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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 fourth quarter of 2008.

SEC RULEMAKING

SEC Adopts Amendments to Rules Relating to Municipal Securities Disclosure

On December 5, 2008, the SEC adopted amendments to the rules relating to municipal securities disclosure providing that a broker, dealer or municipal securities dealer acting as an underwriter in a primary offering of municipal securities must reasonably determine that the issuer or obligated person has agreed to provide in a written agreement or contract for the benefit of holders of the issuer's municipal securities. **(See SEC Release No. 34-59062).** Specifically, the broker, dealer or municipal securities dealer must provide the information covered by such written agreement to the Municipal Securities Rulemaking Board ("MSRB") instead of to multiple nationally recognized municipal securities information repositories and state information depositories and to provide such information in an electronic format and accompanied by identifying information as prescribed by the MSRB.

Pursuant to the amendments, issuers or obligated persons must undertake to file with the MSRB the annual reports, audited financial statements and material event and non-compliance notices required to be filed under the rule as now in effect. The information must be filed in an electronic format, and with identifying information, prescribed by the MSRB with the approval of the SEC.

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The amendments become effective on July 1, 2009; on and after that date, municipal dealers may not purchase or sell municipal securities in a non-exempt offering unless they have reasonably determined that the issuer or an obligated person has entered into a continuing disclosure undertaking that complies with the amendments.

SEC Adopts Interim Final Temporary Rule Regarding Closing Out of Fail to Deliver Positions Resulting From Long or Short Sales

On October 14, 2008, the SEC adopted an interim final temporary rule regarding the close-out of fail to deliver positions resulting from long or short sales by clearing firms. **(See SEC Release No. 34-58773).** The interim final temporary rule requires clearing firms to close-out fail to deliver positions resulting from long or short sales of any equity security by no later than the beginning of regular trading hours on the settlement day after the day to fail to deliver position arose. A participant that does not comply with this close-out requirement, and any broker-dealer from which it receives trades for clearance and settlement, will not be able to short sell the security either for itself or for the account of another, unless it has previously arranged to borrow or borrowed the security, until the fail to deliver position is closed out.

The interim final temporary rule adopts the essential elements of the close-out rule in effect as part of the SEC's emergency orders dated September 18, 2008, September 21, 2008 and October 2, 2008 relating to short sales, with three differences. Specifically, the interim final temporary rule:

- applies to fails to deliver in all equity securities;
- shortens the close-out period for fails to deliver from 13 days (ten days after settlement date) to the beginning of regular trading hours on the settlement day following the date on which the fail to deliver position occurred; and
- imposes a notification requirement on a broker-dealer that has been allocated responsibility for complying with the rule.

The interim final temporary rule became effective on October 17, 2008 and remains in effect until July 31, 2009.

SEC Adopts "Naked" Short Selling Antifraud Rule

On October 14, 2008, the SEC adopted the "naked" short selling antifraud rule to address fails to deliver securities that have been associated with "naked" short selling. **(See SEC Release No. 34-58774).** The rule clarifies the

SEC's position that any person who submits an order to sell an equity security engages in a "manipulative or deceptive device or contrivance" in violation of Section 10(b) of the 1934 Act if that person deceives a broker-dealer, a participant of a registered clearing agency or a purchaser about its intention or ability to deliver the security on or before the settlement date, its source of securities for delivery or its share ownership, and such person fails to deliver the security on or before the date delivery is due.

The antifraud rule applies to all sellers of equity securities. Additionally, broker-dealers (including market makers) acting for their own accounts will be considered sellers for purposes of the rule. The rule became effective October 17, 2008.

SEC Adopts Amendments to Regulation SHO Eliminating the Options Market Maker Exception

On October 14, 2008, the SEC adopted amendments to Regulation SHO under the 1934 Act intended to further reduce the number of persistent fails to deliver in certain equity securities by eliminating the options market maker exception to the close-out requirement of Regulation SHO. **(See SEC Release No. 34-58775).** Specifically the amendments eliminate the exception under Regulation SHO to the mandatory close-out requirement for any fail to deliver in a threshold security for registered options market makers who were establishing or maintaining a hedge on options positions that were created before the underlying security became a threshold security.

