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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 2009.

SEC Rulemaking

SEC Adopts Amendments to Rules Relating to Mutual Fund Prospectus Disclosure and Delivery

On January 13, 2009, the SEC adopted amendments to the rules relating to mutual fund prospectus disclosure and delivery in order to enhance disclosure provided to investors. **(See SEC Release No. 33-8998).** The amendments require a mutual fund to provide key investment information, in plain English, in a standardized order at the front of a mutual fund statutory prospectus. Additionally, the amendments permit mutual funds to satisfy their prospectus delivery obligations under Section 5(b)(2) of the 1933 Act by sending or giving such information directly to investors in the form of a summary prospectus and providing the statutory prospectus on an Internet Web site.

Summary Section of Statutory Prospectus

Specifically, the summary section must include the following information in plain English, in a standardized order:

- **Investment Objective**, including a statement of the mutual fund's investment objectives or goals;
- **Fee Table;**
- **Investment Strategies, Risks and Performance**, including the mutual fund's principal investment strategies, risks and investment performance;
- **Fund Management**, including the name of the mutual fund's investment adviser and sub-adviser (if applicable) and the name, title and length of service of the fund's portfolio manager(s);
- **Purchase and Sale of Fund Shares**, including the mutual

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fund's minimum initial and subsequent investment requirements, the fact that its shares are redeemable and the procedures for redeeming shares;

- **Tax Information**, including whether the mutual fund intends to make distributions that may be taxable as ordinary income or capital gains, or whether it intends to distribute tax-exempt income; and
- **Financial Intermediary Compensation.**

Mutual funds are prohibited from presenting any information before the information above, other than the cover page and table of contents.

Summary Prospectus

The amendments also permit a mutual fund to choose to satisfy its prospectus delivery obligations by sending or giving a summary prospectus to investors and providing its statutory prospectus and other additional information online. The summary prospectus must include the same information, in the same order, included in the summary section of a statutory prospectus. The summary prospectus must also include certain information relating to the mutual fund, including the fund's name and share class(es) to which the summary prospectus relates, the ticker symbol(s) of the fund or funds the summary prospectus relates to, a statement identifying the document as a "Summary Prospectus," the approximate date the summary prospectus is being delivered to investors and a legend on the cover page detailing how investors can get a copy of the mutual fund's statutory prospectus. In addition, a mutual fund that elects to deliver a summary prospectus to investors must also make available, at no charge, the Summary Prospectus, the fund's statutory prospectus, statement of additional information (SAI), and most recent annual and semi-annual reports. These documents must be available online at or before the time the summary prospectus is delivered to investors, and must remain available for at least ninety days after the date of delivery.

The amendments became effective on March 31, 2009.

SEC Adopts Final Rules Relating to Interactive Financial Statement Information

On January 30, 2009, the SEC adopted final rules requiring issuers to provide financial statement information in a form that is intended to improve its usefulness to investors. **(See SEC Release Nos. 330-9002; 34-59324).** The final rules apply to domestic and foreign reporting companies that prepare their financial statements in accordance with U.S. generally accepted accounting principles and foreign private issuers that prepare their financial statements in accordance with International Financial Reporting Standards, as issued by the International Accounting Standards Board. The interactive format, eXtensible Business Reporting Language ("XBRL"), will enable investors to download financial information directly into software that will enable the data to be analyzed in a variety of ways.

All 1934 Act registration statements, quarterly and annual reports and transition reports, as well as Forms 8-K and 6-K that contain revised or updated financial statements must include a new exhibit that contains financial statements and any applicable financial statement schedules in interactive data format. The requirement becomes effective beginning with the quarterly report on Form 10-Q or annual report on Form 20-F or Form 40-F, containing financial statements for a fiscal period ending on or after June 15, according to the following schedule:

- **2009** — Domestic and foreign large accelerated filers that use U.S. GAAP and have a worldwide public common equity float above $5 billion as of the end of the second fiscal quarter of their most recently completed fiscal year;
- **2010** — All other domestic and foreign large accelerated filers using U.S. GAAP; and
- **2011** — All remaining filers that use U.S. GAAP, including smaller reporting companies and all foreign private issuers that prepare their financial statements in accordance with IFRS as issued by the IASB.

