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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions

*Victor M. Rosenzweig**

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 fourth quarter of 2010.

SEC Rulemaking

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act touches on a broad range of topics, including responsibilities of public companies under the securities acts, registration requirements for hedge fund and private equity fund advisers, banks and other financial institutions, regulation of securities, over-the-counter derivatives and credit rating agencies, and modification of the regulatory structure under which the Federal Reserve and the SEC operate. This issue's Survey covers only several of the many proposals put forth under the Dodd-Frank Act.

SEC Proposes Rules Under the Investment Advisers Act of 1940 to Implement Provisions of the Dodd-Frank Act

On November 19, 2010, the SEC proposed new rules and amendments under the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act"), which are intended to implement provisions of the Dodd-Frank Act. **(See SEC Release Nos. IA-3110 and IA-3111).** These proposed rules and amendments, among other things, increase the statutory threshold for registration by investment advisers with the SEC, require advisers to hedge funds and other private funds to register with the SEC, require reporting by certain investment advisers that are currently exempt from registration and implement new exemptions from these registration requirements.

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Registration Eligibility

As proposed, the rules will prohibit advisers from registering with the SEC if they have assets under management between $25 million and $100 million, subject to certain exceptions. Generally, "mid-sized advisers" who do not qualify for an exemption will be required to withdraw their registrations with the SEC and register with one or more state securities authorities. However, a mid-sized adviser may still register with the SEC: (i) if the adviser is not required to be registered as an investment adviser with the securities commissioner (or any agency or office performing like functions) of the state in which it maintains its principal office and place of business, (ii) if registered, the adviser would not be subject to examination as an investment adviser by that securities commissioner or (iii) if the adviser is required to register in 15 or more states.

Exemptions

Venture Capital Fund Exception

Under the proposed rules, advisers that advise "venture capital funds" would be exempt from registration. A "venture capital fund" would be defined as any "private fund" that meets the following conditions:

- Represents to investors that it is a venture capital fund;
- Owns solely (i) equity securities of certain "qualifying portfolio companies," at least 80% of which were acquired directly from the qualifying portfolio company; and (ii) cash or cash equivalents;
- Does not provide investors with the ability, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such equity securities;
- Either controls or provides significant guidance concerning the management or business objectives of each such qualifying portfolio company;
- Does not incur leverage in excess of 15% of its called and uncalled committed capital, and any such leverage is short term; and
- Is not registered under the 1940 Act and has not elected to be treated as a business development company.

Private Fund Adviser Exemption

As proposed, a United States based adviser that manages only private funds and has less than $150 million in assets under management would be exempt from registration. An adviser based outside the United States would be exempt if it has no client that is a United

States person except for one or more private funds, and all assets managed from a place of business in the United States are solely attributable to private fund assets, with a total value of less than $150 million.

Assets Under Management

The SEC has also proposed revisions for calculating assets under management. Specifically, all advisers would need to include in their regulatory assets under management securities portfolios for which they provide continuous and regular supervisory or management services (regardless of whether these assets are proprietary assets) assets managed without receiving compensation, or assets of foreign clients, all of which an adviser currently may (but is not required to) exclude. Additionally, an adviser would no longer be permitted to subtract outstanding indebtedness and other accrued but unpaid liabilities, which remain in a client's account and are managed by the adviser.

Required Disclosure

The SEC is also proposing amending Form ADV to require additional information from registered investment advisers concerning private funds they advise. The private fund information reported would be publicly available on the SEC's website and would include (for both registered and exempt reporting advisers):

- Name;
- State or country of organization and the names of general partners, directors, trustees or persons holding similar positions;
- Information on the organization of the fund, including whether it is a master or feeder fund, the regulatory status of the fund and its adviser, including the exclusion from the 1940 Act on which it relies and whether it relies on a 1933 Act exemption;
- Whether the adviser is a subadviser to a private fund and the names and SEC file numbers of any other advisers to the fund;
- The size of the fund, including gross and net assets;
- Investment strategy;
- Breakdown of assets and liabilities of the fund by class and categorization;
- Number and types of investors;
- Minimum amount of investment; and
- Characteristics of the fund that may present the manager with conflicts of interest.