The amendments include a one-time thirty-five (35) consecutive settlement day phase-in period, which provides that any fails to deliver in threshold securities excepted as of the effective date of the amendments must be closed within thirty-five (35) consecutive settlement days of that effective date.

The SEC also provided guidance relating to what constitutes bona fide market making for purposes of the locate exception[1] but noted that whether or not a market maker is engaged in bona-fide market making will ultimately depend on the facts and circumstances of the particular activity. The amendments became effective October 17, 2008.

SEC Issues Interim Temporary Final Rule Requiring Institutional Investment Managers to File Forms SH Disclosing Daily Short Sales and Short Positions

On October 15, 2008, the SEC adopted an interim final temporary rule requiring certain institutional investment managers to file information on Form SH concerning their short sales and positions of Section 13(f) securities. **(See SEC Release No. 34-58785).** The interim final temporary rule extends the reporting requirements established by the SEC's emergency orders dated September 18, 2008, September 21, 2008 and October 2, 2008, with some modifications.

Effective October 18, 2008, institutional investment managers that, at the end of the most recent calendar quarter, filed, or were required to file, a Form 13F for the calendar quarter and effected a short sale in a Section 13(f) security, other than options, during a calendar week must file a Form SH with the SEC on the last business day of the ensuing calendar week. The Form SH will be a non-public filing. The Form SH must disclose the following information, for each calendar day of the previous week, concerning all short positions in Section 13(f) securities, excluding options[2]:

- the opening short position;
- the number of securities sold short during the day; and
- the closing short position.

Institutional investment managers who do not effect short sales of a Section 13(f) security during a calendar week will not be required to file a Form SH. Additionally, if on each calendar day an opening short position, closing short position and daily aggregate number of securities sold short constitute less than one-quarter of one percent of the class of the issuer's Section 13(f) securities issued and outstanding, as reported in the issuer's most recent annual or quarterly report and any subsequently filed current report (unless the manager knows or has reason to believe the information contained therein is inaccurate), and have a market value of less than $10,000,000, no disclosure is required on Form SH with respect to the Section 13(f) security for that day (the "New De Minimis Exception").

To the extent a filing obligation is triggered for a calendar week, the institutional investment manager may still apply the New De Minimis Exception on a day-by-day and data element-by-data element basis. "N/A" can be used to populate the applicable data elements any time a filer has a filing obligation and is omitting information under the New De Minimis Exception.

The interim final temporary rule became effective on October 17, 2008 and remains in effect until July 31, 2009.

SEC Issues Roadmap for Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers

On November 14, 2008, the SEC published its proposed roadmap for the mandated use by U.S. issuers of financial statements prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the

International Accounting Standards Board ("IASB") **(See SEC Release Nos. 33-8982; 34-58960).** The roadmap outlines several milestones that, if achieved, could lead to the required use of IFRS by U.S. issuers in 2014 if the SEC believes it to be in the public interest and for the protection of investors. The milestones are:

- improvements in accounting standards;
- accountability and funding of the IASC Foundation;
- improvement in the ability to use interactive data for IFRS reporting;
- education and training;
- limited early use of IFRS where it would enhance comparability for U.S. investors;
- anticipated timing of future rulemaking by the SEC; and
- implementation of the mandatory use of IFRS.

As part of the Roadmap, the SEC is proposing amendments to various regulations, rules and forms that would permit early use of IFRS by a limited number of U.S. issuers in cases where the comparability of financial information to investors would be enhanced. Only U.S. issuers whose industry use IFRS as the basis for financial reporting more than any other set of standards would be eligible for the early adoption.

NOTES

1. The locate exception provides an exception from the requirement that broker-dealers "locate" a security before engaging in a short sale transaction in cases where the broker-dealer is engaged in "bona-fide" activities.

