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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions

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This issue's Survey focuses on Securities and Exchange Commission ("SEC") rulemaking activities and major federal appellate decisions under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act") during the second quarter of 2006.

SEC Rulemaking

SEC Seeks Public Comment on New Independence Rules for Investment Companies

As reported in last quarter's Securities Regulation Law Journal (Vol. 34, No. 2, Appellate Decisions, pp. 170-71) the D.C. Circuit Court held on April 7, 2006, that the SEC had failed to comply with its own administrative procedures in amending the Exemptive Rules under the Investment Company Act of 1940 ("the ICA"). The proposed amendment would have required investment companies to adopt certain governance conditions (practices), including (1) a board with no less than 75% independent directors, and (2) an independent chair **(see ICA Release No. 26,520, (August 2, 2004))**. The Court, however, withheld its mandate for 90 days to give the Commission 90 days to correct its procedures. In a statement issued on **June 13, 2006**, the SEC invited further comment on the amendments, specifically on "whether the proposed rule amendments will promote efficiency, competition, and capital formation." The Commission will accept comments until August 21, 2006.

***Chamber of Commerce of U.S. v. S.E.C.*, No. 05-1240, 2006 WL 890669 (D.C. Cir. April 7, 2006).** For prior proceedings see Securities Regulation Law Journal, Vol. 33, No. 4, pp. 354-55; Vol. 32, No. 2 at pp. 260-61; Vol. 34, No. 2, p. 170.

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SEC Adopts Rules Relating to Fund of Fund Investments

On June 20, 2006, the SEC issued final rules adopting three new rules and amendments to numerous forms under the ICA that address fund of fund arrangements. **(See SEC Release Nos. 33-8713, IC-27399).** The new rules will codify several exemptions from the ICA that the SEC has previously issued, and will provide greater transparency of expenses paid by investors in such arrangements.

Fund of funds arrangements are created when an investment company invests in shares of another investment company. The ICA imposes restrictions on these arrangements to prevent abusive pyramiding schemes.

The final rule release promulgated the following three new rules codifying exemptions the SEC had previously issued relating to circumstances that do not create risks for the fund or its investors:

- Rule 12d1-1 permits cash sweep arrangements under which a stock or bond fund may invest its available cash in a registered or unregistered money market fund (rather than directly in short term instruments);
- Rule 12d1-2 permits greater flexibility to a fund of funds arrangement that invests exclusively or primarily in funds in the same fund group – eg. permitting an affiliated fund of funds to make investments in addition to shares of funds in the same group of investment companies or to invest directly in stocks or other securities; and
- Rule 12d1-3 permits greater flexibility for a fund that invests in other funds to structure the sales load it charges by permitting sales loads greater than 1.5% provided that the aggregate sales load (of both the acquiring and acquired funds) does not exceed the sales loads set by the NASD for funds of funds.

Funds and their advisers will no longer have to file routine exemptive applications in these circumstances, eliminating the need for SEC review of such applications and allowing the SEC to have more time to focus on exemptive applications that present new issues.

The final rule release also set forth amendments to Forms N-1A, N-2, N-3, N-4, and N-6 to require a registered fund that invests any of its assets in another fund, including an unregistered fund such as a hedge fund, to disclose in its fee table the cumulative amount of expenses charged by the fund and any fund in which it invests. Currently, the fee table information does not generally include information about fees and expenses charged by the funds in which the fund of funds invests. The increased transparency of fund of funds expenses is intended to allow investors to understand and more easily to compare the relative costs of different fund of funds arrangements.

New rules 12d1-1, 12d1-2, and 12d1-3 will become effective on July 31, 2006. All new registration statements on Forms N-1A, N-2, N-3, N-4, and N-6, and all post-effective amendments that are annual updates to effective registration statements on any of those forms filed on or after January 2, 2007, must include the disclosure required by the form amendments.

SEC Adopts Rules Extending The Compliance Dates For Regulation NMS

On May 18, 2006, the SEC issued final rules extending the compliance dates for Rules 610 and 611 of Regulation NMS under the 1934 Act. **(See SEC Release No. 34-53829)**. Rule 610 requires fair and non-discriminatory access to quotations, establishes a limit on access fees and requires each national securities exchange and national securities association to adopt, maintain, and enforce written rules that prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross protected quotations. Rule 611 requires trading centers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by other trading centers, subject to an applicable exception.