Additionally, reporting advisers would have to provide information concerning their auditors, prime brokers, custodians, administrators and marketers.

Pay to Play

The SEC has also proposed expanding the rules relating to pay to play practices in connection with advisory services provided to government entities to apply such rules to exempt reporting advisers and foreign private advisers. The definition of "covered associate" of an adviser would be amended to include entities, in addition to natural persons. Finally, the SEC has proposed permitting an adviser to pay any "regulated municipal advisor" to solicit government entities on its behalf, where a regulated municipal advisor would be a person that is registered under Section 15B of the 1934 Act and subject to pay to play rules adopted by the Municipal Securities Rulemaking Board.

SEC Proposes Rules to Prevent Fraud, Manipulation and Deception Relating to Security-Based Swaps

On November 3, 2010, the SEC proposed rules intended to prevent fraud, manipulation and deception in connection with the offer, purchase or sale of any security-based swap, the exercise of any right or performance of any obligation under a security-based swap or the avoidance of such exercise or performance. **(See SEC Release No. 34-63236).** Specifically, the proposed rule would prohibit the same categories of misconduct as set forth in Section 10(b) and Rule 10b-5 of the 1934 Act and Section 17(a) of the 1933 Act in the context of security-based swaps.

A security-based swap is any agreement, contract, or transaction that is a swap, as defined in Section 1(a) of the Commodity Exchange Act, that is based on a narrow-based security index, or a single security or loan, or any interest therein or on the value thereof, or the occurrence or non-occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition or financial obligations of the issuer.

The proposal specifies that it would be unlawful for any person, directly or indirectly, in connection with any security-based swap transaction: (a) to employ any device, scheme, or artifice to defraud or manipulate; (b) to knowingly or recklessly make any untrue statement of a material fact, or to knowingly or recklessly omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; (c) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (d) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

SEC Proposes Amendments Relating to Shareholder Approval of Executive Compensation and "Golden Parachute" Compensation Arrangements

On October 18, 2010, the SEC proposed amendments to implement the provisions of the Dodd-Frank Act relating to shareholder approval of executive compensation and "golden parachute" compensation arrangements. (**See SEC Release Nos. 33-9153; 34-63124).** On January 25, 2011, the SEC adopted amendments relating to shareholder approval of executive compensation and "golden parachute" compensation arrangements. The amendments are effective April 4, 2011, except for companies that qualify as "smaller reporting companies." "Smaller reporting companies" will not be subject to these amendments until their first annual meeting occurring on or after January 21, 2013.

Specifically the SEC is proposing to require issuers to, among other things:

- not less frequently than once every three years, provide a separate shareholder advisory vote in proxy statements to approve the compensation of executives. The separate shareholder vote would be required only when proxies are solicited for an annual or other meeting of security holders for which the disclosure of executive compensation is required. The advisory vote is to take place at the first annual or other such meeting of shareholders occurring on or after January 21, 2011.
- disclose in a proxy statement for an annual meeting (or other meeting of shareholders for which SEC rules require executive compensation disclosure) that they are providing a separate shareholder vote on executive compensation and to briefly explain the general effect of the vote, such as whether the vote is non-binding.
- address in the CD&A section of an issuer's proxy statement whether and, if so, how their compensation policies and decisions have taken into account the results of shareholder advisory votes on executive compensation.
- not less frequently than once every six years, provide a separate shareholder advisory vote in proxy statements for annual meetings to determine whether the shareholder vote on the compensation of executives "will occur every 1, 2, or 3 years." Such a vote would be required only in a proxy statement solicited for an annual or other meeting of shareholders for which SEC rules require compensation disclosure.
- include a new table relating to "golden parachute" payments that would present quantitative disclosure of the individual elements of compensation that an executive would receive that are based

on or otherwise relate to a merger, acquisition, or similar transaction, and the total for each named executive officer.
- provide a separate shareholder advisory vote in proxy statements for meetings at which shareholders are asked to approve an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all assets. The vote would be required only with respect to the golden parachute agreements or understandings required to be disclosed.