2. However, certain transactions involving options are required to be reported on Form SH, including the following: (i) if an institutional investment manager exercises a put and is net short, the resulting transaction is a short sale for purposes of Form SH disclosure; and (ii) if an institutional investment manager effects a short sale as a result of assignment to it as a call writer, upon exercise, the resulting transaction is a short sale for purposes of Form SH disclosure.

APPELLATE AND OTHER DECISIONS OF NOTE

Complaint Dismissed for Lack of Scienter But Confidential Sources Need Not Be Identified

On October 8, 2008, the Eleventh Circuit affirmed the dismissal of a securities fraud class action complaint for failure to comply with the requirements of the Private Securities Litigation Reform Act ("PSLRA"). Applying the PSLRA standard requiring a showing of an "intent to deceive, manipulate, or defraud" or "severe recklessness," the Court held that plaintiffs failed to plead scienter against Home Depot's executives. Specifically, the Court noted that the complaint did not contain any allegations connecting the executives to the fraud and that the allegations of widespread geographic scope and amount of fraud failed to create a "strong inference" that the executives orchestrated the fraud, knew about it, or were severely reckless in not knowing about it. There was no evidence of any communications or correspondence to or from any of the executives.

Plaintiffs asserted that Home Depot failed to disclose excessive rebates for its vendors in press releases and company financial statements, which inflated the company's financial performance, in violation of Sections 10(b) and 20(a) of the 1934 Act and Rule 10b-5 promulgated thereunder. Plaintiffs relied on internal documents and confidential witnesses.

The Court noted that the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), which was previously discussed in this journal (*Sec. Reg. L.J.*, Vol. 35, No. 3, p. 322 Fall 2007), did not discuss the role of confidential witnesses, and held that "we see no reason to adopt a per se rule that always requires a securities-fraud complaint to name the confidential source, so long as the complaint unambiguously provides in a cognizable and detailed way the basis of the whistleblower's knowledge."

Mizzaro v. Home Depot, Inc., 544 F.3d 1230 (11th Cir. 2008)

"Public" Information Insufficient to Start Statute of Limitations

On November 17, 2008, the Court of Appeals for the Second Circuit vacated the district court's dismissal of a securities fraud action against Hartford Financial Services Group and remanded the case for further proceedings.

Plaintiff investors contended that Hartford's stock was artificially inflated because Hartford fraudulently concealed its use of kickbacks and price manipulation, in violation of Sections 10(b) and 20(a) of the 1934 Act and Rule 10b-5 promulgated thereunder. The district court had dismissed this action as untimely under the 1934 Act, finding that plaintiffs were on notice about the alleged fraud by July 25, 2001, and applying a two-year statute of limitations.

The Circuit Court held that negative press releases, lawsuits and other publicly available information, known as storm warnings, were not enough to create a duty to inquire or put plaintiffs on notice. Specifically, the Court held that a New York Times article and regulatory filings were insufficient as they focused more on the brokers than the insurance companies. The Court noted that a different outcome might result if the complaint referenced more mainstream articles or the company's 10-K. Moreover, the Court noted that information from an out-of-state court lawsuit that received no publicity would not have been accessible to an investor.

Staehr v. Hartford Financial Services Group, Inc., 547 F.3d 406 (2d Cir. 2008)

No Duty to Disclose All Nonpublic Information

Plaintiff investors in General Motors Acceptance Corp. ("GMAC") alleged that the company failed to make complete financial disclosures in connection with the sale of its bonds. Plaintiffs contended that the offering materials contained material omissions and lacked financial information about the parent company, General Motors Corp. Specifically, plaintiffs allege that certain negative information about the parent company would have affected GMAC's credit rating and the bond's interest rates.

The district court dismissed the complaint, holding that issuers are only obligated to disclose information about themselves, not their parent entities and therefore, GMAC had no duty to disclose information about General Motors.

