Securities Regulation Law Journal

Volume 42 Number 2 Summer 2014

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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions

*By Victor M. Rosenzweig**

This issue's Survey focuses on the Securities and Exchange Commission's ("SEC") rulemaking activities and major federal appellate or other decisions relating to the Securities Act of 1933, as amended, (the "1933 Act"), the Securities Exchange Act of 1934, as amended, (the "1934 Act"), and other Federal Securities laws from January 1, 2014, through March 24, 2014.

SEC Rulemaking

SEC, with OtherAgencies, Adopts Interim Final Rule Authorizing Retention of Interests in and Sponsorship of Collateralized Debt Obligations Backed Primarily by Bank-Issued Trust Preferred Securities

On January 14, 2014, five federal agencies, including the SEC, approved an interim final Rule to permit banking entities to retain interests in certain collateralized debt obligations backed primarily by trust preferred securities ("TruPS CDOs"), thereby relieving them from the investment prohibitions of Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, known as the Volcker Rule.

The interim final Rule will permit banking entities to retain interests in certain TruPS CDOs if the following conditions are met: (i) the TruPS CDO was established and the interest was issued before May 19, 2010; (ii) the banking entity reasonably believes that the offering proceeds received by the TruPS CDO were invested primarily in Qualifying TruPS Collateral (as defined by the Rule); and (iii) the banking entity's interest in the TruPS CDO was acquired on or before December 10, 2013, the date the agencies issued final rules implementing the Volcker Rule. The agencies also released a non-exclusive list of issuers which meet the requirements of the interim final Rule.

The interim final Rule also provides clarification that the relief relating to these TruPS CDOs extends to activities of the banking entity

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as a sponsor or trustee for these securitizations and that banking entities may continue to act as market makers in TruPS CDOs.

The interim final Rule was approved by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission, and the SEC, the same agencies that issued final Rules to implement the Volcker Rule.

SEC Proposes Enhanced Regulatory Framework for Certain Registered Clearing Agencies

On March 20, 2014, the SEC proposed new rules and rule amendments that would enhance the oversight of registered clearing agencies that are deemed systematically important or that have complex risk profiles. Clearing agencies covered under the proposed Rule would be subject to new requirements regarding their financial risk management, operations, governance, and disclosures to market participants and the public. The proposed Rule comes as international banking standards encourage banks to use qualified central counterparties, such as clearing agencies that are overseen by a regulator applying international clearing standards. **(See SEC Release No. 34-71699)**

Under the proposed Rule, a "covered clearing agency" would include the following:

- Clearing agencies designated as systemically important by the Financial Stability Oversight Council (the "FSOC");
- Clearing agencies that provide central counterparty (CCP) services for security-based swaps or are otherwise involved in activities with a more complex risk profile, unless they have been designated systemically important by the FSOC; and
- Clearing agencies that the SEC has determined are "covered clearing agencies" pursuant to a framework established under the proposed Rule.

Under the proposed Rule, a covered clearing agency would be required to establish, implement, maintain, and enforce policies and procedures reasonably designed to address certain aspects of its risk management and operations, including: (i) the general organization of the clearing agency; (ii) the clearing agency's financial risk management; (iii) settlement procedure; (iv) central securities depositories and settlement systems; (v) management of default; (vi) business and operational risk management; (vii) access by participants; and (viii) transparency.

The SEC stated that these requirements reflect enhancements of its existing oversight program for registered clearing agencies and that several requirements would be newly specified in light of the nature and extent of covered clearing agencies' activities.

APPELLATE AND OTHER DECISIONS OF NOTE

Supreme Court Denies Review of Ninth Circuit Ruling that Sale of Condominium Units Was Not Sale of a "Security"

On February 24, 2014, the Supreme Court denied certiorari to a petition challenging a Ninth Circuit decision that the sale of condominium units—and subsequent execution of rental management agreements—did not constitute an "investment contract" and was thus not a "security" as defined by the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act"). Petitioners, plaintiffs-appellants in the proceedings below, stated that the decision was in "clear conflict" with the Supreme Court's decision in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244, 163 A.L.R. 1043 (1946) which defined "investment contract."