Initially, only the issuer's financial statements and footnotes must be tagged. Following a year of tagging, issuers will also be required to tag the detailed quantitative disclosures within the footnotes and schedules. Issuers will also have the option of tagging the associated narrative disclosure. The rules also require that the data be placed on the issuer's corporate website not later than the end of the calendar day it filed or was required to file the report with the SEC. Additionally, the data must be maintained on such website for twelve months. Failure to timely file the interactive data will result in the issuer being deemed not current with its filings.

SEC Adopts Final Rules Relating to Interactive Data For Mutual Fund Risk/Return Summaries

On February 11, 2009, the SEC adopted final rules requiring mutual funds to provide risk/return summary information in a form that is intended to improve its usefulness to investors. **(See SEC Release Nos. 33-9006, 34-59391).** The interactive format, which, like the interactive financial statement information and will be in XBRL, will enable investors to download financial information directly into software that will enable the data to be analyzed in a variety of ways.

Specifically, the rules apply to the "Risk/Return Summary" Items of Form N-1A. In addition, issuers will be required to file the interactive

"Risk/Return Summary" as an exhibit to any prospectus filed under Rule 497(c) or (e) of the 1933 Act. Issuers will also have to make such information available on their websites on the earlier of the day on which the information was filed with the SEC or the day on which the information was required to be filed, for as long as the related registration statement remains current.

Issuers are required to include the interactive "Risk/Return Summary" on all registration statements and annual updates to effective registration statements that are to become effective after January 1, 2011. A form of prospectus filed under Rule 497(c) or (e) is required to include an interactive "Risk/Return Summary" as an exhibit only if the fund has included a corresponding interactive section in its registration statement or post-effective amendment.

APPELLATE AND OTHER DECISIONS OF NOTE

Individuals Must Be Beneficial Owners In Order to Constitute a Member of a Section 13(d) Group

On December 29, 2008, the Eleventh Circuit affirmed the lower court's ruling that individuals must be beneficial owners of a company in order to constitute a member of a "group," as defined in Section 13(d)(3) of the 1934 Act.

Plaintiff is a pharmaceutical company that defendants invested in. The company brought suit against an investor who controlled 30 percent of the company's stock, as well as certain "South African defendants," alleging that they acted in concert to launch a hostile takeover of the company. Based on their takeover plan, plaintiff contended that defendants acted as a group and were therefore required to make disclosures pursuant to Section 13(d).

The lower court dismissed plaintiff's Section 13(d) claim and the appeals court affirmed. While Section 13(d)(3) does not mention the term beneficial owner, Rule 13d-5 states that when a Section 13(d)(3) group is formed, the members of the group "shall be deemed to have acquired beneficial ownership . . . of all equity securities . . . beneficially owned by any such persons." The purpose of Section 13(d)(3) was to prevent those with some amount of beneficial ownership from combining with others to control five or more percent of a class of securities, from avoiding the disclosure requirements of Section 13(d)(1).

The Court dismissed all defendants but one because only beneficial owners were required to file a Schedule 13D with the SEC. The Court held that interpreting the Rule to include only beneficial owners is not inconsistent or contradictory to the purpose of the Rule or traditional notions of partnership law. The Court also noted that to include non-beneficial owners would dramatically expand the Rule.

Hemispherx Biopharma Inc. v. Johannesburg Consolidated Investments, 553 F.3d 1351 (11th Cir. 2008).

Complaint Against Auditors Dismissed for Lack of Scienter

On January 5, 2009, the Fifth Circuit affirmed the lower court's dismissal of a complaint against auditors for failure to sufficiently plead scienter. Applying the standard articulated in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), which was previously discussed in this Journal (35 No. 3 Securities Regulation Law Journal 322–323), the Court held that the more plausible inference was that the auditors in this case were victims of the fraud.

