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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 2009.

SEC Rulemaking

SEC Adopts Amendments to Enhance Proxy Disclosure Regarding Compensation and Corporate Governance

On December 16, 2009, the SEC adopted amendments relating to an issuer's compensation and corporate governance disclosure. **(See Release Nos. 33-9089; 34-61175; IC-29092).** The amendments follow the rule changes proposed by the SEC earlier this year, subject to some modifications. The new rules are effective for issuers beginning February 28, 2010.

Compensation Policies and Overall Compensation Practices

The new rules require an issuer to discuss and analyze its broader compensation policies and overall compensation practices for employees generally, including non-executive officers, if risks arising from those compensation policies or practices may have a material effect on the issuer. This disclosure is to be provided in a new, separate section in the issuer's compensation disclosure section of its proxy. Disclosure relating to these policies and practices will only be required if risks arising from an issuer's compensation policies and practices are reasonably likely to have a material adverse effect on the issuer. This is the same threshold used for purposes of determining disclosure required in the management discussion and analysis rules in Form 10-K. The SEC provided a list of issues that may need to be addressed, including:

- what general design philosophy drives the issuer's compensation policies for employees whose actions would be most influenced by the incentives provided to employees;

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- what risk assessment and incentive considerations were factored into structuring the compensation policies or making compensation decisions;
- how the issuer's compensation policies, such as clawbacks or stock retention policies, relate to the realization of risks resulting from employees' actions;
- what the issuer's policies are regarding amendments to its compensation policies due to changes in its risk profile and what amendments have been made as a result of such changes; and
- the extent to which the issuer monitors its compensation policies to determine whether risk management goals are being met with respect to providing incentives to employees.

Revised Summary Compensation Table

The amendments require revisions to the summary compensation table and director compensation table to include disclosure of the aggregate grant date fair value of stock and option awards made during the year computed in accordance with FASB ASC Topic 718. Additionally, performance awards are to be computed based on the probable outcome as of the grant date of the performance conditions. A footnote is to be provided to disclose the maximum value if the highest level of performance conditions is obtained. Issuers with a fiscal year ending on or after December 20, 2009 will also need to present recomputed disclosure for each preceding fiscal year to be included in the table.

Enhanced Director and Nominee Disclosure

The amendments also address director and nominee disclosure, including:

- *Qualifications of directors and nominees*. Issuers will need to disclosure material experience qualifications and skills beyond the past five years, as currently required.
- *Past directorships held by directors and nominees*. Any directorship held by a director or nominee during the past five years now needs to be disclosed regardless of whether such director currently serves on that board;
- *Legal proceedings*. The amendments require additional disclosure relating to legal proceedings including judicial or administrative proceedings relating to mail or wire fraud, fraud in connection with any business entity or violations of federal or state securities, commodities, banking or insurance laws and regulations and disciplinary sanctions or orders imposed by self-regulatory organizations; and
- *Board diversity*. Disclosure is now required relating to whether and how a nominating committee considers "diversity" in identifying director nominees. The SEC has noted that for

disclosure purposes, issuers should be allowed to define diversity in ways they consider appropriate.

Leadership Structure and Role of an Issuer's Board's in the Risk Management Process

The amendments require that issuers disclose whether and why they have chosen to combine or separate the principal executive officer and board chairman positions, and the reasons why the issuer believes that this board leadership structure is the most appropriate structure at the time of the filing. Should an issuer have combined the position of principal executive officer and board chairman, and a lead independent director is designated to chair meetings of the independent directors, the issuer must disclose that it has a lead independent director, as well as the specific role the lead independent director plays in the leadership of the issuer. Issuers must also describe the board's role in the oversight of risk.

Additionally, to the extent applicable, issuers must provide disclosure about the board's role in risk oversight, including, in the case of funds, information about how an issuer perceives the role of its board and the relationship between the board and its advisor in managing material risks facing the fund.

