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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"), the Investment Company Act of 1940 (the "1940 Act") and other Federal Securities laws during the second quarter of 2011.

SEC Rulemaking

SEC Adopts Rules to Implement Amendments to the Investment Advisers Act of 1940

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). On June 22, 2011, the SEC adopted amendments to implement portions of the Dodd-Frank Act relating to oversight responsibility of mid-sized investment advisers and the elimination of the "private adviser exemption." (*See* **SEC Release No. IA-3221**).

Registration Eligibility

Subject to certain exemptions, investment advisers with assets under management between \$25 million and \$100 million are required to be registered in the state in which they maintain their principal office and place of business and can no longer be registered with the SEC. Accordingly, each such adviser registered with the SEC on January 1, 2012, must file an amendment to its Form ADV no later than March 30, 2012, responding to new items in Form ADV and identifying itself as a mid-sized adviser no longer eligible to remain registered with the SEC. Mid-sized advisers no longer eligible for registration must then withdraw their registration no later than June 28, 2012. Additionally, mid-sized advisers currently registered with the SEC must remain registered with the SEC (unless an exemption from registration is available) until January 1, 2012.

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In calculating assets under management to determine whether they qualify as mid-sized, advisers must include in their regulatory assets under management (i) securities portfolios for which they provide continuous and regular supervisory or management services, regardless of whether these assets are family or proprietary assets, (ii) assets managed without receiving compensation and (iii) assets of foreign clients. An adviser must calculate its regulatory assets under management on a gross basis, i.e. without deduction of "any outstanding indebtedness or other accrued but unpaid liabilities."

Private fund advisers must include in their calculation of regulatory assets under management the value of any private fund over which they exercise continuous and regular supervisory or management services, regardless of the nature of the assets held by the fund, including the amount of any uncalled capital commitments made to a private fund managed by the adviser. Calculations must be made using the market value of private fund assets, or the fair value of private fund assets where market value is unavailable.

Mid-sized advisers who remain registered with the SEC must affirm, upon application and annually thereafter, that they are either: (i) not required to be registered as an adviser with the state securities authority in the state where they maintain their principal office and place of business; or (ii) are not subject to examination as an adviser by that state.

Exempt Reporting Advisers

Although many private fund advisers will be required to register, some of those advisers may not need to do so if they are able to rely on one of three new exemptions from registration under the Dodd-Frank Act (described in further detail below), including: (a) as an adviser solely to venture capital funds; (b) as an adviser solely to private funds with less than $150 million in assets under management in the U.S.; and (c) as a foreign adviser without a place of business in the U.S., subject to certain requirements. The SEC may still impose certain reporting requirements upon advisers relying upon either of the first two of these exemptions ("exempt reporting advisers"). Under the new rules, exempt reporting advisers will nonetheless be required to file and periodically update reports using the same registration form as registered advisers.

Rather than completing all of the items on the form, exempt reporting advisers will fill out a limited subset of items, including: (1) basic identifying information for the adviser and the identity of its owners and affiliates; (2) information about the private funds the adviser manages and other business activities that the adviser and its affiliates are engaged in that present conflicts of interest that may suggest significant risks to clients; and (3) disciplinary history (if any) of the adviser and its employees that may reflect on the integrity of the firm. Exempt reporting advisers will file reports electronically, using the SEC's investment adviser electronic filing system. These advisers will be required to file their first reports in the first quarter of 2012.

Form ADV Amendments

The SEC also adopted amendments to Form ADV including information relating to:

- Private Fund Reporting;
- Advisory Business Information: Employees, Clients and Advisory Activities;
- Other Business Activities and Financial Industry Affiliations;
- Participation in Client Transactions;
- Custody; and
- Assets totaling $1 Billion or More.

Pay to Play

The SEC has amended the "pay to play" rule so that it applies to both exempt reporting advisers and foreign private advisers. The rule also adds municipal advisors to the categories of registered entities, i.e. "regulated person," excepted from the rule's prohibition on advisers paying third parties (placement agents) to solicit government entities, provided the adviser is subject to a pay-to-play rule adopted by the MSRB that is at least as stringent as the investment adviser pay-to-play rule.

SEC Adopts Exemptions from the Investment Advisers Act for Certain Entities

On June 22, 2011, the SEC adopted amendments to implement portions of the Dodd-Frank Act to, among other things, provide an exemption from registration for certain venture capital funds, for advisers with less than $150 million in private fund assets under management in the United States and for foreign private advisers. (*See* **SEC Release No. IA-3222**). These exemptions are intended to replace provisions of the Investment Advisers Act repealed by the Dodd-Frank Act that had exempted any investment adviser from registration if the investment adviser (i) had fewer than 15 clients in the preceding 12 months, (ii) did not hold itself out to the public as an investment adviser, and (iii) did not act as an investment adviser to a registered investment company or a company that has elected to be a business development company.

