Securities Regulation Law Journal

Volume 36 Number 2 Summer 2008

THOMSON WEST

Quarterly Survey of SEC Rulemaking and Major Appellate Decisions

By 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") and other Federal Securities laws during the first quarter of 2008.

SEC RULEMAKING

SEC Adopts Final Rules For the Electronic Filing and Related Revisions of Form D

On February 6, 2008, the SEC adopted final rules mandating the electronic filing of information required by Form D and revisions to Form D and Regulation D in connection with the electronic filing requirement. **(See SEC Release No. 33-8891)**. The amendments require that issuers who wish to use Form D in connection with the offering of securities without registration under the 1933 Act, in reliance on an exemption provided by Regulation D, must file such Form D electronically through the SEC's online filing system.

Revisions to Form D Information Requirements

The amendments also simplified and deleted certain items from Form D. Changes include:

- Permitting filers to identify all issuers in a multiple-issuer offering in one Form D filing;
- Deleting the requirement to identify, as "related persons," owners of 10 percent or more of a class of the issuer's equity securities;

* Member, New York Bar. Of Counsel, Olshan Grundman Frome Rosenzweig & Wolosky LLP. Associates Jason W. Soncini and Christine Wong assisted the author.

- Replacing the issuer's "business description" with a classification chosen from a pre-established list of industries;
- Requiring revenue range information for the issuer, or net asset value range information in the case of hedge funds (subject to an option to decline to disclose);
- Requiring more specific information on the registration exemption claimed by an issuer in its Form D notice, as well as information on any exclusion claimed from the definition of "investment company" under the Investment Company Act of 1940;
- Requiring disclosure of the date of first sale in the offering;
- Specifying when an amendment to a previously filed Form D notice is being filed by reason of mistakes of fact, errors or changes to information in a previously filed notice, or the passage of a calendar year;
- Requiring disclosure of whether the offering is expected to last over a year;
- Limiting disclosure of the minimum investment amount accepted in the offering to the amount accepted from outside investors;
- Requiring disclosure of expenses related to amounts paid for sales commissions and, separately stated, finders' fees, and the use of proceeds only as to the amount of proceeds used to make payments to executive officers, directors and promoters; and
- Replacing the current federal and state signature requirements with a combined signature requirement.

The amendments become effective September 15, 2008, with issuers permitted to voluntarily file the new Form D electronically during a "transition period" lasting until March 15, 2009. During this "transition period" issuers will also have the option of paper filing their Forms D on the current form or on the revised form. Beginning March 16, 2009, all Forms D, as well as amendments to Forms D previously filed (whether on paper or electronically), must be filed electronically.

SEC Proposes Anti-Fraud Rule To Address Fails to Deliver Securities Associated With "Naked" Short Selling

On March 17, 2008, the SEC proposed an anti-fraud rule, Rule 10b-21, aimed at short sellers, including broker-dealers acting for their own accounts, who deceive specified persons, such as a broker or dealer, about their intention or ability to deliver securities in time for settlement and then fail to deliver such securities by the settlement date. **(See SEC Release No. 34-57511).**

As proposed, Rule 10b-21 would specify that it is unlawful for any person to submit an order to sell a security if such person deceives a broker-dealer, participant of a registered clearing agency or purchaser regarding its intention or ability to deliver the security on the date delivery is due, and then such person fails to deliver the security on or before the date delivery is due. Scienter would be a necessary element for a violation. The proposed rule would cover situations where a short seller misrepresents its ability to locate the security in time for delivery and where the short seller causes the broker-dealer to mark its order to sell the security as "long" when the seller knows or recklessly disregards that it is not "deemed to own" the security being sold.

The SEC sought comment on the proposed rule on or before May 20, 2008.

SEC Proposes Amendments to Form ADV and Related Rules Under the Investment Advisers Act

On March 3, 2008, the SEC proposed amendments to Part 2 of Form ADV and related rules under the Investment Advisers Act of 1940, as amended. **(See SEC Release No. IA-2711).** The amendments would require investment advisers registered with the SEC to deliver to clients and prospective clients a brochure written in plain English discussing the adviser's business, fees and other compensation, investment strategies, financial industry affiliations, soft dollar arrangements, disciplinary events involving the issuer and its personnel, risks and various conflicts of interest. The proposed format would replace the current check-the-box format, would be filed electronically, and would be available publicly through the SEC website.