Plaintiffs are the SEC and investors in a parent company of grocery chains. The company inflated its earnings and income, in violation of generally accepted accounting principles. Plaintiffs sued, alleging violations of Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder.

The Court found that the auditors properly advised the company, but that the company provided false side letters to convince the auditors of the propriety and accuracy of the earnings and income in question. Based on this evidence, the Court held that the auditors may have been negligent, but were not knowingly complicit in the fraud nor reckless in their duties. The Court emphasized the fact that the auditors had requested additional proof as evidence that they were not participants in the fraud.

Public Employees' Retirement Assn of Colorado v. Deloitte & Touche LLP, 551 F.3d 305 (4th Cir. 2009).

Supreme Court to Review Suit on Fund Advisory Fees

On March 9, 2009, the Supreme Court granted certiorari on the Seventh Circuit's decision affirming the dismissal of a lawsuit alleging that a mutual fund advisor received excessive compensation. The Seventh Circuit decision, *Jones v. Harris Assoc. LP*, 537 F.3d 728 (7th Cir. Aug. 8, 2008), which dismissed plaintiffs' claims under Section 36(b) of the Investment Company Act, was previously discussed in this Journal (*Sec. Reg. L.J.*, Vol. 36, No. 3, p. 262–263).

The investors argued in their petition to the Supreme Court that the Seventh Circuit's ruling conflicts with other circuit court decisions which generally followed *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982). The question presented to the Court is "[w]hether the Seventh Circuit contravened the Investment Company Act in holding that a shareholder's claim that the fund's investment adviser charged an excessive fee is not cognizable under Section 36(b), unless the shareholder can show that the adviser misled the fund's directors who approved the fee."

Jones v. Harris Assoc. LP, No. 08-586, 2009 WL 578699 (March 9, 2009).

Press Releases Do Not Prove Reliance

On January 23, 2009, the Ninth Circuit affirmed the lower court's dismissal of a securities fraud suit against KPMG. Plaintiff investors alleged that KPMG violated Section 10(b) of the 1934 Act by participating in a "parking" scheme with its partner, Peregrine Systems, Inc. (who was not a party to this action) and enabled Peregrine to improperly recognize revenue and therefore meet its financial projections.

Applying the standard articulated in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 128 S. Ct. 761, 169 L. Ed. 2d 627, Fed. Sec. L. Rep. (CCH) ¶ 94556 (2008), which was previously discussed in this journal (*Sec. Reg. L.J.*, Vol. 36, No. 1, p. 103–104), the Court held there was no liability unless a member of the investing public had knowledge of the deceptive acts and therefore could demonstrate reliance.

Plaintiffs point to press releases announcing the partnership between KPMG and Peregrine as proof of reliance through fraud on the market. The Court rejected this argument, pointing out that the press releases were not misleading and did not discuss any of the transactions at issue.

Loran Group v. Peregrine Systems, Inc., 2009 WL 186165 (9th Circuit 2009).

Audit Letters Do Not Constitute "Assistance" for Purposes of Claim of Aiding and Abetting Rule 10b-5 Violations

The First Circuit affirmed the dismissal of the SEC's civil fraud action on February 9, 2009. The SEC's complaint alleged violations of Section 17(a) of the 1933 Act, Sections 10(b) and 20(e) of the 1934 Act and Rule 10b-5 promulgated thereunder.

The SEC brought suit against six former executives of a money management firm, alleging they engaged in a scheme to defraud a company's contribution plan and certain mutual funds. The district court dismissed the complaint against three of the executives, holding that the SEC failed to allege sufficient conduct to sustain its claims. On appeal, the SEC specified that the three executives aided and abetted the firm's violations of Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder by signing audit letters in 2002 and 2003 while knowing that the wrongful transactions at issue had not been disclosed. According to the SEC, the audit letters, which stated that the executives were "unaware of any uncorrected errors, frauds or illegal acts attributable to" the firm that had affected its clients, assisted the firm in breaching its duty to disclose.