Venture Capital Funds

As adopted, the rule defines a venture capital fund as a foreign or domestic private fund that: (i) holds no more than 20% of its capital commitments in non-qualifying investments (other than short-term holdings) ("qualifying investments" generally consist of equity securities of "qualifying portfolio companies" that are directly acquired by the fund); (ii) does not borrow or otherwise incur leverage, other than limited short-term borrowing (excluding certain guarantees of qualifying portfolio company obligations); (iii) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself as pursuing a venture capital strategy to its investors and prospective investors; and (v) is not registered under the 1940 Act and has not elected to be treated as a business development company. Pre-existing funds that are currently considered venture capital funds are grandfathered in under the rule, subject to certain conditions. Additionally, the exemption is available to non-U.S. advisers.

Exemption for Investment Advisers Solely to Private Funds with Less Than $150 Million in Assets Under Management

The new rules also exempt from registration funds that manage only private funds and have less than $150 million in assets under management. To determine eligibility, an adviser must aggregate the value of all assets of private funds it manages pursuant to instructions provided in Form ADV. The adviser must annually calculate the amount of the private fund assets it manages and report the amount in its annual updating amendments to its Form ADV to determine eligibility. For purposes of the rule, all of the private fund assets of an adviser with a principal office and place of business in the United States are considered to be "assets under management in the United States," even if the adviser has offices outside of the United States. Non-U.S. advisers need only count private fund assets managed at a place of business in the United States. Non-U.S. advisers may not rely on the exemption if they have any client that is a United States person other than a private fund.

Foreign Private Advisers

The SEC has also adopted amendments exempting from registration foreign private advisers (i) with no place of business in the United States, (ii) with fewer than 15 clients in the United States, (iii) with aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25 million, and (iv) that do not hold themselves out generally to the public in the United States as an investment adviser.

SEC Proposes New Rules to Disqualify Certain "Bad Actors" From Reliance on Private Placement Safe Harbor

On May 25, 2011, the SEC proposed new rules and amendments intended to implement provisions of the Dodd-Frank Act to disqualify securities offerings involving certain "felons and other 'bad actors' " from reliance on the safe harbor from 1933 Act private placement registration. (*See* **Release No. 33-9211**). Specifically, the SEC is proposing that Rule 506 of the 1933 Act would not be available to issuers that fail the proposed "bad actors" test. Rule 506 provides a safe harbor from securities registration under the 1933 Act for private placements and permits sales of an unlimited dollar amount of securities to be made, without registration, to an unlimited number of accredited investors, so long as there is no general solicitation, appropriate resale limitations are imposed, and the other conditions of the rule are met.

Covered Persons

The following individuals would be considered "covered persons" under the proposed amendments:

- the issuer and any predecessor of the issuer or affiliated issuer;
- any director, officer, general partner or managing member of the issuer;
- any beneficial owner of 10% or more of any class of the issuer's equity securities;
- any promoter connected with the issuer in any capacity at the time of the sale;
- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering; and
- any director, officer, general partner, or managing member of any such compensated solicitor.

Disqualifying Events

The SEC has proposed that the following events would be considered events and circumstances that give rise to disqualification:

- criminal convictions;
- court injunctions and restraining orders;
- final orders of certain state regulators (such as state securities, banking and insurance regulators) and federal regulators;
- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers and investment companies and their associated persons;

- suspension or expulsion from membership in, or suspension or bar from associating with a member of, a securities self-regulatory organization;
- SEC stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.

SEC Proposes Rules to Relating to Listing Standards for Compensation Committees

On March 30, 2011, the SEC proposed new rules and amendments to implement provisions of the Dodd-Frank Act intended to prohibit the listing of any equity security of an issuer that is not in compliance with certain compensation committee and compensation adviser requirements. (*See* **Release Nos. 33-9199 and 34-64149**). Specifically, the SEC is proposing, subject to certain exemptions, listing standards that, among other things, require each member of a listed issuer's compensation committee to be a member of the issuer's board of directors and to be "independent," as defined in the listing standards of the issuer's respective exchange.