SEC Proposes Rules Requiring Institutional Investment Managers to Disclose Proxy Voting Relating to Executive Compensation

On October 18, 2010, the SEC proposed new rules requiring institutional investment managers subject to Section 13(f) of the 1934 Act to annually disclose their proxy voting record relating to executive compensation matters. **(See SEC Release Nos. 34-63123; IC-29463).** As proposed, every institutional investment manager (as that term is defined in Section 13(f)(6)(A) of the 1934 Act) that is required to file reports under Section 13(f) of the 1934 Act would be required to file its proxy voting record on Form N-PX. Specifically, an institutional investment manager would be required to disclose its voting record for each shareholder vote pursuant to Sections 14A(a) and (b) of the 1934 Act over which it had or shared the power to vote, or to direct the voting of any security.

SEC Proposes Rules to Amend Definition of "Family Offices" Under the Investment Advisers Act

On October 12, 2010, the SEC proposed amendments relating to the definition of Family Offices under the Investment Advisers Act. **(See SEC Release No. IA-3098).** Specifically, the SEC is proposing to amend the definition of "family offices" such that "family offices" would be excluded from the definition of "investment adviser" under the Investment Advisers Act. As a consequence, these family offices would not be subject to any of the provisions of the Investment Advisers Act. The proposed rule (1) would limit the availability of the rule to family offices that provide advice about securities only to certain family members and key employees, (2) would require that family members wholly own and control the family office and (3) would preclude a family office from holding itself out to the public as an investment adviser.

APPELLATE AND OTHER DECISIONS OF NOTE

No Liability for Secondary Actor Law Firm in Tax Scheme

The Fifth Circuit affirmed the lower court's dismissal on October 27, 2010, finding that plaintiffs failed to prove reliance, as required for a claim under Section 10(b) of the 1934 Act.

Plaintiffs alleged that an accounting firm induced them to participate in a tax avoidance scheme with assurances that the strategy was approved by national law firms. After the IRS issued notices on prohibited transactions, defendant law firm issued opinions stating that plaintiffs were not required to disclose their participation in the tax scheme on their tax returns. When plaintiffs reported losses generated by the tax scheme, however, the IRS investigated the matter and imposed millions of dollars in penalties, interest and back taxes on plaintiffs. Plaintiffs brought suit against the law firm, alleging RICO violations, violations of Section 10(b) of the 1934 Act, and violations of Texas law.

The district court dismissed the securities law claim and declined jurisdiction over the state law claims, concluding that plaintiffs failed to sufficiently plead scienter and reliance.

The Fifth Circuit affirmed and held that because defendant law firm was a secondary actor, plaintiffs must show direct attribution to the law firm of its role in the tax scheme. Since plaintiffs did not plead allegations that they knew of the law firm's role in the tax scheme prior to the time they made their decisions to invest, plaintiffs cannot show the requisite reliance. The Court did not reach the question of scienter since it found that plaintiffs lacked reliance.

Affco Investments 2001, L.L.C. v. Proskauer Rose, L.L.P., 625 F.3d 185, Fed. Sec. L. Rep. (CCH) ¶ 95948, R.I.C.O. Bus. Disp. Guide (CCH) ¶ 11941 (5th Cir. 2010)

No Loss Causation Proven By Oracle Investors

On November 16, 2010, the Ninth Circuit affirmed the dismissal of a class action securities case which alleged that Oracle and three of its executives misrepresented the efficacy of the company's software product and issued inflated financials and forecasts in violation of Sections 10(b), 20(a) of the 1934 Act and Rule 10b-5 promulgated thereunder.

Plaintiff investors contended that the software company released a product prematurely and that the product did not work properly. Further, plaintiffs asserted that the company's executives were aware of

these defects but made repeated public statements about the product's functionality, issued inflated earnings reports, issued a false and misleading forecast, and falsely stated that the company was not affected by the slowing economy. Following defendants' representations about the financial health of the company, the company disclosed that its earnings would not meet expectations. The next day, the stock price dropped.

The district court granted summary judgment to the defendant software company and its executives, however, citing a failure to show loss causation. The Circuit Court affirmed the dismissal, holding that the evidence suggested that the drop in share price was caused by market reaction to the company's precarious financial situation, which was a result of lost deals, and not the result of market reaction to the alleged misstatements.

