SPEECH

A Few Things Directors Should Know About the SEC

Chair Mary Jo White

Stanford University Rock Center for Corporate Governance
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Introduction

Thank you very much for that kind introduction. I am honored to be here tonight before this audience to talk about a few of the many things that directors should know about the SEC.

The Stanford Directors' College is a remarkable program. It brings together directors and senior executives from start-ups to the largest public companies in America, to learn and share experiences with each other and with some of the top lawyers, jurists, and academics. I hope my remarks tonight will add a little to the insights you are absorbing here.

The SEC today has about 4,200 employees, located in Washington and 11 regional offices across the country, including one in San Francisco that is very ably led by Regional Director Jina Choi, who is here tonight. Many of you have likely had some contact with our Division of Corporation Finance, which, among other things, has the responsibility to review your periodic filings and your securities offerings. Some of you that work for or represent a company that we oversee know our staff in our National Exam Program, and I imagine a few of your companies know something about our Enforcement Division staff. Our other major divisions are Investment Management, Trading and Markets and the Division of Economic and Risk Analysis.

So that is just a quick snapshot of the structure of the SEC and as you undoubtedly know, the SEC has a lot on its regulatory plate that is

relevant to you – completion of the mandated rulemakings under the Dodd Frank Act and JOBS Act, adopting a final rule on money market funds, enhancing the structure and transparency of our equity and fixed income markets, reviewing the effectiveness of disclosures by public companies, to name just a few. But what you may not be as focused on is the mindset of the agency on some other things that are also relevant to you as directors.

I have selected three such topics for tonight: one attitudinal, one advisory, and one more descriptive, but all of which I think are important. I will begin with how the SEC thinks about the important role that you occupy as gatekeepers for your shareholders; next, I will discuss how we view self-reporting of wrongdoing and cooperating in SEC investigations; and then I will finish with a description of the SEC's whistleblower program, how it works and how the SEC thinks about the relationship between it and a company's own internal compliance programs.

Directors Are Essential Gatekeepers

Those of you who are directors play a critically important role in overseeing what your company is doing, and by preventing, detecting, and stopping violations of the federal securities laws at your companies, and responding to any problems that do occur.[1] In other words, you are the essential gatekeepers upon whom your investors and, frankly, the SEC rely. We see you as our partners in the effort to ensure that investors in our capital markets can invest with confidence and, hopefully, success.

At the SEC, we typically use the term "gatekeeper" to refer to auditors, lawyers, and others who have professional obligations to spot and prevent potential misconduct. And while there are certainly other gatekeepers who may be closer to some of the action or more familiar with the details of a transaction or a disclosure document, a company's directors serve as its most important gatekeepers. For by law, it is ultimately the fiduciary responsibility of the board of directors to oversee the business and affairs of a company.[2]

In discharging this important responsibility, it is essential for directors to establish expectations for senior management and the company as a whole, and exercise appropriate oversight to ensure that those expectations are met. It is up to directors, along with senior management under the purview of the board, to set the all-important "tone at the top" for the entire company.

Ensuring the right "tone at the top" for a company is a critical responsibility for each director and the board collectively. Setting the standard in the boardroom that good corporate governance and rigorous compliance are essential goes a long way in engendering a strong corporate culture throughout an organization.

How directors can most effectively instill a strong corporate culture and how challenging it is to do so will vary from company to company. CEOs come with a range of experiences and perspectives. Many, including some here in Silicon Valley, are, at heart, innovators whose day job has come to include being the business leader of a public company. As board members, one of the most important duties you have is to select the right CEO for your company and to ensure that he or she "gets it," in terms of understanding the importance of tone at the top and a strong corporate culture. Deficient corporate cultures are often the cause of the most egregious securities law violations, and directors, both directly and through the oversight of senior management, play a key role in shaping the prevailing attitude and behaviors within a company.

As a former director and member of an audit committee of a public company, I know the heavy responsibilities you bear and the time-consuming work that is required of you. The best advice I can give for being an effective director is to learn and be engaged. As directors, you must understand your company's business model and the associated risks, its financial condition, its industry and its competitors. You must pay attention to what senior managers say, but also listen for the things they are not saying. You have to know what is going on in your company's industry, but also the broader market. You need to know what your company's competitors are doing and what your shareholders are thinking.

At the risk of hearing a collective groan in response, I would also urge you to consider another outside view that would also be useful to you as a director – the view of your regulators. Listen to what they say publicly is important to them, what is problematic to them. Talk to them. Perhaps visit them. I know of an audit committee chair who visits all of his company's major regulators once a year, including the international regulators. You may get an earful from time-to-time, but it will be invaluable input for you as a director.

To state the obvious, you must ask the difficult questions, particularly if you see something suspicious or problematic, or, simply, when you do not understand. You should never hesitate to ask more questions, and, always, insist on answers when questions arise. It also goes without saying that you should never ignore red flags. It is your job to be knowledgeable about issues, to be vigilant in protecting against wrongdoing, and to tackle difficult issues head on.

Of course, it is always important for you to know what your shareholders – the owners of your company – are thinking. As most boards today recognize, an open and constructive dialogue with shareholders is not only the right thing to do, but also very helpful in providing perspective on the challenges a company is facing. Many institutional shareholders have unique insights on industry dynamics, competitive challenges and how macroeconomic events are shaping the environment for your company. But it is important not to forget about your other shareholders. There is real value in listening to their views and their voice, as well.

Look thoughtfully at the proposals shareholders are submitting to your company. Ask your management team about them and about the proposals that other companies are receiving that could be relevant to your company. Look at the voting results at shareholder meetings – the percentage of votes for a shareholder– supported resolution or against a management–supported resolution are important, irrespective of whether the resolution is approved, or not.

Ethics and honesty can become core corporate values when directors and senior executives embrace them. This includes establishing

strong corporate compliance programs focused on regular training of employees, effective and accessible codes of conduct, and procedures that ensure complaints are thoroughly and fairly investigated. And, it must be obvious to all in your organization that the board and senior management highly value and respect the company's legal and compliance functions. Creating a robust compliance culture also means rewarding employees who do the right thing and ensuring that no one at the company is considered above the law. Ignoring the misconduct of a high performer or a key executive will not cut it. Compliance simply must be an enterprise-wide effort.

One question we are often asked is whether some of the things we are doing may actually discourage strong directors from serving on boards because of the risk that they may unfairly find themselves on the wrong end of an SEC enforcement action. While we do bring cases against directors, these cases should not strike fear in the heart of a conscientious, diligent director. Let me give a couple of examples to show you what I mean.

We recently brought two cases against audit committee chairs, an infrequent but disturbing occurrence.

In one case, the chair of the audit committee, along with other top executives, were charged for their role in a massive accounting fraud in which the company reported nearly a quarter billion dollars of fictitious revenue. The complaint alleges that, in the face of massive red flags, including emails indicating serious problems with the oversight of financial reporting, a report from an internal review detailing how revenue had been falsified, and a recommendation to retain a third-party to investigate, the audit committee chair failed to ensure a proper investigation and disclosure of the scheme.[3]

In the second case, the audit committee chair was charged for signing an annual report that contained a false Sarbanes-Oxley certification. After being informed that the company had lied about who was running the business, the audit committee chair helped advance the fraud by signing a Form 10-K that failed to disclose the false

representation.[4] As I trust you will agree, these were clear lines crossed by directors not doing their jobs, and then some.

I mention these cases because audit committees, in particular, have an extraordinarily important role in creating a culture of compliance through their oversight of financial reporting. As you know, under the Sarbanes-Oxley Act, audit committees are required to establish procedures for handling complaints regarding accounting, internal controls, and auditing matters, as well as whistleblower tips concerning questionable accounting or auditing practices.[5] Audit committees also play a critical role in the selection and oversight of the company's auditors.[6] These responsibilities are critical ones and we want to support you. Service as a director is not for the faint of heart, but nor should it be a role where you fear a game of "gotcha" is being played by the SEC.

Self-Reporting and Cooperation

Even in the best run companies with strong boards, the right tone at the top and robust compliance programs, wrongdoing will almost inevitably occur from time-to-time. What should you do when that happens? How should you respond? What does the SEC expect you to do? When should a company self-report wrongdoing to the SEC or other authorities? All of these questions require careful consideration and appropriate action. For tonight, I will focus just on the last one about self-reporting.

If your company has uncovered serious wrongdoing, you will need to decide whether, how and when to report the matter to the SEC. One immediate question you will have to answer is whether what has been discovered constitutes material information that requires public disclosure. If the answer is yes, that fact will also invariably dictate an obvious affirmative answer to broader self-reporting to the SEC.

In other situations, you will need to decide whether to call us about a serious, but non-material event – perhaps a rogue employee in a small foreign subsidiary has been bribing a foreign official in violation of the Foreign Corrupt Practices Act ("FCPA"). You intend to take decisive action against the employee and enhance your FCPA compliance

program. Your disclosure lawyer's view is that the occurrence does not require public disclosure. That does not, however, end your inquiry or responsibilities. Your company still needs to decide whether to self-report to the SEC, and consider what that may mean for the company.

As many of you know, the Commission in the 2001 *Seaboard* statement on cooperation, explained how self-reporting, cooperation, self-policing, and remediation factor into our decisions when considering enforcement actions.[7] And, I can tell you from experience that of those four factors, self-reporting is especially important to both the SEC and the Department of Justice.

What are the benefits to your company of self-reporting? You can read about that in the SEC's press releases on enforcement actions, which routinely highlight how the quality of a company's cooperation has affected any resulting enforcement action. Typically, a company realizes the benefits of cooperation through a reduced penalty, or, at times, no penalty or even not proceeding in an exceptional case.[8]

Not that you should need any extra incentive, but keep in mind that there are also downsides in deciding not to self-report. If the wrongdoing is not self-reported, the opportunity to earn significant credit for cooperation may be lost. And, with our new whistleblower program, which I will discuss in a moment, the SEC is more likely than ever to learn of the misconduct through another channel.

Let me just say a few words about how to cooperate with SEC investigations.

As an initial matter, the decision to cooperate should be made early in the investigation. The tone and substance of the early communications we have with a company are critical in establishing the tenor of our investigations and how the staff and the Commission will view your cooperation in the final stages of an investigation. Holding back information, perhaps out of a desire to keep options open as the investigation develops, can, in fact, foreclose the opportunity for cooperation credit. We are looking for companies to be

forthcoming and candid partners with the SEC investigative team – and the board has a responsibility to ensure that management and the legal team are providing this kind of cooperation.

When choosing the path of self-reporting and cooperation, do so decisively. Make it clear from the outset that the board's expectation is that any internal investigation will search for misconduct wherever and however high up it occurred; that the company will act promptly and report real-time to the Enforcement staff on any misconduct uncovered; and that the company will hold its responsible employees to account.

There is, of course, cooperation and then there is cooperation, just as there are compliance programs that look great on paper but are not strongly enforced. We know the difference. Cooperation means more than complying with our subpoenas for documents and testimony – the law requires you to do that. If you want your company to get credit for cooperation – and you should – then sincere and thorough partnering with the Division of Enforcement to uncover all the facts is required.

The SEC Whistleblower Program

One possibility that companies worry about is that whistleblowers may get to the SEC first with evidence of corporate wrongdoing that is either unknown to senior management or that the company has not yet reported to the government. As you know, under the Dodd-Frank Act, the SEC created a new whistleblower program, which provides monetary awards to individuals who provide original information to the SEC that leads to an enforcement action resulting in monetary sanctions that exceed $1 million. Last year, the SEC awarded over $14 million to a single whistleblower whose information led to an SEC enforcement action that recovered very substantial investor funds.[9] And earlier this month, we awarded more than $875,000 split between two whistleblowers who provided valuable tips and assistance that helped us bring a significant enforcement action.[10] These rewards provide a powerful financial incentive to report wrongdoing to us.

The SEC's whistleblower program, which has been fully operational for three years, has already had a significant impact on our investigations. We received over 3,000 whistleblower tips in each of the last two fiscal years [11] and many of these were of high quality and extremely useful. They have helped the Enforcement Division identify more possible fraud and other violations and earlier than would otherwise have been possible.

It is important to emphasize, however, that the whistleblower program is designed to motivate those with reliable information about misconduct to come forward, while also encouraging them to work within their company's own compliance procedures. If a whistleblower first reports to the company and then reports to the SEC within 120 days, the whistleblower not only receives credit for the information the company discovers as part of its internal inquiry,[12] but the whistleblower is also considered to have reported to the SEC on the date he or she first reported to the company. [13] And, we consider whether the whistleblower first reported wrongdoing to the company as a factor that determines the amount of an award, something we generally regard as a positive for the whistleblower.[14]

Because of these incentives, we find that in-house whistleblowers often have first reported the issue internally at their company. That is a good thing. And we would expect that you, as directors, are fostering a culture that affirmatively encourages and empowers employees to report wrongdoing and, of course, without fear of being harassed, demoted, or fired.

The Dodd-Frank Act also provided the SEC with expanded authority to protect whistleblowers by bringing enforcement actions against companies that retaliate against whistleblowers for reporting misconduct.[15] And, last week, we exercised that authority for the first time when we brought an action against a company for retaliating against a whistleblower who reported a possible securities violation to the Commission.[16] We take any retaliation against whistleblowers very seriously and will continue to aggressively take action whenever companies attempt to stifle, deter, or punish efforts to expose wrongful conduct.

Let me end our discussion of whistleblowers with one final word of advice that I have passed on to my staffs at the SEC and in the United States Attorney's Office, and to my former clients in private practice. You may well have doubts about the *bona fides* of a particular whistleblower – perhaps because his or her prior nine tips have not proven to be true or management tells you that the would-be whistleblower is a disgruntled employee. But always think – because it is so – that her tenth tip may be right on target. The bottom line is that it is a mistake not to take all tips from whistleblowers seriously.

Conclusion

I will conclude my remarks tonight where I started them. You, as critical gatekeepers, share in the SEC's mission to ensure that investors in our capital markets can invest with confidence, knowing that a company's disclosures are accurate, that their finances have been adequately and transparently reported and audited, and that their management is carrying out the business in the way they have said they are. Our capital markets are the strongest in the world. An engaged, committed director community is one of the keys to maintaining that strength. Thank you for all you do.

[1] *See SEC v. WorldCom*, 2003 WL 22004827 (S.D.N.Y Aug. 26, 2003) ("[B]oards of directors, outside auditors and outside counsel are the gatekeepers of behavior standards who are able to prevent damage before it occurs if they are alert, and above all if they are willing to act when necessary. A common denominator in many of the major frauds has been the failure of these gatekeepers to stop improper practices at the outset.).

[2] 8 Del.C. § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."). *See also, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (1986). "In discharging this function the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders."

Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (1986).

[3] *See* Press Release No. 2014-47, *SEC Charges Animal Feed Company and Top Executives in China and U.S. With Accounting Fraud* (Mar. 11, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541102314.

[4] *See* Press Release No. 2014-59, *SEC Announces Fraud Charges Against Coal Company and CEO for False Disclosures About Management* (Mar. 27, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541317697.

[5] *See* Exchange Act Section 10A(m)(4).

[6] *See* Exchange Act Section 10A(m).

[7] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Release No. 34-44969 (Oct. 23, 2001) (commonly referred to as the "Seaboard report").

[8] *See, e.g.*, Press Release No. 2013-65, *SEC Announces Non-Prosecution Agreement With Ralph Lauren Corporation Involving FCPA Misconduct* (Apr. 22, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514780 (listing various ways that the entity cooperated with the SEC, and noting its "significant remedial measures," which led to a non-prosecution agreement); Lit. Release No. 22589, *SEC Charges Volt Information Sciences, Inc. and Two Former Officers with Securities Fraud* (Jan. 11, 2013), *available at* http://www.sec.gov/litigation/litreleases/2013/lr22589.htm (noting entity's cooperation and significant remediation efforts in connection with a settlement where the entity paid no civil penalty); Press Release No. 2011-37, *SEC Charges AXA Rosenberg Entities for Concealing Error in Quantitative Investment Model* (Feb. 3, 2011), *available at* http://www.sec.gov/news/press/2011/2011-37.htm (noting that the SEC considered the entities' remedial actions and

cooperation in settling with the entities).

[9] *See* Press Release No. 2013-209, *SEC Awards More than $14 Million to Whistleblower* (Oct. 1, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539854258.

[10] *See* Press Release No. 2014-113, *SEC Awards $875,000 to Two Whistleblowers Who Aided Agency Investigation* (June 3, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541980219.

[11] *2013 Annual Report to Congress on the Dodd-Frank Whistleblower Program*, *available at* http://www.sec.gov/whistleblower/reportspubs/annual-reports/annual-report-2013.pdf.

[12] *See* Exchange Act Rule 21F-4(c).

[13] *See* Exchange Act Rule 21F-4(b)(7).

[14] *See* Exchange Act Rule 21F-6(a)(4).

[15] *See* Exchange Act Rule 21F-2.

[16] *See* Press Release No. 2014-118, *SEC Charges Hedge Fund Adviser With Conducting Conflicted Transactions and Retaliating Against Whistleblower* (June 16, 2104), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542096307.

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LATHAM & WATKINS

SEC Enforcement
Trends and Trajectories

James Farrell

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SEC Chair Mary Jo White

In a recent speech, White said:

"*One of our goals is to see that the SEC's enforcement program is – and is perceived to be – everywhere, pursuing all types of violations of our federal securities laws, big and small.*"

"I believe it is important to pursue even the smallest infractions."

SEC Chair Mary Jo White

How will the SEC leverage its resources to identify and pursue more cases?

1. Advanced Bluesheet Analysis Program (ABAP): Uses data from market participants to identify suspicious trading and see the relationships among different players.

2. Whistleblower Program

3. Pursuing Gatekeepers – Including directors

SEC Chair Mary Jo White

On June 23, 2014, White said that Directors are essential gatekeepers, and she discussed two recent enforcement cases against directors.

1. *SEC v. AgFeed Indus. Inc.*: a director of an animal feed company was sued for allegedly ignoring fraud involving $239 million in bogus revenues.
2. *In re Kiang:* a former audit committee chair of a coal company was charged over her role in the company's reporting violations.

2014 Actions Against Directors

SEC v. AgFeed Indus. Inc.: Andrew Ceresney, the SEC's enforcement director, said:

> [That] "enforcement action is a cautionary tale about what happens when an audit committee chair fails to perform his gatekeeper function in the face of massive red flags."

- Although not involved in the underlying fraud -- the director failed to disclose some of the evidence suggesting fraud to the auditors and counsel, and he allegedly helped raise funds for AgFeed while aware of the alleged fraud.
- The SEC's lawsuit is pending in federal court in Tenn.

2014 Actions Against Directors

In re Kiang:

- Kiang, the AC Chair, learned that the company's acting CFO for the last 18 months never worked for the company. The CEO admitted the acting CFO never did any work for the company, but insisted that Kiang tell no one. She agreed and did not inform anyone, including the company's auditors or shareholders about the earlier misstatements. She also signed the company's 10-K, knowing that the company had not disclosed the earlier misstatements.
- Kiang settled the SEC action, without an admission, agreeing to a cease & desist and permanent D&O bar.

SEC Chair Mary Jo White

Good News = Not a Gotcha Game!

"I mention these cases because audit committees, in particular, have an extraordinarily important role in creating a culture of compliance through their oversight of financial reporting. . . . Service as a director is not for the faint of heart, but nor should it be a role where you fear a game of "gotcha" is being played by the SEC."

SEC Chair Mary Jo White

White offered some suggestions to Directors:

1. Establish a strong culture (“tone from the top”) including hiring a CEO who “gets it” and ensuring a strong compliance program.

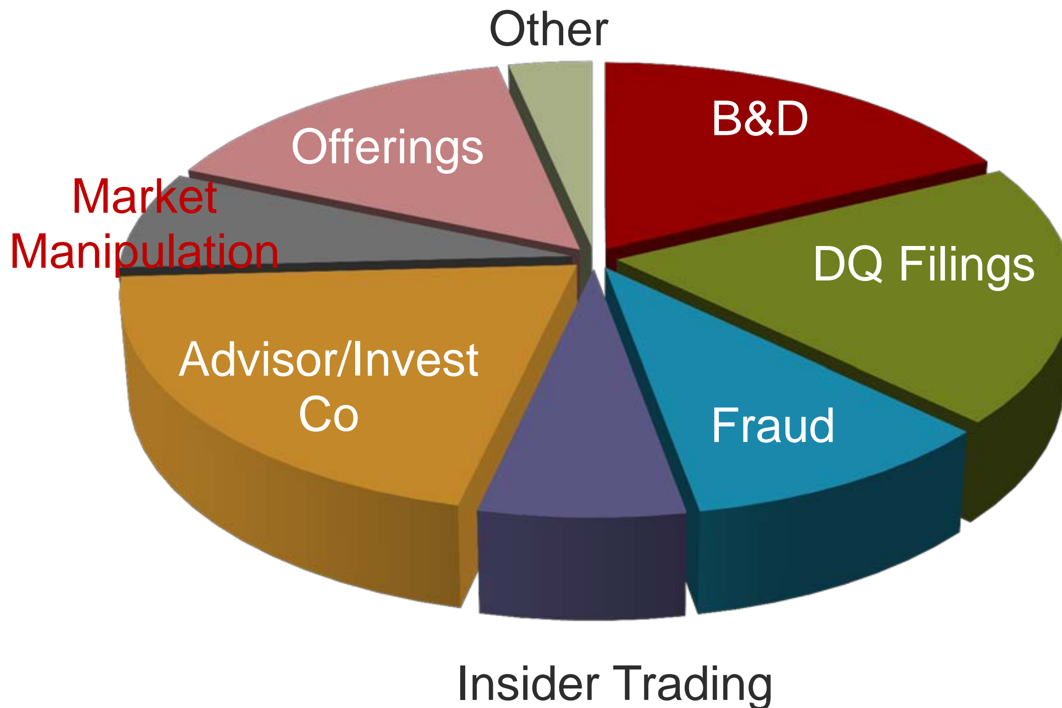
2. Be engaged – monitor your company, competitors, and industry.

3. Listen to your shareholders and regulators.

4. Self-Report and Cooperate with the SEC.

FY 2013 Enforcement Actions

686 Enforcement Actions in FY 2013



- Broker-Dealer: 121 (17.9%)
- Delinquent Filings: 132 (19.2%)
- Financial Fraud/Issuer Disclosure: 68 (9.9%)
- Insider Trading: 44 (6.4%)
- Investment Advisor/Investment Company: 140 (20.4%)
- Market Manipulation: 50 (7.29%)
- Securities Offering: 103 (15.0%)
- Other: 23 (3.3%)

Source: SEC Year-by-Year Enforcement Statistics, SEC.gov

FY 2013 Enforcement Actions

- $3.4 billion in disgorgement and penalties
- 96 separate actions against 161 separate defendants
  - 105 individuals charged
  - 66 CEOs, CFOs, and other executives
  - 36 individuals barred from securities industry, or from serving as officer or director of any public company

Source: *SEC Announces Enforcement Results for FY 2013*, SEC.gov (Dec. 17, 2013)

FY 2013 Enforcement Actions

- Continued focus on financial crisis
  - Improper pricing, concealing risks and terms of CDOs
  - Misleading disclosures about mortgage-related risks
  - Concealing extent of high-risk investments in mutual funds and other financial products
- In FY 2013, cases stemming from the financial crisis resulted in disgorgement and penalties of more than $3 billion

Source: *SEC Announces Enforcement Results for FY 2013*, SEC.gov (Dec. 17, 2013)

Other Enforcement Trends

- Focus on market structure and fair access: Significant actions brought against exchanges and other market participants
- Continued push for gatekeeper accountability
- Increased attention to municipal securities violations
- More cases going to trial

Source: *SEC Announces Enforcement Results for FY 2013*, SEC.gov (Dec. 17, 2013)

New Initiatives

- Task Forces
  - Financial Reporting and Audit (FRAud): meant to detect and prevent financial statement and accounting fraud
  - Microcap: targets gatekeeper fraud in microcap markets

- 908 investigations opened in FY 2013 (13% increase)
- 574 formal orders of investigation in FY 2013 (20% increase)

Source: *SEC Announces Enforcement Results for FY 2013*, SEC.gov (Dec. 17, 2013)

From FY 2013 to now: Remedies

- 566 records of civil penalties between the beginning of FY 2013 and now
- 437 records of disgorgement
- 374 records of pre- or post-judgment interest
- 98 restitution payments

Source: Knowledge Mosaic, SEC Enforcement Search

FY 2014 Enforcement To Date

- 397 enforcement action records thus far this year
  - 122 concern the sale of securities
  - 67 concern insider trading
  - Already as many FCPA cases in FY 2014 as in all of FY 2013
- On pace for 653 total actions this year – a slight decrease from last year
- Three defendants face disgorgement payments of more than $50 million

Source: Knowledge Mosaic, SEC Enforcement Search

Changing Settlement Policies

- New settlement policy (announced June 2013) **purports to *require admissions of facts and misconduct*** where:
  - There is a heightened need for public accountability
  - Misconduct is egregious
  - Controversy involves many investors or otherwise poses serious threat to market
  - Defendant obstructed investigation

Source: *SEC Announces Enforcement Results for FY 2013*, SEC.gov (Dec. 17, 2013)

Changing Settlement Policies

- From defense perspective, standards flexible enough to facilitate negotiation
- But if policy is rigidly enforced, likely fewer settlements and more litigation
  - Forcing admissions may remove incentive to settle
  - Settlement with SEC historically more financially onerous: companies willing to pay more to avoid admissions
  - Admissions may give private litigants the benefit of collateral estoppel

Source: Marc Fagel, *The SEC's Troubling New Policy Requiring Admissions*, 45 Sec. Reg. & L. Rep. 1172 (2013).

Changing Settlement Policies

- Neither-admit-nor-deny settlement policy is still default
- Admissions only to be sought in highly publicized, controversial cases
- Since policy was announced, seven defendants have admitted facts or guilt as part of settlement

Source: *SEC Announces Enforcement Results for FY 2013*, SEC.gov (Dec. 17, 2013); Fagel, 45 Sec. Reg. & L. Rep. 1172.

Changing Settlement Policies

- The future of the admissions requirement is unclear
- Second Circuit just overturned noted decision rejecting *Citigroup* settlement:
  - "Trials are primarily about the truth. Consent decrees are primarily about pragmatism."
  - District Court must approve agency's proposed consent judgment if it is "fair and reasonable, with the additional requirement that the 'public interest would not be disserved'."
  - "Fair and reasonable" factors (non-exclusive): (1) basic legality; (2) clarity of terms; (3) actual resolution of complaint's claims; (4) freedom from collusion or corruption.

Source: *United States Securities & Exchange Comm'n v. Citigroup Global Markets, Inc.*, Nos. 11-5227-cv(L); 11-5375-cv(con); 11-5242-cv(xap) (2nd Cir. June 4, 2014) (Slip op).

Philip Falcone, Harbinger Capital

- Falcone used $113 million in fund assets for personal purposes (including payment of his personal taxes)
- Secretly favored redemption requests of certain large investors at the expense of other customers
- Conducted improper short squeeze in bonds

Source: *Philip Falcone and Harbinger Capital Agree to Settlement*, SEC.gov, August 19, 2013

Philip Falcone, Harbinger Capital

- Settlement
  - Falcone
    - $6,507,574 in disgorgement; $1,013,140 in prejudgment interest; $4,000,000 penalty
    - Barred from association with investment industry for at least five years
  - Harbinger: $6,500,000 penalty

- Admissions
  - Embezzlement
  - Favored certain large investors in particular fund without disclosing to board and other investors
  - Manipulated bond prices

Source: *Philip Falcone and Harbinger Capital Agree to Settlement*, SEC.gov, August 19, 2013

JPMorgan Chase: London Whale Trading Loss

- Two former traders charged with committing fraud to hide losses in Chief Investment Office (CIO)
- Settlement
  - $200 million penalty
  - Public acknowledgment of violation of federal securities laws

JPMorgan Chase: London Whale Trading Loss

- Admissions
  - Deficient accounting controls in CIO
  - Senior management rewrote CIO's valuation control policies before firm filed first quarter report for 2012 with SEC
  - Certain positions in CIO book much less valuable than CIO traders asserted
  - Management did not adequately update audit committee, hindered committee's capacity to ensure accurate financial statements

Source: *JPMorgan Chase Agrees to Pay $200 Million and Admits Wrongdoing to Settle SEC Charges*, SEC.gov, September 19, 2013

Credit Suisse: Unregistered Services

- Credit Suisse provided brokerage and advisory services to U.S. clients without registering with SEC or associating with registered entity
- Firm managers solicited clients, offered investment advice, and induced securities transactions in U.S.
- Collected fees of approximately $82 million

Source: *Credit Suisse Agrees to Pay $196 Million and Admits to Wrongdoing in Providing Unregistered Services to U.S. Clients*, SEC.gov, February 21, 2014

Credit Suisse: Unregistered Services

- Settlement
  - $82,170,990 in disgorgement
  - $64,340,024 in prejudgment interest
  - $50,000,000 penalty
  - Accepted censure and cease-and-desist order
  - Agreed to retain independent consultant
- Admissions
  - Accuracy of facts in SEC order
  - Conduct violated federal securities laws, including willful violation of Section 15(a) of Exchange and Section 203(a) of Investment Advisers Act of 1940

Source: *Credit Suisse Agrees to Pay $196 Million and Admits to Wrongdoing in Providing Unregistered Services to U.S. Clients*, SEC.gov, February 21, 2014

ConvergEx Subsidiaries: Deception

- Brokerage subsidiaries charged institutional clients higher rates for execution of orders than disclosed
- Settlement
  - $87,424,429 in disgorgement and prejudgment interest
  - $20,000,000 penalty (amount reduced in recognition of company's cooperation after investigation was initiated)
- Admissions
  - Accuracy facts underlying SEC's charges
  - Conduct violated federal securities laws, including Sections 10(b) and 15(c) of Exchange Act

Source: *SEC Charges ConvergEx Subsidiaries With Fraud for Deceiving Customers About Commissions*, SEC.gov, December 18, 2013

ConvergEx: Deception

- Two insiders also charged
  - Both cooperated in investigation, admitted wrongdoing
  - Paid disgorgement and prejudgment interest of $1,111,550 and $117,042, respectively

Source: *SEC Charges ConvergEx Subsidiaries With Fraud for Deceiving Customers About Commissions*, SEC.gov, December 18, 2013

Lions Gate: Failure to Disclose Hostile Takeover Defense

- Management issued millions of shares to friendly director to defeat hostile tender offer

- Did not disclose that issuance was part of defensive strategy to entrench management's control
  - Stated in SEC filings that transactions were part of previously announced debt-reduction plan – but no such announcement had taken place
  - Did not disclose extent to which transaction was designed to benefit friendly director; represented that transactions were not prearranged

Source: *SEC Charges Lions Gate With Disclosure Failures While Preventing Hostile Takeover*, SEC.gov, March 13, 2014

Lions Gate: Failure to Disclose Hostile Takeover Defense

- Paid $7.5 million
- Admissions
  - There was no prior announcement of debt reduction plan
  - Amended insider trading policy to allow director to convert his notes into stock
  - Approved director's last-minute request to change conversion price
  - Allowed director to review term sheet and exchange agreement before providing them to note holder
  - Failed to disclose that transaction gave friendly director an almost 9% interest in the company

Source: *SEC Charges Lions Gate With Disclosure Failures While Preventing Hostile Takeover*, SEC.gov, March 13, 2014

Scottrade: Flawed "Blue Sheet" Trading Data

- SEC charged Scottrade with failing to provide complete and accurate information about trades done by firm and its customers
- $2.5 million penalty
- Scottrade admitted violations of recordkeeping provisions of federal securities laws

Source: *Scottrade Agrees to Pay $2.5 Million and Admits Providing Flawed "Blue Sheet" Trading Data*, SEC.gov, January 29, 2014

The Wyly Brothers' Attorney

- SEC alleged thirteen year fraud to conceal sale of $750 million in stock
- Use of offshore trusts, subsidiary companies (including Michael's arts and crafts stores)
- Brothers' former attorney paid $795,000 and admitted assistance in fraud

Source: Nate Raymond, *Wyly brothers' ex-lawyer settles SEC fraud case, admits errors*, Reuters (March 20, 2014), *available at* http://www.reuters.com/article/2014/03/20/us-sec-wyly-lawyer-idUSBREA2J2A020140320

The (Continued) Rise of the Whistleblower

- SEC paid nearly $15 million to whistleblowers in FY 2013 (compared to $46,000 in FY 2012)
  - Most of this (more than $14 million) paid to one whistleblower
- 3,238 tips received from whistleblowers (up from 3,001 in FY 2012)
- 188 notices of covered action
  - Of these, four resulted in payments to whistleblowers

Source: SEC Office of the Whistleblower, *2013 Annual Report to Congress on the Dodd-Frank Whistleblower Program*, SEC.gov

The (Continued) Rise of the Whistleblower

- In FY 2013, whistleblower submissions came from:
  - All fifty states, the District of Columbia, Puerto Rico, Guam, and the U.S. Virgin Islands
  - California, New York, and Florida yielded most tips
- Most common complaint categories:
  - Corporate Disclosures and Financials: 17.2%
  - Offering Fraud: 17.1%
  - Manipulation: 16.2%

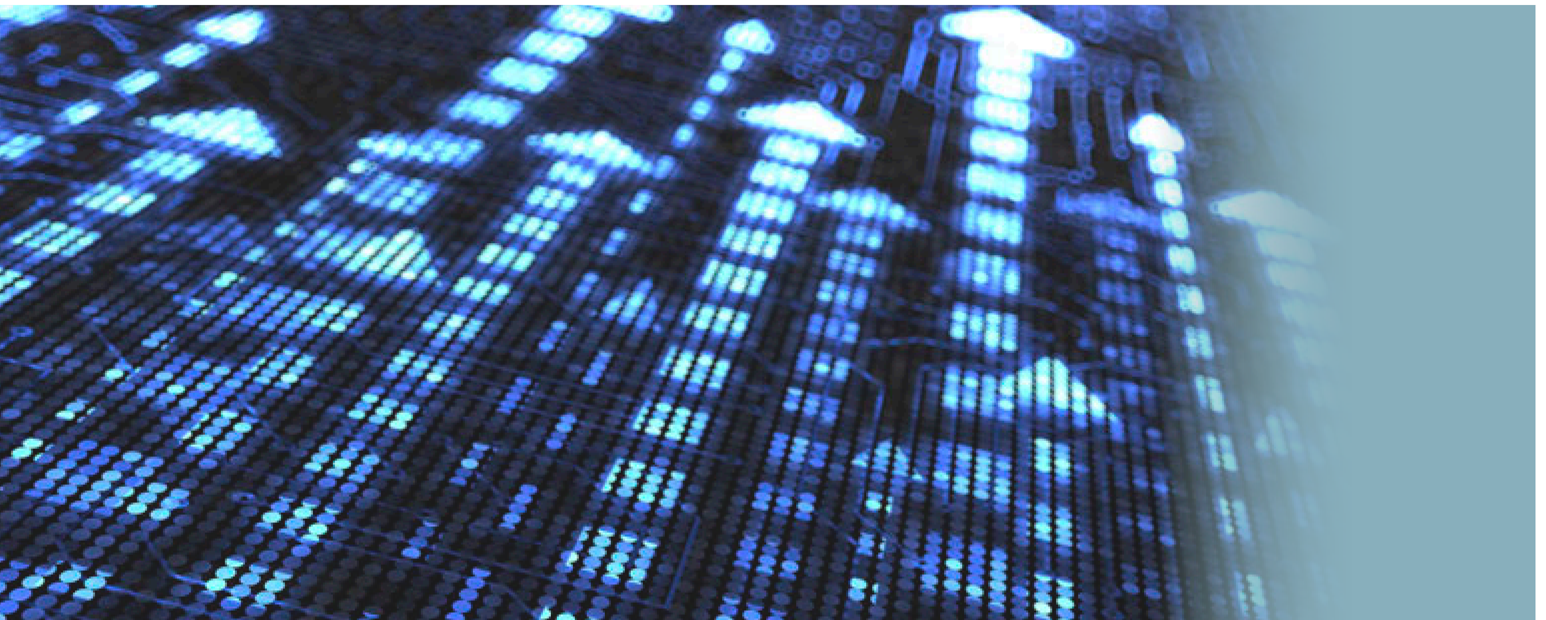
Source: SEC Office of the Whistleblower, *2013 Annual Report to Congress on the Dodd-Frank Whistleblower Program*, SEC.gov

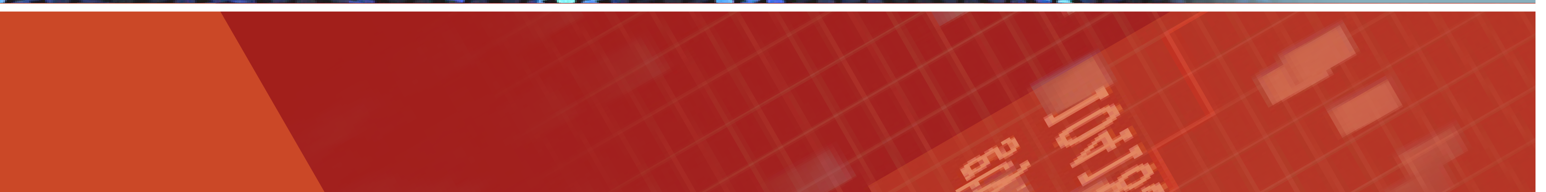
CORNERSTONE RESEARCH

ECONOMIC AND FINANCIAL CONSULTING AND EXPERT TESTIMONY

Securities Class Action Settlements

2013 Review and Analysis





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HIGHLIGHTS

- Total settlement dollars in 2013 increased substantially—46 percent over 2012 and 60 percent above the average for the prior five years. (page 3)
- There were 67 settlements in 2013 (up from 57 in 2012), the first year-over-year increase since 2009. (page 3)
- Mega settlements pushed settlement dollars up in 2013, accounting for 84 percent of total settlement dollars, the second highest proportion in the last decade. (page 4)
- While mega settlements drove up the 2013 average settlement amount, the median settlement amount declined, reflecting a reduction in the size of more typical cases. (page 5)
- For 2013, the median “estimated damages” declined 48 percent from 2012 and is 17.5 percent lower than the median for post–Reform Act settlements in the prior five years. Since “estimated damages” are the most important factor in determining settlement amounts, this decline was likely a major factor contributing to the substantially lower median settlement in 2013 compared with 2012. (page 7)
- The proportion of settled cases in 2013 involving accounting allegations dipped to a ten-year low, but the settlement as a percentage of “estimated damages” for these cases was much higher than for cases not involving such allegations. (page 13)
- The median settlement in 2013 for cases with a public pension as a lead plaintiff was \$23 million, compared with \$3 million for cases without a public pension as a lead plaintiff. (page 15)
- New analyses reveal that settlements of \$50 million or lower are far less likely to involve accompanying SEC actions or a public pension as a lead plaintiff. (page 18)

FIGURE 1: **SETTLEMENT STATISTICS**

(Dollars in Millions)

	2013	1996–2012
Minimum	$0.7	$0.1
Median	$6.5	$8.3
Average	$71.3	$55.5
Maximum	$2,425.0	$8,358.2
Total Amount	$4,773.9	$73,740.2

Note: Settlement dollars adjusted for inflation; 2013 dollar equivalent figures used.