The final rules extend the compliance dates to give automated trading centers additional time to finalize development of their new or modified trading systems, and to give the securities industry sufficient time to establish the necessary access to such trading systems. The initial compliance date for Rule 610 and Rule 611 has been extended from June 29, 2006 to a series of five dates, beginning on October 16, 2006, for different functional stages of compliance.

SEC Announces Next Steps for Implementation of Section 404 of the Sarbanes-Oxley Act of 2002

On May 17, 2006, the SEC issued a press release stating that it intends to take action to improve the implementation of the Section 404 internal control requirements of the Sarbanes-Oxley Act of 2002. **(See SEC Press Release No. 2006-75)**. The actions the SEC intends to take include issuing SEC guidance for companies and working with the Public Company Accounting Oversight Board ("PCAOB") on revisions of its internal control auditing standard. The expected actions will also include SEC inspections of PCAOB efforts to improve Section 404 oversight and a brief further postponement of the Section 404 requirements for the smallest company filers, although ultimately all public companies will be required to comply with the internal control reporting requirements of Section 404.

SEC Announces Description of Duties of the General Counsel

On May 3, 2006, the SEC released final rules amending its description of the duties of the General Counsel to include preliminary investigations, in which no process is issued or testimony compelled, where it appears that an attorney appearing and practicing before the SEC may have violated Rule 102(e) of the SEC's Rules of Practice. **(See SEC Release No. 34-53755).** The Office of the General Counsel of the SEC already has the authority to conduct SEC-authorized proceedings and formal investigations under Section 21 of the 1934 Act, including for violations by attorneys of Rule 102(e) of the SEC's Rules of Practice.

An amendment of the description of the duties of the General Counsel to include preliminary investigations makes it clear that the General Counsel may gather evidence in Rule 102(e) cases without compulsory process where witnesses are willing to testify or provide information voluntarily. This amendment enables the General Counsel to identify, through informal means, those matters that do not warrant full-blown investigation and compulsory process. The rules became effective upon release on May 3, 2006.

SEC Adopts Amendments to Plan of Organization and Operation Effective During Emergency Conditions

On June 5, 2006, the SEC released final rules amending certain of its rules that operate in the event of emergency conditions to revise the provisions on delivering submittals, the line of succession to the Chairman in the event of the Chairman's incapacity or unavailability, and make conforming changes. **(See SEC Release No. 34-53937).** These changes became effective upon release on June 9, 2006.

APPELLATE DECISIONS OF NOTE

D.C. Circuit Rejects SEC Rule Requiring Registration for Hedge Funds Advisors as Arbitrary

An investment advisory firm and a hedge fund petitioned for review of an order of the SEC regulating hedge funds under the Investment Advisers Act of 1940 ("IAA"). Investment advisors must register with the SEC under the IAA unless they qualify for one of several exemptions. One such exemption, and the one at issue in this case, is found in Section

203(b)(3) of the IAA. This section exempts from registration "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under [the IAA]." (emphasis added) The IAA, however, does not specify how to count "clients" for purposes of this exemption. The SEC argued that a 1980 amendment to IAA Section 203(b)(3) suggested that an *investor* in a hedge fund could be counted as a client of the fund's advisor. The D.C. Circuit Court of Appeals on June 23, 2006, rejected the SEC's interpretation of the word "client" and held that the rule was "arbitrary." The Court looked to the definition of "Investment Advisor" and found that the term spoke of advising others "*directly*." In the context of private funds, the Court stated that "[t]he adviser does not tell the *investor* how to spend his money; the investor made that decision when he invested in the fund. Having bought into the fund, the investor fades into the background; his role is completely passive." Therefore, "[i]f the person or entity controlling the fund is not an 'investment adviser' to each individual investor, then…each investor cannot be a 'client' of that person or entity." ***Goldstein v. S.E.C.*, No. 04-1434, 2006 WL 1715766 (D.C. Cir. June 23, 2006).**

No Short Swing Liability Under 1934 Act Where Insider Acquired Stock Through Acquisition of a Third-Party Intermediary Company

