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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 or other decisions relating to the Securities Act of 1933 (the "1933 Act"), the Securities Exchange Act of 1934 (the "1934 Act") and other Federal Securities laws during the second quarter of 2010.

SEC RULEMAKING

SEC Adopts Amendments Relating to Municipal Securities Disclosure

On May 27, 2010, the SEC adopted amendments to Rule 15c2-12 under the 1934 Act relating to municipal securities disclosure. **(See SEC Release No. 34-62184A).** The amendments require, among other things, that a broker, dealer or municipal securities dealer acting as an underwriter in a primary offering of municipal securities reasonably determine that the issuer or obligated person has agreed to provide notice of specified events to the Municipal Securities Rulemaking Board ("MSRB") not in excess of ten business days after the event's occurrence.

The amendments also (i) include additions to the list of events for which notice is to be provided to the MSRB, (ii) eliminate the materiality condition of certain events and revise the exemption for certain offerings of municipal securities with put features.

Additions to the list of events for which notice is to be provided to the MSRB.

The amendments add the following to the list of events for which notice is to be provided to the MSRB:

- tender offers for the issuer's debt;
- bankruptcy, insolvency, receivership or similar proceedings involving the obligated person;
- consummation of a merger, consolidation or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course

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of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms; and
- appointment of a successor or additional trustee, or the change of name of a trustee, if material.

The amendments also eliminate the materiality condition for the following events:

- principal and interest payment delinquencies with respect to the subject securities;
- unscheduled draws on debt service reserves reflecting financial difficulties;
- substitution of credit or liquidity providers, or their failure to perform;
- defeasances; and
- rating changes.

Elimination of certain exemptions for offerings of municipal securities with put features (i.e. "demand securities").

The amendments also eliminate certain exemptions for offerings of municipal securities with put features, i.e. demand securities.[1] Specifically, demand securities are no longer exempt from the annual continuing and event disclosure requirements set forth in Rule 15c2-12.

The amendments are effective on August 9, 2010, with compliance required for new issues or other primary offerings occurring on or after December 1, 2010.

SEC Proposes Amendments to Regulation AB and Other Rules Regarding Asset-Backed Securities

On April 7, 2010, the SEC proposed revisions to Regulation AB and other rules regarding the offering process, disclosure and reporting for asset-backed securities. **(See SEC Release Nos. 33-9117; 34-61858).** The proposed revisions are designed to enhance investor protection and intended to provide investors with timely and sufficient information, including information in and about the private market for asset-backed securities, reduce the likelihood of undue reliance on credit ratings, and help restore investor confidence in the representations and warranties regarding the assets.

Securities Act Registration

The SEC is proposing that the following be required for a shelf offering:

- A certification filed at the time of each offering off of a shelf registration statement, or takedown, by the chief executive officer of the depositor that the assets in the pool have characteristics that provide a reasonable basis to believe that they will produce, taking into account internal credit enhancements, cash flows sufficient to service any payments due and payable on the securities as described in the prospectus;

- Retention by the sponsor of a specified amount of each tranche of the securitization, net of the sponsor's hedging;
- A provision in the pooling and servicing agreement that requires the party obligated to repurchase the assets by reason of breach of representations and warranties to periodically furnish an opinion of an independent third party regarding whether such obligated party acted consistently with the terms of the pooling and servicing agreement with respect to any loans that the trustee put back for violation of representations and warranties and which were not repurchased; and
- An undertaking by the issuer to file 1934 Act reports so long as non-affiliates of the depositor hold any securities that were sold in registered transactions backed by the same pool of assets.

The SEC has also proposed replacing Forms S-1 and S-3 with new forms for registered ABS offerings that reflect these rule changes.

Disclosure

The SEC is proposing new disclosure of specified data relating to the terms of the asset, obligor characteristics, and underwriting of the asset. The disclosure is to be provided in a machine-readable, standardized format so that it is most useful to investors and the markets. Specifically, issuers would be required to provide the asset-level data or grouped account data at the time of securitization, when new assets are added to the pool underlying the securities, and on an ongoing basis.