DEVELOPING TRENDS

The year 2013 saw the highest total dollar value of settlements approved over the last six years. This was due in part to an uptick in the number of cases settled (compared with the prior two years), as well as the relatively high average shareholder losses associated with cases settled in 2013 (the second highest in the last six years). The surrounding economic events are an important backdrop to understanding the settlement trends.

Settlement sizes in 2013 were affected by the resolution of a number of credit crisis cases, which tend to involve relatively large settlement amounts and related investor losses. Pharmaceutical industry sector settlements also contributed to the overall increase.

At the opposite end of the settlement spectrum were settlements of Chinese reverse merger cases. These matters tend to be relatively small. According to *Securities Class Action Filings—2013 Year in Review* released earlier this year by Cornerstone Research, the majority of these cases were filed in 2011 and thus, not surprisingly, a relatively large number (14 cases) were settled in 2013. All but one of these settlements were for amounts less than $10 million.

Despite record enforcement activity by the SEC in the last couple of years, there has not been an increase in securities class action settlements accompanied by SEC actions. This is due in part to the potential lag between the underlying class action settlement and resolution of activity commenced by the SEC. Furthermore, the SEC's enforcement activity includes matters outside the scope of this research. Nevertheless, it is possible there will be an increase in securities class actions accompanied by disclosure-related SEC enforcement actions in the future.

In addition, securities class action filings (i.e., new cases) involving Rule 10b-5, Section 11, and/or Section 12 allegations have been relatively high over the last few years, including a surge in the second half of 2013 (see *Securities Class Action Filings—2013 Year in Review*). Thus, it is unlikely there will be any significant decline in the overall number of cases settled in upcoming years.

Looking ahead, it would be remiss not to mention the *Halliburton Co. v. Erica P. John Fund* matter currently before the U.S. Supreme Court. As has been widely discussed, the case challenges the fraud-on-the-market presumption that was established in 1988 through *Basic Inc. v. Levinson*. The suit has the potential to dramatically affect the entire landscape surrounding securities class actions, including issues that are the focus of this report, such as the damages associated with securities cases, the progression of these cases through the litigation process, and ultimately, the settlement amounts involved.

This report analyzes a sample of securities class actions filed after passage of the Private Securities Litigation Reform Act of 1995 (Reform Act) and settled from 1996 through year-end 2013, and explores a variety of factors that influence settlement outcomes. This study focuses on cases alleging fraudulent inflation in the price of a corporation's common stock (i.e., excluding cases with alleged classes of only bondholders, preferred stockholders, etc., and excluding cases alleging fraudulent depression in price). See page 24 for a detailed description of the research sample.

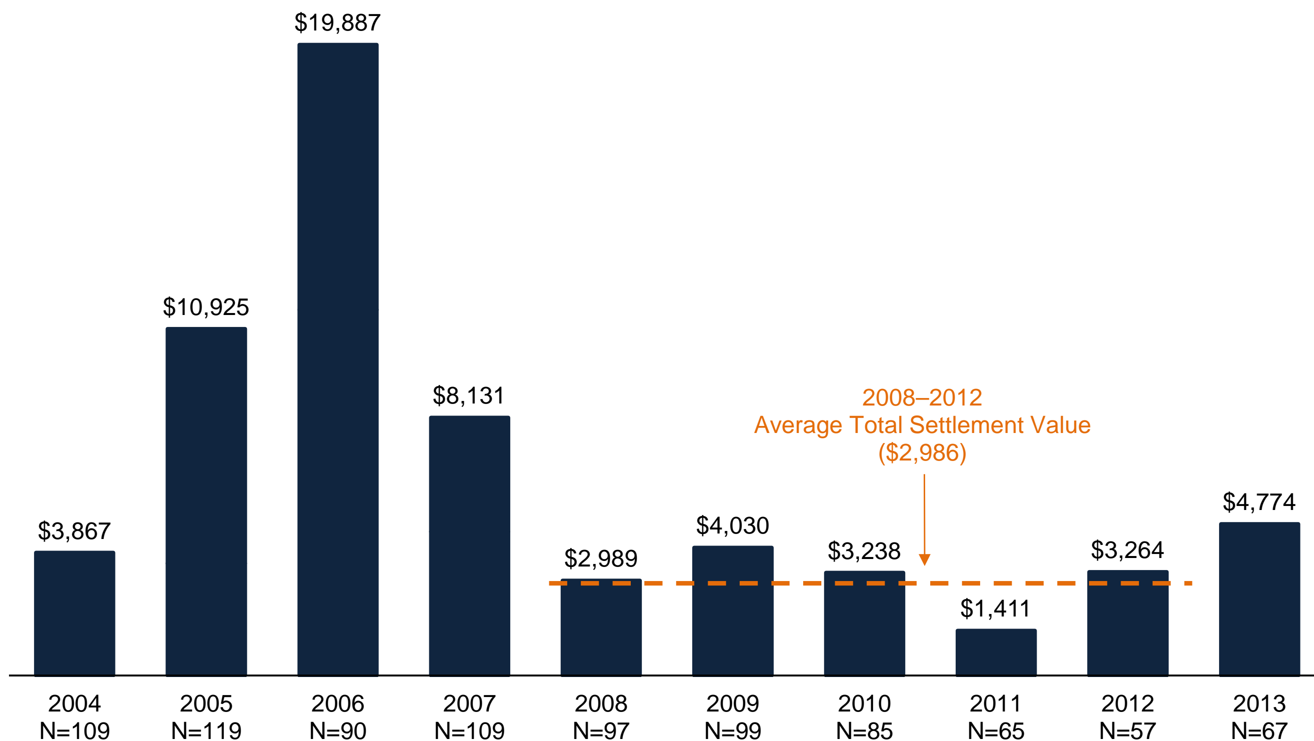
NUMBER AND SIZE OF SETTLEMENTS

TOTAL SETTLEMENT DOLLARS

- In 2013, there were 67 court-approved settlements, a 17.5 percent increase from 2012 and a reversal of the year-over-year decline in the number of settlements observed since 2009.
- The increase in the number of settlements is likely due, in part, to increased securities class action filings during 2010 through 2012.[1] (*See* page 19 for a related discussion of time from filing to settlement.)
- The increase in total settlement dollars in 2013 was largely driven by six mega settlements (settlements at or above $100 million).

Total settlement dollars in 2013 increased 46 percent over 2012.

FIGURE 2: **TOTAL SETTLEMENT DOLLARS**
2004–2013
(Dollars in Millions)



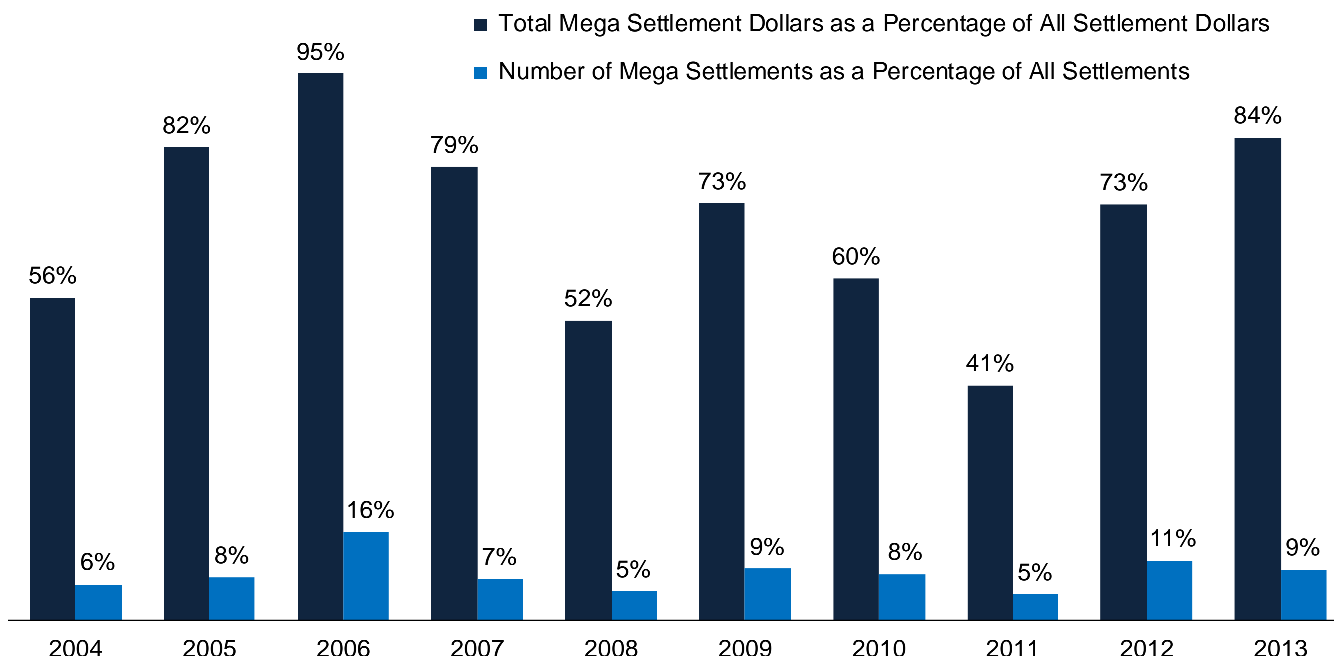
Note: Settlement dollars adjusted for inflation; 2013 dollar equivalent figures used.

MEGA SETTLEMENTS

- The percentage of settlement dollars from mega settlements (settlements at or above $100 million) was the second highest proportion in the last ten years.
- As noted, there were six mega settlements in 2013, including one settlement for more than $2 billion. The remaining five cases settled for between $150 million and $600 million.
- Three mega settlements involved pharmaceutical companies, and three involved financial institutions.

In 2013, six settlements accounted for 84 percent of total settlement dollars.

FIGURE 3: **MEGA SETTLEMENTS**
2004–2013

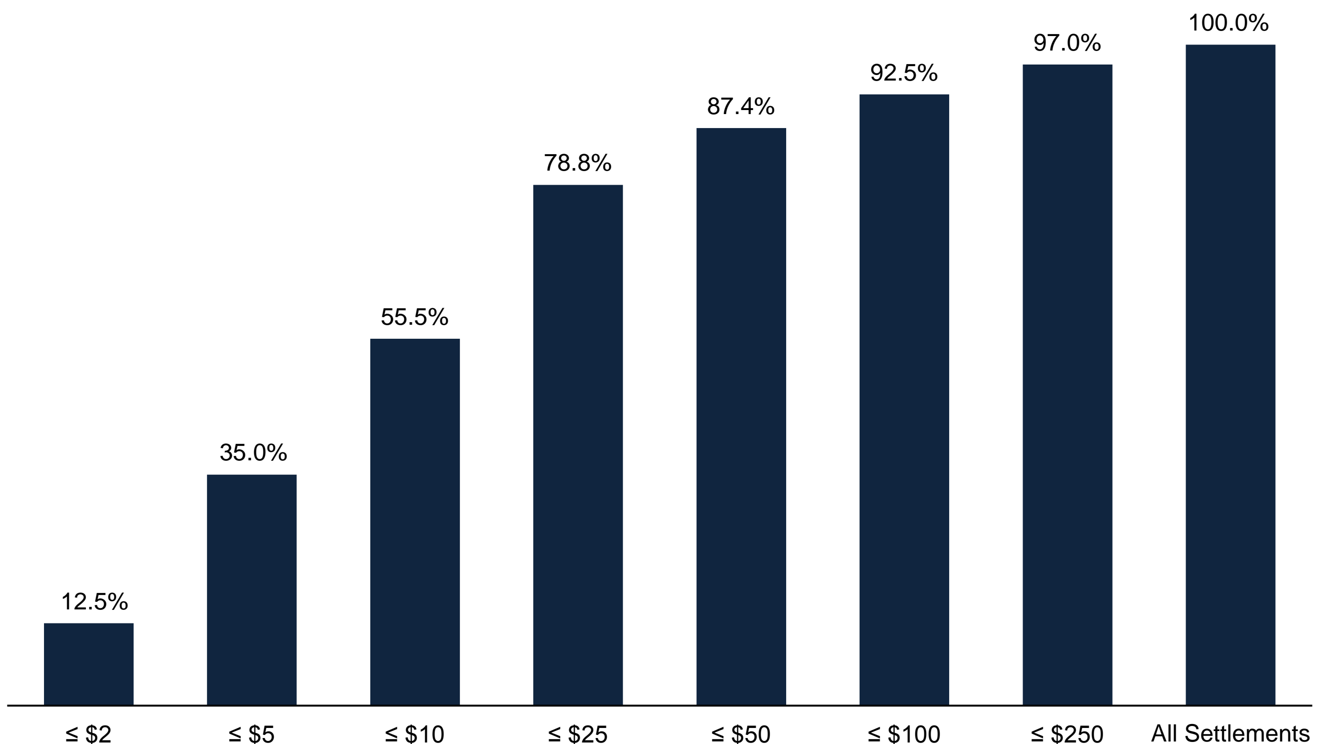


SETTLEMENT SIZE

- In 2013, the settlement size in approximately 60 percent of settled cases was $10 million or less, slightly higher than the cumulative ten-year percentage of about 56 percent.
- This high number of smaller settlements contributed to a 37 percent decline in the median settlement size in 2013 compared with 2012 ($6.5 million in 2013 versus $10.3 million in 2012).
- Roughly 32 percent of settlements less than $10 million in 2013 were for cases involving Chinese reverse mergers.[2]
- A total of 44 cases related to the subprime credit crisis are included in this study.[3] The median settlement for credit crisis–related cases was $30 million and the average settlement was over $140 million. These cases generally settle for higher amounts compared to cases not associated with the credit crisis.

The vast majority of securities class actions settle for less than $50 million.

FIGURE 4: **CUMULATIVE TEN-YEAR SETTLEMENT DISTRIBUTION**
2004–2013
(Dollars in Millions)



Note: Settlement dollars adjusted for inflation; 2013 dollar equivalent figures used.

SETTLEMENT SIZE *continued*

- Overall, 50 percent of post–Reform Act cases have settled for between $3.6 million and $20.6 million.
- Despite recent swings in annual median settlements, the range of settlement values between the 25th and 75th percentiles, with few exceptions, has fluctuated moderately with no discernible trend.

Annual median settlement values have ranged between $6 and $12 million in recent years.

FIGURE 5: **SETTLEMENT PERCENTILES**
(Dollars in Millions)

Year	Average	10th	25th	Median	75th	90th
1996–2013	$42.0	$1.7	$3.6	$8.1	$20.6	$70.6
2013	$71.3	$1.9	$3.0	$6.5	$21.5	$79.5
2012	$57.3	$1.3	$2.8	$10.3	$35.5	$110.6
2011	$21.7	$1.9	$2.6	$6.0	$18.6	$43.3
2010	$38.1	$2.1	$4.5	$12.0	$26.7	$85.0
2009	$40.7	$2.6	$4.2	$8.7	$21.7	$72.1

Note: Settlement dollars adjusted for inflation; 2013 dollar equivalent figures used.

DAMAGES ESTIMATES AND MARKET CAPITALIZATION LOSSES

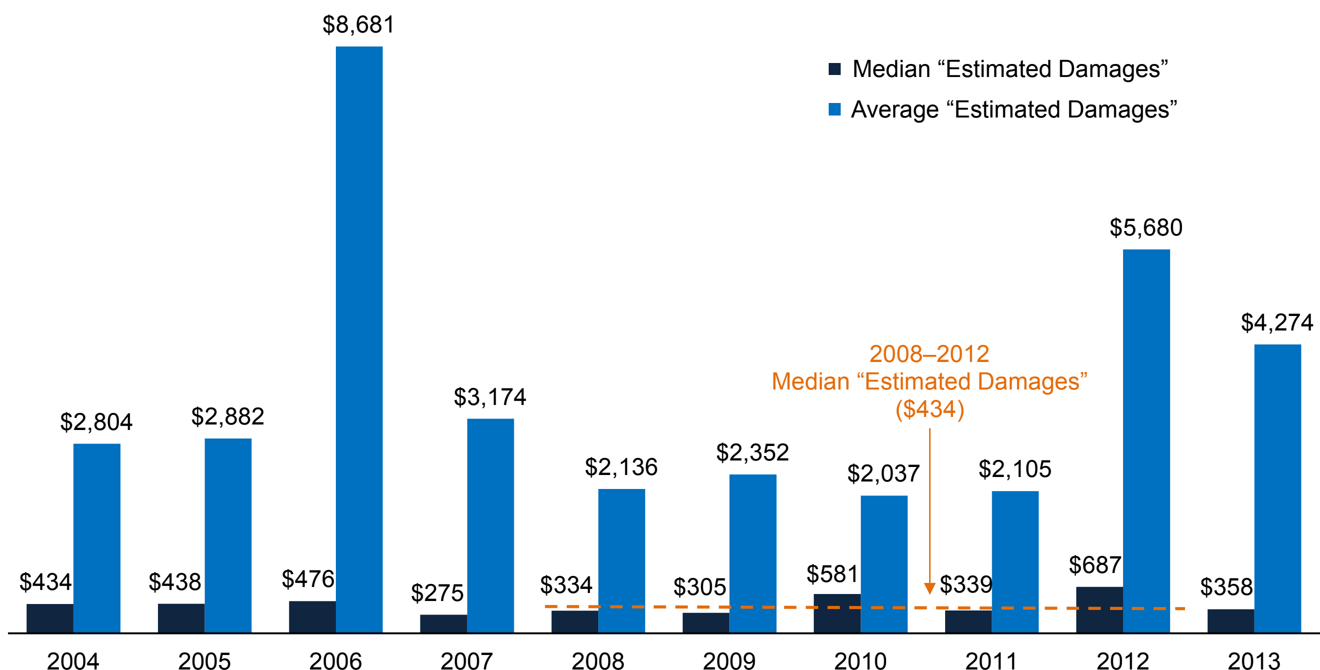
"ESTIMATED DAMAGES"

For purposes of this research and prior Cornerstone Research reports on securities class action settlements, these analyses use simplified calculations of shareholder losses, referred to as "estimated damages." Application of this consistent method allows for the identification and analysis of potential trends. "Estimated damages" are not necessarily linked to the allegations included in the associated court pleadings.[4] Accordingly, damages estimates presented in this report are not intended to be indicative of actual economic damages borne by shareholders.

Median "estimated damages" for 2013 declined 48 percent from 2012.

- Average "estimated damages" for 2013 were the third highest in the post–Reform Act era, due in part to a small number of extremely large cases, two of which related to the credit crisis.
- The decline in median "estimated damages" was likely a major factor contributing to the substantially lower median settlement in 2013 relative to 2012.[5]

FIGURE 6: **MEDIAN AND AVERAGE "ESTIMATED DAMAGES" 2004–2013**
(Dollars in Millions)



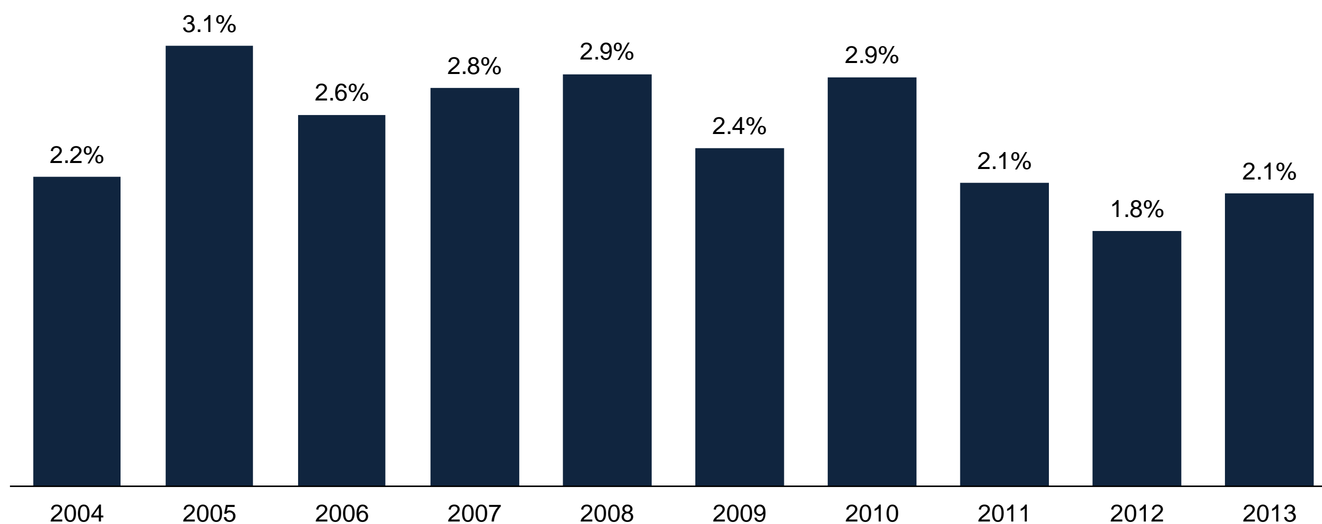
Note: "Estimated damages" are adjusted for inflation based on class period end dates.

"ESTIMATED DAMAGES" *continued*

- In 2013, the median settlement as a percentage of "estimated damages" rebounded slightly from a historic low of 1.8 percent in 2012.
- Median settlements as a percentage of "estimated damages" remained relatively low compared to levels observed over the past decade. Two factors contributed to this: the increased number of extremely large cases and the presence of credit crisis cases.
  - Traditionally, cases with large "estimated damages" have settled for a smaller proportion of those damages.
  - For credit crisis cases settled in 2013, the median settlement as a percentage of "estimated damages" was 0.7 percent, compared with 2.3 percent for all other cases settled in 2013.

Settlements as a percentage of "estimated damages" observed over the last three years are the lowest in the past decade.

FIGURE 7: **MEDIAN SETTLEMENTS AS A PERCENTAGE OF "ESTIMATED DAMAGES" 2004–2013**



"ESTIMATED DAMAGES" *continued*

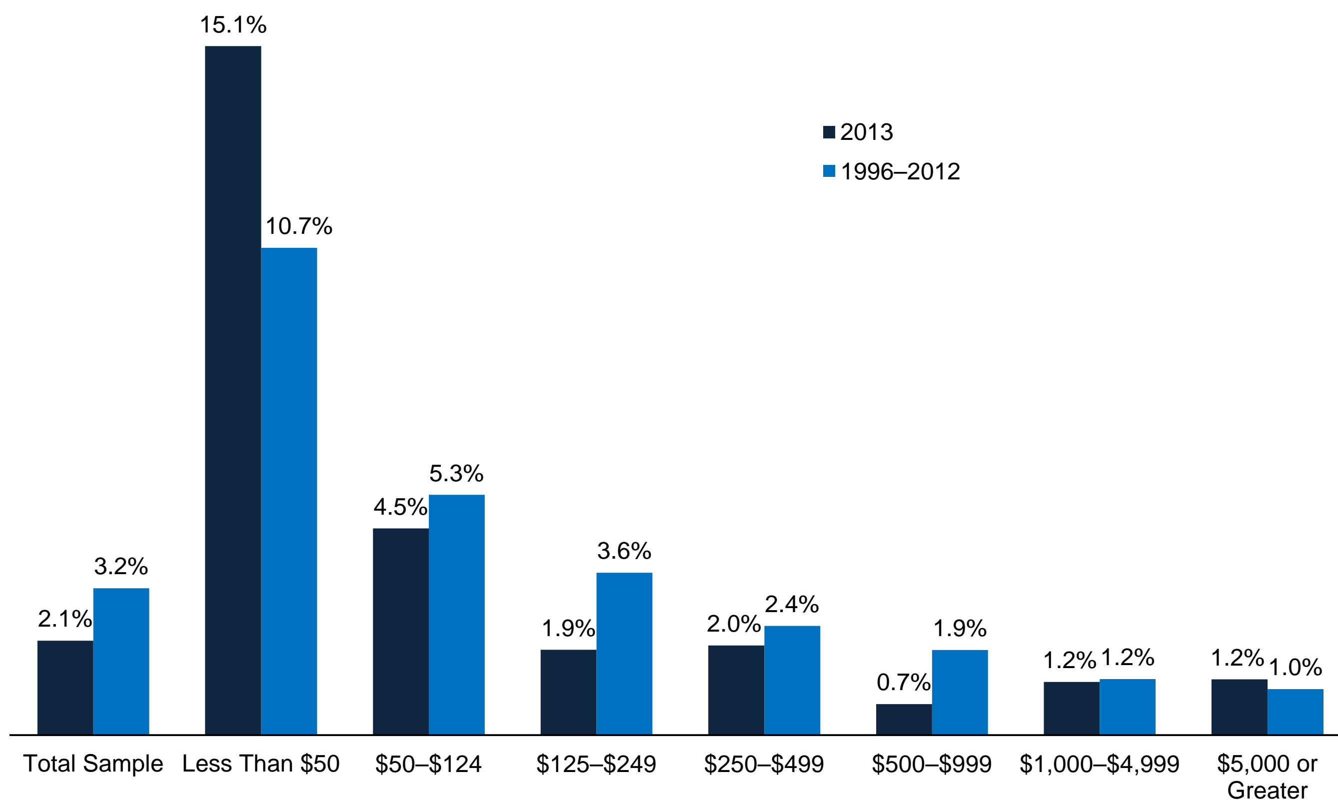
- Settlement amounts are generally larger when "estimated damages" are larger. Yet, as previously mentioned, settlements as a percentage of "estimated damages" tend to be smaller when "estimated damages" are larger.
- In 2013, relatively small cases—those with "estimated damages" of less than $50 million—had a median settlement as a percentage of "estimated damages" of 15.1 percent, compared with 2.1 percent for all 2013 settlements.

In 2013, smaller cases settled at a much higher percentage of "estimated damages."

FIGURE 8: **MEDIAN SETTLEMENTS AS A PERCENTAGE OF "ESTIMATED DAMAGES" BY DAMAGES RANGES**

1996–2013

(Dollars in Millions)



DISCLOSURE DOLLAR LOSS

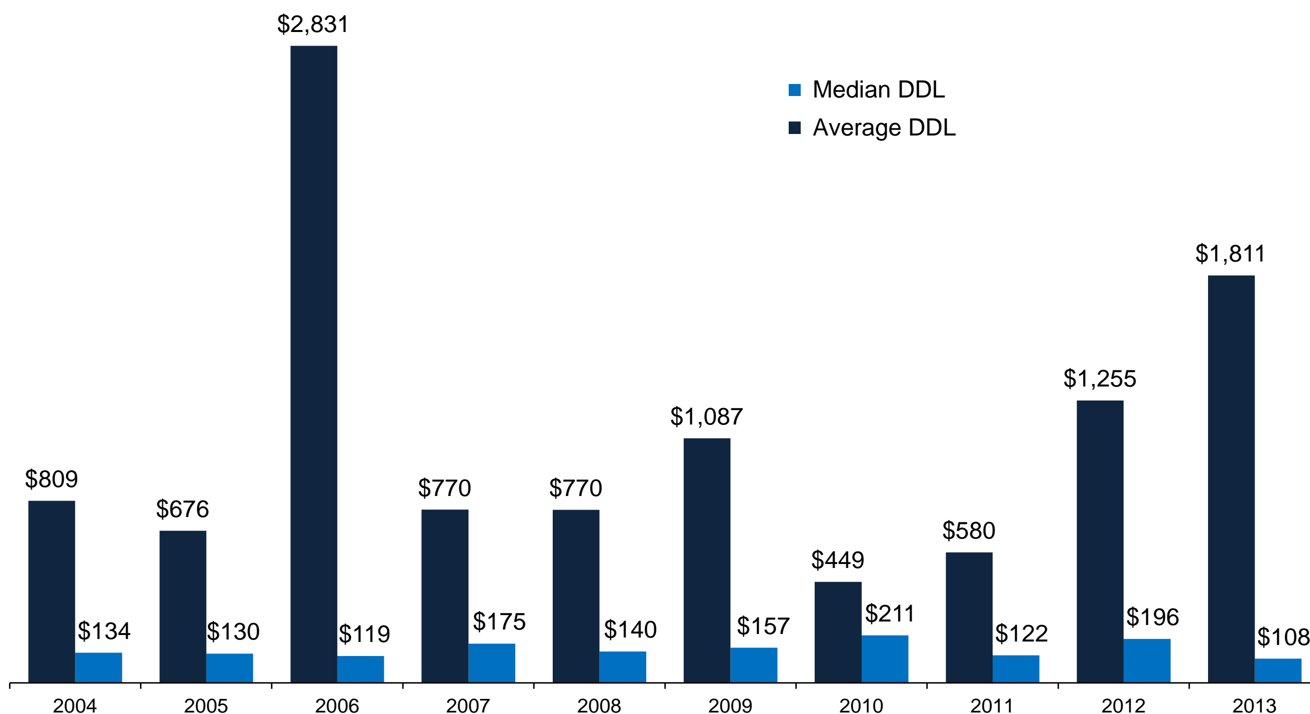
Disclosure Dollar Loss (DDL) is another simplified measure of shareholder losses and an alternative measure to "estimated damages." DDL is calculated as the decline in the market capitalization of the defendant firm from the trading day immediately preceding the end of the class period to the trading day immediately following the end of the class period.[6]

- In contrast to the median DDL, average DDL increased 44 percent from 2012 to $1.8 billion, reflecting the influence of a few very large cases.
- The median market capitalization at the time of settlement for issuers in the top 10 percent of DDL was dramatically higher than the median market capitalization for the next tier of DDL ($133.8 billion compared with $9.2 billion).
- The relationship between settlements and DDL is similar to that between settlements and "estimated damages"—settlements are larger when DDL is larger, yet settlements as a percentage of DDL are generally smaller when DDL is larger.

The median DDL associated with settled cases in 2013 decreased 45 percent from 2012.

FIGURE 9: **MEDIAN AND AVERAGE DISCLOSURE DOLLAR LOSS 2004–2013**

(Dollars in Millions)



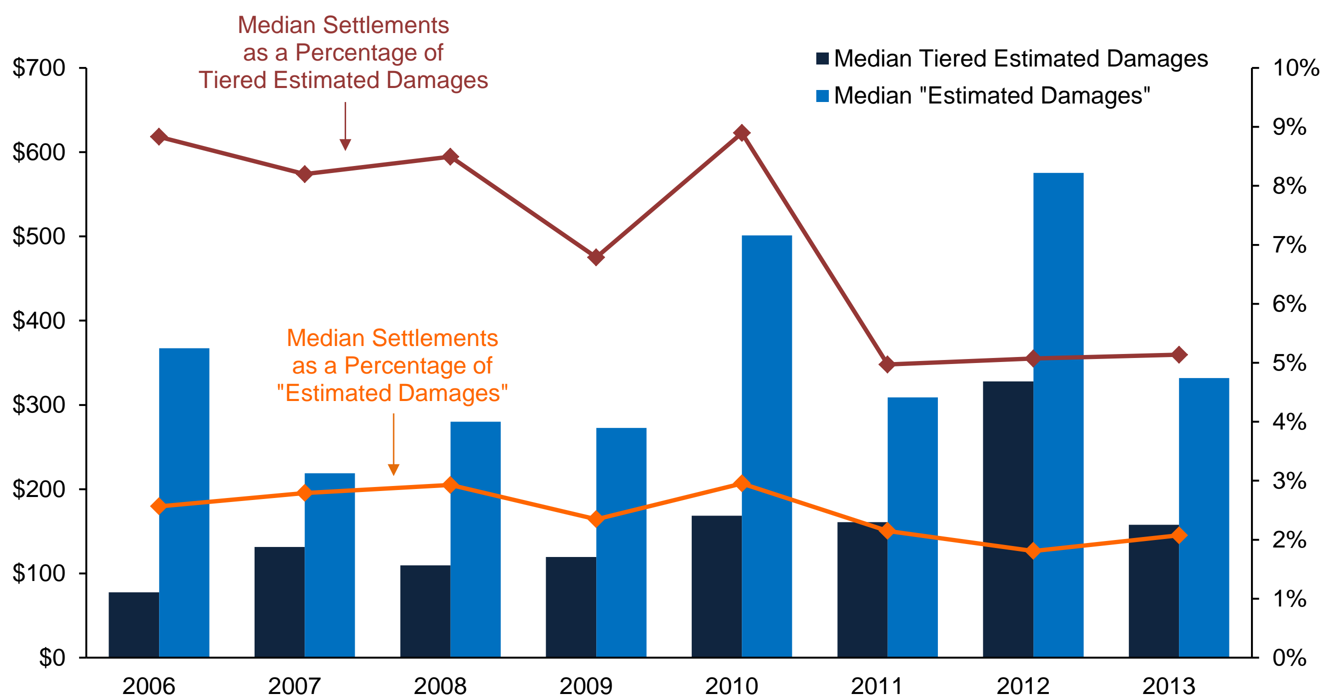
Note: DDL adjusted for inflation based on class period end dates.

TIERED ESTIMATED DAMAGES

The landmark decision in 2005 by the U.S. Supreme Court in *Dura Pharmaceuticals Inc. v. Broudo* (*Dura*) determined that plaintiffs must show a causal link between alleged misrepresentations and the subsequent actual losses suffered by plaintiffs. As a result of this decision, damages cannot be associated with shares sold before information regarding the alleged fraud reaches the market. Accordingly, this report considers the influence of *Dura* on securities class action damages calculations by exploring an alternative measure of damages in settlements research. This alternative measure, referred to here as tiered estimated damages, is based on the stock-price drops on alleged corrective disclosure dates as described in the plan of allocation for the settlement.[7] It utilizes a single value line when there is only one alleged corrective disclosure date (at the end of the class period) or a tiered value line when there are multiple alleged corrective disclosure dates.

This alternative measure has been calculated for a subsample of cases settled after 2005. As noted in past reports, tiered estimated damages has not yet surpassed the traditional measure of "estimated damages" used in this series of reports in terms of its power as a predictor of settlement outcomes. However, it is highly correlated with settlement amounts and provides an alternative measure of investor losses for more recent securities class action settlements.

FIGURE 10: **TIERED ESTIMATED DAMAGES**
2006–2013
(Dollars in Millions)



ANALYSIS OF SETTLEMENT CHARACTERISTICS

NATURE OF CLAIMS

- The number of cases settled in 2013 involving only Section 11 and/or Section 12(a)(2) claims is consistent with the increased activity in the U.S. IPO market in recent years.[8] There were eight such cases in 2013 compared with only four in 2012.
- The median settlement as a percentage of "estimated damages" is higher for cases involving only Section 11 and/or Section 12(a)(2) claims compared with cases involving only Rule 10b-5 claims.

"Estimated damages" are typically smaller for cases involving only Section 11 and/or Section 12(a)(2) claims.

FIGURE 11: **SETTLEMENTS BY NATURE OF CLAIMS**
1996–2013
(Dollars in Millions)

	Number of Settlements	Median Settlements	Median "Estimated Damages"	Median Settlements as a Percentage of "Estimated Damages"
Section 11 and/or 12(a)(2) Only	80	$3.4	$46.7	7.4%
Both Rule 10b-5 and Section 11 and/or 12(a)(2)	246	$11.7	$402.3	3.4%
Rule 10b-5 Only	1,049	$6.8	$272.2	2.9%
All Post–Reform Act Settlements	1,376	$7.0	$257.1	3.1%

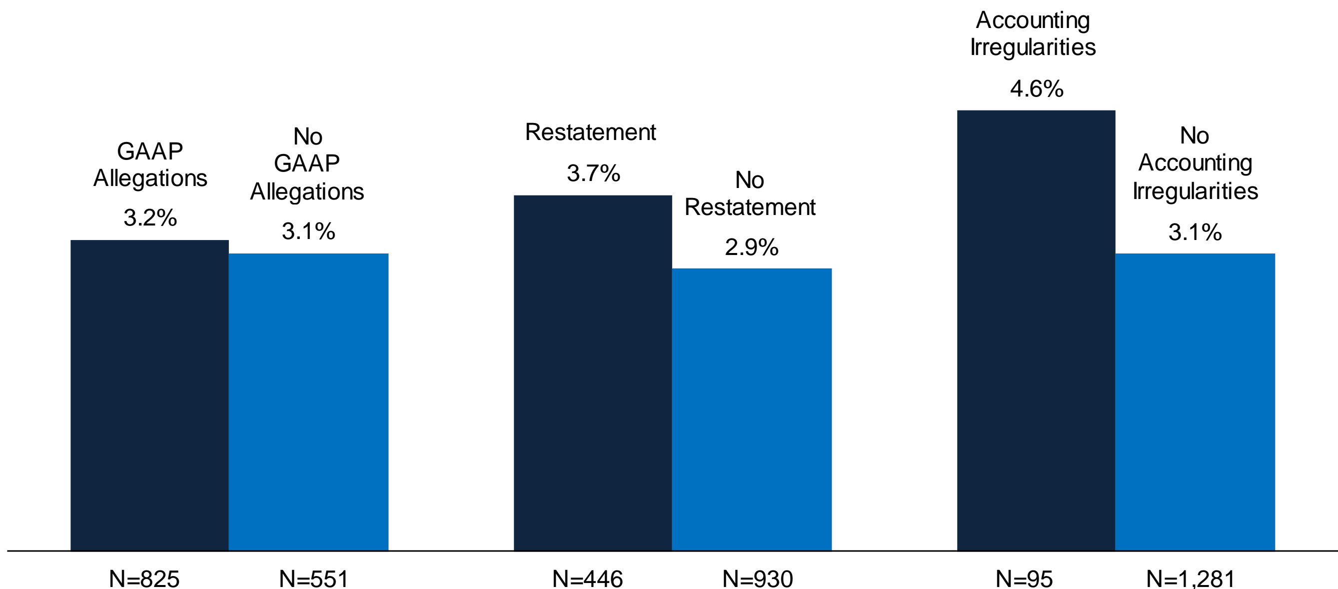
ACCOUNTING ALLEGATIONS

This research examines three types of accounting allegations among settled cases: (1) alleged GAAP violations, (2) restatements, and (3) reported accounting irregularities.[9]

- Cases involving accounting allegations are typically associated with higher settlement amounts and higher settlements as a percentage of "estimated damages."
- Cases alleging GAAP violations settled for only a slightly higher percentage of "estimated damages" than cases not alleging GAAP violations.
- Restatement cases settled for a higher percentage of "estimated damages" compared with GAAP cases not involving restatements.
- In 2013, 55 percent of settled cases alleged GAAP violations, 21 percent were associated with restatements, while only 4 percent involved reported accounting irregularities.
- Although relatively few settlements in 2013 involved reported accounting irregularities, these cases settled for a much larger percentage of "estimated damages" compared with cases not involving accounting irregularities.

