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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 2010.*

## SEC Rulemaking

### SEC Adopts Amendments to Regulation SHO Relating to Short Sales

On February 26, 2010, the SEC adopted amendments to Regulation SHO under the 1934 Act relating to the short sales of securities. **(See SEC Release No. 34-61595).** The amendments implement a short sale-related "circuit breaker" that will impose restrictions in certain situations in which a security may be sold short. The amendments are designed to prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the national best bid, if the price of that covered security decreases by 10% or more from the covered security's prior day's closing price. Once the circuit breaker is triggered, the restrictions will remain in place for the remainder of that trading day and the following trading day.

Specifically, the amendments require trading centers[1] to have policies and procedures reasonably designed to prevent them from executing or displaying any short sale order, absent an exception (as set forth below), at a price that is equal to or below the national best bid, if the price of that security decreases by 10% or more from the security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior trading day.

The amendments apply to any security or class of securities, except options, for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan.

The amendments also establish circumstances under which a secu-

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rity could be traded regardless of whether the circuit breaker had been triggered with respect to that security. Specifically, a short sale order may be marked "short exempt" in the following instances:

- if a broker-dealer identifies the order as being at a price above the current national best bid at the time of submission;
- if a broker-dealer has a reasonable basis to believe that the seller owns the security being sold and that the seller intends to deliver the security as soon as all restrictions on delivery have been removed;
- if a broker-dealer has a reasonable basis to believe that the short sale order is placed by a market maker to offset a customer odd-lot order or to liquidate an odd-lot position that changes such broker-dealer's position by no more than a unit of trading;
- if the order is associated with certain bona fide domestic and international arbitrage transactions;
- if the order is by an underwriter or syndicate member participating in a distribution in connection with an over-allotment, or if the order is for purposes of lay-off sales by such persons in connection with a distribution of securities through a rights or standby underwriting commitment;
- if a broker-dealer is facilitating customer buy orders or sell orders where the customer is net long, and the broker-dealer is net short but is effecting the sale as riskless principal; or
- if the order is being executed on a volume-weighted average price basis.

The amendments are effective on May 10, 2010.

**SEC Adopts Amendments to Rule Requiring Internet Availability of Proxy Materials**

On February 22, 2010, the SEC adopted amendments relating to the internet availability of proxy materials to clarify and provide additional flexibility regarding the format of the Notice of Internet Availability of Proxy Materials that is sent to shareholders and to permit issuers and other soliciting persons to better communicate with shareholders by including explanatory materials regarding the reasons for delivering a Notice of Internet Availability of Proxy Materials, the process of receiving and reviewing the issuer's proxy materials and the methods for voting. **(See SEC Release Nos. 33-9108 and 34-61560).**

Specifically, the amendments grant issuers and other soliciting persons leeway in developing their own language for the explanatory materials in an effort to avoid confusing shareholders as to the purpose of the Notice of Internet Availability of Proxy Materials.

Additionally, the amendments now require that soliciting persons other than the issuer file a preliminary proxy statement within 10 calendar days after the issuer files its definitive proxy statement and to send its Notice of Internet Availability of Proxy Materials to shareholders no later than the date on which it files its definitive proxy statement with the SEC. This replaces the current rule which requires soliciting persons to send their Notice of Internet Availability of Proxy Materials to shareholders 10 calendar days after the date that the issuer first sends its proxy materials. The amendments are effective March 29, 2010.

### SEC Adopts Amendments to Rules Governing Money Market Funds Under the Investment Company Act

On February 23, 2010, the SEC adopted amendments to certain rules that govern money market funds under the Investment Company Act of 1940, as amended (the "1940 Act"). **(See SEC Release No. IC-29132).** Specifically, the amendments tighten the risk-limiting conditions of the money market rules of the 1940 Act to require money market funds to maintain a portion of their portfolios in instruments that can be readily converted to cash, require money market funds to report their portfolio holdings monthly to the SEC and permit a money market fund that has "broken the buck," or is at imminent risk of breaking the buck, to suspend redemptions to allow for the orderly liquidation of fund assets. The amendments are effective May 5, 2010.