In re Oracle Corp. Securities Litigation, 627 F.3d 376, Fed. Sec. L. Rep. (CCH) ¶ 95960 (9th Cir. 2010)

Amicus Briefs Filed in Supreme Court Claiming Investment Adviser Liability For Misleading Prospectus

On November 2, 2010, the Securities and Exchange Commission ("SEC") and Department of Justice ("DOJ") filed an amicus brief urging the Supreme Court to find that defendants were the "makers" of the misleading statements, pursuant to Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder. Likewise, the North American Securities Administrators Association ("NASAA") and AARP filed an amicus brief that same day in support of the investors.

Plaintiff investors alleged that defendants, an investment adviser to mutual funds, 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. Specifically, plaintiffs point to the representation that the funds' managers 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 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, holding that to gain the presumption of reliance afforded by the fraud-on-the-market theory of liability, plaintiffs must demonstrate that defendants made the public misrepresentations. The court held that a showing that interested investors did attribute the allegedly misleading statements to the defendants satisfied the presumption of reliance requirement. Based

on this interpretation, the court concluded that interested investors would infer that the investment adviser played a role in preparing or approved the language in the prospectuses, and that the parent company was a control person pursuant to Section 20(a).

The SEC and DOJ argue that express attribution is not required because "of the close relationship between investment advisers and their mutual funds, investors would naturally infer that statements in a fund's prospectus bear the imprimatur of the fund's adviser."

The NASAA and AARP argue that the Supreme Court should find in favor of the investors because this claim is the "only practical recourse" for them. They further assert that the investment adviser's role with respect to the funds is akin to a corporate insider and its involvement with the misleading statements in the prospectus, which warrants its treatment as a primary actor for the purposes of Section 10(b) and Rule 10b-5 liability.

Janus Capital Group, Inc. v. First Derivative Traders, No. 09-525 (Nov. 2, 2010)

The briefs can be found at http://www.sec.gov/litigation/briefs/2010/januscapital1110.pdf and http://www.nasaa.org/content/Files/Amicus_Jones.pdf.

SEC Sued Over Proxy Access Rulemaking

The Securities Exchange Commission ("SEC") was sued on September 29, 2010 by the U.S. Chamber of Commerce and Business Roundtable in the Court of Appeals for the District of Columbia. Plaintiffs filed a Petition for Review, pursuant to Section 706 of the Administrative Procedure Act, Section 25(b) of the 1934 Act and Section 43(a) of the 1940 Investment Company Act.

At issue are certain amendments to proxy access rules that were approved by the SEC on August 25, 2010. Among them is (i) Rule 14a-11 of the 1934 Act and its amendments, which would require a publicly-traded company to include in its proxy materials a candidate nominated by shareholders that have held shares representing at least three percent of the voting power of the company's stock for the past three years, and (ii) Rule 14a-8(i)(8), which generally precludes companies from excluding from their proxy materials shareholder proposals regarding procedures related to shareholder nominations.

Petitioners' primary argument is that the rules will result in more costly proxy contests and that the SEC failed to consider the economic consequences of its actions. Further, petitioners argue that the rules are arbitrary and capricious, will violate certain state laws, and infringe on shareholder rights since they do not allow shareholders to

decide whether to adopt some form of proxy access mechanism. Petitioners also criticized the procedures which the SEC employed in considering the amendments.

Petitioners also filed an administrative motion to stay the implementation of Rule 14a-11, pending a resolution to the litigation. The SEC agreed to the stay on October 4, 2010 and has asked the Court for expedited review.

On December 9, 2010, the Investment Company Institute ("ICI") and its Independent Directors Council ("IDC") filed a joint amicus brief urging the court to vacate the SEC rules, citing higher costs for investors and claiming that the rules are not suited to the corporate governance structures of fund companies and boards.

Business Roundtable v. SEC, No. 10-1305 (Sept. 29, 2010)

The Petition for review can be found at http://businessroundtable.org/uploads/hearings-letters/downloads/20101130_Petitioners_Opening_Brief_Initial.pdf and the Motion to Stay can be found at http://www.chamberlitigation.com/sites/default/files/cases/files/2010/Business%20Roundtable%20and%20Chamber%20of%20Commerce%20v.%20SEC%20(Motion%20for%20Stay%20of%20Rules).pdf. A copy of the amicus brief can be found at http://www.ici.org/pdf/24777.pdf.