The proportion of settled cases in 2013 involving accounting allegations dipped to a ten-year low.

FIGURE 12: **MEDIAN SETTLEMENTS AS A PERCENTAGE OF "ESTIMATED DAMAGES" AND ACCOUNTING ALLEGATIONS**
1996–2013

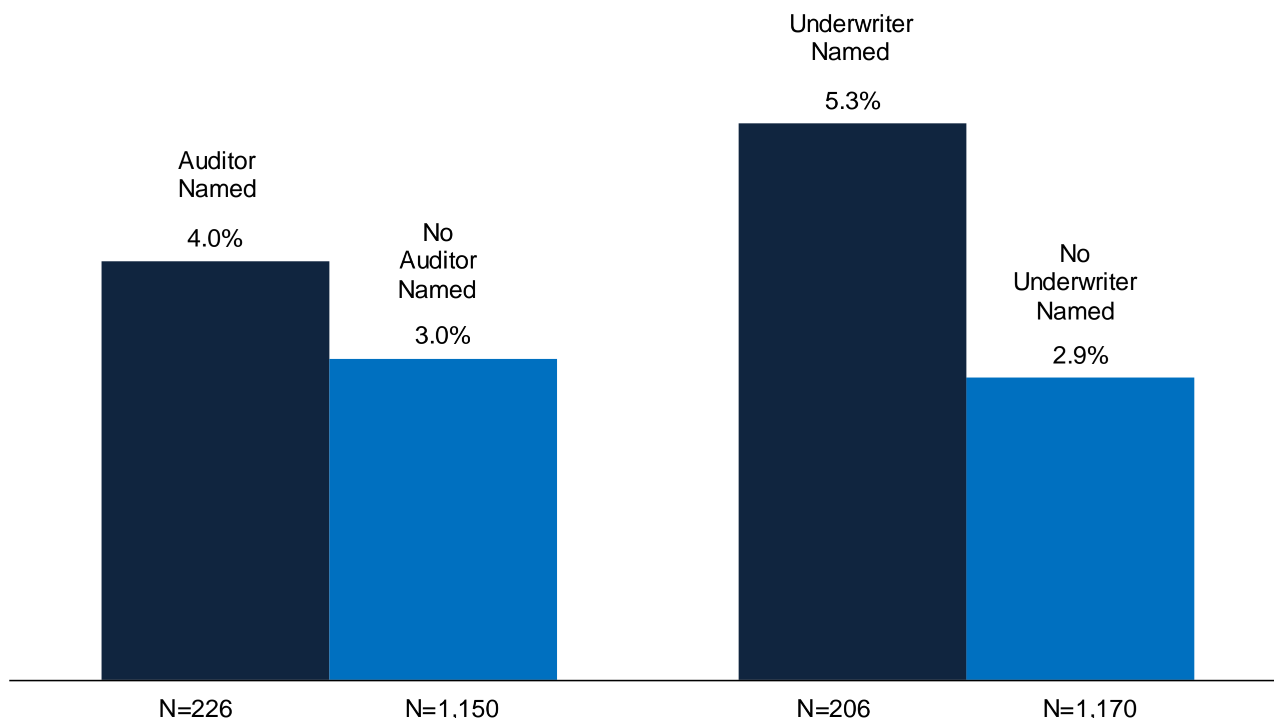


THIRD-PARTY CODEFENDANTS

- Third parties, such as an auditor or an underwriter, are often named as codefendants in larger, more complex cases and provide an additional source of settlement funds.
- Outside auditor defendants are often associated with cases involving restatements of financial statements or alleged GAAP violations, while the presence of underwriter defendants is highly correlated with the inclusion of Section 11 claims.
- In 2013, 32 percent of accounting-related cases had a named auditor defendant, while 76 percent of cases with Section 11 claims had a named underwriter defendant.

Cases with third-party codefendants have higher settlements as a percentage of "estimated damages."

FIGURE 13: **MEDIAN SETTLEMENTS AS A PERCENTAGE OF "ESTIMATED DAMAGES" AND THIRD-PARTY CODEFENDANTS**
1996–2013

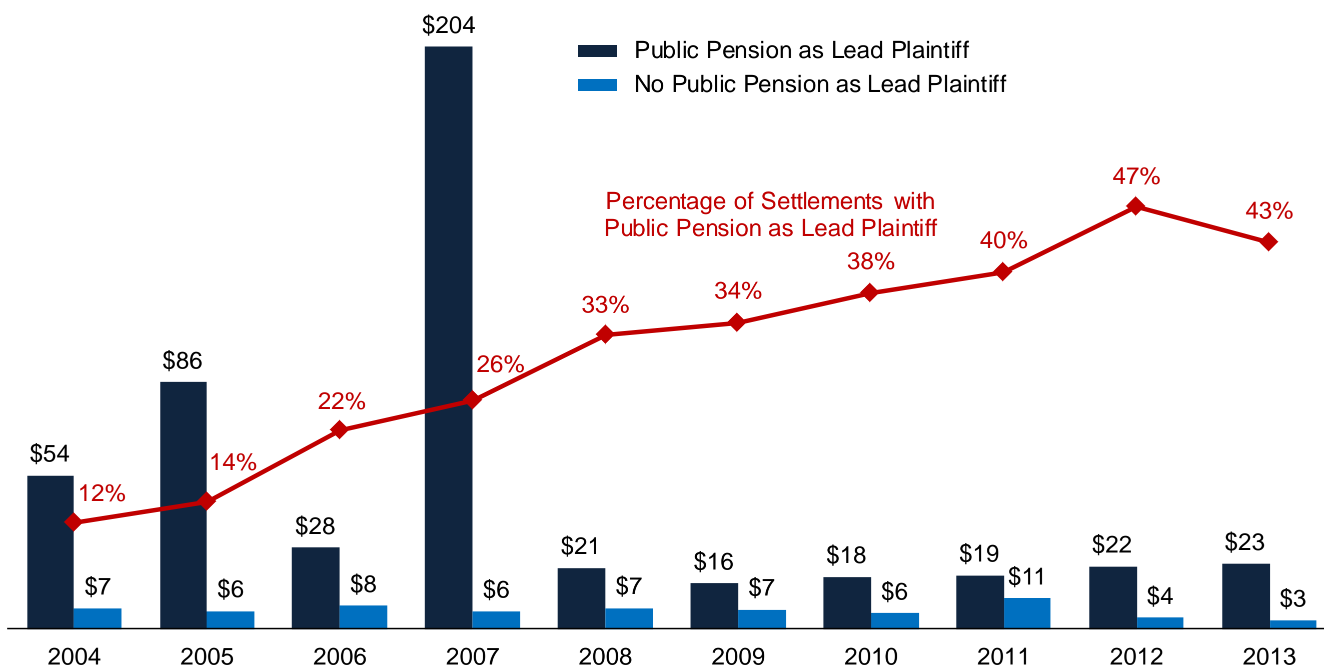


INSTITUTIONAL INVESTORS

- Since 2006, more than half of the settlements in any given year have involved institutional investors as lead plaintiffs.
- Among institutional investors, public pensions are the most active, involved as lead plaintiffs in over 55 percent of settlements with an institutional investor lead plaintiff since 2006.
- In 2013, public pensions served as a lead plaintiff in 43 percent of settled cases, slightly lower than in 2012 (47 percent), but nearly four times the 2004 figure (12 percent).
- The median settlement in 2013 for cases with a public pension as a lead plaintiff was $23 million, compared with $3 million for cases without a public pension as a lead plaintiff.

The presence of a public pension as a lead plaintiff is associated with higher settlements.

FIGURE 14: **MEDIAN SETTLEMENT AMOUNTS AND PUBLIC PENSIONS 2004–2013**
(Dollars in Millions)



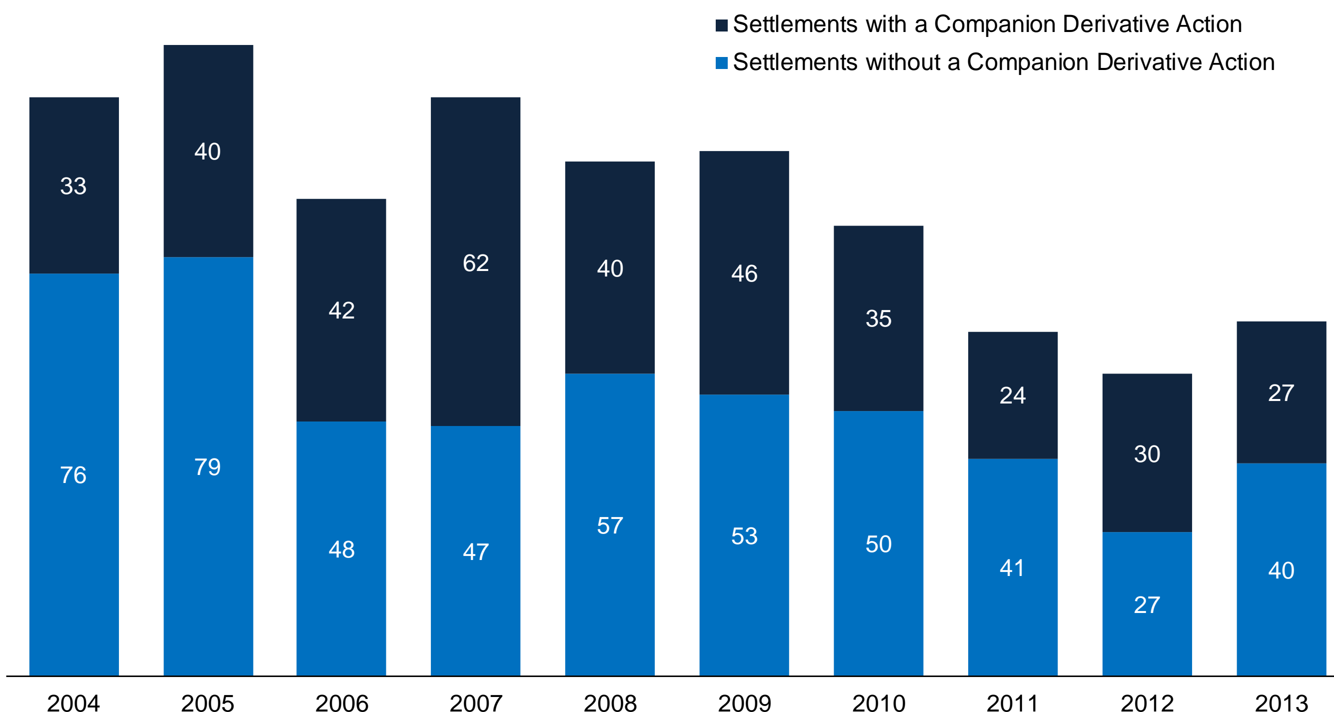
Note: Settlement dollars adjusted for inflation; 2013 dollar equivalent figures used.

DERIVATIVE ACTIONS

- "Estimated damages" for cases with accompanying derivative actions are typically higher compared to cases with no identifiable derivative action.[10]
- In 2013, 40 percent of settled cases were accompanied by derivative actions, compared with 53 percent of settled cases in 2012, and 32 percent of settled cases in prior post–Reform Act years.
- In recent years, cases in the sample have included far fewer simultaneous class and derivative settlements than in prior years.[11] In fact, during 2013, only two securities class actions settled simultaneously with the related derivative action.

Settlement amounts for class actions accompanied by derivative actions are significantly higher.

FIGURE 15: **FREQUENCY OF DERIVATIVE ACTIONS**
2004–2013



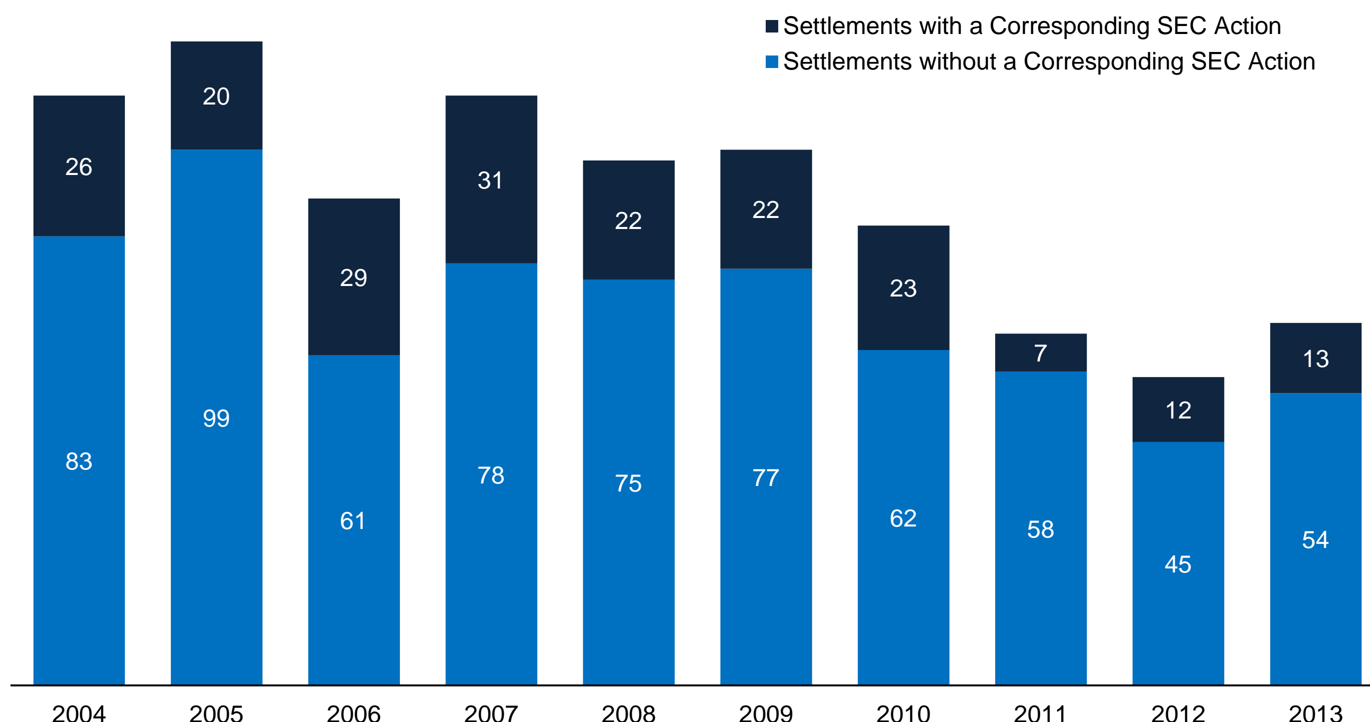
CORRESPONDING SEC ACTIONS

Cases that involve a corresponding SEC action (evidenced by the filing of a litigation release or administrative proceeding prior to the settlement of the class action) are associated with significantly higher settlement amounts and have higher settlements as a percentage of "estimated damages."[12]

- In 2013, 19 percent of settled cases involved a corresponding SEC action, compared with 21 percent in 2012, and 23 percent of settled cases in prior post–Reform Act years.
- The median settlement for cases with an SEC action among all post–Reform Act years ($12.9 million) was more than two times the median settlement for cases without a corresponding SEC action.
- Record enforcement activity by the SEC in 2011 and 2012 was followed by a modest decrease in 2013.[13] SEC enforcements focus on a large scope of allegations, beyond those that may be included in the types of cases examined in this report. However, the SEC is placing sufficient emphasis on disclosure-related fraud and securities offerings such that the rate of securities class action settlements with corresponding SEC actions may increase.[14]

The recent decline in corresponding SEC actions may result from the reported slowdown in financial fraud investigations by the SEC during 2008–2010.

FIGURE 16: **FREQUENCY OF SEC ACTIONS**
2004–2013



COMPARISON OF SETTLEMENT CHARACTERISTICS BY SIZE

Several of the characteristics highlighted in this report are more prevalent for larger cases than smaller cases. For example, among the small proportion of post–Reform Act cases that settled for more than $50 million, 63 percent had a companion derivative action and 52 percent involved a third party as a codefendant. However, for the vast majority of cases in the sample that settled for less than $50 million, only 29 percent had a companion derivative action and only 24 percent involved a third-party as a codefendant.

- In addition, 57 percent were associated with GAAP allegations, compared with 79 percent for larger cases.
- 16 percent had a public pension as a lead plaintiff, compared with 62 percent for larger cases.

Settlements of $50 million or lower are far less likely to involve corresponding SEC actions or public pensions as lead plaintiffs.

FIGURE 17: **COMPARISON OF SETTLEMENT CHARACTERISTICS BY SIZE**
2004–2013

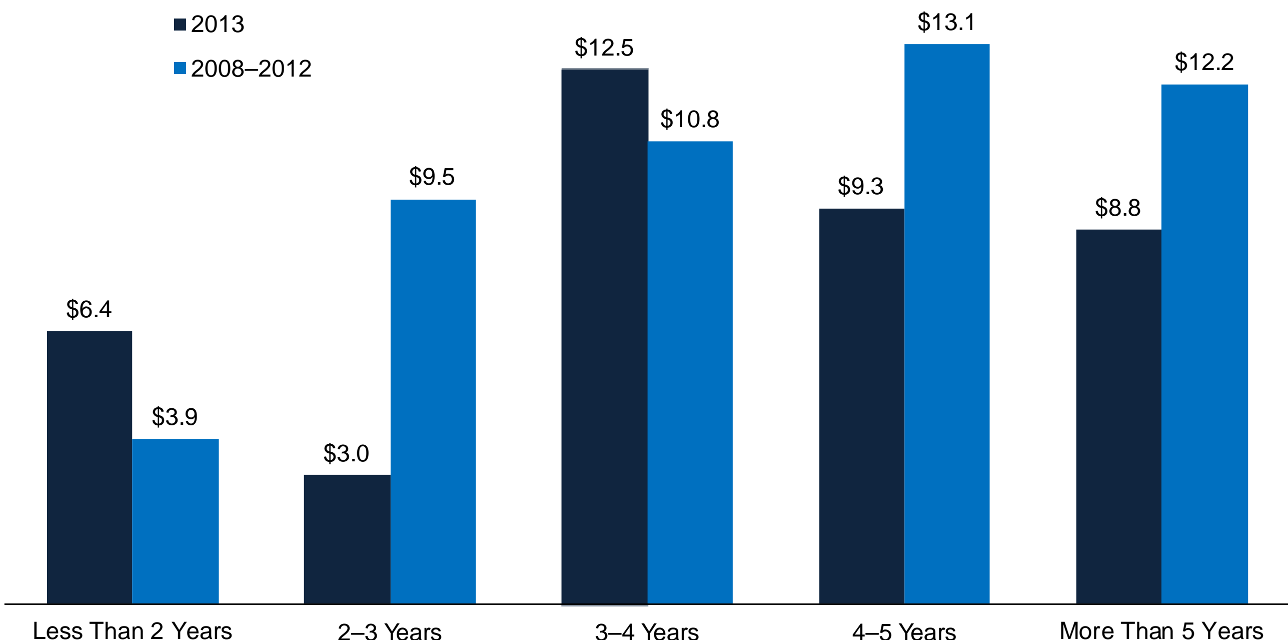
	Corresponding SEC Action	Accompanying Derivative Action	GAAP Allegations	Named Third-Party Codefendant	Public Pension as Lead Plaintiff
$50 Million or Less	19%	29%	57%	24%	16%
More Than $50 Million	54%	63%	79%	52%	62%

TIME TO SETTLEMENT

- Overall, the average time to reach settlement (as measured by the settlement hearing date) has been higher in recent years compared with the early post–Reform Act period.
- However, despite the longer settlement resolutions in recent years, in 2013, a substantial portion of settlements (37 percent) were resolved within 30 months of filing, the highest proportion in the past decade.
- Larger cases (as measured by "estimated damages") and cases involving larger firms tend to take longer to reach settlement.

In 2013, the median time to settlement was 3.2 years.

FIGURE 18: **MEDIAN SETTLEMENTS BY DURATION FROM FILING DATE TO SETTLEMENT HEARING DATE**
2008–2013
(Dollars in Millions)



LITIGATION STAGES

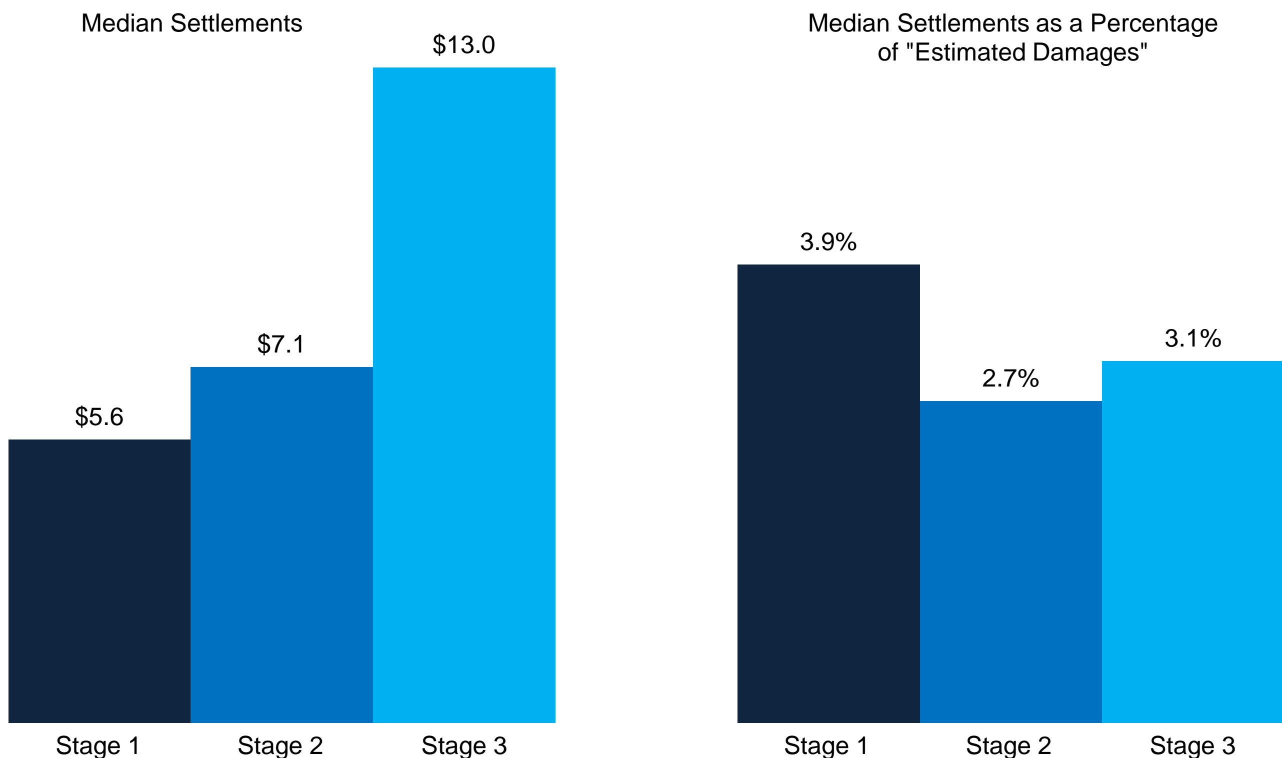
Advancement of cases through the litigation process may be considered an indication of the merits of a case (e.g., surviving a motion to dismiss) and/or the time and effort invested by the plaintiff counsel. This report studies three stages in the litigation process:

Stage 1: Settlement before the first ruling on a motion to dismiss
Stage 2: Settlement after a ruling on motion to dismiss, but before a ruling on motion for summary judgment
Stage 3: Settlement after a ruling on motion for summary judgment[15]

- Settlement amounts tend to increase as litigation progresses.
- Cases settling in Stage 1 settled for the highest percentage of "estimated damages," while there was only a small difference in the percentage between cases settling in Stage 2 versus Stage 3.
- Larger cases tend to settle at more advanced stages of litigation and tend to take longer to reach settlement. Through 2013, cases reaching Stage 3 had median "estimated damages" of more than three and a half times the median "estimated damages" of cases settling in Stage 1.

Settlements occurring early in the litigation process have smaller "estimated damages."

FIGURE 19: **LITIGATION STAGES**
1996–2013
(Dollars in Millions)



INDUSTRY SECTORS

The financial industry continues to rank the highest in median settlement value across all post–Reform Act years. However, industry sector is not a significant determinant of settlement amounts when controlling for other variables that influence settlement outcomes (such as "estimated damages," asset size, and the presence of third-party codefendants).

- Resolution of credit crisis–related cases has comprised a large portion of settlement activity in the financial sector in recent years—22 percent of settlements in 2013, 30 percent in 2012, and 18 percent in 2011.
- The next most prevalent sectors, in terms of the number of cases settled in 2013, were pharmaceuticals (18 percent) and technology (9 percent). In comparison, pharmaceuticals and technology comprised 6 percent and 24 percent, respectively, of cases settled during 1996 through 2012.
- The shift of settled cases to the pharmaceutical sector is consistent with the larger share of filing activity in the consumer non-cyclical sector (which includes healthcare, biotechnology, and pharmaceutical companies, among others) observed in recent years.[16]

The proportion of settled cases involving pharmaceutical firms was higher in 2013 relative to prior years.

FIGURE 20: **SETTLEMENTS BY SELECT INDUSTRY SECTORS**
1996–2013
(Dollars in Millions)

Industry	Number of Settlements	Median Settlements	Median "Estimated Damages"	Median Settlements as a Percentage of "Estimated Damages"
Financial	169	$12.5	$575.4	3.1%
Telecommunications	141	8.0	340.6	2.4%
Pharmaceuticals	94	8.1	434.0	2.2%
Healthcare	56	6.3	212.1	3.5%
Technology	324	6.0	236.7	3.0%
Retail	117	5.8	171.0	4.3%

FEDERAL COURT CIRCUITS

- The highest concentration of settled cases in the Ninth Circuit in 2013 was in the technology and pharmaceutical sectors, each representing 9 percent of all cases. In prior post–Reform Act years, 38 percent of cases in this circuit involved technology firms, while only 6.5 percent related to pharmaceuticals.
- The number of docket entries can illustrate the complexity of a case and is correlated with the length of time from filing to settlement. Interestingly, the Second Circuit, one of the most active circuits, reports a median number of docket entries that ranks among the lowest.
- Generally, settlement approval hearings are held within four to seven months following the public announcement of a tentative settlement.

The Second and Ninth Circuits continue to lead the other circuits in number of settlements.

FIGURE 21: **SETTLEMENTS BY FEDERAL COURT CIRCUIT**
2009–2013
(Dollars in Millions)

Circuit	Number of Settlements	Median Number of Docket Entries	Median Duration from Tentative Settlement to Approval Hearing *(in months)*	Median Settlements	Median Settlements as a Percentage of "Estimated Damages"
First	11	104	7.3	$6.0	2.7%
Second	95	123	6.5	$11.4	2.4%
Third	34	144	5.8	$10.1	2.4%
Fourth	14	183	4.3	$8.8	1.8%
Fifth	19	168	5.2	$6.5	1.6%
Sixth	16	116	4.0	$13.6	4.1%
Seventh	22	158	4.8	$6.2	2.5%
Eighth	8	178	5.9	$6.5	4.0%
Ninth	110	167	6.0	$8.0	2.3%
Tenth	9	180	6.4	$7.5	3.4%
Eleventh	19	154	5.5	$6.3	2.1%
DC	2	603	4.9	$83.3	3.7%

CORNERSTONE RESEARCH'S SETTLEMENT PREDICTION ANALYSIS

Characteristics of securities cases that may affect settlement outcomes are often correlated. Regression analysis makes it possible to examine the effects of these factors simultaneously. As part of this ongoing analysis of securities class action settlements, regression analysis was applied to study factors associated with settlement outcomes. Based on this research sample of post–Reform Act cases settled through December 2013, the variables that were important determinants of settlement amounts included the following:

- "Estimated damages"
- Disclosure Dollar Loss (DDL)
- Most recently reported total assets of the defendant firm
- Number of entries on the lead case docket
- The year in which the settlement occurred
- Whether the issuer reported intentional misstatements or omissions in financial statements
- Whether a restatement of financials related to the alleged class period was announced
- Whether there was a corresponding SEC action against the issuer, other defendants, or related parties
- Whether the plaintiffs named an auditor as codefendant
- Whether the plaintiffs named an underwriter as codefendant
- Whether a companion derivative action was filed
- Whether a public pension was a lead plaintiff
- Whether noncash components, such as common stock or warrants, made up a portion of the settlement fund
- Whether the plaintiffs alleged that securities other than common stock were damaged
- Whether criminal charges/indictments were brought with similar allegations to the underlying class action
- Whether Section 11 claims accompanied Rule 10b-5 claims
- Whether the issuer traded on a nonmajor exchange

Settlements were higher when "estimated damages," DDL, defendant asset size, or the number of docket entries were larger. Settlements were also higher in cases involving intentional misstatements or omissions in financial statements reported by the issuer, a restatement of financials, a corresponding SEC action, an underwriter and/or auditor named as codefendant, an accompanying derivative action, a public pension involved as lead plaintiff, a noncash component to the settlement, filed criminal charges, or securities other than common stock alleged to be damaged. Settlements were lower if the settlement occurred in 2004 or later, and if the issuer traded on a nonmajor exchange.

While the primary approach of these analyses is designed to better understand and predict the total settlement amount, these analyses also are able to estimate the probabilities associated with reaching alternative settlement levels. These probabilities can be useful analyses for clients in considering the different layers of insurance coverage available and likelihood of contributing to the settlement fund. Regression analysis can also be used to explore hypothetical scenarios, including but not limited to the effects on settlement amounts given the presence or absence of particular factors found to significantly affect settlement outcomes.

RESEARCH SAMPLE

- The database used in this report focuses on cases alleging fraudulent inflation in the price of a corporation's common stock (i.e., excluding cases with alleged classes of only bondholders, preferred stockholders, etc., and excluding cases alleging fraudulent depression in price).
- The sample is limited to cases alleging Rule 10b-5, Section 11, and/or Section 12(a)(2) claims brought by purchasers of a corporation's common stock. These criteria are imposed to ensure data availability and to provide a relatively homogeneous set of cases in terms of the nature of the allegations.
- The current sample includes 1,396 securities class actions filed after passage of the Reform Act (1995) and settled from 1996 through 2013. These settlements are identified based on a review of case activity collected by Securities Class Action Services LLC (SCAS).[17]
- The designated settlement year, for purposes of this report, corresponds to the year in which the hearing to approve the settlement was held.[18] Cases involving multiple settlements are reflected in the year of the most recent partial settlement, provided certain conditions are met.[19]

DATA SOURCES

In addition to SCAS, data sources include Dow Jones Factiva, Bloomberg, Center for Research in Security Prices (CRSP) at University of Chicago Booth School of Business, Standard & Poor's Compustat, court filings and dockets, SEC registrant filings, SEC litigation releases and administrative proceedings, LexisNexis, and public press.

ENDNOTES

[1] See *Securities Class Action Filings—2013 Year in Review,* Cornerstone Research, 2014. This report, *Securities Class Action Settlements—2013 Review and Analysis,* excludes merger and acquisition cases since those cases do not meet the sample criteria.

[2] See *Investigations and Litigation Related to Chinese Reverse Merger Companies*, Cornerstone Research, 2011; and *Securities Class Action Filings—2013 Year in Review,* Cornerstone Research, 2014.

[3] For further discussion and case details for subprime credit crisis matters, see the *D&O Diary* at www.dandodiary.com.

[4] The simplified "estimated damages" model is applied to common stock only. For all cases involving Rule 10b-5 claims, damages are calculated using a market-adjusted, backward-pegged value line. For cases involving only Section 11 and/or Section 12(a)(2) claims, damages are calculated using a model that caps the purchase price at the offering price. Volume reduction assumptions are based on the exchange on which the issuer's common stock traded. Finally, no adjustments for institutions, insiders, or short sellers are made to the underlying float.

[5] Twenty settlements out of the 1,396 cases in the sample were excluded from calculations involving "estimated damages" due to stock data availability issues. The WorldCom settlement was also excluded from these calculations because most of the settlement in that matter related to liability associated with bond offerings (and this research does not compute damages related to securities other than common stock).

[6] DDL captures the price reaction—using closing prices—of the disclosure that resulted in the first filed complaint. This measure does not incorporate additional stock price declines during the alleged class period that may affect certain purchasers' potential damages claims. Thus, as this measure does not isolate movements in the defendant's stock price that are related to case allegations, it is not intended to represent an estimate of investor losses. The DDL calculation also does not apply a model of investors' share-trading behavior to estimate the number of shares damaged.

[7] The dates used to identify the applicable inflation bands may be supplemented with information from the operative complaint at the time of settlement.

[8] See *Securities Class Action Filings—2013 Year in Review,* Cornerstone Research, 2014. Annual U.S. IPO activity in 2010–2012 was significantly higher than in 2008–2009.

[9] The three categories of accounting allegations analyzed in this report are: (1) GAAP violations—cases with allegations involving Generally Accepted Accounting Principles (GAAP); (2) restatements—cases involving a restatement (or announcement of a restatement) of financial statements; and (3) accounting irregularities—cases in which the defendant has reported the occurrence of accounting irregularities (intentional misstatements or omissions) in its financial statements.

[10] This is true whether or not the settlement of the derivative action coincides with the settlement of the underlying class action, or occurs at a different time.

[11] Typically, the resolution of derivative suits lags settlement of an accompanying class action. The common practice of seeking a stay in a parallel derivative suit contributes to this lag in the resolution of derivative suits when compared with accompanying class actions.

[12] It could be that the merits in such cases are stronger, or simply that the presence of an accompanying SEC action provides plaintiffs with increased leverage when negotiating a settlement.

[13] "SEC Announces Enforcement Results for FY 2013," SEC press release, December 17, 2013, http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540503617#.UrCA_tJUeuI.

[14] *See* Sara E. Gilley and David F. Marcus, Cornerstone Research, "The Changing Nature of SEC Enforcement Actions," *Law360*, October 8, 2013.

[15] Litigation stage data obtained from Stanford Law School's Securities Class Action Clearinghouse. Sample does not add to 100 percent as there is a small sample of cases with other litigation stage classifications.

[16] See *Securities Class Action Filings—2013 Year in Review,* Cornerstone Research, 2014.

[17] Available on a subscription basis.

[18] Movements of partial settlements between years can cause differences in amounts reported for prior years from those presented in earlier reports. Additionally, four cases, omitted from 2012 settlements, were added to the data sample.

[19] This categorization is based on the timing of the settlement approval. If a new partial settlement equals or exceeds 50 percent of the then-current settlement fund amount, the entirety of the settlement amount is recategorized to reflect the settlement hearing date of the most recent partial settlement. If a subsequent partial settlement is less than 50 percent of the then-current total, the partial settlement is added to the total settlement amount and the settlement hearing date is left unchanged.

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Dr. Simmons's research on pre– and post–Reform Act securities litigation settlements has been published in a number of reports and is frequently cited in the public press and legal journals. She has spoken at various conferences and appeared as a guest on CNBC addressing the topic of securities case settlements. She has also published in academic journals, with recent research focusing on the intersection of accounting and litigation. Dr. Simmons was previously an accounting faculty member at the Mason School of Business at the College of William & Mary. From 1986 to 1991, she was an accountant with Price Waterhouse.

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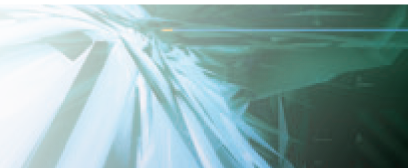
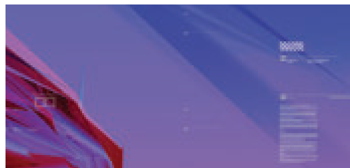
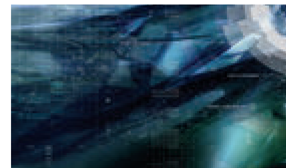
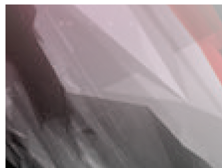



Background

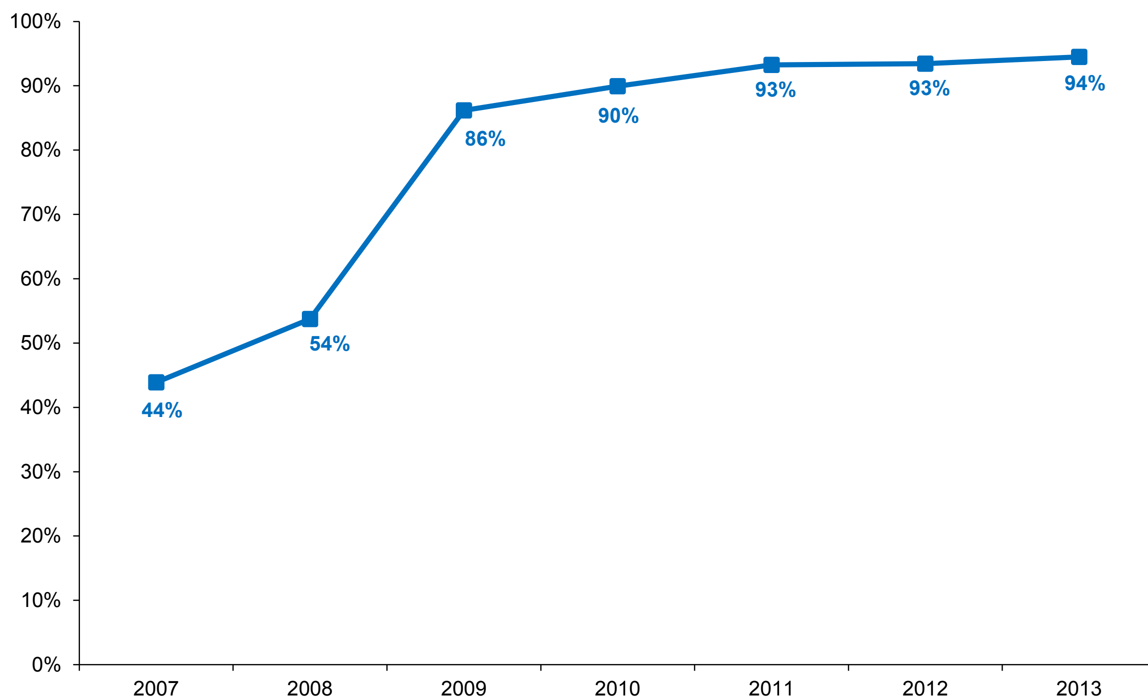
This report looks at litigation challenging M&A deals from 2007 through 2013, filed by shareholders of public target companies. These lawsuits usually take the form of a class action. Plaintiff attorneys typically allege that the target's board of directors violated its fiduciary duties by conducting a flawed sales process that failed to maximize shareholder value. Common allegations include the failure to conduct a sufficiently competitive sale, the existence of restrictive deal protections that discouraged additional bids, and conflicts of interest, such as executive retention or change-of-control payments to executives. Another typical allegation is that the target board failed to disclose enough information about the sale process and the financial advisor's valuation.