On December 5, 2008, the U.S. Court of Appeals for the Sixth Circuit affirmed the lower court's dismissal of a lawsuit brought by investors against GMAC for violations of Sections 11 and 12(a)(2) of the 1933 Act, and against General Motors Corp. for violations of Section 15 of the 1933 Act.

The Court held that, based on Item 303 of Regulation S-K, the company only had a duty to make forward-looking projections regarding the information known to the registrant. The Court also held that GMAC's affirmative statements were not misleading and did not include material misstatements. Specifically, the Court noted that plaintiffs failed to allege that GMAC had any knowledge about General Motors Corp. and instead contended that such information was "knowable" rather than "known." Plaintiff's contention thus extends the duty to disclose to include a duty to investigate "knowable" information. The Court emphasized that there is no duty to disclose all nonpublic, material information (unlike the standard in an insider trading context), but rather that the regulations imposed by Congress and the SEC (*i.e.*, S-K, Item 303) should be followed.

J&R Marketing v. General Motors Corp., 549 F.3d 384 (6th Cir. 2008)

Sarbanes-Oxley Certification Alone Does Not Constitute Scienter in Absence of Recklessness

On November 26, 2008, the Court of Appeals for the Ninth Circuit affirmed the lower court's dismissal of a securities class action concerning alleged misrepresentations in a merger agreement. Plaintiffs asserted violations of Sections 10(b) and 30A of the 1934 Act (anti-bribery provisions) and

Rule 10b-5 promulgated thereunder. Plaintiffs based their claims on three alleged misstatements in the merger agreement.

The Court rejected plaintiff's theory of collective scienter and distinguished the case from *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702 (7th Cir. 2008) on the ground that the nature of this action is limited to the three misstatements identified by plaintiffs from a merger agreement. Accordingly, the Court applied the requirements of the Private Securities Litigation Reform Act ("PSLRA") that plaintiffs "plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct" with respect to the individuals who made the false statements. Further, the Court held that the Sarbanes-Oxley certifications signed by senior executives are not sufficient to demonstrate scienter: "Because Congress expressed no intent to alter the pleading requirements of the PSLRA, 'Sarbanes-Oxley certification is only probative of scienter if the person signing the certification was severely reckless in certifying the accuracy of the financial statements.'"

Glazer Capital Management LP v. Magistri, 549 F.3d 736 (9th Cir. 2008)

SEC Has Authority to Clarify Exemptions to Section 16(b) of the 1934 Act

On October 1, 2008, the Court of Appeals for the Third Circuit held that the SEC acted within its preemptive authority in adopting rule changes to clarify certain exemptions to the restrictions on short swing profit restrictions, as provided in Section 16(b) of the 1934 Act. (Section 16(b) imposes strict liability to corporate insiders who buy and sell, or sell and buy company securities within a six-month window.) In so ruling, the Third Circuit affirmed the district court's decision granting summary judgment in favor of defendants.

Plaintiff is a shareholder who brought a derivative suit against two other shareholders for disgorgement of short swing profits. Defendants were holders of preferred stock that was reclassified as common stock as a result of an initial public offering. Defendants then sold some of the common stock in a second offering less than six months later. Plaintiff contended that the reclassification constituted a "purchase" such that defendants are subject to liability under Section 16(b) of the 1934 Act.

Defendants first moved to dismiss on the grounds that they are exempt under Rules 16b-3 and 16b-7. The former rule exempts certain transactions between an issuer and its officers and directors. The latter rule exempts mergers, reclassifications and consolidations.[1] The district court held that reclassification fell within the scope of rule 16b-7 and dismissed the suit.

On appeal, the Third Circuit decided that neither exemption applied to the case, but emphasized that it lacked guidance from the SEC in making its decision. *Levy v. Sterling Holding Co.*, 314 F.3d 106 (3d Cir. 2002).