### SEC Makes Technical Corrections to Proxy Disclosure Enhancements

On February 23, 2010, the SEC published corrections to the amendments relating to the proxy disclosure rules. **(See SEC Release Nos. 33-9089A, 43-61175A).** The corrections correct Forms 10-Q and 10-K to retain the current numbering of the items appearing in each form to avoid confusion that might otherwise arise from references to the current numbering in professional literature. The SEC also made corrections to Form 8-K to add an instruction allowing certain wholly-owned subsidiaries to omit the disclosure of shareholder voting results and to amend the regulatory text to make it consistent with the discussion contained in SEC Release No. 33-9089.

The corrections are effective February 28, 2010.

### SEC Proposes Amendments to Rule 10b-18 Relating to the "Safe Harbor" for Issuer Repurchases

On January 26, 2010, the SEC proposed amendments to Rule 10b-18 of the 1934 Act relating to the "safe harbor" for issuer share repurchases. **(See SEC Release No. 34-61414).** The proposed amendments are intended to clarify and modernize the safe harbor provisions in light of market developments since Rule 10b-18's adoption in 1982.

Specifically, the SEC is proposing the following:

- to modify the timing condition to preclude Rule 10b-18 purchases as the opening purchase in the principal market for the security and in the market where the purchase is effected;
- to relax the price condition for certain volume-weighted average price transactions;
- to limit the disqualification provision in fast moving markets under certain specific conditions;
- to modify the "merger exclusion" provision of current Rule 10b-18 to extend the time in which the "safe harbor" is unavailable in connection with an acquisition by a special purpose acquisition company; and
- to update certain definitional provisions.

## APPELLATE AND OTHER DECISIONS OF NOTE

### Supreme Court Upholds *Gartenberg* Standard in Mutual Fund Advisory Fee Case

On March 30, 2010, the Supreme Court unanimously upheld the *Gartenberg* standard, (*Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982)), for determining whether mutual fund advisory fees were excessive so as to constitute a breach of fiduciary duty by the adviser under section 36(b) of the Investment Company Act of 1940. In so ruling, the Supreme Court vacated the appeals court's affirmation (*Jones v. Harris Assoc. LP*, 537 F.3d 728 (7th Cir. Aug. 8, 2008)) of the lower court's dismissal, as previously discussed in this Journal (*Sec. Reg. L.J.*, Vol. 37, No. 2, pp. 192–193).

Plaintiffs are shareholders, alleging that defendant, an investment adviser, charged excessive fees in violation of Section 36(b) of the Investment Company Act of 1940. The district court granted summary judgment in favor of the investment adviser after comparing the fees charged to other clients. The Court of Appeals affirmed the district court's decision, but instead of applying the *Gartenberg* test, developed a new approach that relied on disclosure and market efficiency. The Supreme Court held that the Seventh Circuit's standard, particularly its focus on disclosure, was improper, that the *Gartenberg* standard remains the proper test, and remanded the case back to the Circuit Court.

In its decision, the Court emphasized that *Gartenberg* has historically been the standard applied by federal courts and the SEC, and that it offers a compromise between shareholders and the fund industry by taking into account all relevant circumstances to determine whether advisory fees are excessive. Plaintiff still bears the burden of establishing that an investment adviser charged a fee "that is so disproportionately large it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."

*Jones, et al. v. Harris Associates, L.P.*, 559 U.S. ___ (2010)

The decision can be found at http://www.supremecourt.gov/opinions/09pdf/08-586.pdf

### Prospectus Language Cannot be Basis for 10(b)(5) Claims Against Individuals Who Rely On It

The SEC brought suit against two executives of a broker-dealer, alleging that they allowed preferred customers to engage in market timing, in violation of Section 17(a)(2) of the 1933 Act, Section 10(b) of the 1934 Act, and Rule 10b-5 promulgated thereunder. In addition, the SEC contends that the defendants aided and abetted the company's primary violations of section 10(b) and Rule 10b-5, primary violations of section 15(c) of the 1934 Act, and primary violations of section 206 of the Investment Advisers Act of 1940, 15 U.S.C.A. § 80b-6. Market timing is the practice of frequent buying and selling of shares of a single mutual fund in order to exploit inefficiencies in mutual fund pricing. The SEC relied on the company's prospectuses, which "expressed hostility toward" market pricing.