As proposed, the rules would direct any registered national securities association that lists equity securities to develop a definition of independence applicable to compensation committee members after considering relevant factors, including, but not limited to, the source of compensation of a director, including any consulting, advisory or other compensatory fee paid by the issuer to such director, and whether the director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer. Additionally, the SEC is proposing that compensation advisors employed by compensation committees be independent in accordance with a definition of independence applicable to compensation committee members as developed by the exchanges. As proposed, the SEC would also permit the exchanges' rules to provide that if a member of a compensation committee ceases to be independent for reasons outside the issuer's reasonable control, that person, with notice by the issuer to the applicable exchange, may remain a compensation committee member of the issuer until the earlier of the next annual meeting of the issuer or one year from the occurrence of the event that caused the member to no longer be independent.

SEC Proposes Rules Relating to Credit Risk Retention

On May 10, 2011, the SEC proposed amendments to implement portions of the Dodd-Frank Act relating to the securitization of any "residential mortgage asset" to require a securitizer or sponsor to retain not less than 5% of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security ("ABS"), transfers, sells, or conveys to a third party, and to prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under the 1934 Act. (*See* **SEC Release No. 34-64148**). Comments on the amendments are to be received August 11, 2011.

Permissible Forms of Risk Retention

The SEC has proposed a number of ways a sponsor or other entity may satisfy the risk retention requirements including, among others, (a) a vertical risk retention option, whereby the sponsor retains at least 5% of each class of interests issued; and (b) a horizontal risk retention option, whereby the sponsor retains an "eligible horizontal residual interest" equal at least 5% of the par value of all interests in the securitization.

Allocation to the Originator

As proposed, the rules would permit a sponsor of a securitization to allocate a portion of its risk retention obligation to an originator that contributes a significant amount of assets to the underlying asset pool, subject to the satisfaction of certain conditions.

Hedging, Transfer and Financing Restrictions

As proposed, the rules would also prohibit a sponsor or any consolidated affiliate from hedging the credit risk the sponsor is required to retain, including any hedging by a sponsor's consolidated affiliates.

Qualified Residential Mortgages

As proposed, the rules would provide a blanket exemption for ABSs that are collateralized solely by "qualified residential mortgages" that meet specific underwriting standards.

SEC Proposes Rules Relating to Incentive Based Compensation Arrangements

On March 29, 2011, The SEC proposed new rules and amendments intended to implement provisions of the Dodd-Frank Act relating to incentive-based compensation arrangements by covered financial institutions. (*See* **Release No. 34-64140**). Specifically, the proposed rules and amendments would:

- prohibit incentive-based compensation arrangements at covered financial institutions that encourage executive officers, employees, directors, or principal shareholders ("covered persons") to expose the institution to inappropriate risks by providing the covered person excessive compensation;

- prohibit covered financial institutions from establishing or maintaining any incentive-based compensation arrangements for covered persons that encourage inappropriate risks that could lead to material financial loss, including deferral of a portion of incentive-based compensation for executive officers of larger covered financial institutions and requiring that the board of directors, or a committee thereof, of the institution approve the incentive-based compensation arrangement for such individuals, and maintain documentation of such approval;
- require covered financial institutions to maintain policies and procedures appropriate to their size and complexity; and
- require covered financial institutions to provide certain information to their appropriate Federal regulator(s) concerning their incentive-based compensation arrangements for covered persons.

Covered Financial Institutions

As proposed, covered financial institutions would have total consolidated assets of $1 billion or more and would include, with respect to the SEC, a broker-dealer registered under Section 15 of the 1934 Act and an investment adviser, as such term is defined in Section 202(a)(11) of the Investment Advisers Act of 1940, as amended.

APPELLATE AND OTHER DECISIONS OF NOTE

No Loss Causation Required at Class Certification Stage, According to Supreme Court

On June 6, 2011, the Supreme Court unanimously held that proof of loss causation was not required for class certification. In so ruling, the Supreme Court reversed the appeals court's affirmation of the lower court's dismissal, as previously discussed in this Journal (Sec. Reg. L.J., Vol. 38, No. 2, pp. 172-73). In his opinion, Chief Justice Roberts distinguished the concept of loss causation from that of whether an investor relied on a misrepresentation when buying or selling stock, pointing out that a subsequent loss "has nothing to do with whether an investor relied on the misrepresentation in the first place."

Plaintiff investor brought a class action against Halliburton Company and its COO, alleging violations of Sections 10(b) and 20(a) of the 1934 Act and Rule 10b-5 promulgated thereunder. Plaintiff asserted a fraud-on-the-market case, claiming that defendants made false statements in three areas: (i) the company's potential liability in asbestos litigation; (ii) the company's accounting for revenue in its engineering and construction business; and (iii) the benefits of a merger. Plaintiff contended investors lost money as a result of the company's subsequent disclosures correcting such statements, and the market's following decline.