The Court rejected the SEC's theory, finding that the SEC's analysis would create new liability under Section 10(b). The Court emphasized that the "non-disclosures did not cause either the transactions or the concrete losses resulting from them" but that the "SEC's attempt to do so here would extend the supposed wrong indefinitely and until its disclosure—not just as a common law breach of duty but as a federal securities violation." Moreover, the Court noted that the SEC failed to assert a claim of aiding and abetting in connection with the wrongful transactions at issue or the scheme itself, but instead only focused on the firm's failure to disclose them.

SEC v. Papa, 555 F.3d 31 (1st Cir. 2009).

Second Circuit Affirms Dismissal for Lack of Materiality or Scienter Under PSLRA

Plaintiffs brought an action alleging that JP Morgan Chase ("JPMC") "created disguised loans for Enron and concealed the nature of these transactions by making false statements or omissions of material fact in its accounting and Securities and Exchange Commission (SEC) filings." Specifically, plaintiffs asserted that JPMC created "Special Purpose Entities," one of them being an entity called Mahonia Ltd., to facilitate disguised loan transactions with Enron Corporation.

Defendant moved to dismiss the class action for failure to meet the heightened pleading requirements established by the Private Securities Litigation Reform Act (PSLRA). The district court dismissed the class action on the ground that the complaint "failed to plead with the requisite particularity that JPMC made a materially false statement or omitted a material fact, with scienter." In particular, the district court found that plaintiffs adequately pleaded scienter only as to the "alleged improper accounting of the Mahonia transactions as trades rather than loans," but that those transactions were not material.

Plaintiffs then filed an amended class action complaint that included new allegations concerning "(1) JPMC's alleged downplaying of its Enron-related exposure, (2) JPMC's alleged misrepresentation of its integrity and risk management, and (3) the allegedly faulty reporting of the Mahonia transactions." The complaint alleged violations of Sections 11, 14(a) and 15 of the 1933 Act and Section 10(b) of the 1934 Act. Defendant again moved to dismiss the class action, and the district court again granted the motion. On January 21, 2009, the Second Circuit affirmed the district court's dismissal.

With respect to JPMC's allegedly false financial reports, plaintiffs argued that defendants' GAAP violations created a presumption that the financial statements were misleading. While the Second Circuit found that plaintiffs had adequately alleged that JPMC and Mahonia were "related" and that they adequately alleged false or misleading statements by defendants, the Court held the complaint failed to adequately allege scienter. The Circuit Court agreed with the district court's finding that the class action "fail[s] to allege facts explaining why, if it was aware of Enron's problems, [JPMC] would have continued to lend Enron billions of dollars," explaining that "[e]ven if JPMC was actively engaged in duping other institutions for the purposes of gaining at the expense of those institutions, it would not constitute a motive for JPMC to defraud its own investors." The Court further rejected plaintiffs' claim that JPMC disguised its loans to Enron as "trading activities," agreeing with the district court that even assuming JPMC should have treated the prepaid transactions as trades rather than as loans was immaterial. Accordingly, "[b]ecause Plaintiffs have failed to adequately plead that JPMC made a materially false statement or omitted a material fact with scienter," the district court properly dismissed the class action complaint.

ECA v. JP Morgan Chase Co., 553 F.3d 187 (2d Cir. 2009).

Professors File Amicus Brief in Shareholder Proposal Case

On January 23, 2009,a group of sixty law professors filed an amicus curiae brief on behalf of appellant Lucian Bebchuk in *Bebchuk v. Electronic Arts Inc., No. 08-5842*, currently pending before the Second Circuit on appeal.