In their class action suit, petitioners claimed that they purchased condominiums in the Hard Rock Hotel San Diego, and later entered into rental management agreements, pursuant to respondents' material misrepresentations and omissions regarding the units. In doing so, respondents allegedly violated Federal securities law because the two agreements constituted an "investment contract" and thus involved the sale of a "security" as defined by the 1933 and 1934 Acts. Respondents countered that the purchase and rental agreements were distinct, as they were between different entities and were executed eight to fifteen months apart.

The district court dismissed the complaint, and the Ninth Circuit affirmed. The Court of Appeals reasoned that no security was sold when the units were transferred because the rental agreement, executed so long after the purchase agreement, did not constitute a single transaction. According to the 9th Circuit, the "economic reality as we see it is that these two transactions were distinct." Moreover, the petitioners did not allege sufficient facts that the units were an investment property, as they could be used for other purposes, such as an owner's short-term stay.

Salameh v. Tarsadia Hotel, 134 S. Ct. 1322 (2014)

Salameh v. Tarsadia Hotel, 726 F.3d 1124, Blue Sky L. Rep. (CCH) P 75046, Fed. Sec. L. Rep. (CCH) P 97602 (9th Cir. 2013), cert. denied, 134 S. Ct. 1322 (2014)

Ninth Circuit Reinstates Claims in Shareholder Suit Arising from Alaskan Oil Spills in 2006

On February 13, 2014, the Ninth Circuit, with one exception, reinstated all claims in an amended complaint alleging that British

Petroleum ("BP") violated Sections 10(b), 18(a), and 20(a) of the 1934 Act, and Rule 10b-5, by making false and misleading statements about the condition of oil pipelines, the company's maintenance of those pipelines, and its leak-detection practices.

The statements at issue were made in response to two oil spills in separate pipelines in Prudhoe Bay, located in the Northern Slope of Alaska. The first, on March 2, 2006, lasting five days, leached 200,000 gallons of oil onto the Alaska tundra. The second, only five months later, occurred in a different pipeline in Prudhoe Bay. It leached 1000 gallons of oil. In criminal proceedings, BP admitted that the leaks, although occurring in different places, were due to the pipeline's corrosion and BP's insufficient inspection of those pipelines.

In their amended complaint, shareholders alleged 25 materially false and misleading statements in SEC filings concerning the oil pipelines' health and BP's maintenance of the pipelines. The statements, *inter alia*, minimized the degree of the Prudhoe Bay pipeline's corrosion, emphasized the anomalous nature of the first spill, distinguished the conditions of the two pipelines, and touted BP's compliance with "environmental best practices" in maintaining the pipelines.

The district court dismissed the amended complaint in its entirety with prejudice for failure to state a claim. Although recognizing that the statements were actionably false, it found that plaintiffs did not plead facts giving rise to a strong inference of scienter. The district court found that the allegations "portray a company that poorly understood the challenges it faced in Prudhoe Bay, not one that engaged in securities fraud."

The Circuit Court reversed, reinstating all but one claim. Agreeing with the district court, it held that the various statements were actionably false or misleading. In addition, analyzing the totality of the circumstances of the various statements, the Court held that the timing and circumstances under which the statements were made indicated a compelling inference of scienter.

Reese v. Malone, 77 Env't. Rep. Cas. (BNA) 2057, Fed. Sec. L. Rep. (CCH) P 97818, 2014 WL 555911 (9th Cir. 2014)

Second Circuit Holds that Duty against Insider Trading Imposed by Federal Common Law

On January 27, 2014, the Second Circuit held that federal common law imposes and defines the "fiduciary-like duty against insider trading under section 10(b)" of the 1934 Act. In so holding, the Court reinstated a former minority shareholder's insider trading claims against corporate insiders of companies incorporated outside of the

United States who allegedly purchased securities without disclosing material inside information about the company.

In her complaint, the appellant claimed that corporate insiders of Xcelera, Inc. ("Xcelera"), a company formed in the Cayman Islands, engaged in securities fraud in violation of the 1934 Act. Specifically, she alleged that Xcelera's majority shareholders engineered a tender offer to purchase Xcelera shares for the benefit of a shell company it controlled. In doing so, it failed to disclose any information about Xcelera's financial health. Previously, the SEC had delisted Xcelera from the American Stock Exchange due to its failure to comply with disclosure requirements.