The Fifth Circuit had affirmed the district court's denial of class certification. The Circuit Court held that plaintiff needed to establish loss causation by a preponderance of the evidence in order to trigger the fraud-on-the-market presumption.

The U.S. Chamber of Commerce filed an amicus curiae brief urging the Supreme Court to uphold the Fifth Circuit's ruling, arguing that businesses and financial markets would otherwise be harmed by a "flood of Rule 10b-5 litigation." At the request of the Supreme Court, however, the Securities and Exchange Commission and the Justice Department submitted an amicus brief which asserted that the Fifth Circuit erred in its decision because it failed to determine that the issue of loss causation "was relevant to any of the prerequisites for class certification."

Erica P. John Fund Co. v. Halliburton, No. 09-1403, 563 U.S. (June 6, 2011).

Investment Adviser Held Not Liable to Investors for Misstatements of Its Mutual Fund

Plaintiff investors alleged that defendants, an investment adviser to a mutual fund, and its parent company, were responsible for misleading statements in the prospectuses, in violation of Sections 10(b), 20(a) of the 1934 Act and Rule 10b-5 promulgated thereunder, as previously discussed in this Journal (Sec. Reg. L.J., Vol. 39, No. 1, pp. 70-71). Specifically, plaintiffs pointed to the representation that the fund manager did not permit market timing. Plaintiffs contended that they purchased shares at inflated prices in reliance on these misrepresentations and lost money when the market timing practices became known to the public.

The investment adviser in this action is a wholly owned subsidiary of the parent company. The parent company is also the creator of the investment fund itself, which is a separate legal entity. The prospectuses at issue in this case were distributed to investors by the investment fund, not the adviser or its parent company.

The district court dismissed the claims, finding that plaintiffs did not satisfy several of the elements of Section 10(b). The Fourth Circuit reversed the lower court's decision, finding that the adviser and its parent, by participating in the writing and dissemination of the prospectuses, "made" the misleading statements at issue. Accordingly, the Circuit Court held that the reliance element of Rule 10b-5 was met with respect to the adviser because investors would infer the adviser played a role in preparing or approving the prospectuses.

On June 13, 2011, the Supreme Court reversed the Circuit Court's decision, and held that a service provider cannot be held primarily liable for aiding and abetting another company's (i.e., the fund's) misstatements. The Supreme Court held that the adviser did not "make" the misrepresentations in the prospectuses, and thus, cannot be held liable under Rule 10b-5. In deciphering the meaning of the word "maker," the Court looked to the entity who had "ultimate control" over its content and noted that the investment fund was the entity which made the misstatements in its prospectuses, not the parent company or the investment adviser. Accordingly, plaintiffs have no private right of action against the parent company or investment adviser under Rule 10b-5 because they did not "make" any of the misstatements at issue. In its decision, the Court emphasized the importance of the corporate form and disregarded the "uniquely close" relationship between investment fund and the parent company and investment adviser. Further, the Court stated that it was for Congress to make any new rules, not the courts.

In the dissent, the minority persuasively argued that the majority misinterpreted the word "make," emphasizing that there has been no prior limitation of "ultimate control" in either case law or common English. The dissent also expressed concern over the practical impact of such a narrow reading of the law by the Court, pointing out that the ruling provides a loophole or roadmap for companies to avoid liability when "guilty management" prepares a materially false prospectus, which is then ordinarily accepted and approved by the board of directors of the investment fund.

The opinion left open whether officers or directors may be held liable for the misstatements in the prospectus.

Janus Capital Group v. First Derivative Traders, No. 09-526, 563 U.S. (June 13, 2011).

SEC Cannot Impose Monetary Penalties Under Section 21(d)(3) of the 1934 Act for Insider Trading in the Absence of Realized Profits

On June 9, 2011, the Second Circuit reversed the district court and held that civil monetary penalties for insider trading violations were not available under Section 21(d)(3) of the 1934 Act. The issue before the Court was whether monetary penalties are appropriate in cases where no profit was earned from the insider trading.

Defendants are family members and a family friend who engaged in insider trading with respect to two separate deals. Neither of those deals were executed, and as a result, defendants did not realize any profits from their activities. Defendants pled guilty to criminal securities fraud conspiracy in 2007 and the SEC then initiated this civil enforcement action.

The district court granted summary judgment to the SEC and imposed monetary penalties on defendants pursuant to Section 21(d)(3). Defendants then appealed to the Second Circuit, arguing that Section 21(d)(3) is not applicable to them.