This report discusses lawsuit filings and outcomes. A forthcoming report will discuss settlements and plaintiff attorney fees.

HIGHLIGHTS

- For the fourth consecutive year, shareholders filed suit in more than 90 percent of M&A deals valued over $100 million.
- In 2013, 94 percent of M&A deals were challenged by shareholders.
- M&A deals attracted an average of more than five lawsuits. With 26 lawsuits, the Dell Inc. buyout was the most litigated deal in 2013.
- The "race to file" appears to have subsided over the last five years.
- Sixty-two percent of deal litigation was multi-jurisdictional, although the percentage of deals litigated in three or more jurisdictions declined by half over the last two years.
- The most active courts for M&A litigation in the last four years (after Delaware Court of Chancery) were: New York County, NY; Santa Clara County, CA; and Harris County, TX.
- Litigation was resolved before deal closing in 75 percent of the deals. The great majority of lawsuits were settled.

Figure 1: **Percentage of Deals Challenged by Shareholders**
(deals valued over $100 million)



Source: Thomson Reuters SDC; Dockets

Note: Percentages have been rounded to the nearest whole number.

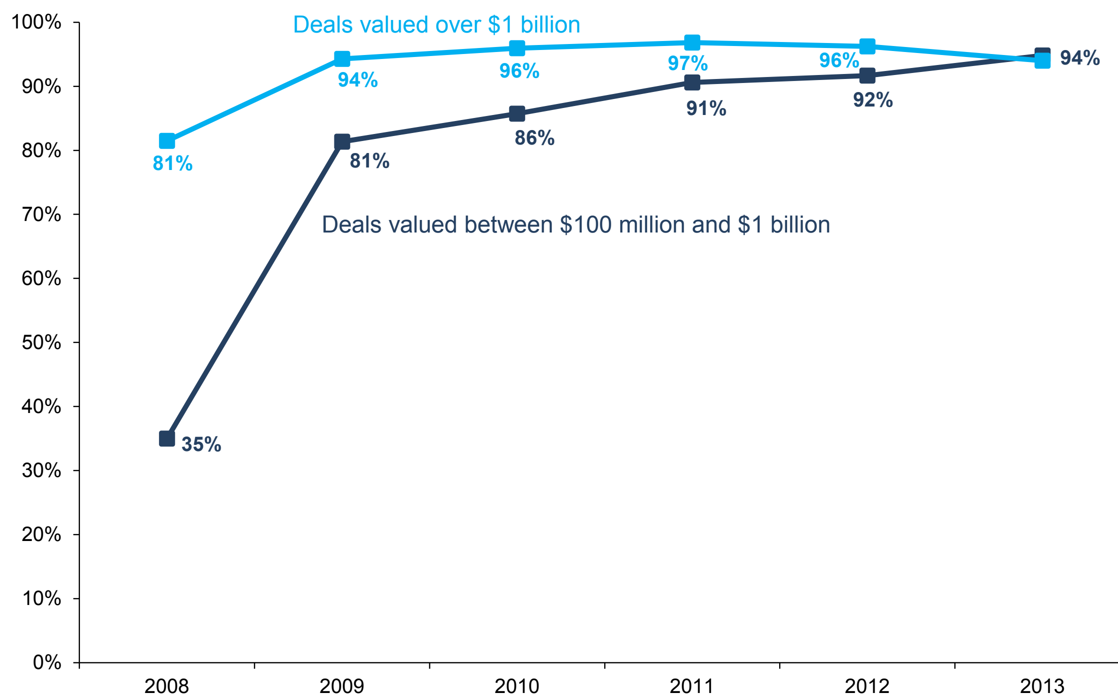
FILINGS

- Plaintiff attorneys filed lawsuits in 94 percent of all M&A deals announced in 2013 and valued over $100 million, a total of 612 lawsuits.
- For the first time, the percentage litigated among smaller deals (valued under $1 billion) and larger deals (over $1 billion) was the same.
- As in prior years, multiple lawsuits were filed for most deals, with an average of five lawsuits for deals valued over $100 million, and 6.2 lawsuits for deals valued over $1 billion.
- The "race to file" appears to have subsided over the last five years. In 2013, the first lawsuit was filed an average of 11.7 days after the deal announcement, compared with 9.3 days in 2012, and 6.5 days in 2009.

Most litigated deals of 2013
(by number of lawsuits)

Deal	Lawsuits
Dell Inc. Buyout	26
Tellabs Inc. Buyout	16
Avago Technologies Ltd./ LSI Corporation	16
LinnCo LLC/ Berry Petroleum Company	14
Management Buyout of Dole Food Company Inc.	13
Toray Industries Inc./ Zoltek Companies Inc.	13
KKR & Co. L.P./ KKR Financial Holdings LLC	13
H.J. Heinz Company Buyout	12
Goldman Sachs & Co./ Ebix Inc.	12

Figure 2: **Percentage of Deals Challenged by Shareholders (by deal value)**



Source: Thomson Reuters SDC; Dockets

Note: Percentages have been rounded to the nearest whole number.

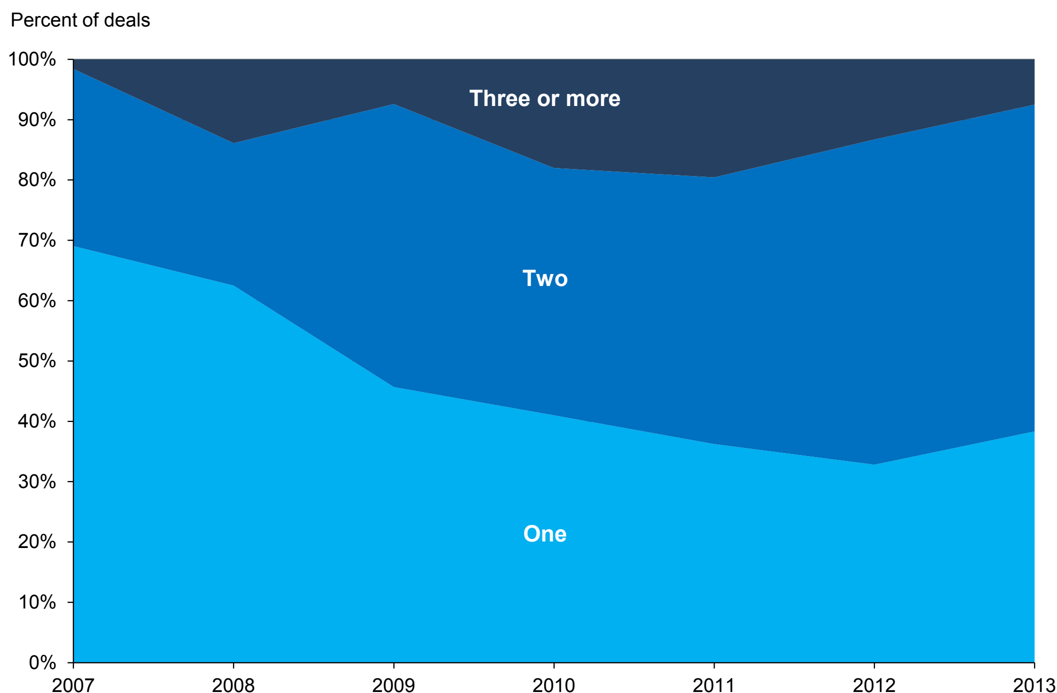
MULTI-JURISDICTIONAL LITIGATION

Most active courts 2010–2013, excluding Delaware (by number of deals litigated)

New York County, NY	39
Santa Clara County, CA	30
Harris County, TX	27
Los Angeles County, CA	17
Orange County, CA	15
San Diego County, CA	15
King County, WA	15
Baltimore County, MD	13
Hennepin County, MN	12

- Multi-jurisdictional challenges to M&A deals continued in 2013. Of the 2013 deals, 62 percent were litigated in more than one court.
- In 2013, the percentage of deals litigated in one, two, and three or more jurisdictions was 38, 54, and 8 percent, respectively.
- The percentage of deals litigated in three or more court has declined by half over the last two years.
- The most active courts for M&A litigation in the last four years (after Delaware Court of Chancery) were: New York County, NY; Santa Clara County, CA; and Harris County, TX.
- The LinnCo / Berry Petroleum deal was challenged in a record six different jurisdictions: Colorado, New York, and Texas federal courts; and Colorado, Delaware, and Texas state courts.

FIGURE 3: **Number of Filing Jurisdictions**



Source: Thomson Reuters SDC; Dockets

LITIGATION OUTCOMES

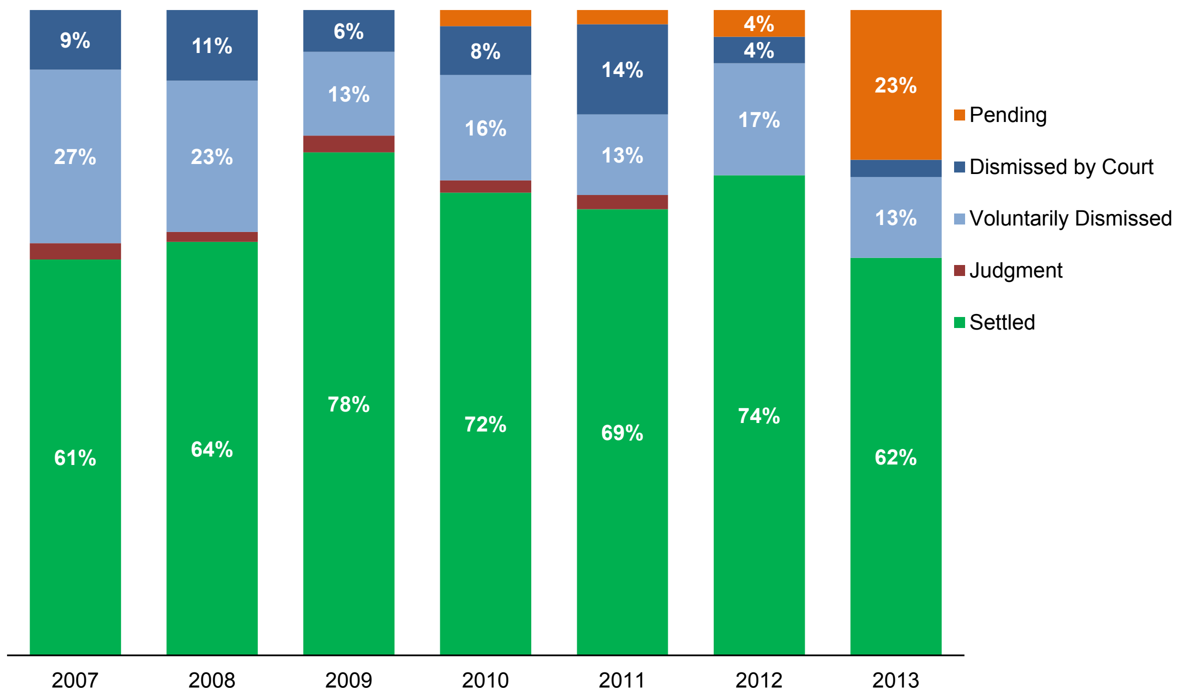
Percentage of deals for which litigation was resolved before closing (by deal announcement year)

2007	60%
2008	66%
2009	79%
2010	73%
2011	78%
2012	79%
2013	75%

Note: Percentages have been rounded to the nearest whole number

- As in prior years, litigation for the majority of deals was resolved before the deal was closed—75 percent of 2013 deals.
- Of the 2013 deals resolved before the deal closed, 88 percent were settled, 9 percent withdrawn by plaintiffs, and 3 percent dismissed by courts.
- Overall, the majority of M&A litigation settled, consistent with prior years.
- Lawsuits that were not settled before the deal closing remained pending for as long as four years. None of the lawsuits in the data went to trial, and all judgments (summary judgments or judgments on the pleadings) were granted to defendants.

FIGURE 4: **Litigation Outcomes**



Source: Thomson Reuters SDC; Dockets

Note: Numbers may not add due to rounding.

The views expressed in this article are solely those of the author, who is responsible for the content, and do not necessarily represent the views of Cornerstone Research.

Please direct any questions, comments, or requests for information to Olga Koumrian. The author requests that you reference Cornerstone Research in any reprint of the figures included in this study and include a link to the report:
http://www.cornerstone.com/Shareholder-Litigation-Involving-M-and-A-2013-Filings

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ABOUT CORNERSTONE RESEARCH

For more than twenty-five years, Cornerstone Research staff have provided economic and financial analysis of complex issues arising in commercial litigation and regulatory proceedings. The firm has four hundred fifty staff who work with a broad network of testifying experts to bring specialized knowledge and experience to each assignment.

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Disclosures of SEC Investigations Resulting in Wells Notices

By Christine Nelson, Sara Gilley, and Garett Trombly Esq.

Cornerstone Research has conducted a study of the market reaction to company disclosures of receipt of a Wells notice from the Securities and Exchange Commission (SEC). Our findings indicate that, when analyzed collectively, the announcement of a Wells notice on average is associated with a statistically significant market-adjusted stock price decline. Analyzed individually, however, only 17 of 58 disclosures of Wells notices between April 2002 and January 2007 were associated with statistically significant market-adjusted stock price declines, indicating that market participants discern firm-specific differences across announcements of receipt of Wells notices.

Moreover, disclosures of an informal investigation or a formal investigation prior to the receipt of the Wells notice resulted on average in negative, statistically significant stock price movements. However, there was no significant difference between the average market-adjusted returns on the day of the disclosure of receipt of a Wells notice for investigations that had been previously disclosed and the market-adjusted returns related to those that had not. These findings are consistent with the hypothesis that market participants perceive the disclosure of an informal or formal investigation as a signal of a higher likelihood that the outcome of the investigation will have a material impact on the company relative to announcing only the receipt of a Wells notice. Otherwise, one would expect the disclosure of the Wells notice that was the first disclosure of the investigation to result in a larger negative price movement than disclosures that followed prior announcements of the investigation. Also consistent with this hypothesis is the finding that investigations disclosed prior to the Wells notice were more likely to result in a fine being imposed on the target company or individual than investigations that were only disclosed at the Wells notice stage.

Historical Trends and Timing of Investigations

From 1997 through 2002 (fiscal year ending September 2002), the SEC initiated between 408 and 570 new investigations each year. As shown in figure 1, following the Enron and WorldCom investigations and the passage of Sarbanes-Oxley (July 30, 2002), the SEC initiated new investigations at nearly twice the previous annual rate. Although new investigations dipped in fiscal year 2007, they rose again in fiscal year 2008.

New investigations are typically "informal" in nature.

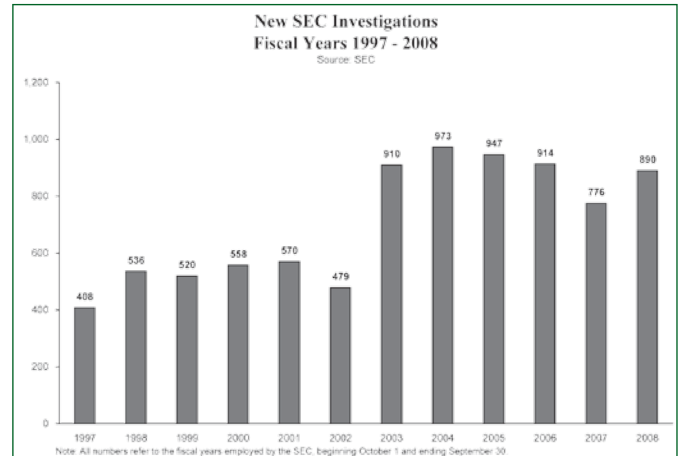

FIGURE 1

If, after an initial review, the commission deems that a violation of the federal securities laws "may have occurred or may be occurring,"[1] it may issue a "formal order of investigation." Such an order empowers the staff to, among other things, subpoena witnesses and compel the production of documents. When the formal investigation is substantially complete, if the SEC is considering filing an action in court or an internal administrative proceeding, a Wells notice generally follows.[2] Recipients of a Wells notice are typically accorded the opportunity to provide a voluntary statement—a Wells submission—arguing why the commission should not bring an action against them.[3] Subsequent steps in the investigation may include termination of the investigation, settlement, court action, or an internal administrative proceeding.

The SEC does not publicly comment on particular investigations until it files an action in court or in its internal administrative process. Prior to such a filing, public disclosure of the investigation is at the discretion of the target company. To identify Wells notice disclosures, we conducted a search of company SEC filings in the EDGAR database for the years 1997–2007, excluding disclosures concerning mutual funds. Our search yielded no Wells notice disclosures in SEC filings in the period 1997–2001. In 2002, 11 Wells notices were disclosed, followed by 14 in 2003, 31 in each of 2004 and 2005, 18 in 2006, and 20 in 2007. We analyzed in detail the 58 investigations of companies that disclosed the receipt of a Wells notice between April 2002 and January 2007 and were traded continuously on a major stock exchange from the initial public disclosure of an SEC investigation

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through the public disclosure of the receipt of a Wells notice.[4] For each of these investigations, we also reviewed public press releases to determine the date and time of each disclosure.

For each of the 58 investigations we researched, we determined whether the company had disclosed an informal SEC investigation, a formal SEC investigation, or both, prior to receipt of the Wells notice, and we found that 33 of the 58 investigations were first disclosed at the informal stage, and 10 were first disclosed at the formal stage. For the remaining 15 investigations, the disclosure of the Wells notice was the first disclosure to the market of an SEC investigation.

Examination of the type and timing of the disclosures of the 58 investigations provides a rudimentary metric for evaluating the length of the investigations of target companies, which is shown in figure 2. For the 33 investigations that were disclosed at the informal investigation stage, the average length of time between the announcement of the informal investigation and the announcement of the Wells notice was one year and four months. For the 29 announcements that disclosed a formal investigation prior to receipt of a Wells notice (10 of which had not been preceded by an announcement of an informal investigation and 19 of which were announcements of a formal investigation following an announcement of an informal investigation), the average length of time between the announcement of the formal investigation and the announcement of the Wells notice was slightly longer than a year. For the 19 investigations for which both an informal investigation disclosure and a formal investigation disclosure were made prior to the receipt of a Wells notice, the average length of time between the announcement of the informal investigation and the announcement of the formal investigation was approximately five months.[5]

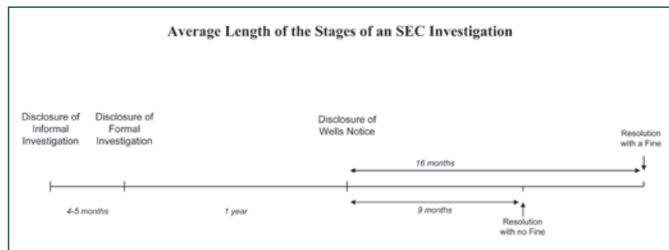

FIGURE 2

Stock Price Reactions to Disclosures of Investigations

With the data set of 58 investigations identified—some of which were disclosed prior to receipt of a Wells notice—we turned to the question of the stock price reaction to each investigation-related disclosure. To analyze the stock price movement associated with target companies' disclosures, we performed a separate event study analysis for each investigation in our data set. Event study methodology is used to determine whether a company's actual stock price movement on a given day is significantly different from the price movement that one would expect for that day, based on the stock's historical price movements relative to the market. The typical relationship between movements in the company's stock price (the "returns") and the overall market is estimated through regression analysis (a "market model"), which enables a prediction of how a company's stock is expected to have performed on a given day. The difference between the actual and predicted returns—the "market-adjusted return"—indicates the portion of a stock's return that is not attributable to market movement.

Market-Adjusted Stock Price Reaction to Wells Notice Disclosures for 58 Investigations Resulting in the Receipt of a Wells Notice

Source: Bloomberg; CRSP; Public Press; SEC Filings

	Number of Disclosures	Mean Market-Adjusted Return on Wells Notice Disclosure	Median Market-Adjusted Return on Wells Notice Disclosure
Total Number of Wells Investigations Disclosed	58	-2.59%	-1.74%
Informal Investigation disclosed at Initial Disclosure	33	-2.69%	-1.69%
Formal Investigation disclosed at Initial Disclosure	10	-2.84%	-2.44%
Wells Notice receipt disclosed at Initial Disclosure	15	-2.21%	-0.86%

FIGURE 3

The market-adjusted return on any given day can be the result of normal (random) movements. However, a market-adjusted return in excess of a certain threshold may be suggestive of a material change in the mix of information regarding the company.

Figure 3 shows that the average market-adjusted return on the day of the Wells notice disclosure for the target company of all 58 investigations was negative 2.59 percent. This average, across all 58 observations, is statistically significant. The median market-adjusted return was negative 1.74 percent and statistically significant. Thus, on average, disclosure of a Wells notice leads to a decline in stock prices.

Evidence shows, nonetheless, that market participants discern firm-specific differences across announcements of receipt of Wells notices. Specifically, of the 58 investigations, only 17 (29 percent) resulted in negative and statistically significant declines in the target company's stock price upon disclosure of the Wells notice. Thus, for any individual case, disclosure of a Wells notice may or may not be perceived as significant negative news by market participants.

Disclosures of an informal investigation or a formal investigation prior to the receipt of the Wells notice also resulted on average in negative, statistically significant stock price movements. However, there was no significant difference between the average market-adjusted returns on the day of the disclosure of receipt of a Wells notice

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for investigations that had been previously disclosed and the market-adjusted returns related to those that had not. These findings are consistent with the hypothesis that market participants perceive the disclosure of an informal or formal investigation as a signal of a higher likelihood that the outcome of the investigation will have a material impact on the company relative to announcing only the receipt of the Wells notice. Otherwise, one would expect the disclosure of the Wells notice that was the first disclosure of the investigation to result in a larger negative price movement than disclosures that followed prior announcements of the investigation.

Resolutions of Investigations

At the time we concluded our study, we had identified announcements of the resolution of the SEC's investigation for 43 of the 58 investigations in our data set. Of those 43 investigations, the average time between the announcement of receipt of a Wells notice and the announcement of a resolution was about 13 months.

To distinguish among outcomes of actions taken by the SEC, we analyzed the incidence of fines levied against the targets of the investigations. For the 17 investigations resulting in no fine being imposed on the target company or individual, the average time between the Wells notice disclosure and the resolution disclosure was approximately nine and a half months. For the 26 investigations resulting in a fine, the time between Wells notice disclosure and resolution announcement was almost 16 months.

Type of Resolution for 43 Investigations Resulting in Receipt of a Wells Notice

Source: Factiva; SEC Filings

		By Resolution Outcome	
Investigation Disclosures	Total Number of Investigations	Investigations Not Resulting in a Fine	Investigations Resulting in a Fine
Wells Notice Only	12	8	4
Informal or Formal Investigation Prior to Wells Notice	16	6	10
Informal and Formal Investigations and Wells Notice	15	3	12
Total	43	17	26

FIGURE 4

Figure 4 shows the breakdown of resolution outcomes by investigation-related disclosures. Compared with other Wells notice recipients, companies that had announced the investigation prior to the Wells notice were more likely to have a fine imposed as a result of the investigation. Conversely, companies that first announced the investigation with the disclosure of a Wells notice were more likely not to be fined. Although these findings are based on a small number of observations, they are consistent with the notion that companies are more likely to disclose informal and formal investigations when it is more likely the outcome will be negative.

Conclusion

With the current market turmoil and push for greater regulation in the securities markets, many observers expect a ramp-up in the number of investigations initiated by the SEC. If recent trends continue, the companies that do not believe that an investigation will result in a material impact on the company, and therefore do not disclose the early stages of an investigation, will not necessarily incur a larger stock price decline upon disclosure of the Wells notice than if they had previously disclosed the investigation. ✺

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1. SEC, Div. of Enforcement, Enforcement Manual 20 (Oct. 6, 2008).
2. If prompt enforcement action is necessary to protect investors, the commission may choose not to issue a Wells notice before taking action such as requesting a temporary restraining order.
3. The term "Wells notice" has its origins in the recommendations made by an advisory committee chaired by John Wells.
4. Investigations were removed from our original data set if the target companies did not trade continuously on a major stock exchange (NYSE, Nasdaq, or American Stock Exchange) from the initial public disclosure of the SEC investigation through the public disclosure of a Wells notice, or if they fell outside our period of examination.
5. It is important to note that these figures are based on dates of public disclosures identified by Cornerstone Research and therefore do not necessarily reflect the actual dates when target companies were notified of an initiation of or a change in an SEC investigation.

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Halliburton II and the Importance of Economic Analysis Prior to Class Certification

Kristin Feitzinger and Amir Rozen

On June 23, 2014, the U.S. Supreme Court handed down its long-awaited decision in *Halliburton Co. v. Erica P. John Fund*.[1] The ruling affirms *Basic Inc. v. Levinson*,[2] but finds that defendants can introduce a direct price impact analysis prior to class certification.

In *Basic* the Supreme Court held that investors could meet the reliance requirement in a securities fraud class action indirectly, by demonstrating market efficiency and invoking a rebuttable presumption of reliance based on the "fraud on the market" theory—a theory holding that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." In *Halliburton II,* the Court declined to overturn *Basic*. It did find, however, that in cases where plaintiffs met their burden of proving market efficiency, defendants could rebut this presumption prior to class certification by showing direct evidence "that the alleged misrepresentation did not actually affect the stock price—that is, that it had no 'price impact.'"

In essence, *Halliburton II* continues to allow plaintiffs to prove price impact indirectly and broadens the scope of evidence that courts must consider at the class certification stage to include direct evidence refuting price impact:

> *Basic* allows plaintiffs to establish price impact indirectly, by showing that a stock traded in an efficient market and that a defendant's misrepresentations were public and material. But an indirect proxy should not preclude consideration of a defendant's direct, more salient evidence showing that an alleged misrepresentation did not actually affect the stock's price and, consequently, that the *Basic* presumption does not apply.

EVENT STUDIES

Halliburton II states that in order to show indirectly that the presumption of reliance holds in a given case, a plaintiff must demonstrate that the stock traded in an efficient market, among other things. Event studies have long played a significant role in assessing market efficiency. Going forward, they (along with other economic analysis) will also be key tools for defendants seeking to establish prior to class certification that an alleged misrepresentation did *not* impact price.

Over the past forty years, academic research in finance and accounting has utilized and refined event study methodology. An event study is now commonly used by financial economists and is a widely accepted methodology that provides an objective measure of whether there has been a significant change in stock price.

The standard event study approach employed in securities fraud class actions uses the statistical method of regression to account for market and industry effects. Because stock prices reflect market-, industry-, and company-specific information, it is necessary to extract the market- and industry-specific portions of stock price changes to isolate the change that may be related to company-specific information. Once market and industry effects are controlled for within the statistical model, standard statistical tests are conducted on the remaining or "residual" stock price change to determine if each daily change is statistically different from normal random price movements, or "statistically significant." Price movements that are not statistically significant cannot be reliably distinguished from statistical noise and cannot be attributed to a particular piece of information within the statistical model.

DIRECT PRICE IMPACT ANALYSIS

Event studies are an important tool in the financial economists' portfolio for determining whether an alleged misrepresentation affected stock price. In order to assess the price impact (if any) of an alleged misrepresentation, it may be useful to employ an event study to examine either contemporaneous stock price movements (front-end) or stock price movements at the time of an alleged corrective disclosure (back-end)—or both.

Using event studies to measure price impact on the front end. The lack of a statistically significant residual stock price change at the time of an alleged misrepresentation indicates no significant change in the total mix of information regarding a company at that time. Such a finding is consistent with a conclusion that the alleged misrepresentation did not impact price.

1. Halliburton Co. v. Erica P. John Fund Inc., 573 U.S. ___ (2014) (*Halliburton II*).
2. Basic Inc. v. Levinson, 485 U.S. 224 (1988) (*Basic*).

In cases where the alleged misrepresentation comprises an omission, event study findings at the front end are not relevant. An event study only measures stock price reaction to information that was actually disclosed, and cannot measure the impact of information that was *not* disclosed. In such cases, a different analysis would be required to establish lack of price impact, such as looking at back-end price reaction when the alleged truth is revealed, or building a fundamental valuation model. Both are discussed further below.

In cases where the alleged misrepresentation is an affirmative misstatement, an event study may establish that the alleged misrepresentation did not impact stock price at the time it was made. In many instances, however, analysis in addition to an event study may be required because an event study measures only the net stock price impact of all simultaneously released information, and only rarely is an alleged misrepresentation made in isolation. It is only infrequently the case that the alleged truth was "A" and the defendant said "not A" and only "not A" (i.e., no additional news was provided at the time of the alleged misrepresentation). When other news is announced simultaneously, a financial economist would need to perform analysis to assess the stock price impact of that other news in order to isolate the price impact (if any) of the alleged misrepresentation.

Using event studies to measure price impact on the back end. The lack of a statistically significant stock price change at the time that an alleged misrepresentation is corrected indicates no change in the total mix of public information at that time. Such a finding is consistent with a conclusion that the alleged misrepresentation did not impact price when it was made.

Again, analysis in addition to an event study may be required in order to assess the price impact (if any) of the alleged misrepresentation when it was made under certain circumstances. For example, when other news is announced at the same time as the corrective information, an economist would need to perform analysis to assess the stock price impact of that other news. Moreover, if market, industry, or company conditions have changed substantially since the time of the alleged misrepresentation, an economist would need to assess the stock price impact of those changes. For example, a company's stock price may react more negatively to a minor EBITDA (earnings before interest, taxes, depreciation, and amortization) forecast miss when the company is close to violating an EBITDA debt covenant than it would when there is a significant cushion. An economist might need to account for such changes in his or her assessment of price impact.

Additional analyses for assessing price impact. In cases when an event study is not itself sufficient to establish the lack of price impact, other important economic tools may be useful. For example, review of investment analyst reports may provide insight into what importance (if any) financial professionals assign to the alleged misrepresentation or correction. Fundamental financial analysis—for example, constructing a discounted cash flow model—may also be relevant. A company's stock price reflects market consensus regarding the value of future cash flows to its stockholders. Fundamental financial analysis can be useful to assess what impact (if any) the alleged misrepresentation would have on expected future cash flows or discount rate, and hence stock price.

CONCLUSION

Halliburton II reiterates the Supreme Court's holding in *Basic* that "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance." The Supreme Court's recent decision establishes another avenue for this prior to class certification—namely, direct evidence that the alleged misrepresentation did not impact price. While the ruling does not provide specific guidance regarding precisely what evidence will be required to sever the link, it does refer to an event study as a possible method for showing that the alleged misrepresentation had no price impact.

Given the new avenue for opposing class certification, the prominence of economic analysis, including event studies, may increase in this early stage of litigation. Analyzing the price impact (if any) of an alleged misrepresentation is not new to securities fraud class actions. It has long been an important part of the merits phase of the case, playing an integral role in the assessment of damages, loss causation, and materiality. However, the Supreme Court's ruling in *Halliburton II* could well accelerate the demand for rigorous economic analysis related to the price impact (if any) of an alleged misrepresentation, providing defendants an additional way to truncate a case if they can meet the burden of showing that the alleged misrepresentation did not impact price.

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The Future Of SEC Enforcement Actions

Law360, New York (April 22, 2013, 2:34 PM ET) -- The U.S. Securities and Exchange Commission has reported a record number of enforcement actions over the past two years, as well as a new focus on what the agency considers “national priority” cases. These record numbers, however, have masked the underlying decline in new investigation activity by the SEC over the same period. Looking forward, this decline in new investigations, a shift in focus in SEC enforcement activity, and the changing legal landscape will likely result in a decrease in the number of enforcement actions filed.

Recent History of Enforcement Actions

In 2009 and 2010, the SEC made an effort to strengthen its enforcement capacity. Among many changes, the Enforcement Division created specialized units to develop expertise in complex, high-priority issues. In 2011, the SEC also created the Office of the Whistleblower. These changes were followed by an increase in the number of enforcement actions filed. Between fiscal years 2003 and 2010 (the SEC fiscal year ends Sept. 30), the SEC filed approximately 650 new enforcement actions annually. In 2011 and 2012, enforcement actions rose to over 730 per year, an increase of approximately 13 percent from the long-term average.

After the reorganization, the SEC also began to identify and prioritize cases that were what the agency called the Enforcement Division’s “most important and complex matters”[1] expected to result in “significant corrective industry reaction.”[2] These national priority cases have become a growing portion of the Enforcement Division’s enforcement cases, representing 20 percent of the total enforcement actions filed in 2012 — almost double the number of national priority enforcement actions filed in 2011.

The focus of enforcement activity also shifted following the reorganization. Between 2003 and 2010, financial fraud and issuer disclosure cases accounted for one in four enforcement actions filed annually. In 2012, these cases resulted in a total of 79 enforcement actions — only 11 percent of the actions filed. The decrease in financial fraud and issuer disclosure cases was offset by an increase in enforcement actions against investment advisors and investment advisory firms. In the past two years, these cases increased to approximately 20 percent of enforcement actions filed, from an average of only 14 percent between 2003 and 2010.

Despite recent high-profile insider trading cases as well as the SEC designating this issue a high-priority topic, insider trading cases in the past two years have remained at the 10-year historical average of 8 percent of all enforcement actions. Although only a small proportion of total enforcement actions, these cases receive extensive press coverage — CR Intrinsic is a recent example. Although still pending approval by the court, the S.A.C. Capital Advisors affiliate agreed to pay a record $600 million to settle insider trading charges brought by the SEC. High-profile defendants, such as top hedge fund players and large sanctions may be the new priority for the SEC.

Forecasting the Future

Enforcement actions are the result of underlying investigation activity. The SEC takes, on average, just under two years to investigate a new case and file an enforcement action. Thus, the record number of enforcement actions in 2011 and 2012 are the result of investigations that likely began in 2009 and 2010. However, paralleling these record-high numbers of enforcement actions was a contemporaneous decline in new investigation activity. New investigations in 2012 declined 14 percent from 2011 levels and were at the lowest level since 2007. Likewise, the SEC issued only 479 formal orders of investigation in 2012, a 17 percent decline from 2011. In fact, the number of formal orders of investigation in 2012 was the lowest level since 2008, the year before the SEC delegated subpoena power to the enforcement director. Because of the roughly two-year lag between the time a new investigation is opened and when an enforcement action is filed (the execution rate), the declining number of new SEC investigations will likely result in a decline in enforcement actions filed in the future.

Separately, the recent Supreme Court decision in Gabelli et al. v. Securities and Exchange Commission has reduced the amount of time that the SEC has to complete its investigations and bring an enforcement action. In this case, the court held that when the SEC seeks civil penalties for violations of securities laws, "the five-year clock [for the statute of limitations] begins to tick when the fraud occurs, not when it is discovered."[3] Thus, the SEC must file any enforcement action within five years of the fraud as opposed to the discovery of the fraud. Although the SEC reports its average execution rate to be two years, over a third of its cases are not filed in this window. For example, in 2012, the SEC filed only 64 percent of its enforcement actions within two years of initiating an investigation. This means that the SEC has a backlog of existing open investigations and a limited amount of time with which to bring an enforcement action. This will likely result in fewer enforcement actions.

The Gabelli ruling will also impact the types of cases the SEC can bring, which could further reduce the number of enforcement actions the agency initiates. To date, the SEC has filed at least 80 enforcement actions related to the financial crisis of 2007 and 2008, a third of which were filed in 2012. However, time is running out for the SEC to bring additional cases. This year will likely be the last year that the statute of limitations will allow for any additional financial-crisis-related cases to be filed. Gabelli may also impact the potential cases the SEC can file alleging Foreign Corrupt Practices Act violations. The typical FCPA case brought by the SEC involves multiple years of alleged wrongdoing that take time to investigate. Of those cases brought forth in 2011 and 2012, the median time interval between the end of the alleged fraud and filing of an enforcement action was four years, which means that many of these cases are at or potentially beyond the legal statute of limitations.

To combat the decline in new investigations, the SEC will likely shift the focus of its enforcement activity. The SEC may choose to pay even more attention to national priority cases, as the SEC has historically converted them to enforcement actions at a higher rate than non–national priority cases. The SEC may also choose to return its focus to financial fraud and issuer disclosure issues. The SEC has already demonstrated an increased reliance on whistleblower tips for new investigations. For example, in 2010, 32 percent of investigations originated from a tip or complaint. By 2011, this number increased to 37 percent. During its first full year of operation in 2012, the Office of the Whistleblower received over 3,000 tips. Almost 20 percent of these tips related to corporate disclosure and financial statements. Going forward, the SEC may choose to focus on those areas where the Whistleblower Program receives tips of the greatest number and substance.

—By David F. Marcus and Sara E. Gilley, Cornerstone Research

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The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] “Fiscal Year 2012 Agency Financial Report,” U.S. Securities and Exchange Commission, p. 13.

[2] “FY 2010 Performance and Accountability Report,” U.S. Securities and Exchange Commission, p. 45.

[3] Gabelli et al. v. Securities and Exchange Commission, 568 U. S. ___ (2013).