Additionally the SEC is proposing to require the filing of a computer program of the contractual cash flow provisions of the securities in the form of downloadable source code in Python. Such computer program would be tagged in XML and required to be filed with the SEC as an exhibit. The source code, when downloaded and run, would be required to allow the user to programmatically input information from the asset data file.

The SEC has also proposed additional requirements to refine current disclosure requirements for asset-backed securities, including:

- aggregated and loan-level data relating to the type and amount of assets that do not meet the underwriting criteria that is specified in the prospectus;
- information for certain identified originators relating to the amount of the originator's publicly securitized assets that, in the last three years, has been the subject of a demand to repurchase or replace;

- for the sponsor, information relating to the amount of publicly securitized assets sold by the sponsor which, in the last three years, has been the subject of a demand to repurchase or replace;
- additional information regarding originators and sponsors;
- descriptions relating to static pool information, such as a description of the methodology used in determining or calculating the characteristics of the pool performance as well as any terms or abbreviations used;
- that static pool information for amortizing asset pools comply with the Item 1100(b) requirements for the presentation of historical delinquency and loss information; and
- the filing of Form 8-K for a one percent or more change in any material pool characteristic from what is described in the prospectus.

Finally, the SEC has proposed limiting some of the existing exceptions to the discrete pool requirement in the definition of an asset-backed security.

Privately-Issued Structured Finance Products

The SEC has also proposed enhanced disclosure by asset-backed issuers who wish to take advantage of the safe harbor provisions for privately-issued CDOs. Specifically, in order to provide additional transparency with respect to the private market for these securities, the SEC has proposed amendments to Rule 144A to require a structured finance product issuer to file a public notice on EDGAR of the initial placement of structured finance products that are eligible for resale under Rule 144A.

SEC Proposes Establishing Large Trader Reporting System

On April 14, 2010, the SEC proposed establishing a large trader reporting system, the purpose of which would be to assist the SEC in identifying and obtaining certain baseline trading information about traders that conduct a substantial amount of trading activity, as measured by volume or market value in the U.S. securities markets. **(See SEC Release No. 34-61908).**

Specifically, under proposed Rule 13h-1, any person would be a "large trader" that "directly or indirectly, including through other persons controlled by such person, exercises investment discretion over one or more accounts and effects transactions for the purchase or sale of any NMS security for or on behalf of such accounts, by or through one or more registered broker-dealers, in an aggregate amount equal to or greater than the identifying activity level." All large traders would be required to identify themselves to the SEC by filing Form 13H, and would be required to update their Form 13H at least annually and more frequently as necessary.

A large trader is "any person that directly or indirectly, including through other persons controlled by such person, exercises investment discretion over one or more accounts and effects transactions for the purchase or sale of any national market system ("NMS") security for or on behalf of such accounts, by or through one or more registered broker-dealers, in an aggregate amount equal to or greater than the identifying activity level," specifically (i) two million shares or $20 million during any calendar day, or (ii) 20 million shares or $200 million during any calendar month.

The SEC has proposed that each large trader would be assigned a unique Large Trader Identification Number ("LTID"), which would allow the SEC to identify and analyze trading activity conducted by the large trader. The large trader would be required to disclose to each of its registered broker-dealers its LTID and identify all of the accounts held by that broker-dealer through which the large trader trades.

As proposed, Rule 13h-1 would also impose recordkeeping and reporting requirements on registered broker-dealers and would require registered broker-dealers to provide large trader transaction data to the SEC upon request. Additionally, registered broker-dealers would be required to establish and maintain systems and procedures designed to help assure compliance with the identification requirements of the proposed rule.

SEC Proposes Rules to Establish a Consolidated Audit Trail for Equities and Options

On May 26, 2010, the SEC proposed new Rule 613 under Section 11A(a)(3)(B) of the 1934 Act that would require national securities exchanges and national securities associations ("SROs") to act jointly in developing a NMS plan to develop, implement, and maintain a consolidated order tracking system, or consolidated audit trail, with respect to the trading of NMS securities. **(See SEC Release No. 34-62174).** As proposed, the rule would require each national securities exchange and SRO to file jointly with the SEC on or before 90 days from approval of the Rule an NMS plan to govern the creation, implementation, and maintenance of a consolidated audit trail and a central repository. The NMS plan would include provisions regarding: (1) the operation and administration of the NMS plan; (2) the creation and oversight of a central repository; (3) the data required to be provided by SROs and their members to the central repository; (4) clock synchronization; (5) compliance by national securities exchanges, FINRA, and their members with the proposed Rule and the NMS plan; and (6) the possible expansion of the NMS plan to products other than NMS securities.