Disclosure Regarding Compensation Consultants

As adopted, the final rules require:

- disclosure of fees exceeding $120,000 during an issuer's fiscal year if the board, compensation committee or other persons performing the equivalent functions has engaged its own consultant to provide advice or recommendations on the amount or form of executive and director compensation. Issuers must also disclose whether the decision to engage the compensation consultant was made or recommended by management, and whether the board has approved these non-executive compensation consulting services provided by the compensation consultant or its affiliate; and
- disclosure of any consultant providing executive compensation consulting services and non-executive compensation consulting services, provided the fees for the non-executive compensation consulting services exceed $120,000 during the previous fiscal year;

This disclosure is not required if both the board and management have separate consultants. Non-customized services or services based on parameters that are not developed by the consultant are not treated as executive compensation consulting services for purposes of the amended rules.

Reporting of Voting Results on Form 8-K

Finally, all issuers are required to disclose voting results on Form 8-K within four business days. In cases of contested elections, issuers are required to disclose preliminary voting results within four business days on Form 8-K and final voting results within four business days after the results are known.

SEC Adopts Amendments Relating to Custody of Funds or Securities of Clients Managed by Investment Advisers

On December 30, 2009, the SEC adopted amendments relating to the custody and recordkeeping rules under the Investment Advisers Act of 1940 (the "Investment Advisors Act") and related forms. **(See SEC Release No. IA-2968).**

As adopted, the amendments require that:

- advisers include a legend in notices to clients urging clients to compare the account statements they receive from the custodian with those they receive from an adviser; and
- advisers with custody of client assets undergo a surprise examination (or an audit, if applicable) of those assets by an independent public accountant, unless certain circumstances apply;

Advisors that use affiliated custodians to hold client assets will not be required to obtain an annual surprise exam if the adviser is deemed to be "operationally independent" of the affiliated custodian, i.e. the adviser and the affiliate operate as distinct entities.

SEC Approves Amendments to NASDAQ Rule Regarding Advance Notice of Material Information

On November 16, 2009, the SEC approved amendments to NASDAQ Rule 5250 and IM-5250-1 that will require NASDAQ listed issuers to notify NASDAQ's MarketWatch Department at least 10 minutes prior to the initial public release of material information that involves any of the events listed in IM-5250-1. **(See SEC Release No. 34–61008.)** Such advance notice must be made through the electronic disclosure submission system available at www.nasdaq.net except in emergency situations.

The events set forth in IM-5250-1, which require notice, are:

- Financial-related disclosures, including quarterly or yearly earnings, earnings restatements, preannouncements or "guidance";
- Corporate reorganizations and acquisitions, including mergers, tender offers, asset transactions and bankruptcies or receiverships;
- New products or discoveries, or developments regarding customers or suppliers (e.g., significant developments in clinical or customer trials, and receipt or cancellation of a material contract or order);

- Senior management changes of a material nature or a change in control;
- Resignation or termination of independent auditors, or withdrawal of a previously issued audit report;
- Events regarding the Company's securities — e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, or public or private sales of additional securities;
- Significant legal or regulatory developments; and
- Any event requiring the filing of a Form 8-K.

SEC Adopts Amendments to Temporary Rules Relating to Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers

On October 13, 2009, the SEC adopted final rule amendments to temporary rules that require issuers that are non-accelerated filers to include in their annual reports an attestation report of their independent auditors on internal control over financial reporting. **(See SEC Release Nos. 33-9072; 34-60813).** Under the final rule amendments, a non-accelerated filer will be required to file the auditor's attestation report on internal control over financial reporting when it files an annual report for a fiscal year ending on or after June 15, 2010.

SEC Adopts Amendments and Proposes New Rules for Nationally Recognized Statistical Ratings Organizations

On November 23, 2009, the SEC adopted amendments to rules relating to nationally recognized statistical ratings organizations ("NRSROs") aimed at addressing concerns about the integrity of the credit rating procedures and methodologies at NRSROs. **(See SEC Release No. 34-61050)** The amendments are effective February 2, 2010. In conjunction with the adoption of the amendments, the SEC also proposed amendments that would require additional disclosure from the NRSROs relating to, among other things, annual compliance and revenues. **(See SEC Release No. 34-61051)**.

Availability of Information Provided to NRSROs for Determining Initial Ratings for Structured Finance Products

As adopted, the amendments require that NRSROs hired by a third party to determine the initial credit ratings for structured finance products disclose to non-hired NRSROs that such third-party is in the process of determining the credit rating for the structured finance product and to obtain representations from the third-party that the third-party will provide all information given to the hired NRSRO used to determine the product rating to the non-hired NRSROs.