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CORNERSTONE RESEARCH

ECONOMIC AND FINANCIAL CONSULTING AND EXPERT TESTIMONY

Accounting Class Action Filings and Settlements

2013 Review and Analysis

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HIGHLIGHTS

- While the number of accounting case[1] filings in 2013 remained relatively constant at 47, the market capitalization losses associated with these cases increased compared with 2012. (pages 3 and 4)

- In 2013, accounting case filings were almost evenly distributed over seven industry sectors, but the majority of settlement dollars in accounting cases were in the financial sector. (pages 7 and 8)

- In 2013, the proportion of filings involving allegations of internal control weaknesses was higher than in any of the prior five years. (page 11)

- Although filings were relatively unchanged, the number of accounting case settlements in 2013 increased for the second year in a row, but remained relatively low compared with the ten-year history. (page 5)

- In a reversal of the typical pattern, accounting case settlement amounts were lower than for non-accounting cases in 2013 primarily due to the large proportion of Chinese reverse merger settlements, which tend to be smaller in size. This change is not expected to indicate a long-term trend. (page 6)

- Settlements of accounting cases are generally associated with substantially higher "estimated damages" than those for non-accounting cases; however, this was not true in 2013. (page 13)

- Cases involving accounting irregularities typically settle for higher amounts than cases that do not involve these allegations. (page 14)

FIGURE 1: **SUMMARY STATISTICS**

2013 Filings Summary

	Accounting Cases	Non-Accounting Cases
Number of Filings	47	119
Total Disclosure Dollar Losses	$44.8B	$58.7B

2013 Settlements Summary

	Accounting Cases	Non-Accounting Cases
Number of Settlements	44	23
Median Settlement	$4.2M	$15.3M
Average Settlement	$26.6M	$156.7M
Total Settlement Value	$1,193.5M	$3,580.5M

Note: The majority of the total settlement value for non-accounting cases is represented by one large settlement. Without this case, the total value for non-accounting cases is $1,155.5 million, and the median and average are $14.4 million and $53.6 million, respectively.

SPOTLIGHT: SEC INVESTIGATIONS OF ACCOUNTING-RELATED FRAUD

"Our aim is . . . to create an environment where you think we are everywhere—using collaborative efforts, whistleblowers, and computer technology to expand our reach, focusing on gatekeepers to make them think twice about shirking responsibilities, and ensuring that even the small violations face consequences."

—SEC Chair Mary Jo White at the Securities Enforcement Forum, 10/9/2013

The SEC has made it well known that it has aggressively renewed its focus on identifying accounting-related fraud. In July 2013, the SEC's Division of Enforcement unveiled the creation of a new Financial Reporting and Audit Task Force (Task Force). The objective of the Task Force is to more proactively identify misstatements in financial statements and disclosures. The Task Force is reported to have already generated several "significant investigations," with more expected to follow.[2]

Working with the Division of Economic and Risk Analysis (DERA, previously known as RiskFin), the Task Force initiatives rely at least partly on analytical models, such as the widely discussed Accounting Quality Model (AQM), commonly referred to as "RoboCop." The AQM is intended to be a predictive scoring model to flag "earnings management," or anomalous discretionary accounting choices made by companies compared with their peers. Building on existing academic research that provides "indicators" of earnings management, the AQM incorporates in its model consideration of "inducers" (i.e., incentives to commit fraud).[3]

DERA is also developing text analytic tools that analyze patterns in companies' financial statement footnotes and the management discussion and analysis (MD&A) section of their SEC filings to identify those that might indicate fraud. These recent developments are in addition to the SEC's efforts to facilitate whistleblower tips. The SEC reported that it received over 550 tips in 2013 related to allegations involving corporate disclosure and financials.

The SEC's recent efforts have garnered much attention, and are generally expected to increase SEC enforcement actions involving accounting issues. These efforts could also have significant potential consequences for private securities litigation involving accounting issues. Increased SEC enforcement activity may affect not only the volume of private securities litigation filed, but also the amount for which these cases settle. This is because securities class actions accompanied by SEC actions are associated with higher settlement amounts.[4]

With the dwindling of other targeted litigation, such as credit crisis and Chinese reverse merger cases, it is conceivable that the SEC's current focus could provide an opportunity for plaintiff counsel to make accounting-related cases a future wave in securities class action litigation.

"I think financial-statement fraud, accounting fraud has always been important to the SEC. . . . It's certainly an area that I'm interested in and you're going to see more targeted resources in that area going forward."

Mary Jo White, in *Forbes*, "How SEC's New RoboCop Profiles Companies for Accounting Fraud," 8/9/2013

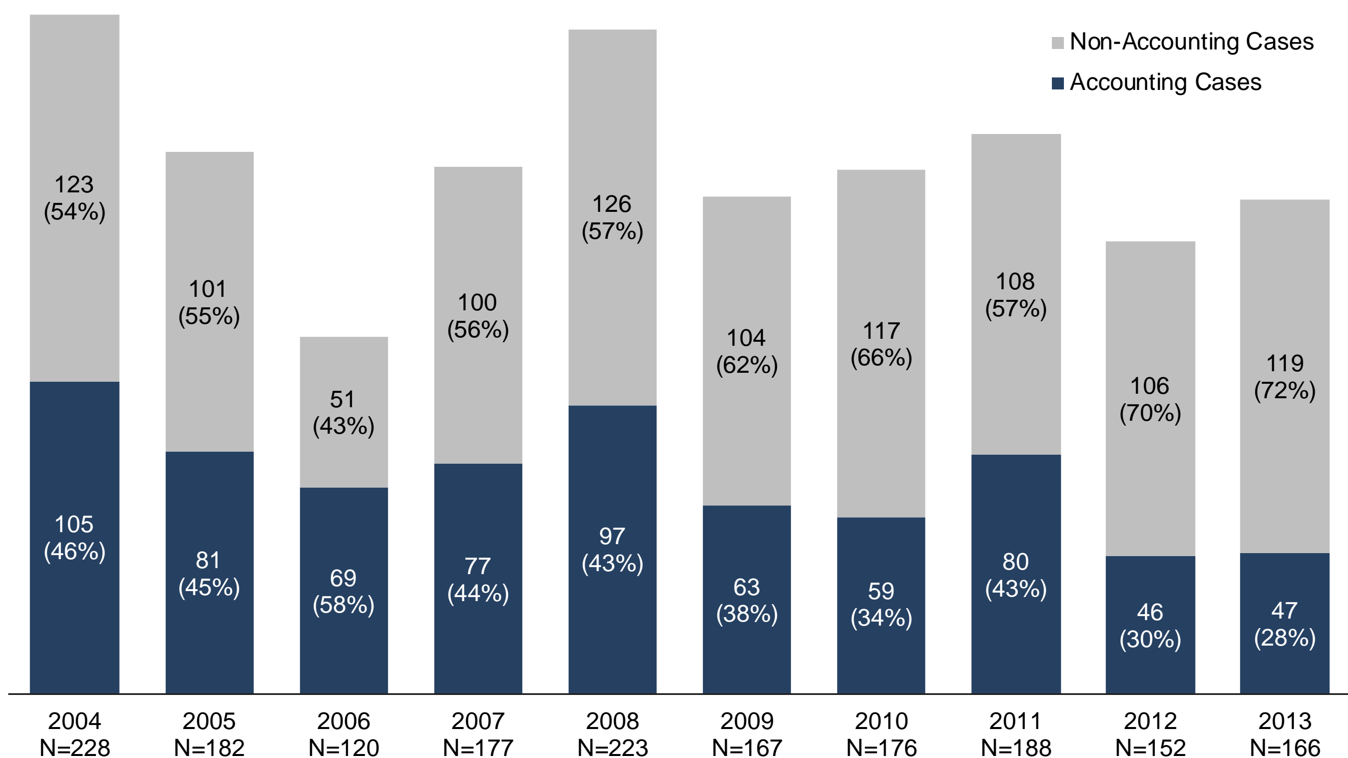
FILINGS AND SETTLEMENT ACTIVITY

FILINGS AND SHARE OF ACCOUNTING CASES

- In 2013, there were 47 accounting case filings, compared with 46 in the prior year.
- The low number of accounting case filings and absence of a year-over-year change is consistent with trends in overall securities class action filing activity.[5] The past two years have been marked by an absence of any new types of securities class actions, such as those that involve Chinese reverse mergers (CRMs).
- Only two filings in 2013 were CRM cases, compared with a peak of 31 in 2011, which represented 39 percent of all accounting cases for that year.

At 28 percent of all cases filed, the proportion of accounting cases was at a ten-year low.

FIGURE 2: **FILINGS AND SHARE OF ACCOUNTING CASES**
2004–2013



Note: Percentages may not add to 100 due to rounding.

FILINGS AND MARKET CAPITALIZATION LOSSES

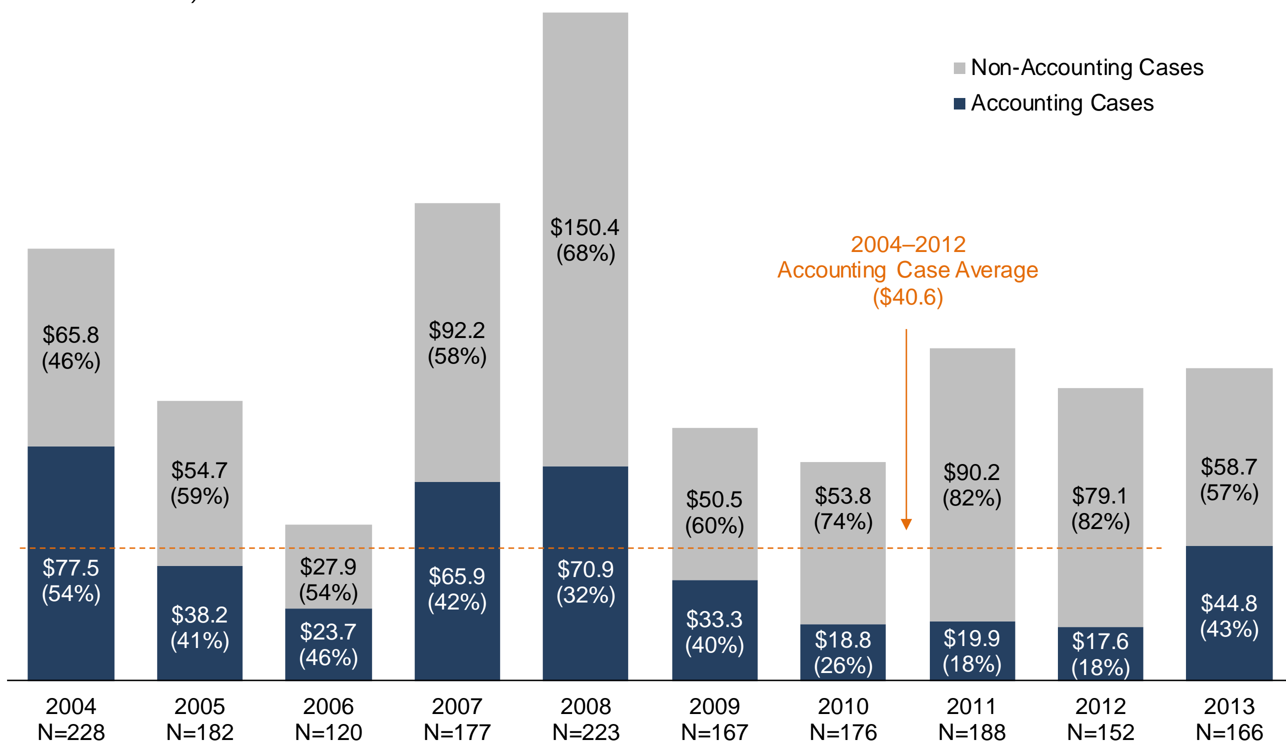
Disclosure Dollar Loss (DDL) Index™

This index measures the aggregate DDL for all filings over a period of time. DDL is the dollar value change in the defendant firm's market capitalization between the trading day immediately preceding the end of the class period and the trading day immediately following the end of the class period. DDL should not be considered an indicator of liability or measure of potential damages.

- The DDL Index increased 155 percent from 2012 to 2013 for accounting cases, in contrast to the 26 percent decrease for non-accounting cases.
- Over the last 10 years, the DDL Index for accounting cases has fluctuated significantly. At $44.8 billion, the DDL Index for accounting cases in 2013 was higher than the historical average of $40.6 billion.
- The proportion of the total DDL Index in 2013 represented by accounting cases was also relatively high compared with prior years.
- The 10-year history shows that market capitalization losses are determined in part by the nature of the cases involved. For example, the relatively large number of accounting case filings in 2011 did not translate to a high level of DDL, since a fairly large percentage of the filings in that year involved CRM cases, which tend to involve smaller issuers.

In 2013, the DDL Index for accounting cases reached the highest level since 2008.

FIGURE 3: **DISCLOSURE DOLLAR LOSS INDEX™**
2004–2013
(Dollars in Billions)

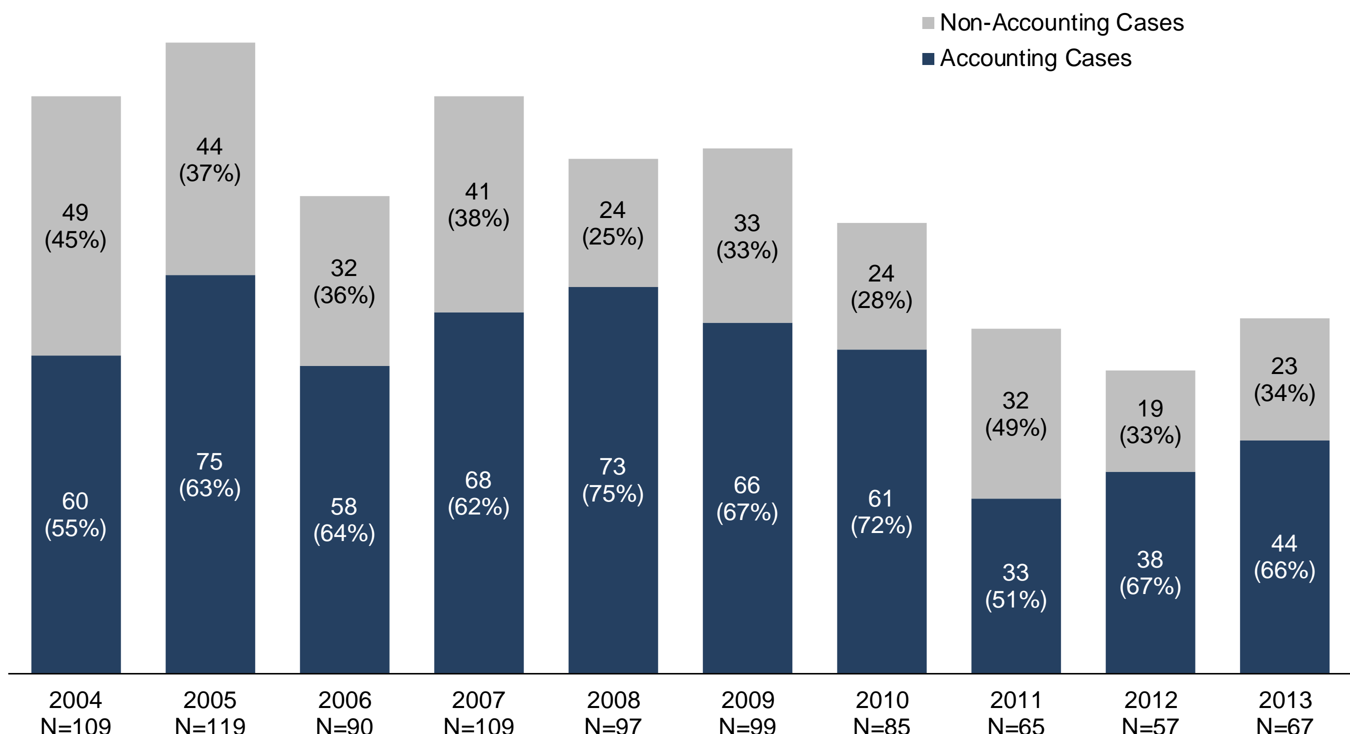


SETTLEMENTS AND SHARE OF ACCOUNTING CASES

- Despite recent year-over-year increases, the number of accounting case settlements has remained relatively low over the last few years. For example, in 2011–2013 the number of accounting settlements ranged from 33 to 44 per year compared with 58 to 75 per year in 2004–2010.
- Recent trends in the number of accounting case settlements are generally consistent with trends in overall securities class action settlements.[6]
- Over the last 10 years, accounting case settlements as a percentage of the total number of cases settled have ranged from 51 percent to 75 percent.
- In 2013, 14 of the 44 settled accounting cases were CRM cases, representing the highest number of CRM settlements to date.
- Given that CRM case filings peaked in 2011 and the fact that, overall, cases generally take about three years to settle, additional CRM case settlements are expected in 2014.

For the second year in a row, the number of settlements of cases involving accounting issues increased.

FIGURE 4: **SETTLEMENTS AND SHARE OF ACCOUNTING CASES 2004–2013**

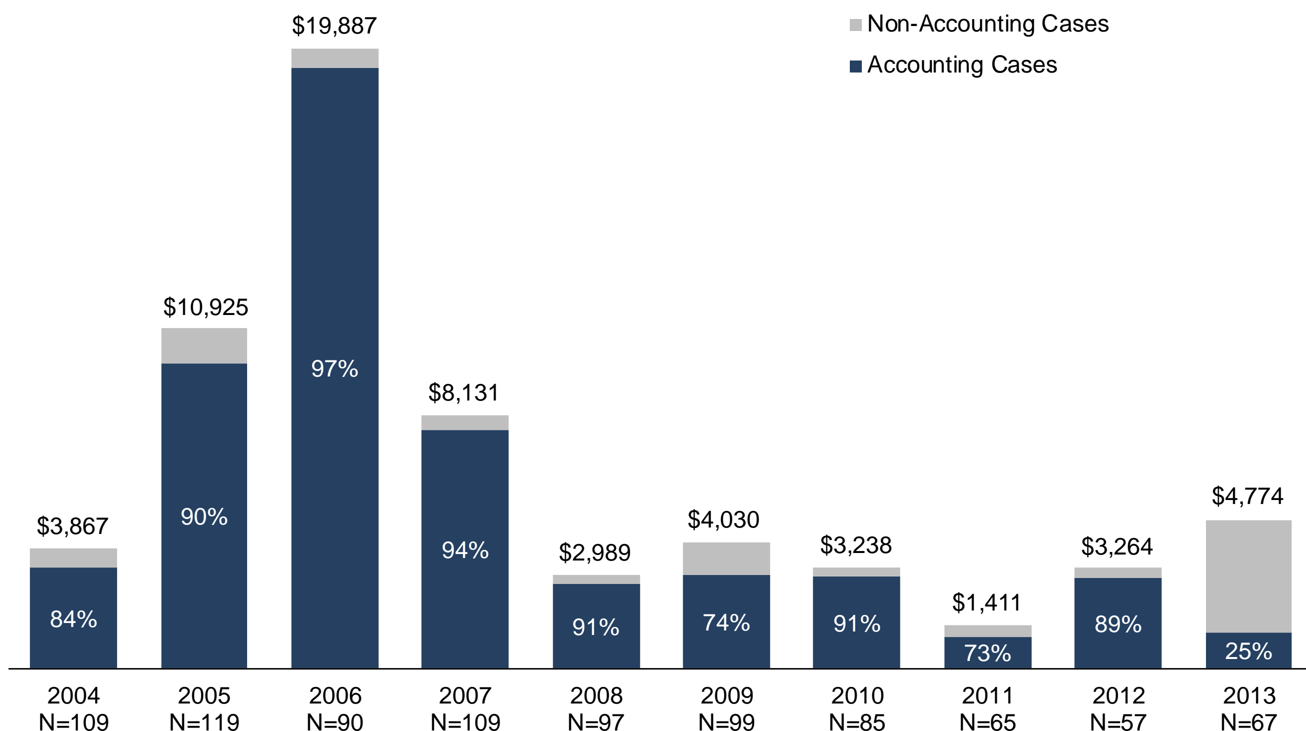


SETTLEMENT DOLLARS AND SHARE OF ACCOUNTING CASES

- Historically, accounting cases have represented the vast majority of the total value of cases settled.
- In contrast to prior years, in which accounting cases have represented as much as 97 percent of the total value of case settlements, accounting cases represented only 25 percent of the total value of cases settled in 2013.
  - This unusual result was due to the presence of one non-accounting case that comprised more than 50 percent of the total value of cases settled. Accordingly, this change is not expected to indicate a future trend.
  - Excluding the settlement mentioned above, accounting cases represented just over 50 percent of the value of cases settled in 2013.

For the first time since passage of the PSLRA, the total value of accounting case settlements was lower than non-accounting cases.

FIGURE 5: **SETTLEMENT DOLLARS AND SHARE OF ACCOUNTING CASES**
2004–2013
(Dollars in Millions)



Note: Settlement dollars adjusted for inflation; 2013 dollar equivalent figures used.

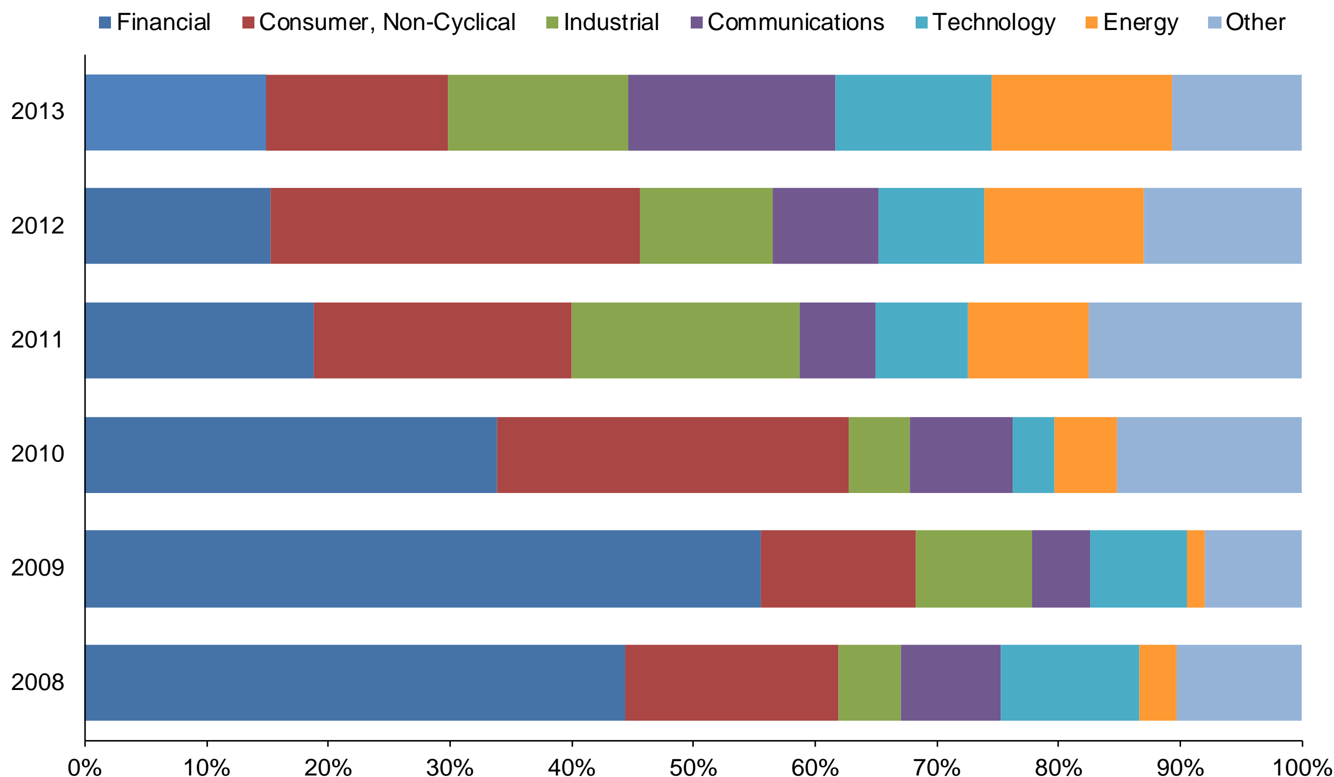
INDUSTRY SECTORS

ACCOUNTING CASE FILINGS AND INDUSTRY SECTORS

- In 2013, securities class action filings of accounting cases were more evenly distributed across industry sectors compared with prior years.
- Recent years have seen fewer accounting case filings against companies in the financial sector while, at the same time, filings against companies in the energy, technology, industrial, and communications sectors have increased.

No single industry sector accounted for a significant portion of accounting case filings in 2013.

FIGURE 6: **ACCOUNTING CASE FILINGS BY INDUSTRY SECTOR**
2008–2013

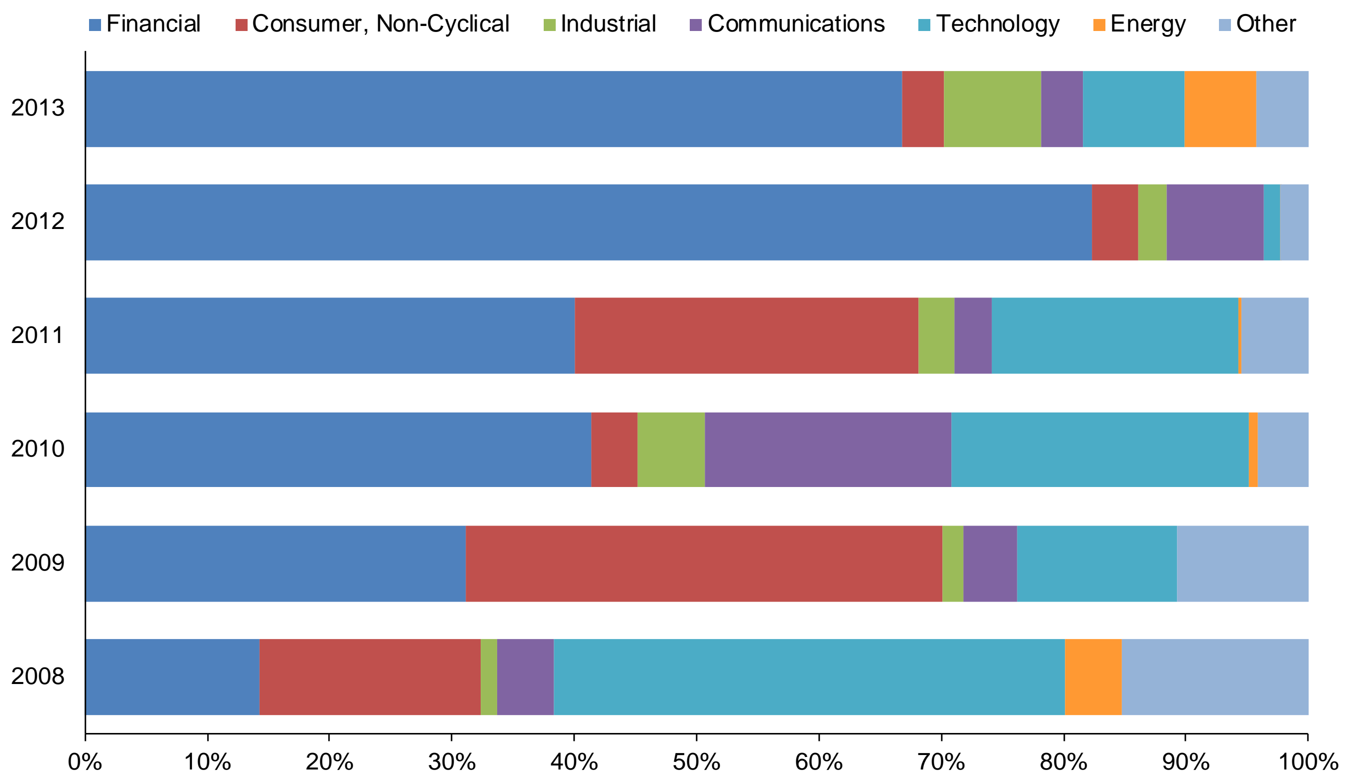


ACCOUNTING CASE SETTLEMENT DOLLARS AND INDUSTRY SECTORS

- The prevalence of accounting allegations is correlated with industry type.
  - For example, financial institution cases settled in recent years have tended to include accounting allegations.
  - In contrast, pharmaceutical cases (included within the consumer non-cyclical sector) comprised a large portion of non-accounting case settlements in 2013, and they represented a small portion of total settlement dollars in accounting cases.
- The distribution of settlement dollars by industry sector in 2013 is very different from that of five years ago, when cases in the technology sector comprised the largest portion of accounting case settlement dollars, and financial sector cases represented a relatively small amount.

Reflecting the resolution of a number of credit crisis cases, total settlement dollars recently have been dominated by cases in the financial sector.

FIGURE 7: **ACCOUNTING CASE SETTLEMENT DOLLARS BY INDUSTRY SECTOR**
2008–2013



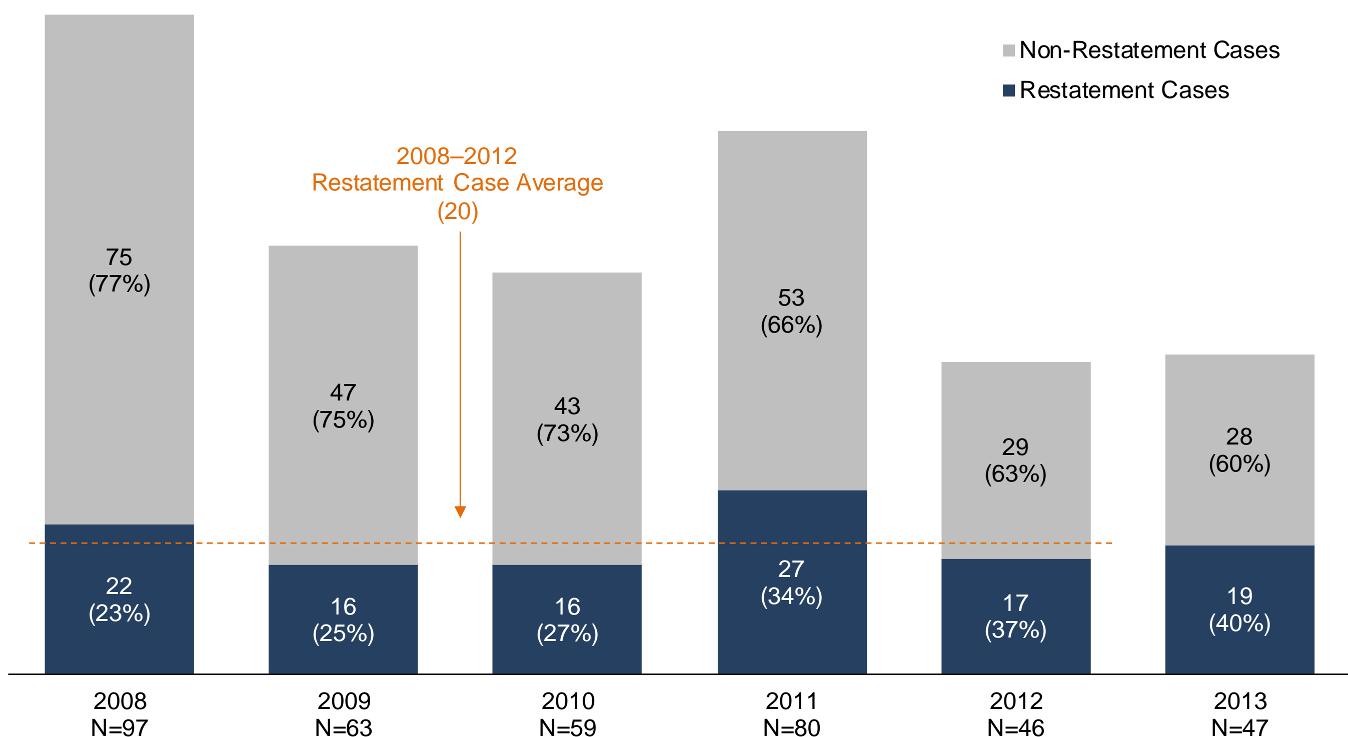
ACCOUNTING RESTATEMENTS

ACCOUNTING CASE FILINGS AND RESTATEMENTS

- At 40 percent of all accounting cases, the proportion of filings involving restatements in 2013 is higher than any of the prior five years.
- This is consistent with data showing that the number of restatements by accelerated filers (i.e., large companies that are heavily targeted in securities class actions) has increased in recent years.[7]
- The 2013 increase in new filings involving restatements also suggests a possible change from observations over the last several years that restatements of financial statements had become less severe in nature (e.g., smaller downward restatements and shorter periods covered).[8]

Recent increases in the number of restatements by large firms have led to a rise in the proportion of accounting case filings involving restatements.

FIGURE 8: **ACCOUNTING CASE FILINGS AND RESTATEMENTS**
2008–2013

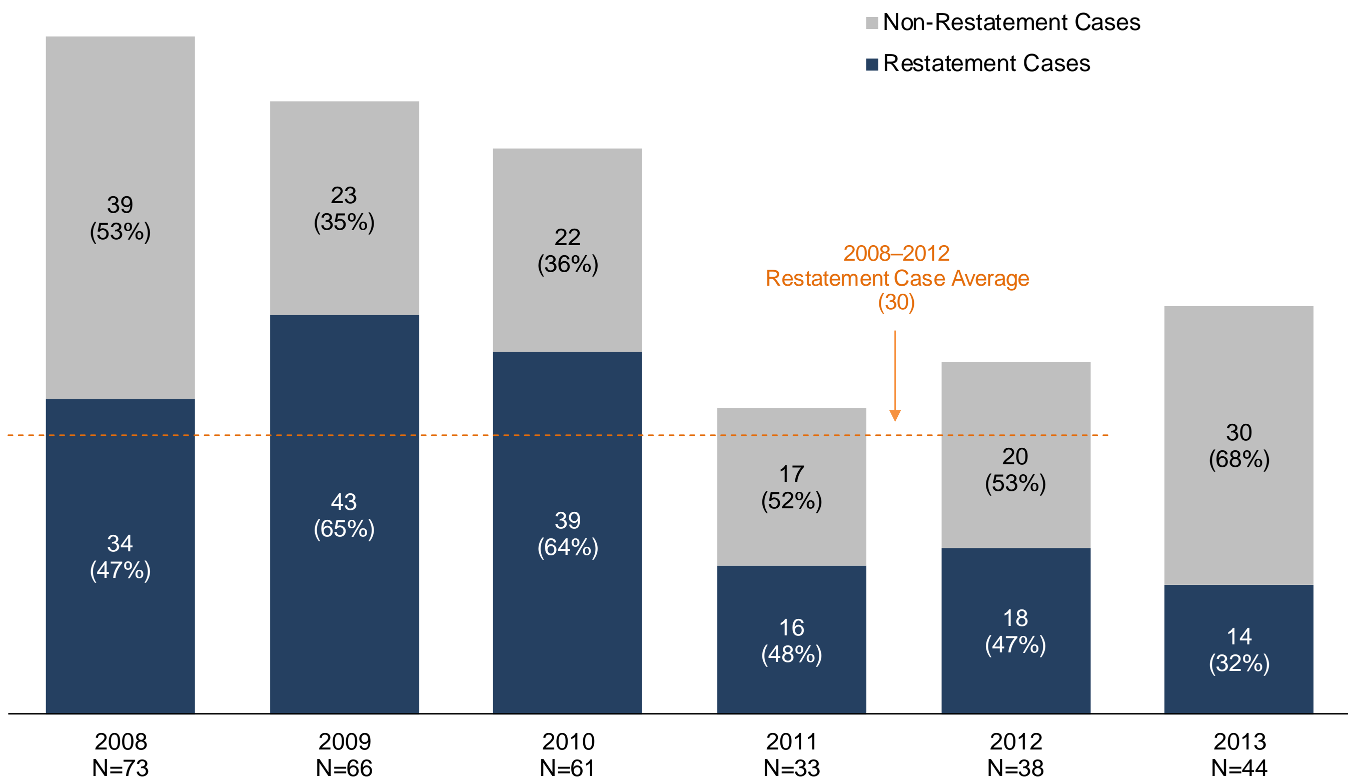


ACCOUNTING CASE SETTLEMENTS AND RESTATEMENTS

- The number and proportion of case settlements involving restatements were lower than any of the prior five years, and more broadly, the number of such cases has been relatively low in the last three years.
- Since cases often take about three years from filing to settlement, the recent increase in filings involving restatements has not yet translated to an increase in the number of settlements involving restatements.

The proportion of accounting case settlements involving restatements dropped to 32 percent in 2013.

FIGURE 9: **ACCOUNTING CASE SETTLEMENTS AND RESTATEMENTS**
2008–2013



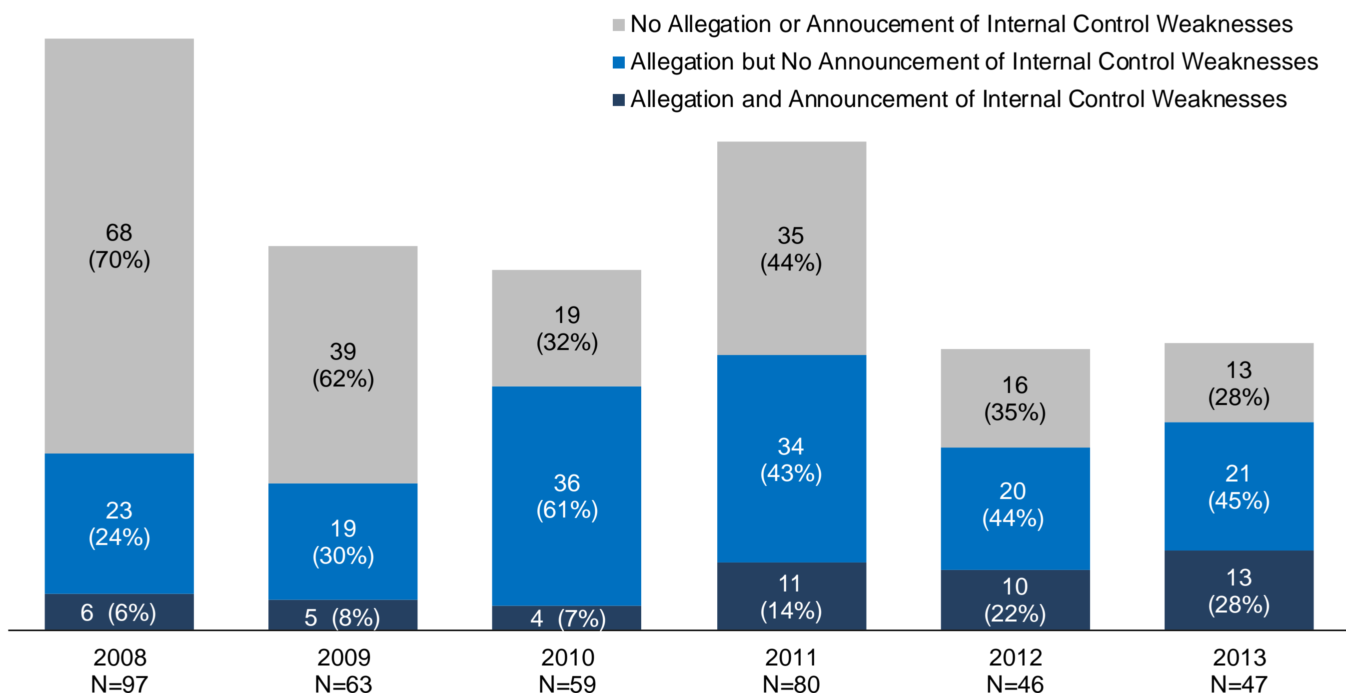
INTERNAL CONTROL ALLEGATIONS

ACCOUNTING CASE FILINGS AND ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES

- In 2013, the proportion of filings involving allegations of internal control weaknesses was higher than in any of the prior five years.
- The proportion of cases involving company announcements of internal control weaknesses has also grown substantially over the past three years—reaching 28 percent of all accounting cases in 2013, compared with only 6 to 8 percent in 2008–2010.
- In 2013, plaintiffs alleged internal control weaknesses when there were no accompanying announcements in 45 percent of all accounting cases.
- Most cases that include allegations of internal control weaknesses also allege Generally Accepted Accounting Principles (GAAP) misstatements. For example, in 2013, more than 90 percent of cases that included internal control weakness allegations also involved accompanying GAAP allegations.