As proposed, the amendments to Part 2 of Form ADV would consist of three different sections:

- Part 2A, the "Brochure"—The Brochure would be written in narrative form in plain English and describe conflicts between an adviser's own interests and those of its clients.
- Appendix 1 to Part 2A, the "Wrap Fee Program Brochure"—The Wrap Fee Program Brochure would be required for advisers that sponsor wrap fee programs[1] to prepare a separate, specialized firm brochure for clients of the wrap fee program in lieu of the sponsor's standard advisory firm brochure. Disclosure would be substantially similar to those in Schedule H of the current Form ADV.
- Part 2B, the "Brochure Supplement"—The Brochure Supplement would be written in narrative form in plain English and would provide information about the advisory personnel on whom clients rely for investment advice.

Part 2A – The Firm Brochure

As proposed, the Firm Brochure would have 19 separate items, each of which would require disclosure on a distinct topic. These would include information concerning conflicts of interest between an adviser's own interests and those of its clients, including

- Material changes since an adviser's last annual update;
- A description of an adviser's advisory business;
- A description of compensation for providing advisory services and other costs and fees;
- Disclosure of performance-based fees;
- A description of methods of analysis and investment strategies;
- Disclosure of any legal or disciplinary event that is material to a client's evaluation of the integrity of an adviser or its management;
- A description of other financial industry activities and affiliations;
- A brief description of an adviser's code of ethics and participation or interest in client transactions and personal trading;
- A description of an adviser's brokerage practices;
- Disclosure of payments for client referrals;
- Disclosure of an adviser's investment discretion and the voting of its client securities; and
- Disclosure of material financial information.

Appendix 1 to Part 2A—The Wrap Fee Program Brochure

The proposed disclosure in the Wrap Fee Program Brochure would be substantially similar to the disclosure in Schedule H of the current Form ADV. Advisers that sponsor wrap fee programs would continue to provide separate specialized firm brochures for clients of their program in lieu of the sponsor's standard advisory firm brochure. In addition, advisers would be required to disclose whether any of their related persons are portfolio managers in the program and to describe the conflicts that may be present as a result of those relationships.

Part 2B – The Brochure Supplement

An adviser would also be required to send a brochure supplement containing selective information about certain supervised persons who provide investment advise to clients, including those persons who formulate investment advice for a particular client and have direct contact with that client or who make discretionary investment decisions regarding a particular client's assets, even without direct client contact.

Advisers would not be required to deliver supplements to four types of clients:

- Clients to whom an adviser is not required to deliver a firm brochure;
- Clients who receive only impersonal investment advice;
- Clients who are "qualified purchasers;" and
- Certain "qualified clients" who are also officers, directors, employees and other persons related to the adviser.

SEC Proposes Amendments to Extend Auditor Attestation Requirement for Non-Accelerated Filers by One-Year

On February 1, 2008, the SEC proposed to extend the deadline for non-accelerated filers to comply with the requirement that an independent auditor provide an attestation report on the issuer's report on internal control over financial reporting, to be included in the issuer's annual report. **(See SEC Release No. 33-8889).** Currently, a non-accelerated filer is required to provide such a report as part of its annual report following the fiscal year ending on or after December 15, 2008. Under the proposed rule a non-accelerated filer would be required to provide such a report as part of its annual report following the fiscal year ending on or after December 15, 2009.

SEC Adopts Technical Amendments Relating to Communications in Connection with Certain Types of Business Transactions

On March 17, 2008, the SEC adopted final rules containing several technical amendments correcting, among other things, certain typographical errors to the rules and forms governing mergers and acquisitions. **(See SEC Release No. 34-55146A).** Most notably, the amendments clarify that the use of the notice and access model regarding Internet availability of proxy materials is not permitted with respect to business combination transactions, including both cash and stock transactions. The amendments became effective April 1, 2008.

NOTES

1. Under wrap fee programs, or "separately managed accounts," advisory clients pay a specified fee for investment advisory services and the execution of transactions.