Any non-hired NRSROs who wish to be provided with access to this information will be required to furnish to the SEC a certification that it is accessing such information solely for the purpose of determining or monitoring credit ratings, that such non-hired NRSRO will treat the accessed information as material nonpublic information pursuant to its internal policies and that it has determined and maintained ratings for at least 10% of the products for which it obtained similar access in the previous calendar year (or did not access such information 10 or more times during that calendar year).

Disclosure of Ratings History Information Required

As amended, the rules also require that NRSROs disclose ratings history information for 100% of their credit ratings initially determined on or after June 26, 2007, with each ratings action to be disclosed no later than twelve months or twenty-four months after it is taken, depending on whether the rating is issuer-paid. Specifically, the information must be provided in XBRL format within sixty days following the SEC's publication of a list of related XBRL tags and it must be made publicly available within twelve months from the date such ratings action is taken if the credit rating is paid for by an issuer or within twenty-four months for credit ratings that are not issuer-paid.

SEC Adopts Model Privacy Form for Financial Institutions Providing Privacy Notices to Customers

On November 16, 2009, the SEC and certain other federal agencies adopted final amendments to rules that implement the privacy provisions of the Gramm-Leach-Bliley Act ("GLB Act") that require financial institutions to provide initial and annual privacy notices to their customers. **(See SEC Release Nos. 34-61003, IA-2950, IC-28997).** Specifically, the agencies are adopting a model privacy form that financial institutions may rely on as a safe harbor when providing disclosure to customers. In addition, the agencies other than the SEC are eliminating the safe harbor permitted for notices based on the Sample Clauses currently used by financial institutions to satisfy the privacy provisions for notices provided after December 31, 2010 (the SEC's privacy rules only provide guidance with respect to the Sample Clauses, not a safe harbor). The SEC is eliminating its guidance associated with the use of notices based on the Sample Clauses in its privacy rule for notices provided after December 31, 2010.

Financial institutions relying on the model form will have limited ability to modify the form, including the categories of information that can be included in an institution's privacy notice. Use of the model form remains optional and institutions that have been using their own forms may continue to do so.

SEC Proposes Amendments Relating to the Internet Availability of Proxy Materials

On October 14, 2009, the SEC proposed amendments to the rules relating to the internet availability of proxy materials **(See Release Nos. 33-9073; 34-60825; IC-28946).** Specifically, the SEC is proposing amendments to the form of the current Notice of Internet Availability of Proxy Materials provided to shareholders (the "Notice"), the materials that accompany the Notice and the deadlines by which the Notice must be provided.

As proposed, the amendments would provide issuers with greater latitude in formatting and selecting the language contained in the Notice. Issuers would only be required to address certain topics in the Notice and would not be restricted to providing specific information. Additionally, issuers would be permitted to provide explanatory materials in order to better educate shareholders on the "notice and access model." Finally, the SEC also proposed requiring soliciting persons other than an issuer relying on the notice and access model to file a preliminary proxy statement within 10 days after the issuer files its definitive proxy statement and send a Notice to shareholders no later than the date on which the third-party files its own definitive proxy statement with the SEC.

SEC Proposes Amendments Relating to "Dark Pools" of Liquidity

On November 13, 2009, the SEC proposed amendments to non-public trading interest in National Market System ("NMS") stocks, including so-called "dark pools" of liquidity. **(See SEC Release No. 34-60997).** In general, the SEC is proposing to amend the definition of "bid" or "offer" in the 1934 Act quoting requirements, to amend the display obligations of alternative trading systems ("ATSs") in Regulation ATS under the 1934 Act, and to amend the joint-industry plans for publicly disseminating consolidated trade data to require real-time disclosure of the identity of dark pools and other ATSs on the reports of their executed trades. Comments on the proposals are due by February 22, 2010.