In response to the Third Circuit's 2002 decision on the motion to dismiss, the SEC adopted amendments to Rules 16b-3 and 16b-7 to clarify the scope of these exemptions. Defendants then moved for summary judgment on the same grounds as their motion to dismiss. In light of the newly adopted amendments, the district court then granted defendants' motions for summary judgment, finding that the new rules applied to the reclassification at issue in this case. The district court also noted that there was no retroactive effect to these amendments because the changes served to clarify only and were not substantive. The Court also emphasized the "reasonable explanation" for these exemptions: there is little opportunity for abuse of insider information, and that other courts have reached the same conclusion (citing the Second and Ninth Circuits).

In making its latest ruling, the Court of Appeals noted that to the extent its earlier ruling in this case is inconsistent with the current ruling, then the earlier decision is overruled.

Levy v. Sterling Holding Co., 544 F.3d 493 (3d Cir. 2008)

Attorneys Liable Under Section 10(b) of the 1934 Act and Rule 10b-5 for Statements Made to Third Parties and Non-Clients

On October 27, 2008, the Court of Appeals for the Ninth Circuit reinstated a claim under Section 10(b) of the 1934 Act against a law firm and three partners for false statements made to a non-client during settlement negotiations.

Plaintiff was the CFO of a company, YP.net, and when she resigned from her position, the company sued her allegedly in order to protect the company's CEO. The parties then entered into a settlement agreement whereby plaintiff would receive shares of the company's common stock. Three days after the settlement agreement was finalized, the CEO was indicted and the value of the plaintiff's shares declined. Plaintiff then brought suit, alleging that the law firm and three of its partners violated Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder by representing to her during settlement negotiations that there was no criminal investigation of the CEO at that time. The district court dismissed the action for failure to state a claim, finding that she had no right under state law to rely on the statements at issue.

Plaintiff now appeals on the ground that the district erred by relying on state law rather than Federal law. The Ninth Circuit agreed, relying on case law from the Third, Fifth, Sixth, and Seventh Circuits, and held that "[a]n attorney who undertakes to make representations to prospective purchasers of securities is under an obligation, imposed by Section 10(b) of the 1934 Act, to tell the truth about those securities. That he or she may have an attorney-client relationship with the seller of the securities is irrelevant under Section 10(b)."

The Court further held that the pleading under Section 10(b) of the 1934 Act meets the heightened standard of the Private Securities Litigation Reform Act ("PSLRA")

Thompson v. Paul, 547 F.3d 1055 (9th Cir. 2008)

Secondary Actors (Securities Analysts) Entitled to Rebut Presumption of Reliance

The Court of Appeals for the Second Circuit held that in a class securities fraud litigation against a "secondary" actor, plaintiffs need not make a heightened evidentiary showing in order to benefit from the presumption of reliance. However, on September 30, 2008, the Circuit Court vacated and remanded the lower court's grant of class certification in order to give defendants the opportunity to rebut the presumption, as is their burden.

Plaintiffs contended that a research analyst made materially misleading optimistic statements in their reports about a company's credit facility and failed to disclose its problems, in violation of Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder. Defendants asserted that the analyst had no access to information because of the "Chinese Wall" within the investment bank between investment bankers and equity analysts.

Although the Court found that the Chinese Wall had been breached, it held that defendants should have the opportunity to rebut the presumption of reliance, as stated in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). In *Basic*, the Supreme Court held that the market price reflects all publicly available material information about a publicly traded security and therefore there is no need to show individual reliance.

The Court concluded "there is no reason in law or logic to apply a bright-line rule prohibiting the application of the *Basic* presumption in suits against secondary actors such as research analysts." Moreover, the Court cautioned against limiting the holding of *Basic* because "[i]t does not matter, for purposes of establishing entitlement to the presumption, whether the misinformation was transmitted by an issuer, an analyst, or anyone else."

In re Salomon Analyst Metromedia Litigation, 544 F.3d 474 (2d Cir. 2008)

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[1] Although the latter exemption cites reclassifications in its title, the text of the exemption does not specifically refer to them.