APPELLATE AND OTHER DECISIONS OF NOTE

Supreme Court Refuses to Review Case by Enron Shareholders

On January 22, 2008, the Supreme Court of the United States denied the petition for writ of certiorari brought by the Enron shareholders in *The Regents of the University of California v. Credit Suisse First Boston*, 482 F.3d 372 (5th Cir. 2007). Petitioners were Enron shareholders who sought review of the Fifth Circuit's ruling that the investment banks did not violate section 10(b) of the 1934 Act or Rule 10b-5 promulgated thereunder because such banks were not fiduciaries and owed no obligation to shareholders.

As previously discussed in this journal, on March 19, 2007, the Fifth Circuit rejected class certification of the claims because there was no presumption of reliance since there was no duty to disclose. (*Sec. Reg. L. J.*, Vol. 35, No. 2, p. 171). Relying on *In re Charter Commc'ns, Inc. Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006), the Fifth Circuit applied a narrow definition of the term "deceptive acts," and concluded that defendants were, at most, guilty of aiding and abetting, because they did not make any fraudulent statements or omissions, and did not directly engage in any manipulative securities trading practices.

This denial closely follows the Supreme Court's recent decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., et al.*, 128 S.Ct. 761 (January 15, 2008), which was discussed in our journal's previous issue. (*Sec. Reg. L. J.*, Vol. 36, No. 1, p. 103-104). In *Stoneridge*, the Supreme Court rejected scheme liability and denied there is a private right of action against third party vendors as primary violators. The Enron shareholders asserted that *Stoneridge* applied to suppliers and customers, but did not apply to "financial professionals." The Supreme Court's refusal to review this matter suggests its rejection of this argument. Thus, the *Stoneridge* decision and the Supreme Court's denial of certiorari can be read together to dismiss scheme liability, regardless of the identity of the third party.

The Supreme Court's refusal to hear this case ends the Enron shareholders' claims against the investment banks for damages.

Supreme Court Remands Case in Light of its Decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., et al.*

On January 22, 2008, the Supreme Court of the United States granted the petition for writ of certiorari in *Avis Budget Group, Inc. v. California State Teachers Retirement System*. Here, a teacher's retirement group asserted claims that certain outside companies were liable because their transactions with Homestore and Cendant Corp., now known as Avis Budget Group, Inc., constituted a scheme to inflate revenues. The Supreme Court vacated the judgment and remanded the case to the United States Court of Appeals for the Ninth Circuit "for further consideration in light of *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.,* 552 U.S. __ (2008)."

As discussed above, the Supreme Court in *Stoneridge* held that there was no violation of Section 10(b) of the 1934 Act because suppliers and customers were not primary violators and could not be sued as such. (*Sec. Reg. L. J.*, Vol. 36, No. 1, p. 103-104).

Avis Budget Group, Inc. v. California State Teachers Retirement System, 128 S.Ct. 1119 (Jan. 22, 2008).

Supreme Court Declines to Review Insider Trading Case

On March 17, 2008, the Supreme Court of the United States declined to hear the appeal brought by defendants in *Johnson v. Aljian*, 490 F.3d 778 (9th Cir. 2007). Shareholders of DaimlerChrysler AG brought a securities fraud class action against Tracinda Corporation and two of its executives, Kerkorian and Aljian. Plaintiffs allege violations of Sections 10(b), 20A, and 20(a) of the 1934 Act, and Rules 10b-1 and 10b-5 promulgated thereunder.

The district court dismissed plaintiffs' claims under Section 10(b) and 20(a) as untimely, but upheld the remaining claims under Section 20A.[1] The Ninth Circuit affirmed. Defendants contend that the Section 20A claims should be dismissed since Section 20A requires a predicate violation of the 1934 Act and there is no such predicate violation since plaintiff's claims under Sections 10(b) and 20(a) had already been dismissed.

The Ninth Circuit disagreed, reasoning that each section of the 1934 Act has a different statute of limitations for a purpose and that to dismiss Section 20A claims would render the statute of limitations meaningless. Further, the Ninth Circuit interpreted the word "violates," and concluded that the term "does not require that the predicate claim be filed within its own period of limitations."

The Supreme Court's refusal to review the Ninth Circuit's decision permits the shareholders to pursue their claims under Section 20A of the 1934 Act.