The district court dismissed the complaint, finding, *inter alia*, that Cayman Islands law controlled, and that such country has no analogous Section 10(b) duty.

The Second Circuit reversed. The Court reasoned that applying the law of the Cayman Islands—i.e. looking into the "idiosyncratic differences in state law"—would "thwart the goal of promoting national uniformity in securities markets." It held that the duty imposed under Section 10(b) "springs from federal law." That duty obligates either the disclosure of material inside information or the abstention from trading based on that information. Applying the rule, the Second Circuit held that, while respondents had no general affirmative duty to disclose material information, once Xcelera was deregistered by the SEC, insiders could not trade in Xcelera shares based on that information. Therefore, plaintiff had adequately pleaded securities fraud.

Steginsky v. Xcelera Inc., 741 F.3d 365, Fed. Sec. L. Rep. (CCH) P 97797 (2d Cir. 2014)

Second Circuit Holds that Civil Disgorgement Can Include Profits Not Directly Enjoyed by Insider

On February 18, 2014, the Second Circuit held that the remedy of civil disgorgement in insider trading cases can include (1) profits not accrued to the insider personally and (2) prejudgment interest on that amount.

Joseph Contorinis was the former manager and director of an investment fund (the "Fund"). In that capacity—and not with his own personal money—Contorinis executed several illegal insider trades using material, nonpublic information that he received from an employee of UBS Investment Bank. As a result of these insider trades, the Fund realized profits of $7,304,738 and avoided losses of $5,345,700.

After a criminal trial, Contorinis was found guilty on various counts

of securities fraud, was sentenced to six years' imprisonment, and was ordered to pay $12,650,438 in criminal forfeiture penalties (the total profits and avoided losses). On appeal, the Second Circuit affirmed the conviction but vacated the forfeiture order. The court reasoned that the criminal forfeiture statute did not support the proposition that a defendant must forfeit proceeds that "go directly to an innocent third party and are never possessed by the defendant." On remand, the district court found Contorinis' "personal profit" to be $427,875 and ordered forfeiture of that amount.

The SEC brought this subsequent civil action against Contorinis. In it, the district court ordered that Contorinis pay $7,260,604, the Fund's total profits less trading costs. The district court also ordered that Contorinis pay $2,485,205 in prejudgment interest on the disgorgement amount. Contorinis appealed.

The Second Circuit affirmed, finding that the district court did not abuse its discretion in making either order. The Court analogized Contorinis' actions to that of a tipper and tippee, where a "tippee's gains are attributable to the tipper, regardless whether benefit accrues to the tipper." Moreover, while Contorinis did not profit directly from the illegal trades, he nevertheless profited through "self-aggrandizement, psychic satisfaction from benefitting a loved one, or future profits by enhancing one's reputation as a successful fund manager."

The Court also differentiated the civil remedy from the criminal one. Criminal forfeiture is mandatory and "serves no remedial purpose." Rather, it is "designed to punish the offender." Civil disgorgement, "in contrast, is a civil remedy which serves the remedial purpose of preventing unjust enrichment." It is discretionary, and its goal is not furthered when the failure to order civil disgorgement by defendants like Contorinis "would allow them to unjustly enrich their affiliates." Therefore, the district court acted within its discretion in requiring the disgorgement of the Fund's entire profit.

S.E.C. v. Contorinis, 743 F.3d 296, Fed. Sec. L. Rep. (CCH) P 97822 (2d Cir. 2014)

Second Circuit Affirms Dismissal of Short-Swing Suit Involving Call Options

On January 29, 2014, the Second Circuit held that under Section 16(b) of the 1934 Act and Rule 16b-6(d), promulgated thereunder, the expiration of a short call option constitutes a purchase to be matched with the sale, which occurs when that option is written. Therefore, Goldman Sachs Group ("Goldman") was not required to disgorge profits earned from writing options because it was not a statutory insider both at the time of purchase and sale.

