Responding to Enforcement and Disclosure Requirements in the Securities Law Realm

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Securities enforcement has changed in the recent past, and the real change—and something that could represent a significant shift in the market if it continues—is in the realm of enforcement proceedings.

The Securities and Exchange Commission (SEC) now appears to be focused on enforcement based not on the extent of the fraud committed, but on the extent of the harm to investors. The tremendous failures of investment vehicles like subprime mortgage securitizations and derivatives flowing from those securitizations, including collateralized debt obligations (CDOs) created from the riskiest tranches of certificates issued by the subprime mortgage securitizations, have left the public blaming the recession and market crashes on a lack of regulation and oversight, as well as on the Wall Street banks that profited handsomely on these investment vehicles.

The SEC's response has been to shift its focus in enforcement actions from violations of disclosure obligations to a more protectionist view of investors. While relying on the classic fraud-based framework, the SEC has turned its attention to investment vehicles (and their sponsors) that are now seen as just too risky for investors. If a type of investment has ultimately resulted in overwhelming losses to investors, it may be irrelevant how detailed the risk disclosures were; instead, the SEC is searching for violations and prosecuting any of the remaining companies that were involved in developing those investments and selling them to the public.

This movement represents a dramatic shift in the philosophy of enforcement in the United States from a disclosure-risk model (as long as there is no deception—i.e., false or misleading statements or omissions—investment banks or brokers are free to create or promote vehicles with higher risks that allow investors to earn greater returns) to a protectionist approach (pursuing claims based on certain investment types that are now, in hindsight, deemed too risky to have been created and promoted at all). This protectionist approach may help protect investors from devastating losses, but it could also limit the innovations and opportunities within U.S. capital markets.

New Prosecution Trends in Securities Litigation

The biggest news in the world of securities litigation this year is the shift in the type of case and the type of conduct being prosecuted by the SEC and other enforcement agencies. There seems to be a much greater focus in recent years on bringing enforcement actions against players in industry sectors based primarily or exclusively on the financial results, rather than the conduct of the actors. Rather than assume that investors failed to fully assess risks in light of full disclosures, the SEC seems to be proceeding with the theory that if the outcome is ultimately worse than the market anticipated, there must have been some fraud that caused the risks to investors not to be fully disclosed.

If that concept takes hold, I believe it will significantly change our capital markets. I differentiate that type of investigation from classic insider trading situations, which the SEC is prosecuting with all the weapons at its disposal. Those are acts of real fraud, perhaps a bit more sophisticated than they used to be, but classically committed and caught with the weapons we classically use against crime—wiretaps and informants.

By contrast, in the other arena of securities enforcement, the government is essentially saying that some types of investments are simply too risky. Raymond James was charged for fraud relating to auction rate securities; Morgan Keenan settled claims relating to the sale of mortgage-backed securities; J.P. Morgan settled claims arising out of its structuring and sale of real estate-related CDOs. I believe that is a significant change that everyone practicing in this area has to be aware of.

Simply put, a typical securities disclosure, in and of itself, probably cannot be used to defend in a situation where the security is so risky that it could cause catastrophic losses by its very nature. I had a professor who once asked, "Let us say that I include this statement in a prospectus: 'I am about to sell you a stock that is a complete fraud, and I am warning you there is no return on it.' Could you sell that stock and avoid being found liable for securities fraud because of the disclosure?" He believed that it was okay to sell that stock because a disclosure was made, and you could point to the disclosure and say that no investor could have been misled. But in today's environment, my answer would be "no" because the government has said that some things are just too risky for the public to invest in.

Allocating Resources to Updating Client Securities Strategies

Virtually any company that is publicly traded or involved in the securities markets needs to devote substantial resources to securities compliance these days. Part of that trend is the passage of the Dodd-Frank Act. The enforcement activities under SEC Chairman Mary Schapiro make it quite clear that significant amounts of resources will be devoted to securities law compliance for public companies.

Simply put, any clients who are active in the market—trading firms, hedge funds, derivatives firms, private equity firms, and institutional clients of all sorts—have enormous compliance situations to deal with now.

Lawyers and clients face many difficulties in interpreting the current securities laws. Fortunately, our clients in the public markets have a healthy respect and a high degree of caution regarding enforcement activity. Like failing to disclose isolated reports of negative drug effects in *Matrixx*, activities that were close to the line in the past will today be viewed as being over the line. Therefore, the safest thing for clients to do is to be well short of the line.

In the past, a stock drop might occur because of an adverse event, and a company's prior documents would be scrutinized, including its registration statements, press releases, and the like. Now, there is a new game in town because the SEC has stepped up its enforcement in this area. In almost any stock-drop case, there is a cry from the public that fraud must have been involved, and the SEC is so sensitive to what happened with the financial meltdown that it will scrutinize any such accusation. If the SEC decides to bring charges against a company based on information it obtains during its investigation, regardless of the result (which is usually an agreement by the company to settle by the issuance of a consent decree), this attracts the attention of private securities lawyers who use the SEC's reported information to support a tag-along private class action.

It is increasingly difficult to defend against claims of fraud or omissions by public companies because the process has been opened up in such a way that significant government intervention is now possible without the hurdles that the plaintiff's bar normally faces. As a result, we are likely headed toward a much more rigorous disclosure regime.

Upcoming Challenges for Securities Law Attorneys

Looking ahead, I think securities law attorneys will be called on to defend cases involving allegations or claims that we have never seen before (like market manipulation, rather than outright fraud), and I think that will be difficult. There needs to be more and complete disclosure, and companies need to get used to the idea that if a mistake is made, intense scrutiny will result. In every instance where the market goes down, we are likely to face intense government scrutiny, and we can do nothing about it because of the fallout from the collapse of Lehman Brothers and the mortgage securities marketplace. The public has put pressure on the SEC regarding increased enforcement in this area. Consequently, we are now operating in an intense, protectionist-related world.

My advice to lawyers in this practice area is to look at the big picture. You need to see what is developing in the securities terrain—that we are moving to a disclosure-intensive environment; that some of the risk is being eliminated from the marketplace; and that the SEC is under tremendous political pressure to ensure the integrity of the marketplace to a degree far beyond what has ever been envisioned before. If you cannot see these developments, you may not be emphasizing the importance of the new compliance rules, regulations, and requirements on corporations. Meeting those standards through compliance is very expensive, but it is less expensive than facing an SEC investigation or a huge private plaintiff's class action lawsuit.

Although only some of us have clients who were involved in the mortgage-backed securities market, the fallout from the collapse of that market has affected every stock traded everywhere in the world. The 1933 and 1934 Securities Acts were reactions to a terrible Depression that was caused by the stock market manipulations of the 1920s, culminating in the crash of 1929. I suggest that the Lehman crash is at least as significant as that crash, and that the recent changes in the securities world are as significant as the 1933 and 1934 acts in changing the ways in which the public markets are viewed—and that is what I think securities lawyers have to become aware of.

M. Norman Goldberger is practice leader of the Securities Litigation Group and a member of the Accounting and Professional Liability, Appellate, Complex Commercial Litigation, and Consumer Class Action Litigation Groups. He concentrates his practice in a wide variety of complex commercial matters, including securities litigation, consumer fraud class actions, restrictive covenants, derivative actions, internal investigations, False Claims Act litigation, Racketeer Influenced and Corrupt Organizations (RICO) Act litigation, and issues relating to the availability of insurance coverage for commercial litigation matters.