Over 70 percent of accounting cases filed in 2013 involved allegations of internal control weaknesses.

FIGURE 10: **ACCOUNTING CASE FILINGS AND ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES**
2008–2013



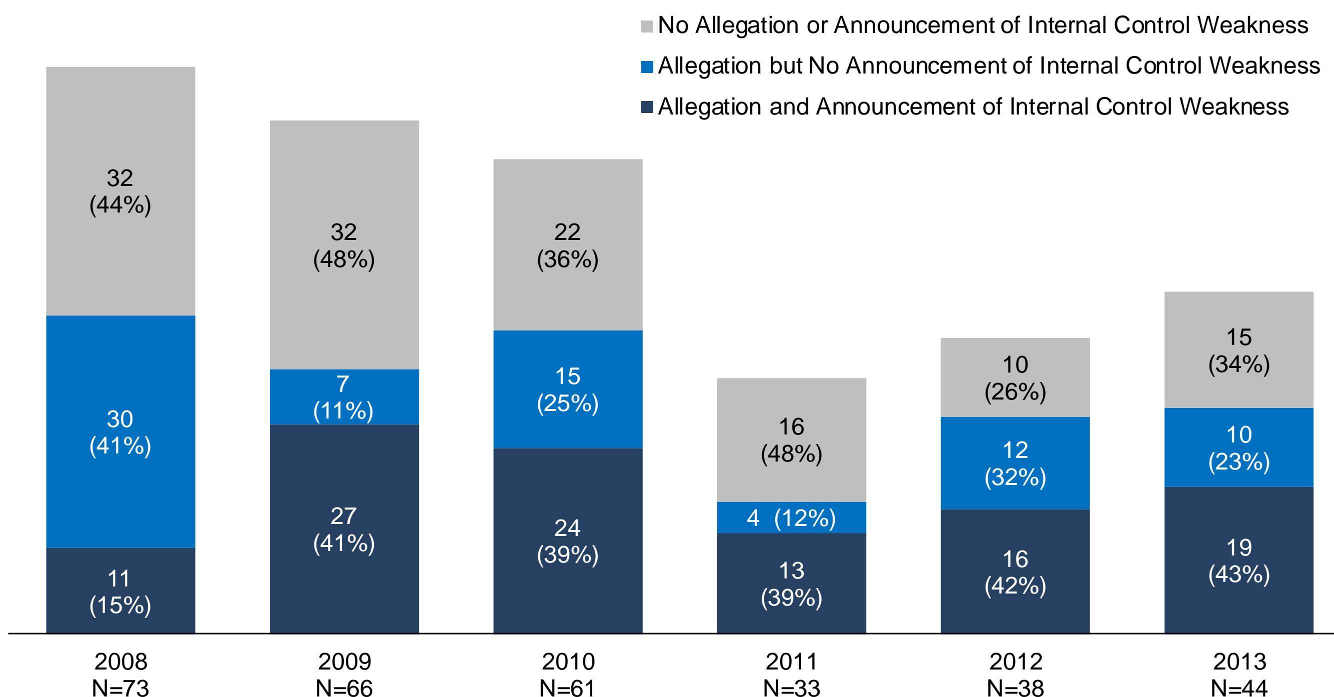
Note: Percentages may not add to 100 due to rounding.

ACCOUNTING CASE SETTLEMENTS AND ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES

- Since 2009, the proportion of settlements of cases involving an announcement by the company of an internal control weakness has fluctuated within a narrow range of 39 to 43 percent.
- While plaintiffs often allege internal control weaknesses, such allegations are not associated with higher settlement amounts, unless accompanied by company announcements reporting the presence of such weaknesses.
- Cases that involve a company announcement of internal control weaknesses settle for substantially higher amounts and higher settlements as a percentage of shareholder losses compared to cases with no such announcements (medians of $12.4 million and 2.9 percent compared with $7.1 million and 2.3 percent, respectively).

Over 65 percent of accounting cases that settled in 2013 involved allegations of internal control weaknesses.

FIGURE 11: **ACCOUNTING CASE SETTLEMENTS AND ALLEGATIONS OF INTERNAL CONTROL WEAKNESSES**
2008–2013



FACTORS AFFECTING ACCOUNTING CASE SETTLEMENTS

MEDIAN "ESTIMATED DAMAGES"

This section examines case attributes across different types of allegations and accounting issues, with comparisons to non-accounting cases.[9] The measure "estimated damages" is discussed in detail in *Securities Class Action Settlements—2013 Review and Analysis*. As a brief overview, this measure is a simplified calculation of shareholder losses measured consistently across years; thus, it is not intended to represent actual damages borne by shareholders but enables the identification and analysis of potential trends.[10]

- Overall, accounting cases involve substantially higher median "estimated damages" than cases without accounting-related allegations.
- Cases involving allegations of asset write-downs rank second in median "estimated damages," driven in part by the fact that these cases often have involved large financial institutions.

Cases involving reported accounting irregularities are associated with the highest median "estimated damages."

FIGURE 12: **MEDIAN "ESTIMATED DAMAGES"**
2008–2013
(Dollars in Millions)

Note: "Estimated Damages" are adjusted for inflation based on class period end dates. Allegations of write-downs, restatements, and accounting irregularities are subsets of GAAP.

MEDIAN SETTLEMENT AMOUNTS

- Since shareholder losses are the most important determinant of settlement amounts, the patterns in median settlement amounts closely parallel those observed with "estimated damages."
- Cases involving accounting issues tend to be associated with accompanying SEC actions and accompanying derivative actions, both of which are also associated with higher median settlement amounts.
- In recent years, cases involving restatements have not been associated with substantially higher median settlement amounts. These cases are, however, associated with higher settlement amounts when other important settlement determinants are controlled for (i.e., when regression analysis is used to examine multiple factors simultaneously).

The median settlement amount for accounting cases is higher than for non-accounting cases.

FIGURE 13: **MEDIAN SETTLEMENT AMOUNTS**
2008–2013
(Dollars in Millions)

Note: Settlement dollars adjusted for inflation; 2013 dollar equivalent figures used. Allegations of write-downs, restatements, and accounting irregularities are subsets of GAAP.

MEDIAN SETTLEMENT AMOUNTS AS A PERCENTAGE OF "ESTIMATED DAMAGES"

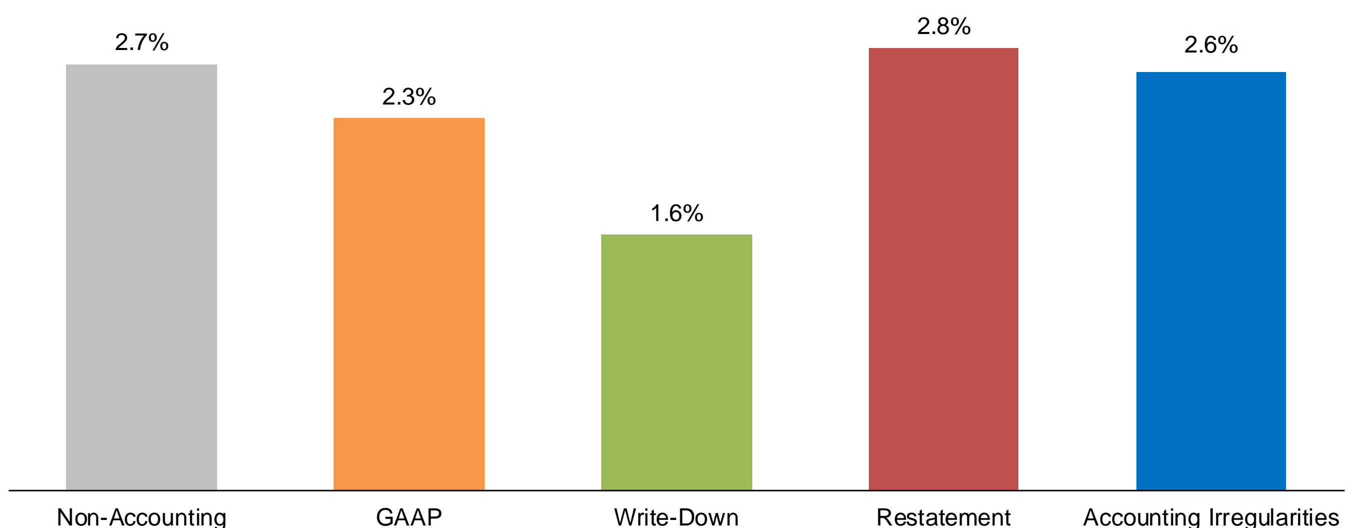
As the most important factor affecting settlement amounts, it is useful to consider settlement amounts in relation to shareholder losses.

- Across the different types of allegations, median settlements as a percentage of "estimated damages" are quite different from the patterns observed in median settlement amounts.
- The lowest settlements in relation to "estimated damages" are for cases involving asset write-downs. This may be due to the fact that:
  - These cases tend to be larger, and larger cases tend to settle for smaller percentages of "estimated damages."
  - Write-downs involve accounting judgment, and it may be more difficult for plaintiffs to substantiate claims of wrongdoing in these cases.

Cases involving asset write-downs are associated with the lowest median settlement as a percentage of "estimated damages."

FIGURE 14: **MEDIAN SETTLEMENT AMOUNTS AS A PERCENTAGE OF "ESTIMATED DAMAGES"**

2008–2013



Note: Allegations of write-downs, restatements, and accounting irregularities are subsets of GAAP.

AUDITOR DEFENDANTS

ACCOUNTING CASE SETTLEMENTS AND AUDITOR DEFENDANTS

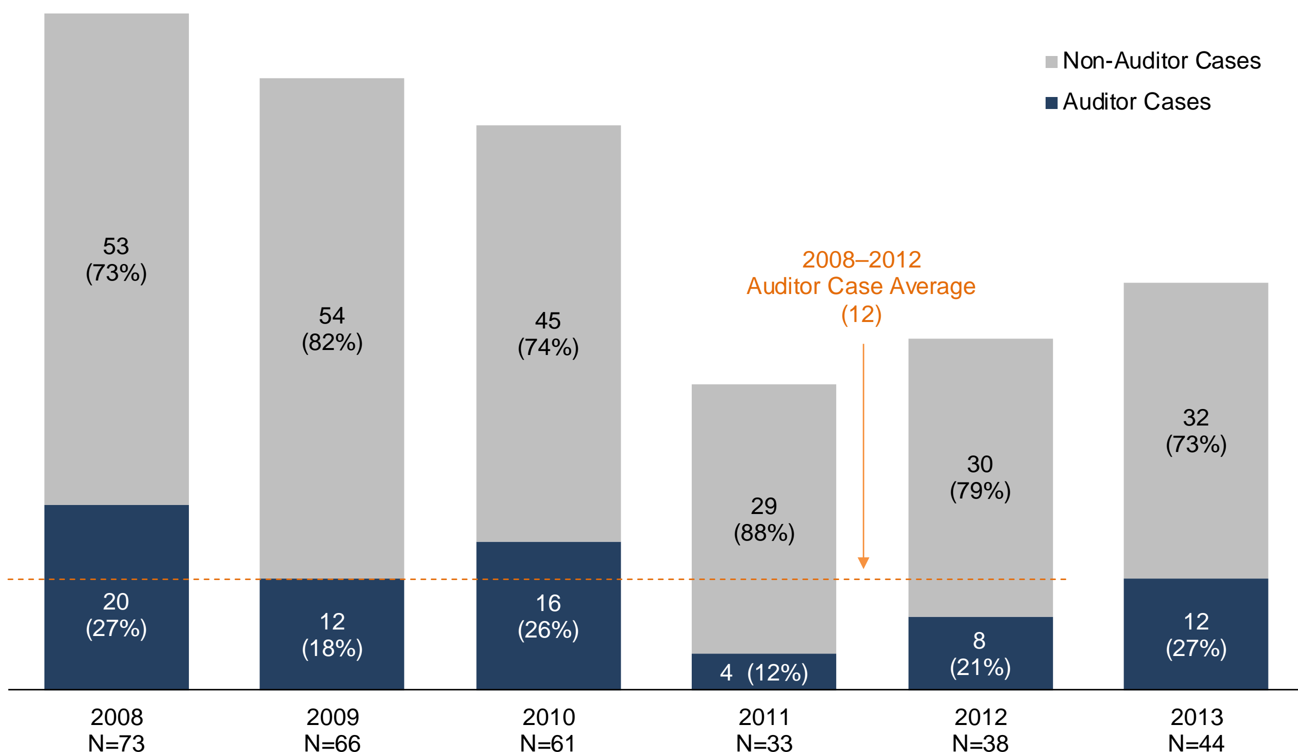
Overall, auditor participation in class action settlements in the last several years has been lower than in the early years following passage of the Private Securities Litigation Reform Act (PSLRA). This is likely due in part to U.S. court decisions that have reduced auditor liability,[11] as well as the changing nature of restatements (see page 9). The latter is due to the fact that auditor liability in securities class actions is closely tied to whether audited financial statements were restated, as well as the nature of any restatement.

- Reflecting an increase over the last couple of years, auditors were named as defendants in 12 out of 44 accounting cases that settled in 2013. This is due in part to the fact that auditors have been named more frequently in CRM cases (6 out of the 14 CRM settlements in 2013 involved auditors as named defendants).

- Cases involving auditors as named defendants tend to settle for higher amounts.[12]

In 2013, the proportion of accounting case settlements involving auditor contributions was the highest in several years.

FIGURE 15: **ACCOUNTING CASE SETTLEMENTS AND AUDITOR DEFENDANTS**
2008–2013



RESEARCH SAMPLE

This report utilizes the databases described in *Securities Class Action Filings—2013 Year in Review* and *Securities Class Action Settlements—2013 Review and Analysis*. Most of the charts in this report focus on cases filed or settled in 2008 or later; thus, the samples consist of subsets of the full databases described in these related Cornerstone Research reports.

ENDNOTES

[1] For purposes of this research, cases are considered "accounting cases" if they include allegations related to Generally Accepted Accounting Principles (GAAP) violations, auditing violations, or internal control weaknesses.

[2] Mary Jo White, chair of the SEC, "Chairman's Address at SEC Speaks 2014" (speech, Washington, DC, February 21, 2014).

[3] Craig M. Lewis, chief economist and director, Division of Risk, Strategy, and Financial Innovation, SEC, "Risk Modeling at the SEC: The Accounting Quality Model" (speech, Financial Executives International Committee on Finance and Information Technology, December 13, 2012).

[4] See *Securities Class Action Settlements—2013 Review and Analysis*, Cornerstone Research.

[5] See *Securities Class Action Filings—2013 Year in Review*, Cornerstone Research.

[6] See *Securities Class Action Settlements—2013 Review and Analysis*, Cornerstone Research.

[7] See *2012 Financial Restatements: A Twelve Year Comparison*, Audit Analytics, March 2013.

[8] See *2012 Financial Restatements: A Twelve Year Comparison*, Audit Analytics, March 2013.

[9] The accounting allegations and issues analyzed are: (1) GAAP—cases with allegations of GAAP violations; (2) Write-Down—cases with allegations involving an asset write-down or reserve increase; (3) Restatement—cases involving a restatement (or announcement of a restatement) of financial statements; and (4) Accounting Irregularities—cases in which the defendant has reported the occurrence of accounting irregularities (intentional misstatements or omissions) in its financial statements.

[10] As described in *Securities Class Action Settlements—2013 Review and Analysis*, "estimated damages" are not necessarily linked to the allegations included in the associated court pleadings. Accordingly, damages estimates presented in this report are not intended to be indicative of actual economic damages borne by shareholders.

[11] For example, see *Janus Capital Group Inc. v. First Derivative Traders*.

[12] This finding refers to the total settlement amount and does not imply any information about amounts actually paid by auditors to the class. Overall, auditors contribute to securities class action settlements relatively infrequently. Moreover, the association between auditor involvement and settlement amounts is not necessarily causal; it is possible that plaintiffs choose to name auditors as defendants in certain cases that result in higher settlements due to unobservable factors not captured by our research.

Please reference Cornerstone Research in any reprint of the figures or findings included in this report.

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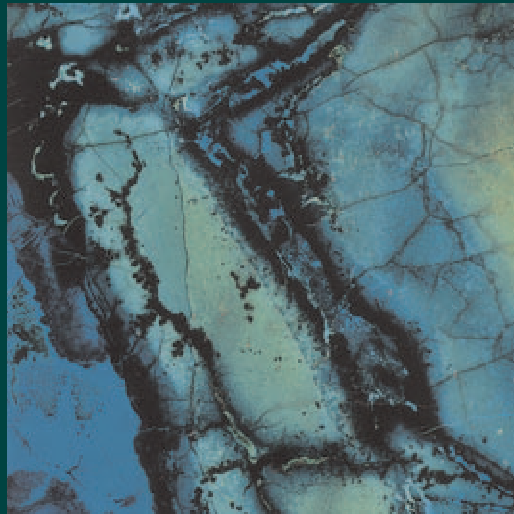
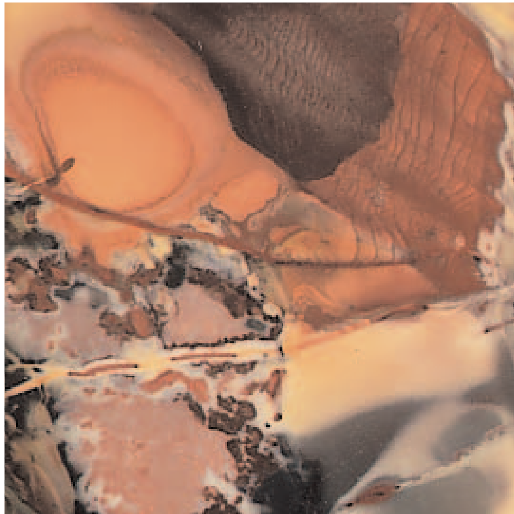


Cornerstone Research provides economic and financial consulting and expert testimony to attorneys in complex business litigation. Our goal is to be the recognized leader in providing high-quality analysis of challenging business problems.



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Baker Botts
Baker & Hostetler
Baker & McKenzie
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Patton Boggs
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Perkins Coie
Pillsbury Winthrop Shaw Pittman
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Proskauer Rose
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Simpson Thacher & Bartlett
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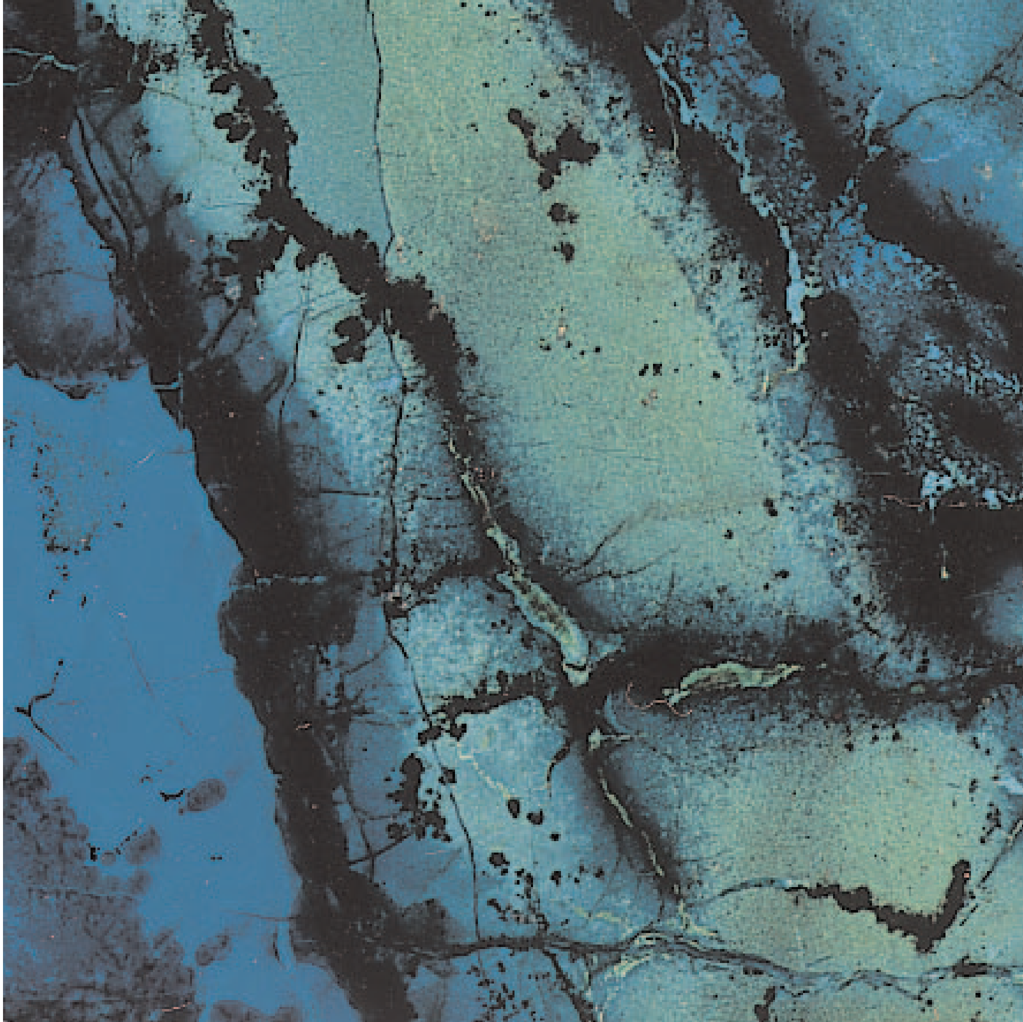
Sonnenschein Nath & Rosenthal
Stroock & Stroock & Lavan
Sullivan & Cromwell
Thompson & Knight
Vinson & Elkins
Vorys, Sater, Seymour and Pease
Wachtell, Lipton, Rosen & Katz
Weil, Gotshal & Manges
Weston Benshoof Rochefort Rubalcava MacCuish
Wiley Rein
Williams & Connolly
Willkie Farr & Gallagher
Wilmer Cutler Pickering Hale and Dorr
Wilson Sonsini Goodrich & Rosati
Winston & Strawn



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16 Antitrust
18 Intellectual Property
20 Financial Institutions
22 Energy
24 Other Matters

About Our Firm

For more than twenty-five years Cornerstone Research staff have provided high-quality expert testimony and economic and financial analysis to attorneys in all phases of commercial litigation and regulatory proceedings. During that time we have become one of the leading firms consulting to attorneys involved in complex litigation. Our objective, state-of-the-art analysis has earned us a reputation for excellence and effectiveness.

We work with faculty and industry experts in a distinctive "partnership" that combines the strengths of the business and academic worlds. The faculty, from the nation's leading business schools, economics departments, and law schools, keep us at the forefront of academic research. Our staff consultants contribute expertise in the fields of economics, finance, accounting, and marketing research, as well as business acumen, familiarity with the litigation process, and a commitment to produce outstanding results. Our faculty-staff team approach combines theoretical and practical knowledge to develop high-quality analyses that are tailored to the needs of each case.

Our clients have brought us a wide range of challenging assignments, including some of the most important cases of the past quarter century. We have helped clients to achieve favorable outcomes in hundreds of trials, arbitrations, and regulatory hearings, and in pre-trial efforts.

As attorneys have sought our services in a variety of matters, we have built experience and specialized knowledge in many areas of business litigation. Our staff now exceeds four hundred. Cornerstone Research senior consultants have advanced degrees in such fields as economics, finance, accounting, marketing, mathematics, and computer science. Our consultants demonstrate exceptional skill and commitment and are known for developing practical, innovative solutions to challenging problems. We are recognized as providing responsive, insightful support while managing the preparation of analysis and expert testimony in complex matters.

Even with the marked growth of our practice, our cases generally come from attorneys who have worked with us and from colleagues they refer to us. The support we give our clients is built on a thorough understanding of their needs and a commitment to provide value through quality, integrity, and responsiveness. In the following pages we describe the services and experience we bring to each matter.

Our Services

Cornerstone Research provides attorneys with analytical support in all phases of commercial litigation and regulatory proceedings, from identifying relevant issues and developing case strategy to engaging expert witnesses, conducting research, and preparing effective testimony.

Consulting to Attorneys

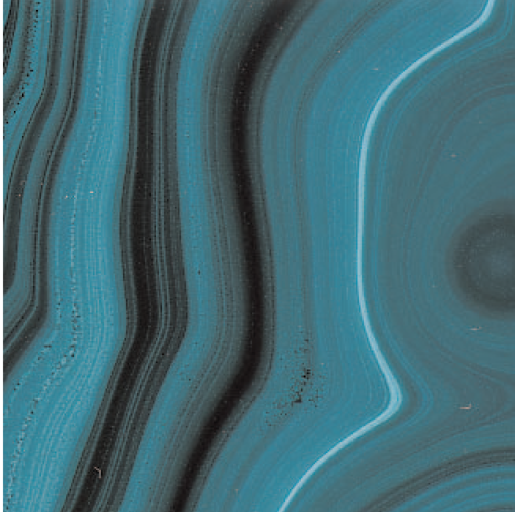
During the early stages of a case, often prior to the engagement of an expert witness, Cornerstone Research consults directly with attorneys to identify key business, economic, and financial issues. In addition, we outline areas requiring expert testimony and help determine the types of experts, data collection, and analyses needed.

We also provide estimates of potential damages and other preliminary analyses for attorneys to apply in developing case strategies. In many instances our clients use the results of these analyses to negotiate favorable settlements.

Our early involvement in a case also benefits counsel in the discovery process. We assist in writing discovery requests and in organizing and interpreting materials.

Identifying and Supporting Expert Witnesses

When testimony from one or more expert witnesses is needed, Cornerstone Research assists clients in locating the experts whose research, recognized industry expertise, and prior experience in litigation proceedings make them effective witnesses. In many cases we call upon our network of several hundred outstanding faculty experts and industry specialists. In other cases, our senior staff provide expert testimony. Once the appropriate experts are engaged, we provide them with complete support throughout the litigation process.

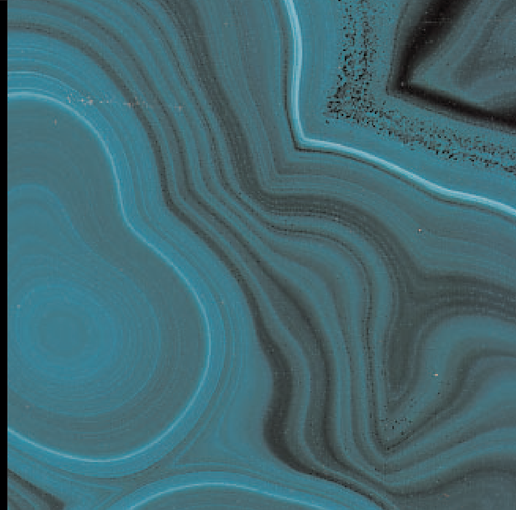


"I would not go to anyone else on a bet the company case. I think they are the best. In addition to the Cornerstone Research staff, they draw on an outside group of experts that provides expertise tailored to the problem, not just someone off the shelf."

Chuck Koob
Simpson Thacher & Bartlett

"The Cornerstone Research people are knowledgeable, experienced, and always responsive. They are invaluable members of a litigation team."

Frank Barron
Cravath, Swaine & Moore



Conducting Research and Analysis

Managing analyses in complex proceedings is an important aspect of the services we offer. We have experience organizing research efforts and coordinating the work of multiple experts. We ensure that work is conducted efficiently and is of the highest quality and integrity.

Our specialized financial and economic databases and research capabilities provide our clients with a distinct advantage. We are able to collect and analyze relevant data quickly using our state-of-the-art computer network and the most current econometric, statistical, graphical, and database software. We also use proprietary software to build, manage, and analyze the large data sets needed in today's litigation environment. These resources enable us to take on diverse assignments and consistently meet case requirements and deadlines.

Preparing for Deposition and Trial

Cornerstone Research staff have substantial trial experience. Our support can extend through the entire trial process and to post-trial briefs. We also assist counsel in preparing for depositions of opposing witnesses and in developing cross-examination questions.

We prepare expert witnesses thoroughly for deposition and trial. We help the experts translate the results of their analyses into concise testimony and clear exhibits that juries can easily understand.

"Cornerstone Research always finds the right expert—they have a very deep bench. During trial, I have found their support to be excellent."

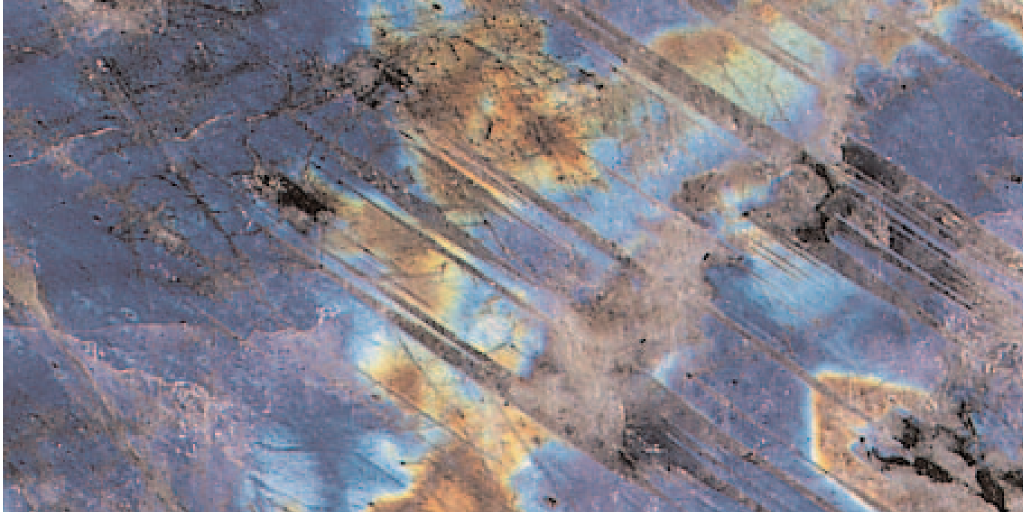
Paul Blankenstein
Gibson, Dunn & Crutcher

"In the most complex and demanding business litigation and investigations, Cornerstone Research has time and time again brought to bear sophisticated and invaluable expertise."

Jim Rouhandeh
Davis Polk & Wardwell

Our Practice

Attorneys have retained Cornerstone Research in a wide variety of cases involving numerous industries. Our diverse areas of specialization enable us to provide clients with a breadth of perspective and expertise. We are known for our work in such fields as securities, antitrust, intellectual property, financial institutions, accounting, and energy. Our extensive background in business litigation covers issues as varied as taxation, breach of contract, fraudulent conveyance, and piercing the corporate veil. We have worked on matters in numerous industries, including pharmaceuticals, healthcare, telecommunications, real estate, and high technology. The following pages briefly describe some of our areas of specialization and provide summaries of representative case assignments.

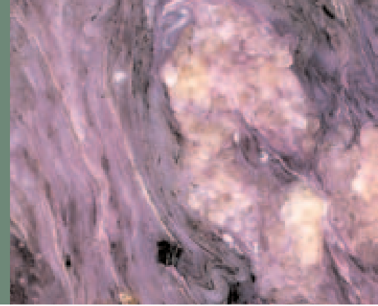


"Cornerstone Research staff take an economic approach to thinking about legal issues, and they understand the way lawyers think."

Peter Wald
Latham & Watkins

"In addition to a smart and creative staff, Cornerstone Research has an outstanding network of experts. They would always be a firm that I turn to in a complex case."

Jim Benedict
Milbank, Tweed, Hadley & McCloy



Securities

Our experience in over a thousand securities cases has given Cornerstone Research expertise that spans many areas of finance. Drawing upon decades of academic research in security price formation, we have developed innovative approaches to evaluating alternative per-share damages scenarios and modeling settlement outcomes in Rule 10b-5 and Section 11 and 12 claims. Our analyses of market efficiency and trading behavior have supported successful arguments concerning class certification. Our securities expertise extends beyond issues arising in typical securities class actions and includes issues related to asset and business valuation, market microstructure, market manipulation, bond default, and derivatives. We have provided analyses in ERISA company stock cases. We have worked with clients to achieve favorable outcomes in numerous securities matters, including many trials.

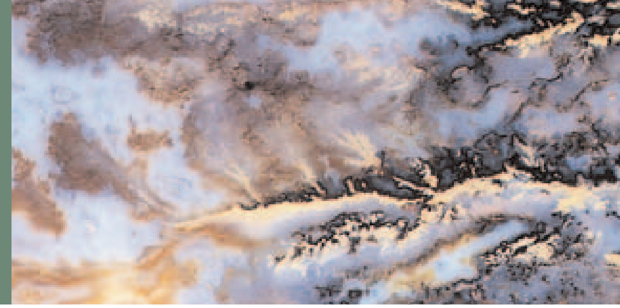
Disclosure

Cornerstone Research was retained by a law firm representing a computer maker in a decade-long securities class-action suit. Shareholders alleged that the company had overstated its earnings shortly before large losses led to bankruptcy. Cornerstone Research addressed the issue of damages by performing a detailed event study and reviewing the personal computer market. We concluded that the company's stock price decline was not in any way attributable to the accounting-related allegations. We also found fundamental flaws in the analysis and findings of the plaintiffs' damages expert, which were explored extensively during discovery. The jury ruled in favor of our client on liability.

Accounting Restatement/Market Efficiency

After a computer software company announced that it was restating its 1997, 1998, and 1999 financial results, the company and its auditor were named in a class-action lawsuit alleging that the announcement had caused a one-day $11 billion drop in market capitalization. Counsel for the auditor retained Cornerstone Research. Our accounting expert conducted an event study and determined that changes in market capitalization were largely unrelated to the reported financials. Our finance expert performed an assessment of the efficiency of the market for the company's stock and found that the stock was traded at a value that diverged significantly from its fundamental value over a long time period. The case settled shortly after defense counsel moved to decertify the class based on these findings.

Securities Class Action Clearinghouse
Cornerstone Research and Stanford Law School cosponsor the Securities Class Action Clearinghouse, the leading source of data and analytical information regarding the financial and economic characteristics of securities class-action litigation.
http://securities.stanford.edu



Bond Default

In the largest municipal bond default case ever litigated, Cornerstone Research staff supported and coordinated the work of five experts on a variety of liability and damages issues. Working closely with the experts, we constructed a model to predict the creditworthiness of each of the municipalities involved and proved that the municipalities would likely have defaulted on their debt obligations. We also developed damage models and analyzed proof of claim data to assist our client in evaluating the damage models of opposing experts. The case settled during trial.

Valuation

In a breach of contract case involving a national restaurant chain, Cornerstone Research assisted counsel for plaintiffs, two potential franchisees, in valuing damages based on their claimed contractual share of the franchise. Cornerstone Research assessed the value of a regional restaurant franchise by performing discounted cash flow and comparable transaction analyses. We also analyzed defense experts' damages calculations, showing them to contain fundamental errors that substantially understated damages. The case went to arbitration, where our clients were awarded substantial damages.

Trading Behavior/Class Certification

In a putative class action involving an online brokerage company, plaintiffs alleged that they had experienced delays in using an online brokerage system. Plaintiffs claimed that their experts could determine on a class-wide basis what damages these alleged delays had caused. Cornerstone Research analyzed the claim and concluded that it would be impossible to determine on a class-wide basis whether plaintiffs had suffered damages or to determine damages without having information on each individual's trading intentions at the time of delay. The court found that individual issues predominated and denied certification of the proposed class. This case was followed by two other claims, and class certification was denied in each case based on our analysis.

Derivatives

In this mutual fund litigation, defense counsel for a fund's auditor retained Cornerstone Research. Plaintiffs claimed that the risk of the fund's investments, including mortgage-backed derivative securities, was not disclosed and that allegedly illiquid securities held by the fund were misvalued. Working with the expert, we analyzed the sales prices of the allegedly illiquid securities and demonstrated that the securities in the fund's portfolio were properly valued. The expert also found that the fund's disclosures informed investors of the risk of its investments and were consistent with the disclosure practices of other funds during the relevant time period. The case settled shortly before trial.

ANTITRUST

Cornerstone Research provides sophisticated economic analyses to counsel and corporations involved in antitrust matters. Our experience and expertise span a broad spectrum of antitrust issues, including price fixing, horizontal collusion, monopolization, predation, tying, exclusionary practices, and antitrust issues associated with intellectual property and mergers. We have worked on some of the most prominent antitrust cases in private litigation and in matters involving the Department of Justice, Federal Trade Commission, Federal Communications Commission, Securities and Exchange Commission, and other agencies. Attorneys seek our involvement to address issues of class certification, liability, and damages.

Price Fixing

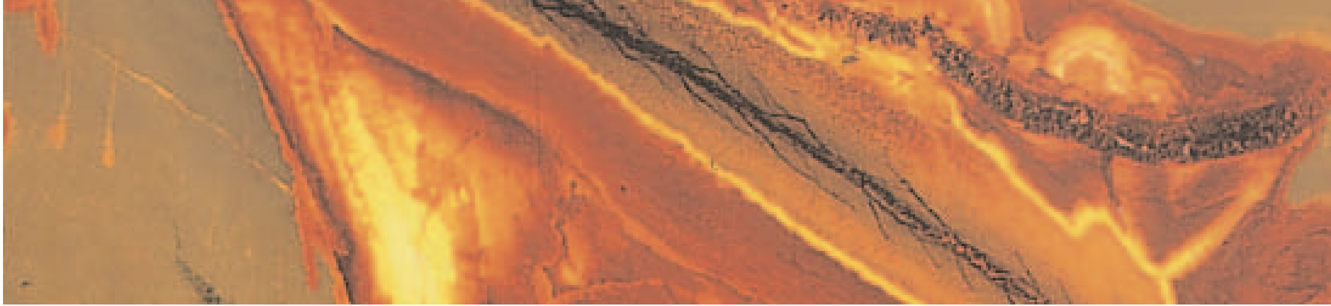
When several major gasoline refiners were accused of fixing prices, restricting capacity, and limiting production, counsel for one of the defendants retained Cornerstone Research to evaluate plaintiffs' collusion theory. We showed that our client's pricing, capacity, and production decisions were consistent with competition and contradicted plaintiffs' claims of collusion. The trial court awarded summary judgment for the defendants, and that ruling was unanimously affirmed on appeal.