The central repository would be jointly owned by the SROs. For each order being originated, routed, modified or executed in relation to an NMS stock or listed equity option, the following would be provided: (1) a unique identifier for each order, (2) the identity of the customer, (3), the identity of the broker-dealer or national securities exchange receiving, originating or routing the order, (4) the date and time, in milliseconds, of the receipt, routing, modification or execution of the order and (5) the material terms of the order or any changes to such order.

Additionally, SROs and their members would be required to provide promptly, but in no instance later than midnight of the day that the reportable event occurs, (1) account numbers for any subaccounts to which an execution is allocated, (2) the unique identifier of the clearing broker or prime broker for the transaction, if applicable, and the unique order identifier of any contra-side order and (3) a cancelled trade indicator, in instances where the execution was cancelled.

APPELLATE AND OTHER DECISIONS OF NOTE

Supreme Court Vacates and Remands Advisory Fee Case in Light of *Jones v. Harris* Ruling

On April 5, 2010, the Supreme Court of the United States vacated and remanded an investment adviser fee case back to the Eighth Circuit in light of its recent decision in *Jones v. Harris*, 130 S.Ct. 1418 (2010), upholding the Gartenberg standard (*Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, Fed. Sec. L. Rep. (CCH) P 99001 (2d Cir. 1982)) for determining whether mutual fund fees were so excessive as to constitute a breach of fiduciary duty by the adviser under Section 36(b) of the Investment Company Act of 1940. In so ruling in *Jones v. Harris*, the Supreme Court vacated the appeals court's affirmation (*Jones v. Harris Associates L.P.*, 537 F.3d 728 (7th Cir. 2008)) of the lower court's dismissal, as previously discussed in this Journal [Vol 38 Issue 2 Securities Regulation Law Journal 6 at pp. 170–171; Vol 37 Issue 2 Securities Regulation Law Journal 6 at pp. 192–193].

As previously discussed in this Journal [Vol 37 Issue 3 Securities Regulation Law Journal 7 at p. 307], plaintiff shareholders of mutual funds alleged that defendant adviser breached its fiduciary duty under Section 36(b) of the Investment Company Act of 1940 by misleading the board of directors during fee negotiations. The Eighth Circuit had held that the lower court's review of Ameriprise's fee structure should include a comparison of the fees charged to institutional and mutual fund clients and that the proper approach was to consider the adviser's conduct during the negotiations and end result, rather than relying on the *Gartenberg* standards.

Ameriprise Financial, Inc. v. Gallus, 130 S. Ct. 2340, 176 L. Ed. 2d 559 (2010)

SEC Argues Entrepreneur's Conduct was Deceptive Under Rule 10b-5 Since He Violated Confidentiality Agreement

The Securities and Exchange Commission ("SEC") filed its reply brief on appeal before the Fifth Circuit on April 12, 2010, arguing that the sole issue on appeal is whether defendant Mark Cuban's conduct was deceptive. The SEC argues that a common sense approach is incorporated in Rule 10b5-2(b)(1), thus imposing a duty to disclose on an individual before trading when that individual had agreed to maintain the information in confidence.

The SEC brought the action against Cuban for trading on confidential nonpublic information about a corporation, Mamma.com, that he agreed to maintain in confidence. As a result of his trading, defendant allegedly avoided losses in excess of $750,000, in violation of Section 17(a) of the 1933 Act, Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereafter. The SEC is appealing from a decision of the District Court for the Northern District of Texas dismissing the SEC's charges of violations of Section 10(b) of the 1934 Act against Cuban, as previously discussed in this Journal [Vol 38 Issue 2 Securities Regulation Law Journal 6 at pp. 174–175].