Law Firm May Be Liable Under Oregon Statute for Aiding and Abetting

On March 27, 2008, the Southern District of New York held that an investor in a hedge fund could sue the New York law firm that drafted the offering documents for aiding and abetting the securities fraud of the principal under an Oregon securities statute. The federal district court ruled against the defendant, Seward & Kissel, on a motion to dismiss and rejected its arguments that federal law preempted the state statute and the state statute violated the dormant commerce clause. The Court did, however, agree with defendant that plaintiff failed to allege that the securities were not federally covered securities and dismissed a separate claim based on the sale of unregistered securities.

The Court noted that while the U.S. Supreme Court recently held in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.* that there is no private right of action for "scheme" liability against alleged aiders and abettors under Section 10(b) of the 1934 Act, the decision also recognized a state's authority to regulate and enforce its own securities fraud statutes independent of federal law. "Some state securities laws permit state authorities to seek fines and restitution from aiders and abettors." *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., et al.*, 128 S.Ct. 761, 773 (January 15, 2008).

The Court also found nothing in the National Securities Markets Improvement Act (NSMIA) that preempted state oversight of fraud or deceit in the securities area. The Oregon Blue Sky Statute expressly provides a cause of action against aiders and abettors of securities fraud, and the Oregon Supreme Court has previously found that an attorney's preparation of legal materials for an offering qualifies as participating in or materially aiding under the statute. The Court noted that while the principal probably lied to the law firm, the statute requires the defendant to establish its due diligence as an affirmative defense.

Houston v. Seward & Kissel, LLP, 2008 WL 818745 (S.D.N.Y. Mar. 27, 2008).

Seventh Circuit Finds Scienter Adequately Pled

On January 17, 2008, the U.S. Court of Appeals for the Seventh Circuit adhered to its earlier ruling that plaintiffs satisfied the scienter requirement. As discussed in a previous issue of this journal, the Supreme Court remanded the case back to the Circuit Court to apply its clarification of the scienter requirement in determining whether there is a violation of Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder. (*Sec. Reg. L. J.*, Vol. 35, No. 3, p. 322-323).

Applying the Supreme Court's standard, the Seventh Circuit held that plaintiffs, who were investors of Tellabs, Inc., still satisfied the scienter requirement because "a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." In particular, the Seventh Circuit noted that it was "exceedingly unlikely" that the alternative hypotheses of innocent or careless errors or acts of subordinate employees were cogent since the allegedly false statements concerned two of Tellabs' most important products and many of the allegedly false statements came from the CEO himself. Given these facts, the Seventh Circuit held that scienter was adequately pled under the Supreme Court's clarification.

Makor Issues & Rights, Ltd., et al. v. Tellabs, Inc., 513 F.3d 702 (7th Cir. Jan. 17, 2008).

Monetary Penalty Rejected By the New York Court of Appeals For Lack of Subject Matter Jurisdiction

On February 7, 2008, the New York Court of Appeals dismissed an action by the Financial Industry Regulatory Authority's ("FINRA") to collect a one million dollar penalty against a brokerage firm and its owner in *Financial Industry Regulatory Authority v. Fiero*, 33 A.D.3d 547, 827 N.Y.S.2d 4 (1st Dep't 2006). The Court held that state courts lacked jurisdiction and reversed the lower court's order and dismissed the complaint.

FINRA, previously known as the National Association of Securities Dealers ("NASD"), filed a disciplinary complaint against Fiero Brothers, a brokerage firm, and its owner, alleging violations of Section 10(b) of the 1934 Act, Rule 10b-5 promulgated thereunder, and several NASD rules. Specifically, the complaint alleged that defendants conducted a "bear raid" that lowered the price of securities underwritten by a competitor and drove the competitor out of business. A NASD panel ruled against the brokerage firm and its owner, expelled them from NASD membership, barred them from associating with member firms, and imposed a $1 million fine. On appeal, the NASD's National Adjudicatory Council affirmed this finding and upheld the sanctions.

The NASD filed an action in state court to recover the penalty. The New York State Supreme Court granted the NASD's motion for summary judgment and awarded judgment for $1.3 million (including costs and interest). The First Department affirmed this ruling on appeal. The Court of Appeals reversed this ruling, finding that subject matter jurisdiction is not waivable and may be a considered by a court on its own motion.