The case focuses on a shareholder proposal that was submitted by Lucian Bebchuk to Electronic Arts (EA). The proposal is precatory and recommends that the EA board submit to a shareholder vote a charter or bylaw amendment that, if adopted, would require the company (to the extent permitted by law) to include qualified proposals for a bylaw amendment in the company's proxy materials. For a proposal to be qualified, it would have to meet certain significant requirements, including being submitted by a shareholder(s) with more than 5% of the company's stock.

EA excluded the proposal from the company's ballot, and the issue is whether the SEC's shareholder proposal rule (Rule 14a-8 of the 1934 Act) allows the company to do so. The District Court granted summary judgment for EA in a brief bench ruling and sent the case to the Second Circuit.

The professors' *amici curiae* brief, filed in support of the appellant's position, focuses on two central arguments made by EA in defense of excluding the proposal. The first argument is that a company is entitled to omit a proposal as inconsistent with Rule 14a-8. The professors assert that acceptance of the District Court's ruling would invalidate any charter or bylaw provisions that provide shareholders with any access to a company's proxy. Further, they argue that this position is contrary to the long-standing principles under which state law governs companies' internal affairs and determines how they exercise their powers.

A second argument made by EA is that adoption of the recommended arrangement might one day lead to the inclusion of proposals that EA would otherwise be free to include or exclude under one of eight provisions of Rule 14a-8. Acceptance of this argument would lead to a large increase in the power of companies to exclude shareholder proposals. The professors' *amici curiae* brief urges the Court not to accept EA's invitation to deviate from the clear language of the Rule and rewrite the provisions of Rule 14a-8 to expand considerably companies' power to exclude proposals.

The Amicus Brief can be found at: http://www.law.harvard.edu/faculty/bebchuk/pdfs/amici-curiae-brief.pdf

Lawsuit Revived Due to Lack of Inquiry Notice of Alleged Fraud

The Third Circuit on January 30, 2009 revived a securities fraud suit against Pfizer brought by investors who claim the company hid the truth about the outcome of a clinical study on possible side effects of Celebrex, an arthritis drug. Plaintiffs claimed that Pharmacia (which has since been acquired by Pfizer) falsely trumpeted the data from the first six months of a study to claim that Celebrex had fewer gastrointestinal side effects than other arthritis drugs, in violation of Sections 10(b) and 20(a) of the 1934 Act. The suit alleged that Pharmacia knew that results of the full, 13-month study would show no such reduction in side effects.

The District Court dismissed the suit on statute-of-limitations grounds, finding that investors had "storm warnings" of potential problems with the study as early as February 2001 when the Food and Drug Administration released a critical report and therefore had "inquiry notice" of the alleged fraud.

The Circuit Court reversed, ruling that the district court imposed too strict a test for gauging the existence of storm warnings. In reversing the dismissal, the Third Circuit noted that ". . . the hypothetical reasonable investor need not be a scientific expert; to the contrary, the relevant inquiry is whether a reasonable investor of 'ordinary intelligence' would have recognized the available information as indicative of possible fraud." The Court held that the totality of the evidence in the public realm as of February 2001 did not indicate a possibility of fraud or even hint at any malfeasance or intentional impropriety; rather, the evidence only supported the view that there existed a legitimate dispute over scientific and statistical models.

The Court found that the evidence of fraud (statements by corporate officers were false, but also that the officers did not genuinely believe the accuracy of their statements) surfaced upon the publication of a Washington Post article which stated that defendants withheld data from Journal of the American Medical Association.

Accordingly, the Third Circuit found that in order for investors to be on inquiry notice of Section 10(b) claims, there must be some indication that defendants did not, in fact, hold the views expressed. The Third Circuit concluded that investors are not placed on inquiry notice of fraud when an apparently legitimate scientific dispute arises between the FDA and a pharmaceutical company: "[a] rule that would place investors on inquiry notice of fraud the moment that the FDA questions the seemingly good faith scientific analysis of a pharmaceutical company would encourage putative plaintiffs to file premature securities suits."

Alaska Electrical Pension Fund v. Pharmacia Corp., 554 F.3d 342 (3d Cir. 2009).