SEC Proposes Amendments Relating to Disclosure of Credit Ratings

On October 7, 2009, the SEC proposed amendments to current rules that would require disclosure of information regarding credit ratings used by registrants, including closed-end management investment companies, in connection with a registered offering of securities. The amended disclosure would inform investors about potential conflicts of interest that could affect the credit rating and provide disclosure of preliminary credit ratings in certain circumstances so that investors have enhanced information about the credit ratings process that may bear on the quality or reliability of the rating. **(See Release Nos. 33-9070; 34-60797; IC-28942).**

As proposed, the amendments would require the following disclosure for each applicable credit rating:

- the identity of the assigning credit rating agency;
- the assigned credit rating and the date it was assigned;
- the relative rank of the credit rating;
- a description of the rating category assigned, including any material scope limitations and whether contingencies relating to the securities are or are not reflected in the rating;
- published designations reflecting the results of any other evaluation done by the agency in connection with the rating;
- any material differences between the terms of the securities as assumed or considered by the credit rating agency; and
- a statement informing investors that a credit rating is not a recommendation to buy, sell or hold securities, that a credit rating may be subject to revision or withdrawal at any time by the assigning credit rating agency, that each credit rating is applicable only to the specific class of securities to which it applies and that investors should perform their own evaluation as to whether an investment in the security is appropriate.

Disclosure of Potential Conflicts of Interest

Under the proposed amendments, issuers would also be required to identify the party who compensates the credit rating agency for providing the credit rating. The issuer would also be required to disclose any other services supplied by the credit rating agency or any of the agency's affiliates, along with fees paid, in the period leading up to the filing by the issuer.

APPELLATE AND OTHER DECISIONS OF NOTE

Supreme Court Agrees to Hear "Foreign-Cubed" Securities Case

On November 30, 2009, the Supreme Court agreed to review the lower court's dismissal of securities fraud claims, over the objections of the Securities Exchange Commission ("SEC") and the U.S. Solicitor General.

Plaintiffs are shareholders of National Australia Bank ("NAB") who alleged that defendant NAB, a foreign company, made fraudulent statements from its headquarters in Australia in violation of Sections 10(b) and 20(a) of the 1934 Act and Rule 10b-5 promulgated thereafter. The alleged fraudulent statements concerned NAB's subsidiary, a mortgage service provider based in Florida. The mortgage service provider allegedly manipulated its books and records, and then provided those false numbers to NAB in Australia, who in turn incorporated them into the company's public filings and statements. NAB then revealed that certain interest assumptions in the mortgage service provider's valuation model were incorrect. As a result of the subsequent write-downs, NAB's stock price declined. The district court dismissed the foreign plaintiffs' claims for lack of subject matter jurisdiction and plaintiffs appealed this decision.

On appeal, plaintiffs contended that the alleged fraud, the manipulation of the balance sheet, took place in the United States, where the mortgage service provider is located. Defendants argued that any harm to investors occurred in Australia, where the company is based and where the public filings and statements were created and distributed.

The U.S. Court of Appeals for the Second Circuit affirmed the lower court's dismissal, finding no subject matter jurisdiction over an action involving foreign plaintiffs, foreign issuers of securities, and where the transaction occurred outside of the country (known as a "foreign-cubed" action). The Court declined to adopt a bright line rule finding subject matter jurisdiction when the conduct in question has an effect in the United States or on American investors. Instead, the Court applied the "conduct test," where subject matter jurisdiction exists when "defendant's conduct in the United States was more than merely preparatory to the fraud, and particular acts or culpable failures to act within the United States directly caused losses to foreign investors abroad." Based on this standard, the Court concluded that it was the responsibility of the corporate headquarters, not the subsidiary in Florida, to report to its shareholders and the financial community and ensure the accuracy of the information distributed.

Both the SEC and the U.S. Solicitor General opposed certiorari, arguing that the link between the alleged falsehoods and ultimate injury was "too indirect to support liability in a private suit." The SEC also pointed out that the Supreme Court should not hear this appeal because a proposed statute, the Investor Protection Act, would soon clarify the issue of when U.S. courts have jurisdiction over violations of antifraud provisions involving transnational frauds.

Morrison v. National Australia Bank Ltd., 2009 WL 4111014 (U.S. 2009).

Second Circuit Finds No Short Swing Violation Where Percentage of Share Ownership Reduced by Issuer Action

Plaintiff is a shareholder of Local.com. As of early 2007, defendant Hearst was the beneficial owner of more than 10% of Local.com's securities. Hearst subsequently converted some notes and sold some of its stock to the public, thereby triggering Section 16(b) of the 1934 Act, which prohibited Hearst from then buying shares of Local.com at a profit within six months of the sale. On August 1, 2007 (within the six-month window), Local.com raised additional capital through a private placement, which had the effect of diluting Hearst's ownership to less than 10%. Later that same day, Hearst purchased additional securities.