A group of law professors also filed an amicus brief in support of Cuban's position on April 2, 2010, arguing that the SEC's position constitutes an expansion of its statutory authority.

SEC v. Cuban, No. 09-10996 (Fifth Cir. Apr. 12, 2010)

The reply brief for the SEC can be found at http://www.sec.gov/litigation/briefs/2010/cubanbrief0410.pdf.

Forward-Looking Statements Protected Under the PSLRA

The U.S. Court of Appeals for the Second Circuit affirmed the lower court's dismissal on May 18, 2010, holding that "the alleged misleading statement is a forward-looking statement that is protected by the safe harbor of the [PSLRA]."

As previously discussed in this Journal [Vol 38 Issue 2 Securities Regulation Law Journal 6 at pp. 173–174], investors filed suit against a publicly traded financial services corporation, alleging that the company and certain individual officers knowingly issued false and misleading statements, in violation of Sections 10(b) and 20(a) of the 1934 Act and Rule 10b-5 promulgated thereunder. The district court dismissed the amended complaint for failure to state a claim and plaintiffs appealed.

The Court concluded that the appeal concerned a statement filed with the Securities and Exchange Commission ("SEC") on May 15, 2001, in which the company disclosed losses from high yield debt investments in the first quarter of 2001, and stated that it expected substantially reduced losses for the remainder of 2001.

The Court held that PSLRA's safe harbor provides that a defendant is not liable for a forward-looking statement if (i) the statement is identified as such and accompanied by cautionary statements identifying important factors that could cause actual results to differ; or (ii) plaintiff fails to prove that the forward looking statement was made or approved by an executive officer with actual knowledge that the statement was false or misleading. Applying these factors, the Court concluded that the statement was identified as forward looking but that the cautionary language was too vague to warrant safe harbor protection. However, the Court also concluded that the second prong of this standard is satisfied because plaintiffs did not plead facts demonstrating actual knowledge and that the scienter requirement for forward-looking statements is stricter than for the statements of current fact.

Slayton v. American Exp. Co., 604 F.3d 758, Fed. Sec. L. Rep. (CCH) P 95746 (2d Cir. 2010)

Supreme Court Clarifies Statute of Limitations Period for Section 10(b) Claims

On April 27, 2010, the Supreme Court affirmed the lower court's ruling and unanimously held that the two-year statute of limitations period for claims under Section 10(b) of the 1934 Act does not begin to run until the earlier of (i) the date when a reasonably diligent plaintiff would have discovered the facts of the violation; or (ii) the date on which a plaintiff actually discovered the facts constituting the violation. The Court concluded that an FDA warning letter and pleadings filed in products-liability actions did not trigger the limitations period because they did not contain specific information.

As previously discussed in this Journal [Vol 37 Issue 3 Securities Regulation Law Journal 7 at pp. 307–308], plaintiff investors alleged violations of Sections 11, 12, and 15 of the 1933 Act, Sections 10(b), 20(a) and 20A of the 1934 Act, and Rule 10b-5 promulgated thereunder. The Third Circuit held that the investors have no duty to investigate suspicion of fraud, and the two-year filing period does not begin to run until the investors come upon evidence that the fraud was intentional.

Noting the heightened pleading requirements for scienter for Section 10(b) fraud claims, the Court specifically rejected Merck's claims that the statute of limitations begins to run when plaintiffs are on inquiry notice of the alleged violations. The Court emphasized that it would frustrate the purpose of discovery in this provision if the statute of limitations begins to run regardless of whether a plaintiff has discovered any facts suggesting scienter.

Merck & Co., Inc. v. Reynolds, 130 S. Ct. 1784, 176 L. Ed. 2d 582, Fed. Sec. L. Rep. (CCH) P 95733 (2010)

Third Circuit Affirms Lack of Omission Liability Where There is No Duty to Disclose

The U.S. Attorney for the District of New Jersey brought suit against an executive for violations of Section 10(b) of the 1934 Act for omissions in financial filings and for alleged misstatements in conference calls with analysts. Specifically, the government alleged that the executive engaged in a practice known as "channel-stuffing" whereby excessive amounts of product are sold ahead of demand, did not disclose such practice in the company's financial statements, made omissions of material fact about such inventory in conference calls, and failed to correct the misstatements of others during the same conference calls.