Collusion

In a class action alleging collusion among certain manufacturers, defense counsel retained Cornerstone Research and an economics professor to assess the extent of competition in the industry and to analyze the plaintiffs' contentions regarding the current pricing and marketing programs of the defendants. In granting summary judgment to the defendants, the judge accepted our expert's testimony, unrefuted by the plaintiffs, that if there had been a cartel, prices should have been higher during the alleged cartel period.

Daubert/Price Fixing

Plaintiffs alleged that several manufacturers had participated in a scheme to fix and maintain prices. We were retained by plaintiffs to review the methodology presented by plaintiffs' experts and to address defense experts' criticisms. When defendants filed a motion to exclude the testimony of plaintiffs' experts, we demonstrated at the subsequent hearing that the experts had used sound econometric methodology. The court concluded that most of the testimony was admissible.



Mergers & Acquisitions

Cornerstone Research supported the parties of a multi-billion-dollar telecommunications merger during regulatory review by the Department of Justice Antitrust Division and the Federal Communications Commission. To assess the effects of the merger on prices, quality, and market concentration, Cornerstone Research analyzed data provided by the parties to estimate the relationships among these variables at various levels of market aggregation. Our analysis demonstrated that prices were not affected by variations in local market structure, suggesting that the merger would not lead to pockets of high-priced service. The merger and license transfers were approved, with some divestitures, by the regulatory agencies.

Monopolization/Tying

In a class-action antitrust case, the franchisees of a major fast-food company alleged that it illegally tied approved products, which franchisees were required to purchase, to its franchise licenses. The franchisees separately claimed that the company monopolized a purported market for approved products and that it colluded with multiple warehouse distributors in order to achieve this monopolization. Cornerstone Research worked with an economics professor who, assessing franchising and distribution economics, demonstrated that the company did not have the ability or the long-term incentives to act as a monopolist. Our finance expert analyzed the validity of the plaintiffs' damage claims. The case settled favorably for the defendants.

Wage Fixing/Class Certification

Plaintiffs alleged that firms in a major energy-related industry participated in compensation surveys in an effort to restrict wages and benefits for tens of thousands of their workers. Defendants retained Cornerstone Research and two expert economists to examine class certification issues. The experts showed that any impact of the alleged conspiracy could only be measured on an individual basis and that many workers would not have been harmed even if the allegations were true. The experts also showed that there was no systematic relationship between the survey results and subsequent compensation decisions. Prior to any decision on class certification, the case settled for a small percentage of the original, multi-billion-dollar damages claim.

Intellectual Property

To address the wide range of issues that arise in intellectual property matters, Cornerstone Research uses a multidisciplinary approach that combines economic, marketing, accounting, and financial perspectives. We assist attorneys in cases involving allegations of patent, copyright, and trademark infringement, as well as matters involving theft of trade secrets and breach of technology-licensing agreements. We formulate and assess damage claims, considering loss causation, lost profits, reasonable royalties, and prejudgment interest. Our work also includes assessment of liability issues, such as commercial success in patent matters, antitrust counterclaims, and customer confusion in trademark cases.

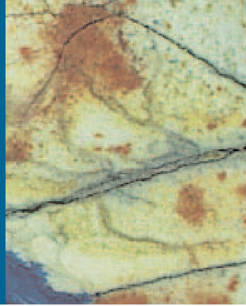
Patent Infringement

A firm that provided commercial applications of digital encryption technology for use in Internet commerce was sued for alleged patent infringement. Retained by counsel for the defendant, Cornerstone Research analyzed the success of the technology and licensing agreements and assessed the calculation of damages allegedly sustained by the plaintiff. We demonstrated that the plaintiff had no basis for its damage claims. The trial judge agreed and excluded a key portion of plaintiff's damage claims during the trial. The jury found no liability and no damages.

Copyright Infringement

In a landmark case for the computer software industry, the plaintiff accused a rival of infringing its copyright on several features of a software product. Defense counsel retained Cornerstone Research to develop damage estimates and to evaluate the plaintiff's damage models. Working with an interdisciplinary team of economics, marketing, accounting, and software industry experts, we used econometric analysis, industry research, surveys, and cost-accounting models to estimate the effect of the allegedly infringing features on product sales, costs, and profits. The First Circuit found for our client, concluding that the allegedly infringing features were not copyrightable. Its decision was upheld by the Supreme Court on appeal.

Our focus on quality requires a high level of attention to detail. We provide objective, state-of-the-art analysis that has earned us a reputation for excellence and effectiveness.



Trade Secrets

A leading telecommunications equipment company sued a startup for alleged misappropriation of trade secrets involving fiber-optic networks. Defense counsel retained Cornerstone Research to assess liability and damages. On liability, we worked with an economics professor to predict the effects of the plaintiff's attempt to restrict employee mobility and concluded that it would likely hinder innovation and economic growth in the area. On damages, our royalty and finance experts demonstrated that the plaintiff's proposed damages were highly speculative and had vastly underestimated the risk inherent in a startup. The case settled shortly before trial on terms favorable for our client.

Breach of Technology-Sharing Agreement

One high-technology firm sued another for an alleged breach of a joint software development agreement. Counsel for defendant asked Cornerstone Research to evaluate damages, if any, and to assess the validity of the plaintiff's damage study, which included projections of future revenue. Working with experts in software development and venture capital, we showed that the plaintiff's damage claims were significantly overstated. The court found for our client on summary judgment.

Trademark Infringement

When a software provider sued a competitor for wrongful misappropriation of its mark, plaintiff's counsel retained Cornerstone Research to review the defendant's advertising and marketing programs and to estimate the cost to correct the mistaken impressions created by those programs. When the case went to trial, the jury awarded substantial compensatory and punitive damages to our client, and the court permanently enjoined the defendant from using our client's mark.

Patent Infringement

A biotechnology company alleged that a rival infringed its patents for a product used to analyze complex genetic information in biomedical research. Retained by the defense, Cornerstone Research reviewed licensing agreements within the biotechnology and related industries to determine a reasonable royalty rate on the technology covered in the disputed patents. We also evaluated the opposing expert's report and outlined several significant flaws in its methodology. The case settled on confidential terms, and all pending lawsuits were dismissed.

Financial Institutions

Our expertise in securities analysis, valuation, risk management, financial services regulation, real estate markets, and industry economics makes Cornerstone Research particularly qualified to address issues related to banks, savings and loans, insurers, securities firms, and other financial institutions. We have developed a number of specialized databases, including comprehensive financial data on all U.S. bank and thrift institutions, stock price information on all publicly traded banks and thrifts, merger and failure data on financial institutions, and related macroeconomic and real estate data. Our experience with financial institutions includes many of the largest litigation matters and regulatory proceedings to date.

Savings and Loans

A savings and loan sought recovery for damages after certain accounting practices previously guaranteed by the government were later disallowed by the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). Cornerstone Research initially identified and supported rebuttal experts. Our role later expanded to include supporting the plaintiff's experts as they developed their damage theories, providing analyses and exhibits for both fact and expert witnesses, and helping attorneys prepare their cross-examination and rebuttal of government experts. After a fourteen-month trial and two appeals, the Federal Circuit affirmed a judgment of $381 million to our client.

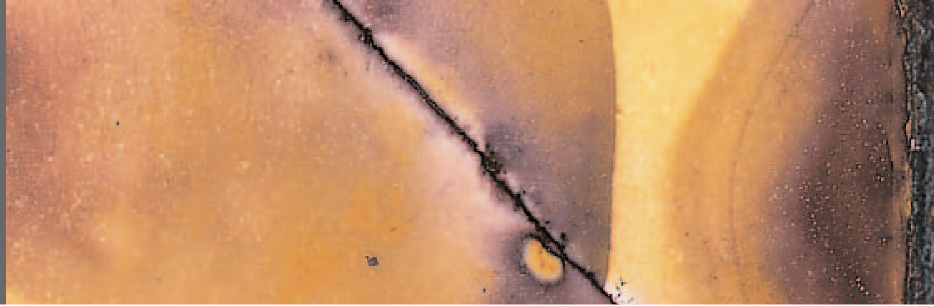
Securities Firms

Counsel for codefendant market makers retained Cornerstone Research to assess allegations of "tacit collusion" among securities dealers that spawned private and regulatory antitrust actions. The research concluded that collusion was "extraordinarily unlikely" given the market structure and there was "no responsible scientific basis for drawing a conclusion of collusion."

Insurance

A property-casualty insurer and a large corporate client were engaged in a dispute over approximately $100 million in settlement costs and legal fees incurred in nearly two dozen product liability suits brought by industrial customers against the corporate client. Counsel for the insurer retained Cornerstone Research to assess the economics of the original product liability cases and of the corporate client's claim against the insurer. We analyzed opposing experts' findings, applied a variety of models to predict product failure, and assessed the impact of product warranty terms on claimed damages. Counsel used our findings in depositions of opposing witnesses and in settlement negotiations. The case settled favorably.

Specialized databases and sophisticated software enable Cornerstone Research to analyze relevant data efficiently and accurately.



Banks

In a dispute between a bank and a former corporate client, counsel for the bank retained Cornerstone Research in a matter involving over-the-counter derivatives transactions. In preparation for trial we worked with three finance experts on several issues, including developing an overview of derivatives and how corporations use them in managing risk, developing models to determine the prices of certain derivatives, examining risk management activities undertaken by the plaintiff, and assessing various pricing models for the derivatives in question. In a series of pretrial rulings, the court dismissed most of the plaintiff's claims against our client. The case settled shortly thereafter.

Asset Management

Cornerstone Research was retained by attorneys representing a custodial bank that was sued by three pension funds whose asset portfolios had disappointing returns because of a decline in certain real estate markets. The funds claimed the bank should have alerted them to the declining performance of their investments. Cornerstone Research analyzed delinquency rates within the portfolios and more broadly. We then identified and supported several experts to assess real estate market conditions, real estate investment allocation within pension funds, and the fiduciary obligations of custodial banks. The case settled favorably.

Private Equity

A leveraged buyout fund sued a venture capital firm, claiming an operating company sold to the plaintiff had been valued inappropriately and alleging failure to disclose material information about the operating company. Cornerstone Research worked with a finance expert to assess the practice of due diligence in venture capital transactions, to consider the materiality of information in such transactions, and to examine the valuation analysis prepared by the plaintiff's expert. After both experts submitted reports and were deposed, the case settled on terms favorable to our client.

Market Timing

Cornerstone Research has worked with a number of clients to investigate issues relating to "market timing" of mutual funds and insurance products. Working with leading experts, Cornerstone Research has assisted mutual fund and insurance complexes in internal investigations, negotiations with the Securities and Exchange Commission and state attorneys general, the distribution of settlement funds, and shareholder class-action lawsuits.

Energy

Deregulation and restructuring have created new challenges for the energy industry. In this changing environment, Cornerstone Research has consulted on a wide range of issues, including market design, market monitoring, utilities mergers, and antitrust litigation in trading disputes.

Contract Disputes

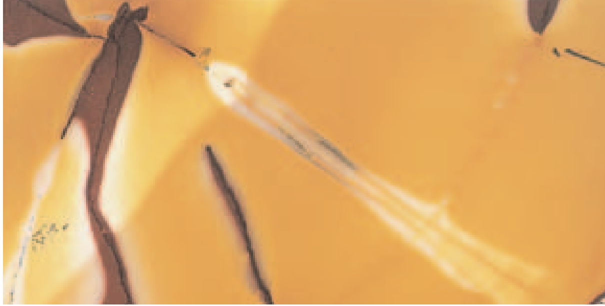
Claiming over $1 billion in damages, an independent power producer filed a breach of contract suit over the construction of a major power plant. Working on behalf of the defendant, Cornerstone Research evaluated the damages claims submitted by the plaintiff's experts. We supported the defense experts' testimony about factors that affected the damages calculation, including projected electricity prices, the potential for fuel purchase agreement renegotiation, fuel transportation costs, displacement provisions in the purchase power agreement, and the appropriate discount rate. The final arbitration award for damages was a small fraction of the amount originally claimed by the plaintiff.

Price Fixing

When a state filed a lawsuit against several major oil companies for allegedly colluding to fix the price of gasoline, counsel for one of the oil companies retained Cornerstone Research to analyze the operations of the gasoline market in the state and to assess the collusion claim. Our research showed that our client's decisions on pricing, capacity, purchasing, importing, and capital investment contradicted the plaintiff's claims of collusion. A settlement favorable to the oil companies—a local newspaper reported it was one percent of what the state had sought—was reached.

Mergers and Acquisitions

In its assessment of a proposed merger of major oil companies, the Federal Trade Commission raised a number of competition issues for further review. Cornerstone Research supported an antitrust expert who was retained as a consultant on many of these issues. Following extensive FTC scrutiny, the merger was permitted.



Cornerstone Research's distinctive network of eminent faculty and industry experts allows us to identify effective witnesses for a wide range of cases.

Market Manipulation

A variety of market participants in the natural gas and electricity markets have retained Cornerstone Research to evaluate allegations of attempted market manipulation. Drawing on the experience and market perspective developed in these engagements, Cornerstone Research sponsored a day-long conference that provided a discussion of widely disputed issues of market manipulation in the energy markets. The conference, attended by market participants, their counsel, federal regulators, and academics, promoted a vigorous interchange of ideas among parties on all sides of the market manipulation investigations.

Regulatory Proceedings

Cornerstone Research was retained by parties active in California energy proceedings to collect and consolidate data on California electricity markets, analyze bidding behavior, and suggest appropriate methodologies for calculating FERC-ordered refunds.

Strategy Consulting

Cornerstone Research was retained by the compliance unit of an auction market in a deregulated electricity market to develop analytical tools and procedures for monitoring bidding dynamics in its daily auctions. A Cornerstone Research team developed reporting and monitoring tools to enable the auction market's staff to assess the large amounts of market data generated daily in the electricity markets.

Bidding Strategy

A major oil exploration and production company retained Cornerstone Research to examine the company's bidding strategy in auctions of deep-water offshore oil leases. Working with an economics expert, Cornerstone Research staff examined bidding outcomes in the auctions of deep-water leases and developed analytical software to quantify the risk of overpayment by the highest bidder, a practice known as the "winner's curse."

Other Matters

We apply expertise in economics, finance, and accounting to a wide variety of complex business issues faced by our clients. We have experience in a number of areas of litigation and business analysis, bringing together our general business knowledge and financial modeling techniques. Decades of application of finance and economics to issues arising in litigation have enabled us to develop expertise in such industries as telecommunications, pharmaceuticals, healthcare, high technology, entertainment, and professional services.

Breach of Contract

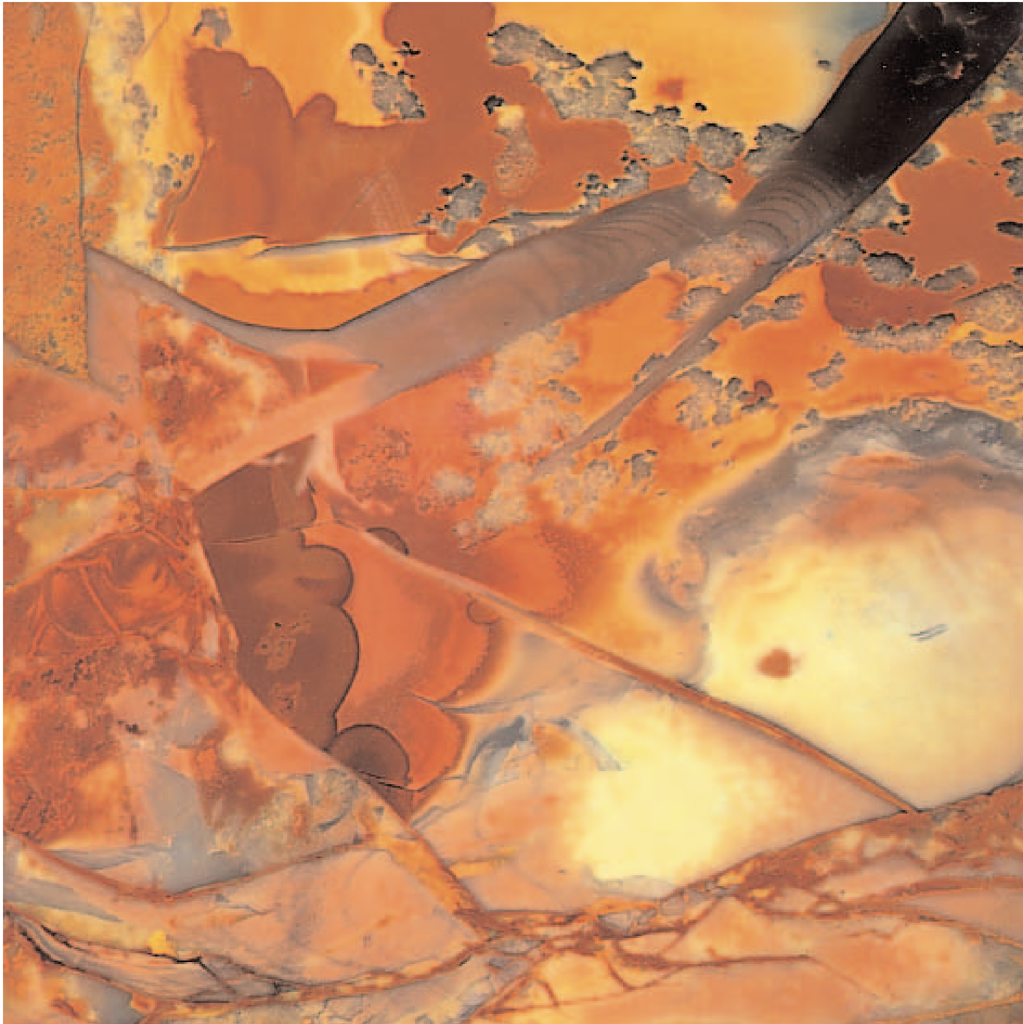
A professional services firm was retained by a manufacturing company to implement an enterprise computer system. The manufacturing company claimed that the implementation was flawed and that its business operations had been severely disrupted. The company asked an arbitration panel to order the professional services firm to pay substantial damages related to the liquidation of the company. Cornerstone Research was retained by defense counsel to identify an expert to testify on liability issues and to support another expert's damages analysis. Following an arbitration with testimony from each of the experts, the panel ruled that our client did not owe any damages. The panel further ordered the plaintiff to pay our client's outstanding bills from the implementation and to reimburse our client for its defense costs.

Bankruptcy

In the context of the impending bankruptcy of a major corporation, Cornerstone Research worked with a finance expert to analyze a complex transaction that was alleged to constitute a fraudulent conveyance. Our analysis of the firm's securities prices at the time the transaction was announced showed that the transaction actually enhanced the value of the corporation. Restating the corporation's balance sheet on a market value basis confirmed that an increase in value resulted from the disputed transaction. The case settled on favorable terms for our client.

Tax Treatment of a Partnership

Cornerstone Research examined the economic substance of a partnership, addressing whether the partnership had features of an equity investment. Working with a finance professor, we constructed a model to simulate the future returns on an investment in the partnership. The model produced a probability distribution of returns that formed the basis of our expert's opinion regarding the potential and economic substance of the partnership. The expert testified in tax court, and the judge found in favor of our clients.



Piercing the Corporate Veil

In attempting to pierce the corporate veil, plaintiffs alleged that a holding company had exerted undue influence on a subsidiary by controlling decision-making as well as the subsidiary's assets. Working with two business experts on behalf of the defense, we analyzed over twenty years of financial and operating documents. We found that the corporate governance process and the parent-subsidiary financial relationship were consistent with the normal business practices of other large U.S. holding companies. We also assisted in the deposition of opposing experts and helped fact witnesses prepare demonstrative exhibits. The court found in favor of our client.

Real Estate

Cornerstone Research identified and supported a team of three experts in a class action regarding a rollup of real estate limited partnerships into a publicly traded master limited partnership. The experts provided testimony and exhibits on national real estate trends, local real estate valuation issues, and Rule 10b-5 and Section 11 damages rebuttal. Additionally, Cornerstone Research provided research and support to counsel during pre-trial motions and six months of trial. The case settled favorably shortly before closing arguments.

Corporate Governance

Plaintiffs brought a stockholder derivative action against the directors of a major manufacturer following an accidental explosion and allegations of illegal hazardous waste storage and disposal practices. Plaintiffs claimed that the directors had failed to monitor environmental compliance. Our business expert testified at trial on behalf of the defense that the conduct of the directors had been reasonable, prudent, and in accordance with generally accepted practices. The court found in favor of the directors.

Auditor Independence

Cornerstone Research was retained by defense counsel for an accounting firm in a case involving an audit of a large company. Plaintiffs claimed that the independence of the auditor had been impaired. We supported an accounting expert addressing issues related to the independence, both in fact and appearance, of the auditor. Our analysis of the audit workpapers and facts of the case revealed that no impairment of independence had occurred and that plaintiffs' expert had misinterpreted the relevant accounting and auditing authoritative guidance in developing his opinions.

"I have worked with Cornerstone Research and come back. Their work is very insightful, and I have the highest regard for their people. They are extremely responsive in addressing issues that arise during a case."

Don Scott
Bartlit Beck Herman Palenchar & Scott

"Cornerstone Research's people, both outside experts and inside the firm, have a first-rate understanding of the economic issues and the strengths and flaws of an opponent's case."

Rich Bernstein
Sidley Austin

"Cornerstone Research provides a collegial and collaborative exercise in testing factual and logical underpinnings used in a case to make sure they are practical and usable."

Bill Dallas
Sullivan & Cromwell

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WWW.CORNERSTONE.COM

The Directors Roundtable: Key Issues Facing Boards of Directors

New SEC Enforcement Initiatives & Governance Risks

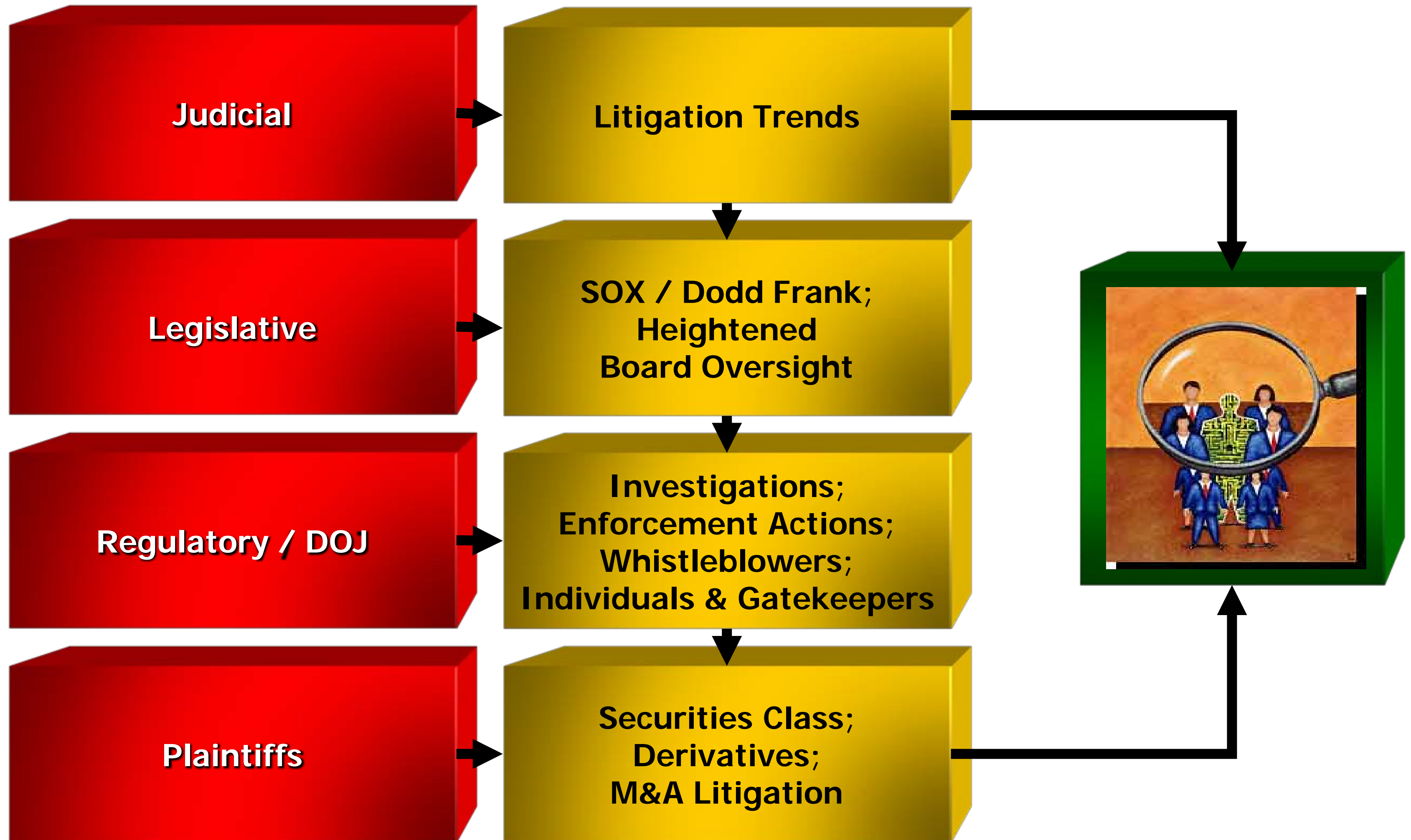
Dana Kopper, Managing Director

July 1, 2014

Environmental Scan
Evolving Trends
Integrated Risk Management

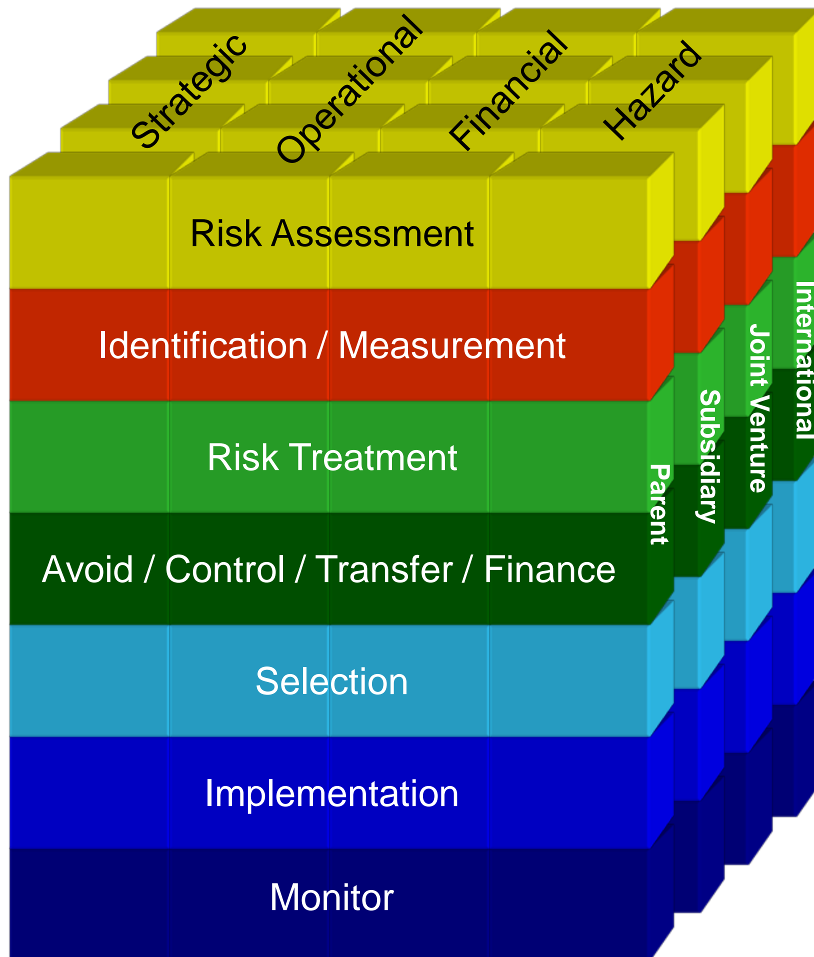
Domestic & International Environmental Scan…

Continuing Challenges / Evolving Risks: D&O Market Reactions:
Loss Ratios: High. Result: Increased Scrutiny; Premiums; and Retentions



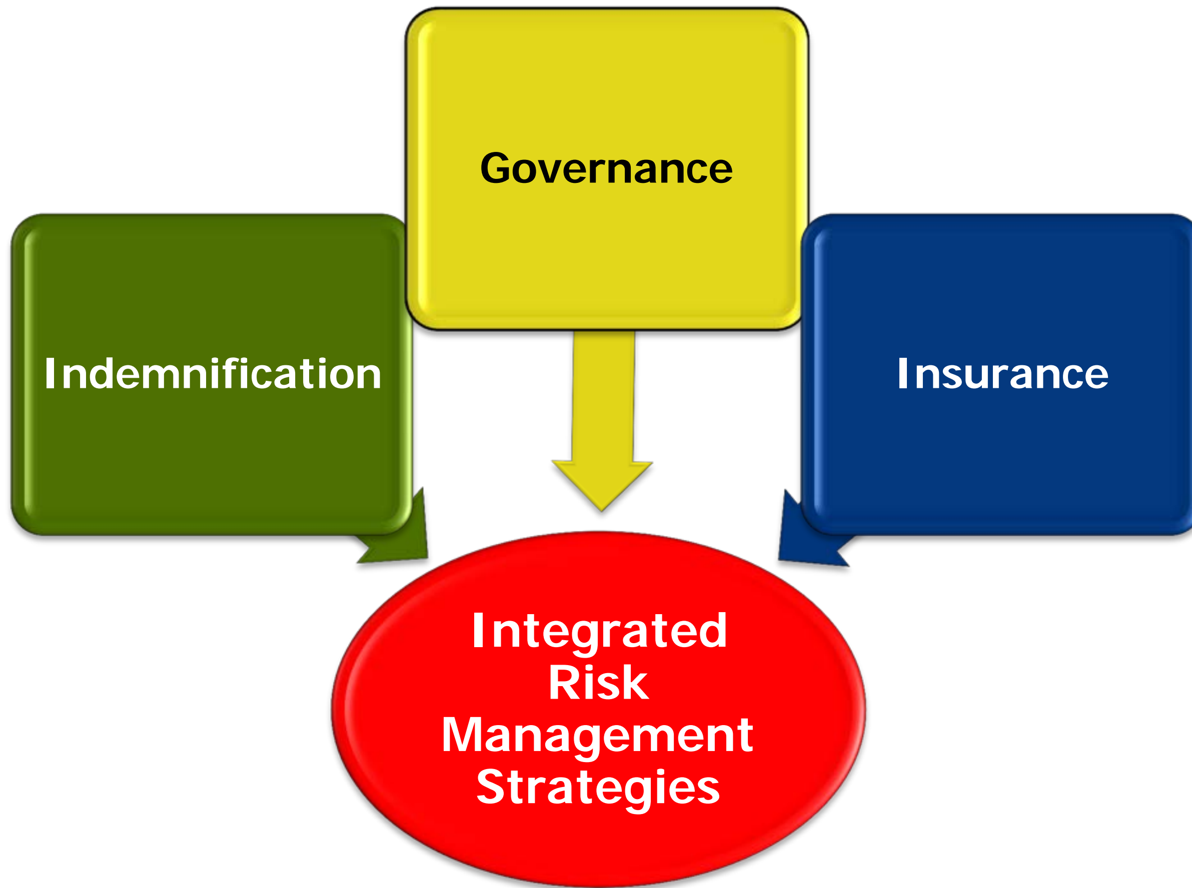
Enterprise Risk Management

Foundational Platform For Today's Complex Environment



- **Strategic**
  - Competition, Social, Capital Availability, Merger, Acquisition
- **Operational**
  - Cyber, Product Failure, Regulatory, Compliance, Internal Controls, Integrity, Reputational
- **Financial**
  - Pricing Risk, Asset Risk, Currency Risk, Liquidity Risk, Credit Risk, Investment Management Risk
- **Hazard**
  - Property Damage, Income, Liability, Personnel

Integrating Risk Management Strategies



CORE BENEFITS

- Reduced Risk Profile
- Reduced Cost of Risk
- Enhanced Personal and Organizational Asset Protection

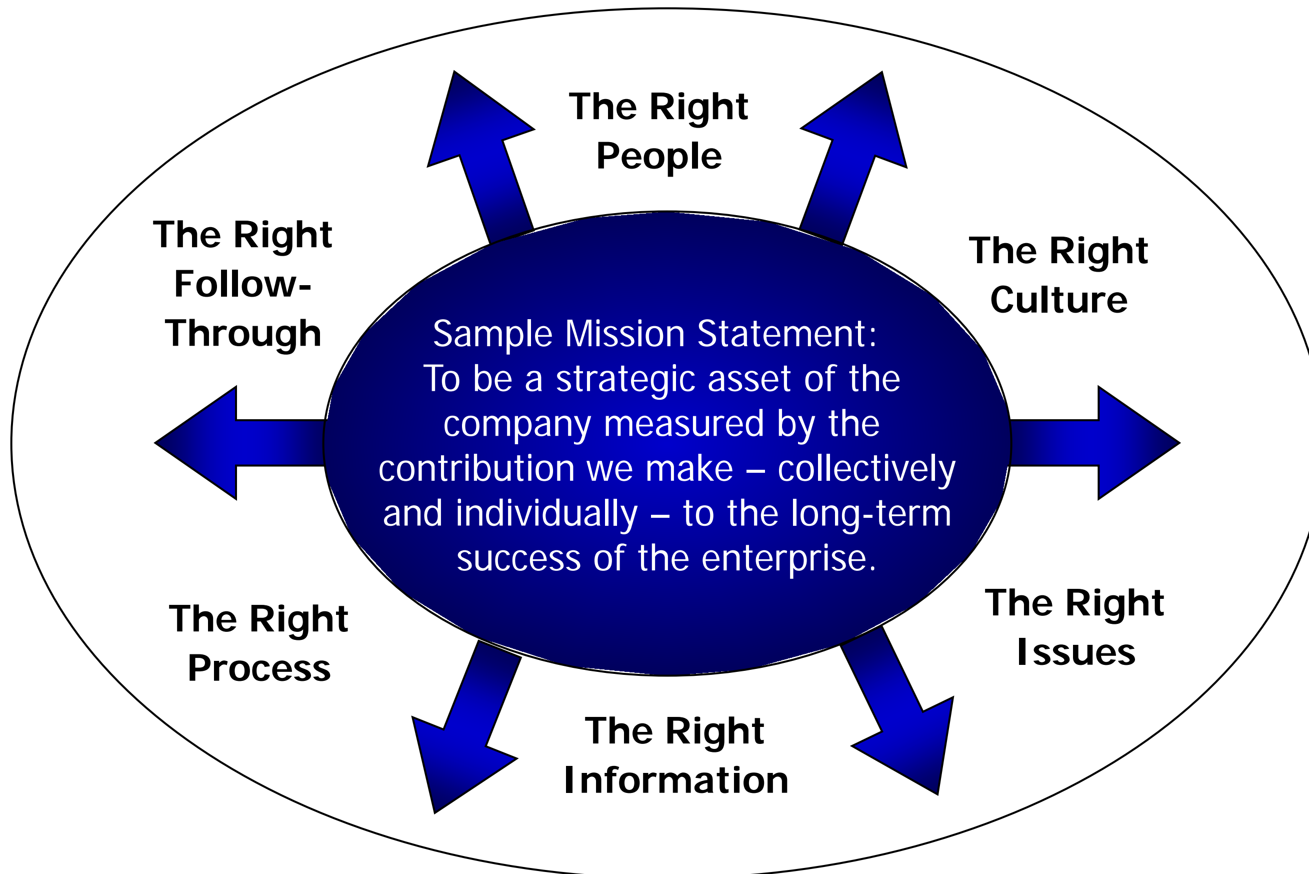
Governance Risk Management

Management & Professional Liability

Board Dynamics…

Structure Versus Execution…Substantial Source of D&O Claims
More Than Guidelines, Charters & Checklists …

These High-Performance Characteristics…



…Foster Superior Shareholder Value & Risk Mitigation

Source: NACD

How Effective Are We?

Sample Core Areas of Board Governance

- Structure & Composition
- Director & CEO Compensation
- Strategic Planning
- Processes & Procedures
- Interaction
- Information
- Committees
- Roles & Responsibilities
- Accountability Methods
- Risk Oversight; Organizational Compliance Efficacy
- Code of Conduct & Ethics

How Engaged Should We Be?

LEAST INVOLVED MOST INVOLVED

The Passive Board

- Functions at the discretion of the CEO.
- Limits its activities and participation
- Limits its accountability
- Ratifies management's preferences

The Certifying Board

- Certifies to shareholders that the CEO is doing what the board expects and that management will take corrective action when needed.
- Emphasizes the need for independent directors and meets without the CEO.
- Stays informed about current performance and designates external board members to evaluate the CEO.
- Establishes an orderly succession process.
- Is willing to change management to be credible to shareholders.

The Engaged Board

- Provides insight, advice, and support to the CEO and management team.
- Recognizes its ultimate responsibility to oversee CEO and company performance; guides *and* judges the CEO.
- Conducts useful, two-way discussions about key decisions facing the company.
- Seeks out sufficient industry and financial expertise to add value to decisions.
- Takes time to define the roles and behaviors required by the board and the boundaries of CEO and board responsibilities.

The Intervening Board

- Becomes intensely involved in decision making around key issues.
- Convenes frequent, intense meetings, often on short notice.

The Operating Board

- Makes key decisions that management then implements.
- Fills gaps in management experience.