Plaintiff brought suit for disgorgement of short swing profits, alleging violations of Section 16(b) of the 1934 Act. The district court granted summary judgment to Hearst, finding that as a result of the August 1, 2009 private placement and the ensuing dilution, Hearst was no longer a beneficial owner of more than 10% of Local.com's shares and therefore no longer subject to Section 16(b). Accordingly, Hearst's subsequent purchase of securities was not in violation of Section 16(b). Plaintiff appealed the decision, arguing that the private placement was only complete upon the filing of the company's Form 8-K and delivery of stock certificates to the investors, thus making Hearst's purchase of stock later that same day still subject to Section 16(b).

The U.S. Court of Appeals for the Second Circuit affirmed the lower court's grant of summary judgment against plaintiff on December 9, 2009, and rejected plaintiff's argument, holding that "the private placement investors obtained an ownership interest in those shares once Local.com assumed control over the proceeds of the private placement."

Donoghue v. Hearst Communications, Inc., Fed. Sec. L. Rep. (CCH) ¶ 95544, 2009 WL 4640653 (2d Cir. 2009).

Zicam Class Action Survives Motion to Dismiss Under PSLRA

On October 28, 2009, the Ninth Circuit reversed the lower court's dismissal of plaintiffs' class action securities laws claims, holding that the complaint sufficiently pled scienter and materiality of company events related to its awareness of a drug's side effect.

Plaintiffs are shareholders of defendant, a pharmaceutical company and the maker of Zicam, a cold remedy. Plaintiffs allege that the company and certain directors and officers were aware that one of the side effects of the drug was a loss of sense of smell, failed to disclose this risk, and instead issued false and misleading statements about the drug, in violation of the Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder.

The district court granted defendants' motion to dismiss for lack of scienter and materiality. The Ninth Circuit reversed this decision, finding that the lower court should have applied the materiality standard of the Private Securities Litigation Reform Act ("PSLRA"), not the statistical significance standard, and that the allegations of the complaint were sufficient to satisfy the materiality standard under the PSLRA. The appeals court emphasized that the Supreme Court has rejected bright-line rules and has held that materiality is determined by the trier of fact. Moreover, the appeals court applied a "holistic" approach to the issue of scienter in finding in favor of plaintiffs. Finally, the Ninth Circuit noted that the defendant's failure to disclose was an " 'extreme departure from the standards of ordinary care' " and posed the " 'danger of misleading buyers or sellers.' "

Siracusano v. Matrixx Initiatives, Inc., 585 F.3d 1167, Fed. Sec. L. Rep. (CCH) ¶ 95386 (9th Cir. 2009).

No Analysis of Market Efficiency Needed in Class Certification of 1933 Act Claim

Purchasers of shares of stock pursuant to an IPO brought a class action suit against a manufacturing company, claiming that the share price was inflated by materially false and misleading statements or omissions in the offering materials, in violation of Section 11 of the 1933 Act.

A special master for the district court recommended that the class be certified based on the Federal Rules of Civil Procedure and the district court approved this recommendation. Defendant manufacturing company appealed, arguing that it was improper for the district court to decide class certification without first deciding whether the market for the company's stock was efficient and that the district court applied a too-liberal construction of Rule 23 of the Federal Rules of Civil Procedure. Specifically, the company asserted that an examination of efficiency was necessary because in an inefficient market, determinations of materiality, loss causation and injury would require an individualized analysis. Class certification would be inappropriate when such an individualized analysis is needed because then common issues would not predominate in the proposed class, as required by Rule 23.

The Third Circuit rejected the defendant's arguments on October 29, 2009, and affirmed the lower court's certification, finding that the district court made no error. The Circuit Court held that the case was brought under Section 11 of the 1933 Act and not Section 10(b) of the 1934 Act, that "a [Section] 11 case will never demand individualized proof as to an investor's reliance or knowledge" and that "Section 11 does not require a showing of individualized loss causation, because injury and loss are presumed." Therefore, the Court concluded that the issue of market efficiency was not relevant.

In re Constar International Inc. Securities Litigation, 585 F.3d 774, Fed. Sec. L. Rep. (CCH) ¶ 95504 (3d Cir. 2009).