The district court did not find any liability for defendant and in so ruling, noted that the government "has not alleged any misstatements in those filings . . .. Thus, omission liability must be predicated on other prior statements."

The Third Circuit affirmed the lower court's decision on April 7, 2010, explaining that absent a duty to disclose, silence is neither fraudulent nor misleading under Rule 10b-5. The Court also found there was no fiduciary duty to rectify or correct the financial statements. The government's case against defendant was allowed to proceed, however, on other grounds.

U.S. v. Schiff, 602 F.3d 152, Fed. Sec. L. Rep. (CCH) P 95715 (3d Cir. 2010)

Second Circuit Rejects SEC's Argument for Application of "Creator" Standard to Secondary Actor, Law Firm

On April 27, 2010, the Second Circuit affirmed the lower court's dismissal of a securities class action against Mayer Brown LLP and one of its former partners, thus rejecting the arguments of the SEC, as previously discussed in this Journal [Vol 37 Issue 4 Securities Regulation Law Journal 5 at p. 402].

Plaintiff alleged violations of Sections 10(b) and 20(a) of the 1934 Act and Rule 10b-5 promulgated thereunder, brought against Mayer Brown LLP and a former partner over their alleged roles in the Refco fraud. The district court dismissed the case, finding no primary violation. Plaintiff then appealed and the SEC submitted an amicus brief, arguing that one can be a primary violator by attribution or by intentionally creating a misstatement.

The Court held that secondary actors can only be liable for false statements attributable to them at the time of dissemination. Otherwise, the Court reasoned, plaintiffs cannot show they relied on defendants' false statements. At the time of dissemination, all of the statements were attributable to the broker and not the law firm or its lawyers.

In affirming the lower court, the Second Circuit rejected plaintiff's assertion that a "creator" standard is appropriate, which provides that a defendant may be liable for creating a false statement that investors rely upon, regardless of whether the statement is attributed to defendant at the time of dissemination. Instead, the Court noted that plaintiff's Rule 10b-5 claim against the former partner of Mayer Brown was properly dismissed because plaintiff could not have relied on any misstatement made by the former partner because he was not identified in the documents cited by plaintiff. Likewise, the Rule 10b-5 claims against Mayer Brown were also properly dismissed, because the "mere mention" of the firm's representation is not sufficient to be considered an articulated statement by Mayer Brown that it adopted Refco's statements as its own.

Pacific Inv. Management Co. LLC v. Mayer Brown LLP, 603 F.3d 144, Fed. Sec. L. Rep. (CCH) P 95722 (2d Cir. 2010)

No Private Cause of Action for Violation of the Anti-Pyramiding Provision of the Investment Company Act

The United States District Court for the District Court of Maryland held on April 1, 2010 that there is no private cause of action under Section 12(d)(1)(A)(i) of the Investment Company Act of 1940 (ICA), the anti-pyramiding provision, which bars an investment company from acquiring more than three percent of the shares of another investment company.

In this case, plaintiff, a closed end fund, brought suit against defendant investment companies, alleging violations of the anti-pyramiding provision, by illegally acquiring more than three percent of plaintiff's stock and threatening a proxy contest at plaintiff's next shareholder meeting. The lower court granted defendants' motion to dismiss on the ground that no private right of action exists under ICA Section 12(d)(1)(A)(i).

In its decision, the court relied on the fact that the ICA's purpose is to protect investors, not investment companies and that "just because a statute is found to protect a certain party [the plaintiff fund] does not mean that that party is automatically conferred a private cause of action under the statute."

Gabelli Global Multimedia Trust Inc. v. Western Inv. LLC, 700 F. Supp. 2d 748, Fed. Sec. L. Rep. (CCH) P 95739 (D. Md. 2010)

NOTES:

[1]Demand securities are municipal securities in authorized denominations of $100,000 or more which, at the option of the holder thereof, may be tendered to the issuer or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by the issuer or its designated agent.