In reaching its decision, the Court noted that FINRA is "not seeking to enforce a state law claim" but rather seeks to enforce a penalty under the rules and regulations of the 1934 Act. Accordingly, the Court applied Section 27 of the 1934 Act, which grants "[t]he district courts of the United States" with "exclusive jurisdiction [over] violations of [the 1934 Act] or the rules or regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by [the 1934 Act] or the rules and regulations thereunder."

Financial Industry Regulatory Authority v. Fiero, 882 N.E.2d 879, 10 N.Y.3d 12, 853 N.Y.S.2d 267 (Feb. 7, 2008).

SEC's Registration Claims in Connection with PIPE Transaction Dismissed

On February 4, 2008, the U.S. District Court for the Eastern District of Pennsylvania dismissed the SEC's claims against a hedge fund operator and his funds to the extent that they relied on Section 5 of the 1933 Act.

The SEC filed an action claiming that a hedge fund operator and his funds were engaged in a scheme to avoid registration requirements in connection with private investments in public equities ("PIPEs"), whereby defendants used PIPE shares to cover their short positions on the stock. The proper approach would have been to use shares purchased in the open market to cover short positions. Thus, the SEC brought four counts against defendants, alleging insider trading and fraud, in violation of Sections 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder (Count I), insider trading in violation of Sections 17(a)(1)-(3) of the 1933 Act (Counts II and III), and violations of registration and prospectus delivery pursuant to Sections 5(a)-(c) of the 1933 Act (Count IV). The SEC also sought an order requiring defendants to disgorge profits and pay a penalty under Section 20(d) of the 1933 Act and Section 21(d)(3) of the 1934 Act.

The District Court dismissed Counts I and IV of the Complaint to the extent they relied on Section 5 of the 1933 Act and ordered the SEC to file an amended complaint alleging with particularity the meaning of the term "PIPE information" with respect to the remaining claims.

This decision marks the third time in recent months that district courts have dismissed the SEC's registrations claims. Previously, the Southern District of New York and the Western District of North Carolina responded similarly to such claims.

Securities and Exchange Commission v. Berlacher et al., No. 07-3800 (E.D. Pa. 2008).

First Circuit Applies *Tellabs* Decision Pleading Standards

On January 10, 2008, the First Circuit applied the pleading standards articulated in *Tellabs* and affirmed the U.S. District Court for the District of Massachusetts' dismissal of a complaint brought by bondholders against a college's trustees and officers, and the underwriter for violations under Section 12(a)(2) of the 1933 Act and Sections 10(b) and 20(a) of the 1934 Act and Rule 10b-5 promulgated thereunder.

The Circuit Court held that the Private Securities Litigation Reform Act ("PSLRA") did not constrict the liberal amendment policy of Rule 15(a) of the Federal Rules of Civil Procedure, but still refused to grant leave to amend the Complaint because of undue delay. Specifically, the Court noted Appellants had many opportunities to amend the Complaint over the course of a year and a half, even after discovering allegedly "new" evidence, but failed to do so.

Further, the Court noted that under the *Tellabs* decision, the complaint should be considered as a whole and that inferences of scienter should be weighed against competing inferences of non-culpable behavior. Applying this new standard, the Circuit Court upheld the dismissal of Appellants' Section 10(b) and Rule 10b-5 claims on the grounds that Appellants failed to prove scienter or plead their claims with particularity. The Court noted that the Official Statement issued to bondholders did disclose the financial state of the college and that Appellants failed to prove any misrepresentations or incorrect information at the time the Official Statement was issued. Because the Court did not find any Rule 10b-5 violation, it also dismissed Appellants' Section 20(a) claim since such a claim is contingent upon a finding of a Rule 10b-5 violation.

Finally, the Court dismissed the Section 12(a)(2) claim against the underwriter on the ground that the claim is essentially one for fraud, which must be plead with particularity pursuant to Rule 9(b). The Court held that Appellant failed to plead with the requisite specificity.

In reaching its determination, the Court emphasized that Respondents were not typical defendants in securities fraud cases since they were members of a non-profit educational institution and there were no allegations that they personally benefited from the proceeds of the bonds.

ACA Fin. Guaranty Corp. v. Advest, Inc., 512 F.3d 46 (1st Cir. Jan. 10, 2008).

NOTES

1. Section 20A of the 1934 Act provides a private cause of action for insider trading, but does not limit any action by the Commission or Attorney General. This provision also sets forth a five-year statute of limitations and certain limitations on liability.