A corporation brought a suit against shareholders to disgorge alleged short-swing profits in connection with the exercise of hybrid put options. The transaction here involved the grant of put options by AT&T, as holder of a large block of shares in At Home Corp., to two cable companies whose holding in At Home were an impediment to AT&T's effective control over that company. The put option's exercise price was the greater of a fixed price or the average trading price over a specified period of time. Within six months of the granting of the put, one of the cable companies purchased three cable systems that held warrants for At Home stock; the other company made no purchases. Both companies exercised the put option under the fixed-price mechanism. With respect to the company that purchased no shares within six months of the grant date, the Court of Appeals for the Second Circuit on April 28, 2006, affirmed the district court's dismissal and found that the short swing trading claim failed because the grant of a hybrid option- rather than the exercise- is the only relevant § 16(b) event if the option is eventually exercised pursuant to the fixed-price mechanism. With respect to the company that purchased the three cable systems within six months of the grant date, the Court was faced with the issue of whether an insider's acquisition of stock in the issuer by acquisition of the third-party intermediary company gave rise to § 16(b) liability for short swing profits. In affirming the district court's dismissal, the Court looked to the intent of the short swing profits provisions and found convincing the arguments put forth by the SEC, as *amicus curiae*, that "a typical change of control transaction does not present an intolerable risk of abuse." "No one seeking an insider's edge speculating in the shares of an issuer would pursue that advantage by acquiring other companies if no more than a small fraction of the purchase price could be (notionally) attributed to the shares of the issuer. It would be like speculating in tractors by buying a farm." ***At Home Corp. v. Cox Communications, Inc.*, 446 F.3d 403 (2d Cir. 2006).**

Insurer of Municipal Bonds May Sue Under 1934 Act § 10(b) for Default

An insurer of defaulted municipal bonds which financed a county's solid waste processing facility brought a suit against the underwriter of the bonds asserting a Rule 10b-5 claim. The district court dismissed plaintiff's claim holding that plaintiff insurer was not a purchaser or seller of securities as required by Section 10(b) of the 1934 Act and Rule 10b-5 thereunder, and thus lacked standing to bring the claim. On appeal, plaintiff contended that it had standing on four grounds. On May 31, 2006, the Court of Appeals for the Eleventh Circuit rejected three of the grounds but found standing under the third category- namely, that plaintiff actually purchased the securities pursuant to the terms of the insurance policy. Under this ground, plaintiff argued that because the Exchange Act defines the term "purchase" to include "any contract to buy, purchase or otherwise acquire" securities (15 U.S.C.A. § 78(a)(13)), it acquired a contingent interest in the bonds because the policy constituted a contract to otherwise acquire them upon the occurrence of a specified contingent event, i.e. default. The Bond Market Association filed an *amicus curie* brief in support of the defendant-underwriter and argued that an insurance policy is a fundamentally different instrument than contracts to purchase securities and therefore falls outside the purview of § 10(b). The Court of Appeals analogized the insurer's situation to that of a bank that accepts a security as collateral for a loan. "Just as a bank relies on the value of the securities pledged as collateral when deciding whether to issue a loan and, if so, what interest rate to charge, a bond insurer may well consider the expected recovery value of bonds in deciding whether to insure them and, if so, what premium to charge." Accordingly, the Court concluded that plaintiff had standing to bring a Rule 10b-5 claim as a purchaser of a contingent interest in the bonds. ***Financial Security Assurance, Inc. v. Stephens, Inc*., No. 04-14894, 2006 WL 1472934 (11th Cir. May 31, 2006).**

SEC Did Not Exceed Its Authority in Exempting Foreign Issuers from Proxy Rules

A shareholder brought a class action suit against a foreign company, its directors, and certain investors alleging that the corporation's proxy statement was materially misleading in violation of Section 14(a) of the 1934 Act and Rule 14a-9. The district court rejected the plaintiff's claim that the SEC exceeded its authority in promulgating Rule 3a12-3, which excludes foreign issuers from the strictures of Rule 14(a), and dismissed the complaint. On appeal, the plaintiff argued that in light of Section 12(h), which authorizes the SEC to create the exemption from a number of provisions of the 1934 Act if such action is "not inconsistent with the public interest or the protection of investors," the SEC could not justify a "blanket exception" for foreign issuers. In essence, plaintiff argued that "in order to adopt an exemption to the [1934] Act, the SEC must first determine that it does not decrease the level of protection afforded investors in the absence of *any* exemption," and because this exemption decreased investor protection, it exceeded the SEC's exemptive authority. In response, the Court of Appeals for the Second Circuit stated on June 1, 2006, that "[n]owhere does § 12(h) or § 3(a)(12)(A)(iii) purport to establish a minimum acceptable level of investor protection, let alone a level equal to that imaginable in a parallel universe where the securities laws and regulations exist in a form unadulterated by exemptions." Affirming the district court's dismissal, the Court concluded that "the most plausible reading of § 12(h)…is that the [SEC] can promulgate an exemption once it has determined that the exemption serves the public interest while at the same time leaving in place adequate investor protections." ***Schiller v. Tower Semiconductor Ltd*., 449 F.3d 286 (2d Cir. 2006)**.