Section 21(d)(3) states that penalties may be imposed against a person who violates securities laws, "other than by committing a violation subject to penalty pursuant to section 78u-1." This language refers to the 1988 Insider Trading and Securities Fraud Enforcement Act, which added Section 21A to the 1934 Act, codified at section 78u-1. Thus, the question is whether defendants' actions were subject to penalty pursuant to Section 21A.

The district court agreed with the SEC and held that defendants were not subject to penalties under Section 21A and thus it was proper to impose penalties pursuant to Section 21(d)(3). The SEC's interpretation was that a defendant is exempted from Section 21(d)(3) penalties only if he or she is liable under Section 21A.

The Second Circuit disagreed with the district court and SEC, and held that Section 21A distinguishes between the SEC's right to bring a civil enforcement action, and the amount of penalties that can be imposed for violations. The appeals court concluded that defendants were guilty of violations of Section 21A but that any penalties were limited to three times the profit gained or losses avoided, as set forth in Section 21A(a)(2). In this case, defendants did not realize any profit and accordingly, the penalties amount to zero. In reaching its decision, the Circuit Court looked to congressional intent and found that penalties were meant to be directly proportional to the amount of profit gained or losses avoided.

S.E.C. v. Rosenthal, Fed. Sec. L. Rep. (CCH) P 96331, 2011 WL 2271743 (2d Cir. 2011).

Sixth Circuit Court Takes "Holistic" Approach in Holding Claims Against Auto Executives Sufficiently Allege Scienter

Investors filed suit against the chief executive officer and chief financial officer of an auto parts manufacturer for misrepresenting the company's finances and falsely assuring investors that the company used sound accounting controls, in violation of Section 10(b) and 20(a) of the 1934 Act and Rule 10b-5 promulgated thereunder. Plaintiffs also cited the fact despite the positive outlook in 2004 and early 2005, the company announced a 50% reduction in earnings projections in September 2005, defaulted on millions of dollars of debt, and ultimately filed for bankruptcy in March 2006.

The district court dismissed the complaint for failure to adequately plead scienter. The Sixth Circuit reversed the lower court's decision and reinstated the class securities fraud action on May 25, 2011. Citing the Supreme Court's decision in Matrixx Initiatives v. Siracusano, No. 09-1156, 563 U.S. (2011), which has been previously discussed in this Journal, (Sec. Reg. L.J., Vol. 38, No. 1, pp. 82-83), the Circuit Court determined it would take a "collective," "holistic" approach. In concluding that plaintiffs adequately pled scienter, the Court noted that the inference that the executives recklessly ignored the falsity of their statements is at least as plausible as the inference of failed accounting systems. Further, the Court emphasized that "it is difficult to grasp the thought that [the executives] really had no idea that [the company] was on the road to bankruptcy" given the general state of the automotive industry at that time.

Frank v. Dana Corp., Fed. Sec. L. Rep. (CCH) P 96319, 2011 WL 2020717 (6th Cir. 2011).

Securities Fraud Claims Against Auditor Reinstated by the Ninth Circuit

Plaintiffs alleged that Ernst & Young issued an unqualified audit opinion in 2005 which covered three years of a technology company's financial statements, in violation of Sections 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder. Specifically, plaintiffs alleged that the accounting firm knew about or recklessly disregarded information about backdated options.

The district court dismissed the complaint for lack of scienter and the Ninth Circuit reversed the dismissal on April 14, 2011. The Circuit Court held that three instances which plaintiffs cited whereby the auditor should have investigated further or learned of the backdating were sufficient to support an inference of scienter. These instances were: (i) the auditor "knew the material consequences of a May 2000 backdated option grant that would have resulted in a $700 million charge to [the company's] financial results but, despite violations of GAAS, signed off on the grant without obtaining documentation"; (ii) the auditor "knew that several significant option grants were approved on dates when [the company's] compensation committee was not legally constituted due to the death of one of the two committee members"; and (iii) the auditor "presided over corrective reforms in 2003 to prevent and detect any future instances of improper stock option awards without questioning the integrity of Broadcom's accounting for options granted prior to the corrective reforms." The Court explained that in determining scienter, courts look for "red flags," meaning facts that would cause a reasonable auditor to further investigate. The more red flags, the stronger the inference of scienter.

New Mexico State Investment Council v. Ernst & Young LLP, 641 F.3d 1089, Fed. Sec. L. Rep. (CCH) P 96290 (9th Cir. 2011).