Individual Contractual Indemnity
A Critical Tool

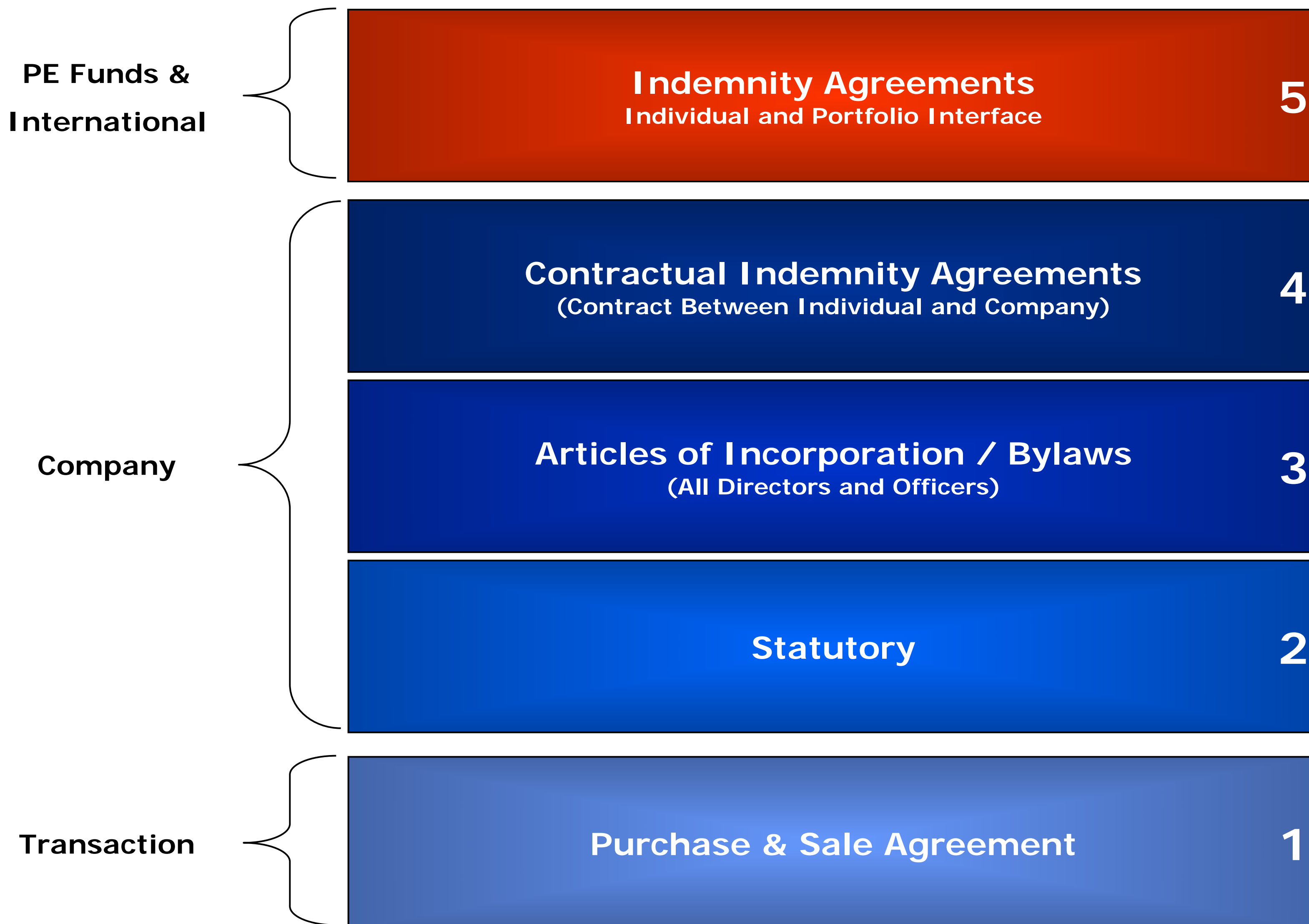
Indemnification…Generally

3 — **Contractual Indemnity Agreements**
(Contract Between Individual and Company)

2 — **Articles of Incorporation/Association/Bylaws**
(All Directors and Officers)

1 — **Statutory**

Harmonized Indemnification



International Indemnity Topics

A Partial Sampling

- Individual contractual agreements (U.S. and international) expand and clarify the nature and scope of indemnification.
- Enhanced indemnification will create more financial risk for funding organization.
- Enhanced indemnification is consistent with original intent of indemnification to encourage good faith risk-taking on the part of directors and officers.

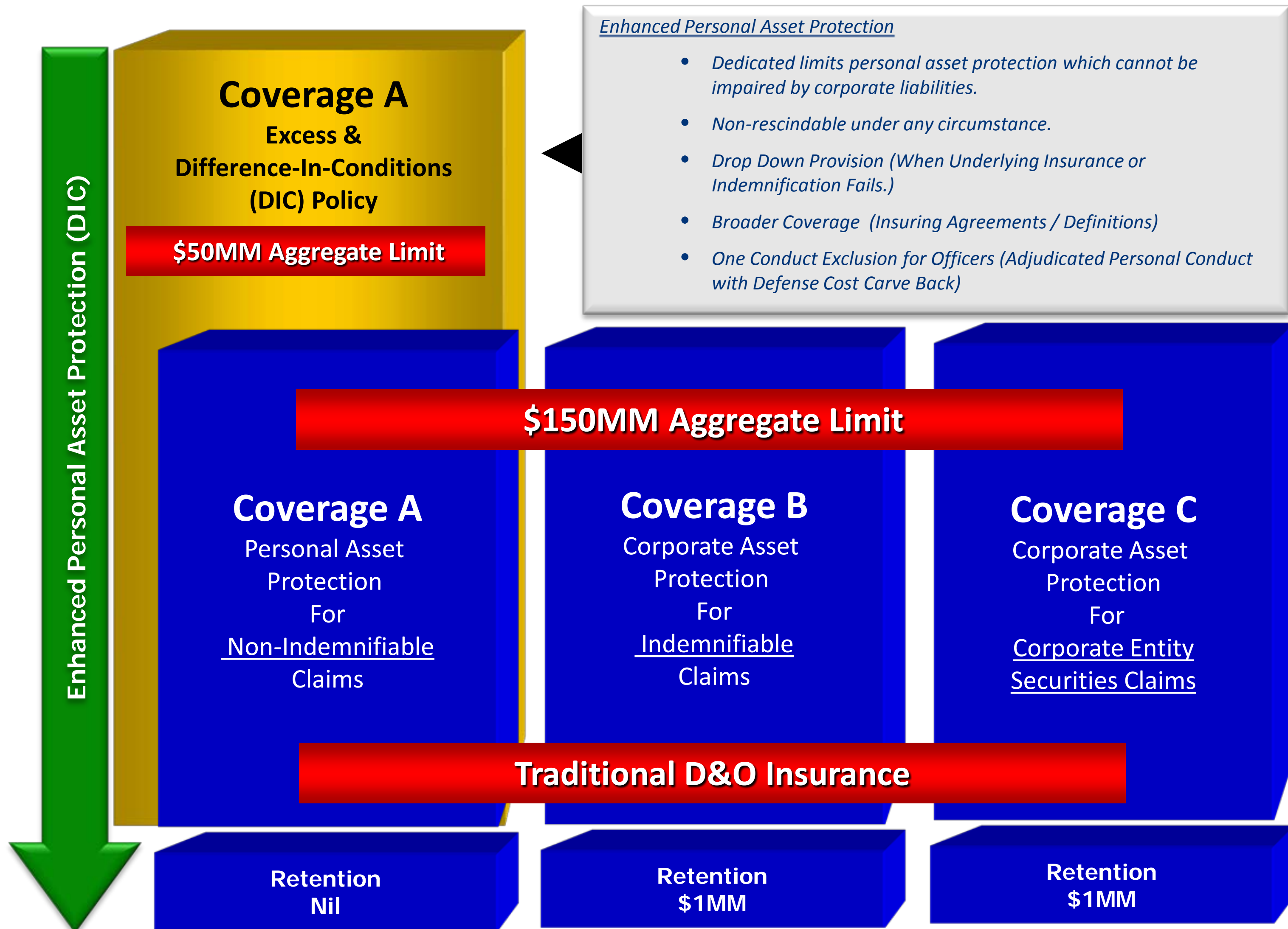
- Mandate indemnification
- Not prohibit indemnification for gross negligence, recklessness, etc. (standards of conduct)
- Mandate advancement of defense expenses "on demand"
- Terms to discourage wrongful refusals to indemnify; enhance enforcement rights
- Create individual contractual rights that cannot be unilaterally amended, or misinterpreted by successor organizations
- Expand expense definition to include federal, state, local, or foreign taxes based upon actual or deemed receipt of indemnity payments or advancements
- Specify outside directorships
- Provide right and prosecution costs to enforce rights
- Accelerate determination process
- Clarify lack of action to be deemed favorable determination
- Provide appropriate severability provisions
- Burden of proof on corporation to overcome indemnity presumptions; order or plea not determinative of good faith conduct
- Provide litigation appeal rights
- Strengthen binding effect provisions in change of control situations

D&O Liability Insurance Overview

D&O Liability Insurance Coverage Part Overview

Including Enhanced Personal Asset Protection (DIC)

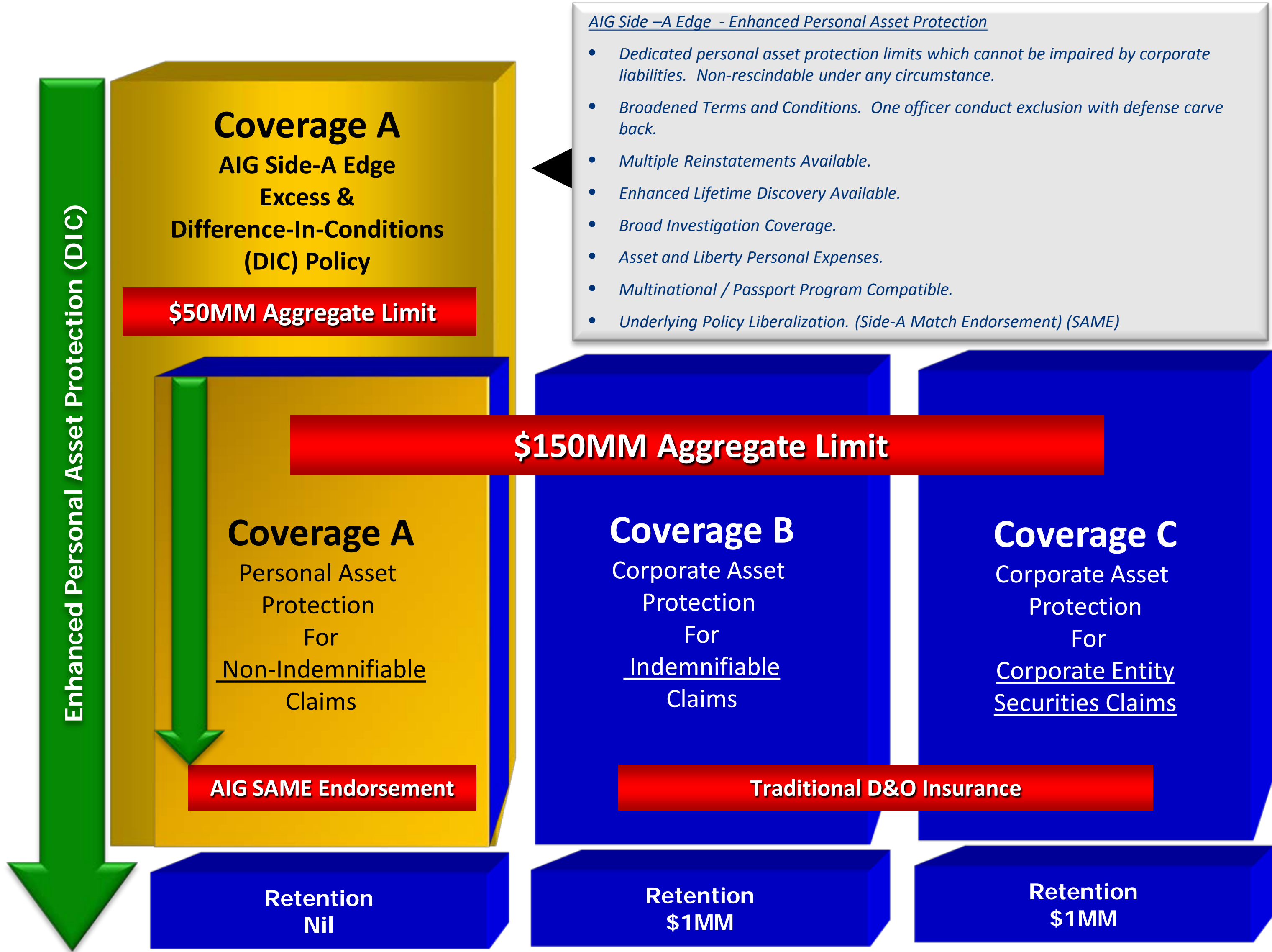
Important Note: Terms, conditions, limitations, exclusions, and exceptions apply.



D&O Liability Insurance Coverage Part Overview

Full Tower Enhanced Personal Asset Protection (DIC)

Important Note: Terms, conditions, limitations, exclusions, and exceptions apply.



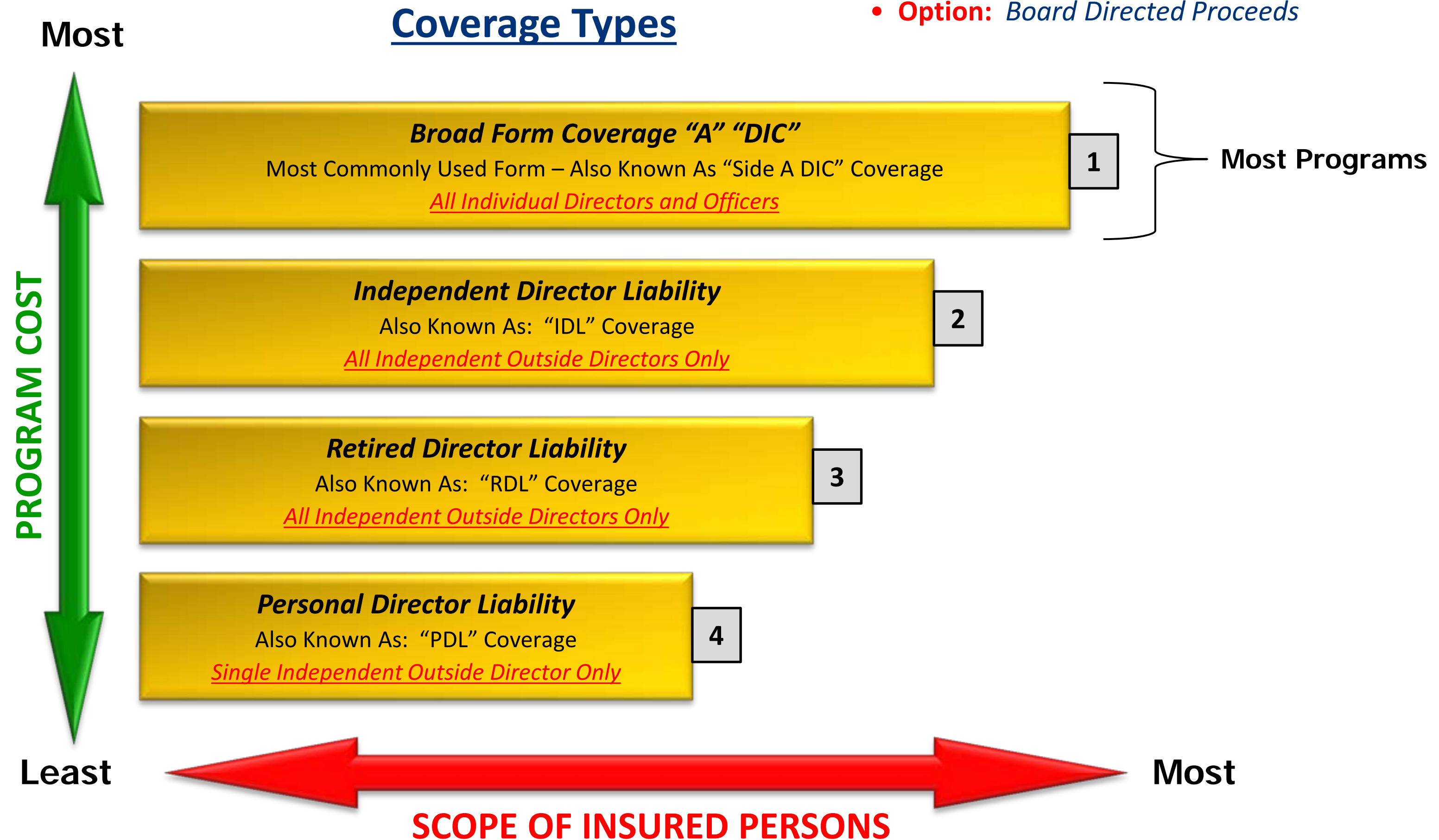
Enhanced Personal Asset Protection

Four (4) Coverage "A" Difference-In-Conditions (DIC) Optional Forms

Important Note: Terms, conditions, limitations, exclusions, and exceptions apply.

Coverage Quality Versus Coverage Focus

- **Coverage Quality:** *Same When Properly Negotiated*
- **Coverage Focus:** *Insured Persons*
- **Implications:** *Objective Driven – Discuss*
- **Option:** *Board Directed Proceeds*



Basic Insuring Agreement Preambles

A Partial Sampling

Important Note: Terms, conditions, limitations, exclusions, and exceptions apply.

- **Coverage A / Non-Indemnifiable Loss**
  - *Policy shall pay the Loss of any Insured Person that no Organization has indemnified or paid arising from a Claim against an Insured Person for any Wrongful Acts of such Insured Person.*
  - *Applies to Pre-Claim Inquiry without Wrongful Act requirement.*
- **Coverage B / Indemnifiable Loss**
  - *Policy shall pay the Loss of an Organization arising from a Claim made against an Insured Person for any Wrongful Act of such Insured Person, but, only to extent Organization has indemnified such Loss.*
  - *Applies to Pre-Claim Inquiry without Wrongful Act requirement.*
- **Coverage C / Organization**
  - *Policy shall pay the Loss of any Organization arising from a Securities Claim made against such an Organization for Wrongful Acts of such Organization. (Derivative demand investigation [sublimit] and derivative dismissals included)*

Basic Definitions
A Partial Sampling

Important Note: Terms, conditions, limitations, exclusions, and exceptions apply.

- **Loss**
  - *Damages; settlements; judgments; Defense Expenses; Crisis Loss; Derivative Investigation Cost (sublimit); Liberty Protection Costs; Pre-Claim Inquiry Costs; and others.*
- **Insured Persons & Entities (Organizations)**
  - *Entities (Organizations): named entity and each subsidiary (>50% control).*
  - *Persons: executives –past, present, future duly elected or appointed director, officer, trustee, governor, management committee member of JV, management board of LLC; foreign equivalents including supervisory boards; shadow directors; general counsel; risk managers; employees (co-defendant basis); and others.*
- **Claim & Securities Claim**
  - *See following slides*
- **Wrongful Act**
  - *Breach of duty; neglect; error; misstatement; misleading statement; omission; or act; employees on co-defendant basis; Organization solely with respect to Securities Claims.*

Claim Definition
A Partial Sampling

Important Note: Terms, conditions, limitations, exclusions, and exceptions apply.

- **Written demand for monetary, non-monetary, or injunctive relief.**
- **Civil, criminal, administrative, regulatory or alternative dispute resolution *proceeding* against an *Insured* commenced by:**
  - Service of a complaint or similar pleading;
  - Return of an indictment, information, or similar document (criminal);
  - Receipt or filing of a notice of charges.
- **Civil, criminal, administrative, regulatory *investigation* of an *Insured Person* commenced by:**
  - Insured Person identified in writing by an Enforcement Body as a target;
  - Service of a subpoena (or foreign equivalent) against an Insured Person;
  - Target letters can include Wells Notices, whether or not labeled as such.

Securities Claim Definition

A Partial Sampling

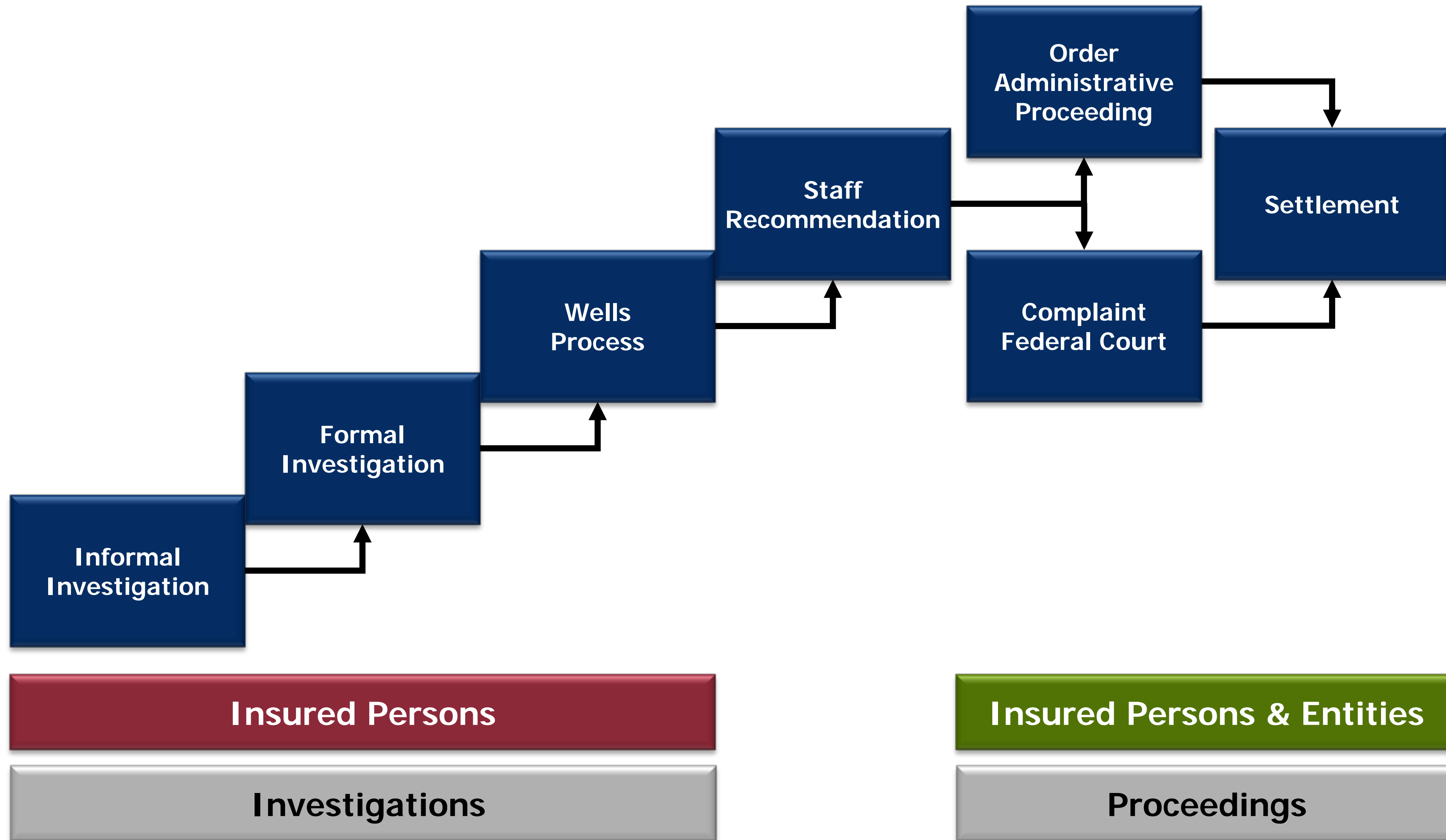
Important Note: Terms, conditions, limitations, exclusions, and exceptions apply.

- **Securities Claim**, *other than an administrative or regulatory "proceeding" against, or "investigation" of an Organization*, made against any Insured
- Alleging violation of any law, rule, or regulation, whether statutory or common law (including, but, not limited to the purchase or sale or offer or solicitation of an offer to purchase or sell securities).
- Which is brought by…
  - *Any person or entity alleging, arising out of, based upon or attributable to the purchase or sale or offer to purchase or sell any securities of an Organization; or*
  - *Any security holder or purchaser or seller of securities of an Organization with respect to such security holder's, purchaser's, or seller's interest in securities of such Organization; or*
  - *Derivative Suit.*
- **Administrative or Regulatory Proceeding –Organization**
  - *Securities Claim definition does include administrative or regulatory proceeding coverage against the Organization provided that such proceeding is commenced and continuously maintained against Insured Persons.*

SEC Investigations

How Do Most Public Company D&O Policies Respond?

Important Note: Terms, conditions, limitations, exclusions, and exceptions apply.



Entity Investigation Option Sample

Important Note: Terms, conditions, limitations, exclusions, and exceptions apply.

- ***Response Coverage*** **(Separate Program / Not Liability Insurance)**
  - Limits Available: $1MM to $50MM
  - Estimated Costs: $40K to $60K Per Million of Limits (Expensive)
  - **Part 1**:
    - ***Securities Violations By Enforcement Body***.
    - Wrongful Act Not Required to Begin or Sustain Investigation Response Cover.
  - **Part 2**:
    - ***Internal Investigations / Derivative Investigations*** (With or Without a Securities Claim).
    - Wrongful Act or Enforcement Body Involvement Not Required to Begin or Sustain Investigation Response Cover.
  - **Part 3**:
    - ***FCPA, or Foreign Equivalent, Investigations*** (With or Without a Securities Claim)
    - Wrongful Act or Enforcement Body Involvement Not Required to Begin or Sustain Investigation Response Cover.

Entity Investigation Option Sample

Important Note: Terms, conditions, limitations, exclusions, and exceptions apply.

- *Liability Coverage* **(Part of D&O Liability Insurance Contract)**
  - Limits Available: Same as Underlying Primary and Excess "ABC" Insurance Programs.
  - Estimated Costs: 25% to 40% (of Underlying Insurance Premiums) Additional Premium (AP). (Relatively Expensive)
  - Limited Coverage:
    - **Only Available Concurrently with a Securities Claim Against Insured Persons.**
    - **Not Available for Investigations of Insured Entity that Pre-Date Securities Claims.**
    - **Not Available for Any Form of Informal or Internal Investigation of Insured Entity.**
    - **Only for Formal Investigations. Wrongful Act Requirement.**

Directors & Officers Liability - New

Halliburton – U.S. Supreme Court Decision June 23, 2014

Important Note: Terms, conditions, limitations, exclusions, and exceptions apply.

- *Class Certification Event Study Endorsement*
  - *Limits Available: Policy Aggregate*
  - *Estimated Costs: No Additional Premium*
  - *Retention: None*

Class Certification Event Study Expenses means the reasonable and necessary fees, costs and expenses of an expert witness consented to by the Insurer, which consent shall not be unreasonably withheld, incurred by an Insured to conduct an admissible event study regarding any issues of fact relevant to the court's decision as to whether to grant class certification in a Securities Claim.

If the Panel Counsel firm defending a Securities Claim recommends to the Insured a specific expert witness to conduct an event study in the defense of such Securities Claim, then the Insured may hire such expert witness to perform such event study without further approval by the Insurer.

Other Claim & Coverage Types

A Partial Sampling

Important Note: Terms, conditions, limitations, exclusions, and exceptions apply.

- **Pre-Claim Inquiry** *(Insured Persons)*
  - *Verifiable request to appear at a meeting or interview; or produce documents;*
  - *But, only at request of Enforcement Body or Organization; and*
  - *As respects Organization, only as part of Enforcement Body investigation; or*
  - *An Organization's Derivative Demand Investigation.*
  - *No Wrongful Act requirement.*
  - *Does not include routine or regularly scheduled regulatory actions.*
- **Extradition** *(Insured Persons)*
- **Liberty Protection** *(Insured Persons – Foreign)*
- **Personal Reputation** *(Insured Persons)*
- **Employed Lawyers Professional** *(Insured Persons)*
- **Whistleblower Actions** *(Insured Persons and Entities)*
- **SOX 304 and Dodd-Frank 954 Expenses** *(No Actual Clawback)*
- **FCPA & UK Bribery Act** *(No Fines and Penalties – Insured Persons and Entities)*
- **Foreign Liberalization** *(Insured Persons & Entities)*
- **Selling and/or Controlling Shareholders** *(Insured Persons)*

Common Policy Exclusions

A Partial Sampling *(Within Exclusions or Definitions)*

Important Note: Terms, conditions, limitations, exclusions, and exceptions apply.

- **Personal Conduct**
  - *Illegal personal profit, advantage, or remuneration;*
  - *Deliberate fraud, or deliberate criminal acts by the Insured;*
  - *Subject to a final, non-appealable, adjudication.*
- **Prior or Pending Litigation**
- **Personal Injury** *(Securities Claim Carveback)*
- **Bodily Injury or Property Damage**
- **Entity versus Insured** *(With Carvebacks)*
- **ERISA** *(Company Benefit Plans Only)*
- **Compensation and Labor Liability**
- **Taxes, Fines, and Penalties** *(except punitives, multiplied, or exemplary where permitted by law)*
- **Matters Deemed Uninsurable Pursuant to Law**
- **Inadequate Price Paid or Consideration in M&A**

International D&O and E&O Notes…

- **Top 10 Countries With Mature D&O Liability Systems / Laws**
  1. Australia
  2. Canada
  3. England
  4. France
  5. Germany
  6. Hong Kong
  7. Italy
  8. Japan
  9. Korea
  10. The Netherlands

- **Up & Coming Jurisdictions – Economically More Powerful Than Most of the Top 10**
  - ✓ **Brazil**
  - ✓ **China**
  - ✓ **India**

- ***Summary Notes***
  - Public & private company D&O litigation trending upward.
  - Mature D&O liability systems (Top 10) all include specific laws focused on right of civil and criminal remedies for class or mass tort actions.
  - Heightened awareness of individual culpability within corporate settings, especially amongst regulators.
  - Aggrieved overseas investors seek litigation alternatives outside of the U.S.
  - Anti-Corruption/Anti-Bribery Laws: FCPA; UK Bribery Act; OECD based; United Nations conventions far reaching.
  - Enforcement and follow-on civil actions increasing significantly and now converging with domestic enforcement

International D&O and E&O Considerations

- International litigation increasing.
- Many countries have reconsidered (or are reconsidering) D&O insurance and indemnity.
- Host Country Considerations:

1. Non-admitted insurances permitted or specifically prohibited?
2. If non-admitted form permitted, does host country form provide specific benefit?
3. Organizational indemnification of individual directors, officers, principals, et al, permitted?
4. Organizational indemnity payments permitted from one country to another?
5. Insurance proceeds repatriated from one country to another?
6. Civil or criminal penalties for such repatriations?
7. Tax implications associated with premium, claim, or indemnity payments?
8. Subsidiary or JV boards?
9. Board member insurance / indemnity expectations?

MICHELE WEIN LAYNE

Michele Wein Layne is the Regional Director the Los Angeles Regional Office of the Securities and Exchange Commission and oversees its enforcement and examination programs. Prior to becoming the Regional Director, Ms. Layne was the co-head of the Los Angeles office's enforcement program, where she lead numerous high-profile and significant cases involving financial reporting and accounting misconduct, subprime lending, stock options backdating, mutual fund and hedge fund abuses, investment adviser and broker-dealer violations, offering frauds, market manipulation, auditor misconduct, FCPA violations and insider trading. Prior to joining the Commission in 1995, Ms. Layne spent eleven years in private practice at the law firms of Dewey & LeBoeuf, and Buchalter, Nemer. Her practice concentrated on complex business litigation. Ms. Layne graduated *magna cum laude* and *Phi Beta Kappa* from the University of California at Los Angeles and her law degree from the University of Southern California.

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James Farrell is a litigation partner in the Los Angeles office of Latham & Watkins and has broad experience in a wide variety of complex civil litigation, with particular emphasis on securities and professional liability matters.

Mr. Farrell has worked on a significant number of large securities class action lawsuits and accountants' liability cases. He specializes in defending cases involving a range of complex accounting issues, such as securitizations, off-balance sheet entities, reserves and various structured finance transactions. For example, Mr. Farrell defended Arthur Andersen in the multi-billion dollar claims asserted in the consolidated class actions regarding Enron. He has also handled all phases of securities litigation, including matters related to hostile takeovers, management buyouts, directors' and officers' liability, class action securities disputes and SEC investigations. He has served as lead trial counsel in civil and regulatory matters. Mr. Farrell has also conducted internal investigations and was involved in several appeals relating to the McKesson class action securities lawsuits, which addressed the confidentiality of work product created during internal investigations.

Mr. Farrell's financial services litigation work has been recognized by *The Legal 500 US*. He has served as volunteer trial counsel for the Los Angeles City Attorneys' Office, and he is currently on the board of the Association of Business Trial Lawyers and the Legal Aid Foundation of Los Angeles.

The following is a partial list of representative matters:

- Washington Mutual - Represented Deloitte & Touche LLP in a multi-district litigation, asserting securities claims against Washington Mutual (WaMu) and its officers and directors, alleging that they omitted and misrepresented material information in WaMu's public disclosures relating to risk management practices, the quality of its underwriting procedures, the accuracy of appraisals used in underwriting residential mortgage loans, and the adequacy of its allowance for future loan losses. *In re Washington Mutual Securities Litigation*, Case No. 08-MDL-1919 MJP (W.D. Wash.).
- IndyMac - Represented Ernst & Young LLP in a class action securities lawsuit in US District Court for the Central District of California related to the failure of IndyMac Bancorp, Inc. *Robert Daniel v. Michael Perry*, *et al.*, Case No. CV 08-03812 (VBKx).
- BDO Ltd. – Lead counsel, defending BDO Ltd. in a class action securities lawsuit, claiming damages in excess of US$100 million. *Munoz v. China Expert Technology, Inc. et al.*, Case No.: 1:07-cv-10531-AKH (SDNY)
- First Regional Bancorp – Won motion to dismiss on behalf of Deloitte in a securities class action lawsuit concerning the failure of First Regional Bank. *Buttonwood Tree Value Partners, LP v. Sweeney, et al.*, Case No.: SACV10-00537-CJC (CD Cal.)

- Enron - Represented Arthur Andersen in a multi-billion dollar consolidated case, *In re Enron Corp. Securities*, *Derivative "ERISA" Litig.*, MDL 1446, as well as defending Andersen in numerous other venues relating to Enron's collapse.
- LDK - Lead defense counsel in a securities class action lawsuit, seeking over US$300 million in damages, based on Section 10(b) and 20(a) claims against a solar wafer manufacturer, its senior executives and members of its board of directors. *In re LDK Solar Co. Ltd, Sec. Litig.*, Case No. 07-CV-05182 (ND Cal).
- Agria - Defended the company and its directors and officers in a securities class action lawsuit, seeking over US$140 million in damages based on Section 11 claims against an agricultural products company its senior officers and members of its board of directors. *In re Agria Corp. Sec. Litig.*, Case No. 08-CV-03536 (SDNY).

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Practices

Corporate and Government Investigations

Corporate Transaction Litigation

Financial Institutions

Real Estate

Securities

Valuation

Education

Stanford University, M.B.A.

Stanford University, M.S.

Stanford University, B.S.

Selected Cases

In re Broadcom Securities Litigation

JDS Uniphase Corporation Securities Litigation

Publications

Halliburton II and the Importance of Economic Analysis Prior to Class Certification

Events

Directors Roundtable Institute

Kristin Feitzinger has more than two decades of experience addressing securities and valuation issues arising in class actions, breach of contract, and general damages litigation. Her experience spans all stages of the litigation process, including: exposure analysis and settlement estimation; class certification; expert reports and depositions; summary judgment filings; mediation, arbitration, trials, and regulatory agency hearings.

Securities and white collar

She particularly focuses on Rule 10b-5 and Section 11 disclosure cases involving equity and debt trades. Having consulted on more than a hundred securities cases, including some of the largest class actions in recent history, she has handled all aspects of securities litigation, directing research on market efficiency, loss causation, materiality, and damages issues. Representative matters include:

- *In re JDS Uniphase Securities Litigation*
- *In re Broadcom Securities Litigation*
- *In re Flowserve Securities Litigation*
- *In re Retek Securities Litigation*

Ms. Feitzinger also consults on Securities and Exchange Commission matters, dealing with issues such as materiality and loss causation due to options backdating, and executives' alleged gains resulting from accounting misstatements.

Financial institutions and real estate

She applies her financial expertise to matters involving financial institutions and real estate, including trials such as the Glendale Federal Bank breach of contract case, which resulted in a major judgment against the U.S. government. Following the more recent financial crisis, she has done extensive work on litigation involving mortgage-backed securities cases, addressing class certification issues such as market efficiency, differences among debt offerings and tranches, and differential knowledge among putative class members. Her work has also addressed issues of loss causation and damages.

Valuation

Ms. Feitzinger provides valuation analyses in the context of breach of contract and merger and acquisition (M&A) deals. Her M&A work includes assessing the appropriateness of valuation methodologies employed in fairness opinions, analyzing the effect of acquisition-related news on stock prices, and evaluating the sufficiency of control premia.

Ms. Feitzinger previously worked for Mercer Management Consulting, Paine-Webber Managed Futures Division, and Syntex Laboratories (acquired by Roche Laboratories).

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Professional Profile

Dana is a Senior Vice President with Lockton Companies, LLC, and the Director of the Governance Risk Management Group.

He has provided a broad range of governance and risk management consulting and transactional services to public, private, for-profit, and not-for-profit organizations for the past 31 years.

He is one of the country's leading D&O and professional liability brokers – a noted expert in the areas of directors' and officers' legal liability, investment management professional liability, governance infrastructure design, board effectiveness, director accountability, organizational compliance efficacy, and associated risk mitigation strategies.

Dana is also the co-chair of Lockton's Investment Management Advisory Group, advising international investment management, private equity, hedge funds, and mutual funds.

Prior to his career in risk and insurance management, Dana was a federal agent with the Office of Special Investigations (OSI) – criminal and counterintelligence.

Previous Positions

- Marsh and McLennan Companies
  Senior Vice President
  National Practice Leader – Advisory
  Chief Operating Officer – BoardWorks
  Principal – Mercer Delta

- Corroon & Black Corporation
  Region Head
  Public Entities National Company

Professional Designations and Affiliations

- Forum for Corporate Directors (FCD)
  Member, Board of Directors
  Chair, Governance Committee
- University of California, Irvine
  FCD Faculty Member
  Paul Mirage School of Business
  Governance Risk Management
- Corporate Directors Forum (CDF)
- Stanford University Directors College
- National Association of Corporate Directors
- Directors Roundtable
- Lecturer
  University of California, Los Angeles
  University of Texas
  Rice University
  Stanford University
  University of Delaware
  Directors Roundtable
  American Bar Association
  American Corporate Counsel
  Society of Corporate Secretaries
  Financial Executives International
  American Electronic Association
  California Biotechnology Summit
- Professional Liability Underwriters Society
- Certified Insurance Counselor (CIC)
- Associate in Risk Management (ARM)