In his derivative action on behalf of Leap Wireless International, Inc. ("Leap"), a Leap shareholder sought to recover Goldman's alleged "short-swing profits" derived from writing call options on Leap stock. In his complaint, the appellant claimed that on September 30, 2009, Goldman became a Section 16(b) statutory insider of Leap through the purchase of more than 10% of Leap's outstanding stock. On that same day, Goldman wrote and sold 32,000 call options, bearing an expiration date of January 16, 2010. On October 6, 2009, Goldman disposed of a sufficient number of Leap shares to bring its ownership stake below 10%; it then disclosed that it was no longer a statutory insider. On January 16, 2010, the call options at issue expired unexercised. Appellant sought the profits generated by the writing of the options, which totaled $1,056,000, claiming that the writing of a short-term call option constituted a simultaneous purchase and sale.

The district court dismissed the complaint, and the Second Circuit affirmed. The Court of Appeals adopted the district court's reasoning: a short call option's expiration (without exercise) amounts to a Section 16(b) purchase by the option writer. For purposes of disgorgement, that purchase is to be matched against the date of the option's writing, which is the sale The Second Circuit reasoned that Rule 16b-6(d) was adopted to eliminate the potential that an insider/option-writer could generate profits by "knowing by virtue of his inside information that the option will not be exercised within six months." Goldman had disposed of its shares before the expiration date and hence was not subject to Section 16(b).

Roth v. Goldman Sachs Group, Inc., 740 F.3d 865 (2d Cir. 2014)

Supreme Court to Review Sixth Circuit Ruling on Knowledge Requirement of Section 11

On March 3, 2014, the Supreme Court agreed to review a Sixth Circuit decision that held that the standard for pleading falsity of statements of opinion or belief ("soft information") under Section 11 of the 1933 Act requires only that plaintiffs allege objective falsity. According to the petition for certiorari, the decision conflicts with case law from the Second, Third, and Ninth Circuits. There, applying the Supreme Court's decision in *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 111 S. Ct. 2749, 115 L. Ed. 2d 929, Fed. Sec. L. Rep. (CCH) P 96036 (1991), the Courts have held that claims arising under Section 11 must include allegations that soft information is both objectively and subjectively false.

Petitioners, Defendants-Appellees in the proceedings below ("Omnicare"), were Omnicare, the nation's largest provider of pharmaceutical care services for the elderly, and Omnicare's officers and directors during the relevant period. In December 2005, Omnicare

made a public offering and, in connection with the offering, made filings with the SEC. Those filings were incorporated into Omnicare's Registration Statement.

Respondents, Plaintiffs-Appellants below ("Plaintiffs"), participated in the December offering. In their complaint, they alleged that Omnicare's Registration Statement included material misstatements and omissions, in violation of Section 11, regarding "legally and economically valid arrangements" with the pharmaceutical industry. However, according to Plaintiffs, Omnicare was actually engaged in a variety of illegal activities, including kickback arrangements with pharmaceutical manufacturers and submission of false claims to Medicare and Medicaid. Notably, Plaintiffs did not plead that Omnicare knew that the statements of legal compliance were false.

On that ground, the district court dismissed the complaint for failure to state a claim. It held that Plaintiffs had not adequately pleaded knowledge of wrongdoing on the part of Omnicare because Section 11 requires that plaintiffs plead knowledge of falsity.

The Court of Appeals reversed. It held that Section 11 provides for strict liability; it was therefore inappropriate for the district court to require Plaintiffs to plead knowledge in connection with their Section 11 claim. The Court noted that the statements at issue consisted of soft information, which there is generally no duty to disclose. However, once disclosed and proven false, "a defendant's knowledge is not relevant to a strict liability claim." The Court therefore reinstated Plaintiffs claim because Section 11, which imposes strict liability, does not require a plaintiff to plead a defendant's state of mind.

Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund, 2014 WL 801097 (U.S. 2014)

Indiana State Dist. Council of Laborers and HOD Carriers Pension and Welfare Fund v. Omnicare, Inc., 719 F.3d 498, Fed. Sec. L. Rep. (CCH) P 97502 (6th Cir. 2013), cert. granted, 2014 WL 801097 (U.S. 2014)