, arguing the claims were time-barred. The court held that the legislative history indicated that Congress intended for the extended statute of limitations to apply retroactively if the events occurred prior to SOXA, but the action was filed after the act was passed. The court did not rule definitively on the issue, stating that such arguments were outside the four corners of the complaint, and therefore inappropriate for a motion to dismiss. The court denied the motion to dismiss, and permitted the defendants to seek interlocutory review. Roberts, 2003 U.S. Dist. LEXIS 5675 at *13.

In Rayovac, the court held that joining a party to a complaint qualifies as a “proceeding” under §804(b) of SOXA, such that if the original complaint is filed pre-July 30, 2002, and the new defendant is joined post-enactment of SOXA, the extended statute of limitations period applies to the newly-joined defendant even though the original defendants to the action are not subject to the SOXA statute of limitations. 2003 U.S. Dist. LEXIS at *31. The court held, “(f)urthermore, as plaintiffs point out, they could have filed a separate action against defendant Partners in January 2003, in which case there could be no dispute over the application of the new statute of limitations. It would make little sense to create a rule encouraging judicial inefficiency

by requiring separate lawsuits for claims against different defendants arising out of the same conduct.” Id.

Whether Roberts and Rayovac are representative of what will become the majority view on the issue is uncertain. The plain language of the statute appears to support retroactive application, with its emphasis on proceedings rather than events. However, retroactive application of any provision of law is unusual because it punishes individuals for conduct they had no way of knowing was illegal at the time. Statutes of limitations are arguably distinct from the retroactive application argument because they are concerned not with whether the act itself is wrong, but instead with how long a person may be punished for the wrongful act. Further litigation will determine whether all circuits will apply the extended statute of limitations period retroactively to events that occurred before the enactment of SOXA.

5. SOXA Applies to the ‘34, not the ‘33 Act.

Section 804(b) of SOXA changes the statute of limitations period for allegations of violations of securities laws as defined in the Securities Exchange Act of 1934. On its face, the act does not apply to claims brought under the 1933 Act. Friedman v. Rayovac Corp., 2003 U.S. Dist. LEXIS 13135, *28 (D. Wisc. May 29, 2003). Therefore, in situations such as Rayovac, where the plaintiff brings claims under the ‘33 Act and the ‘34 Act outside of the 1 year statute of limitations, but before two years have passed, the ‘34 Act claims may be allowed under SOXA while the ‘33 claims will be time-barred.

6. A Lingering Question of Interpretation.

The extension of the statute of limitations for securities claims under Section 804 of SOXA has created an issue of interpretation concerning the scope of Section 804 as applied to all

federal claims. It is clear that Section 804 was meant to apply to 10(b) and 10(b)-5 claims. What is not clear is whether Section 804 applies to federal code provisions that already contain a specific statute of limitations provision. Title 28, Section 1658, was written to provide a statute of limitations for federal actions that do not contain express limitations periods, demonstrated by the language, “Except as otherwise provided by law,” in 28 USC § 1658(a). Section 804 of SOXA seems to apply to explicit and implicit actions, separating itself from § 1658(a) only with the language, “Notwithstanding subsection (a),” and neglecting to address securities laws that have pre-existing statute of limitations provisions. 28 USC § 1658(b). Judicial interpretation will ultimately determine the applicability of the 2/5 statute of limitations period to all securities actions.

D. The NASD May Arbitrate a SOXA Claim.

In Boss v. Salomon Smith Barney, Inc., a former employee filed an action alleging that he was pressured by Salomon to change the recommendations he made as a research analyst, and when he failed to do so, was terminated. 263 F. Supp. 2d 684 (S.D.N.Y. 2003). Salomon moved to stay the litigation and compel arbitration consistent with Boss’s U-4 application. Boss objected to the arbitration, arguing that his whistleblower claims brought under SOXA are exempt from the U-4. In a short opinion, District Judge Richard Owen reiterated the Second Circuit Decision in Oldroyd v. Elmira Savings Bank, 134 F.3d 72 (2d Cir. 1998). “The Oldroyd court stated that Congress may override the presumption in favor of arbitration if it manifests its intent to do so ‘in the text of the [statute], its legislative history, or an ‘inherent conflict’ between arbitration and the [statute’s] underlying purposes.’” (citation omitted) There is nothing in the text of the statute or the legislative history of the Sarbanes-Oxley act evincing intent to preempt

arbitration of claims under the act. Nor is there an inherent conflict between arbitration and the statute's purposes. Accordingly, Boss's claims are arbitrable." Boss v. Salomon Smith Barney, Inc., 263 F. Supp. 2d at 684.