Defendants moved to dismiss, arguing that the SEC had failed properly to plead any actionable misstatements by the individual defendants. The SEC responded that the complaint sufficiently alleged that defendants made material misrepresentations regarding market timing in the company's prospectuses. Specifically, the SEC asserted that the defendants "made" false statements of material facts within the meaning of Rule 10b-5(b) by (i) participating in the drafting of the language on market timing in the prospectuses, and (ii) using the prospectuses in their sales efforts, and referring clients to them for information.

The district court dismissed the SEC's complaint, finding that allegations of defendants' participation in the drafting process and their subsequent use of the prospectuses were too conclusory to satisfy the particularity requirement of Federal Rule of Civil Procedure 9(b). On appeal, an earlier panel of the First Circuit reversed the district court's ruling. Defendants then sought en banc review, and on March 9, 2010, the full Court affirmed the district court's decision.

The Court held that the issue was whether a securities professional "makes" a statement, for the purposes of attaching liability under Rule 10b-5(b), either by (i) using statements to sell securities, regardless of whether those statements were crafted entirely by others, or (ii) directing the offering and sale of securities on behalf of an underwriter, thus making an implied statement that he has a reasonable basis to believe that the key representations in the relevant prospectus are truthful and complete. The Court answered both parts in the negative. The Court noted that adopting the SEC's reasoning would blur the lines between primary and secondary violations and interpreting " 'make' to include the use of a false statement by one other than the maker would extend primary liability beyond the scope of conduct prohibited by the text of Rule 10b-5(b)."

*SEC v. Tambone*, 597 F.3d 436, 2010 WL 796996 (1st Cir. 2010)

### American Depositary Shares Not Considered Common Stock Traded on a National Exchange

On February 19, 2010, the Second Circuit affirmed the lower court's decision that the acquisition of a company did not trigger the conversion of convertible notes into cash and stock. The Court held that there was no change in control because the acquiring company was not a public acquirer with shares of common stock offered on a U.S. exchange, as required under the indenture agreement between noteholders and the acquired company.

The indenture trustee brought suit against defendants, the acquired and acquiring companies, on behalf of itself and noteholders, for breach of contract (as against the acquired company), and unjust enrichment and tortious interference with contract (as against the acquiring company), asserting that defendants improperly denied holders' requests to convert their notes, as allegedly required by the indenture.

The indenture agreement at issue provides that noteholders could convert notes into cash or stock "after the occurrence of Public Acquirer Change of Control." A public acquirer was defined as an entity with "a class of common stock traded on a United States national securities exchange." The acquiring company in this case, a foreign company, is not listed on a stock exchange. It does however, offer American Depositary Shares on the New York Stock Exchange.

The district court found that American Depositary Shares were not considered common stock for the purposes of Public Acquirer definition under the indenture and dismissed plaintiff's claims. The Circuit Court, applying New York law, agreed.

*Law Debenture Trust Co. of New York v. Maverick Tube Co.*, 595 F.3d 458 (2d Cir. 2010)

### Fifth Circuit Denies Class Certification for Lack of Loss Causation

Plaintiff investor brought a class action against Halliburton Company and its COO, alleging violations of Sections 10(b) and 20(a) of the 1934 Act and Rule 10b-5 promulgated thereafter. Plaintiff asserted a fraud-on-the-market case, claiming that defendants made false statements in three areas: (i) the company's potential liability in asbestos litigation; (ii) the company's accounting of revenue in its engineering and construction business; and (iii) the benefits of a merger. Plaintiff contended investors lost money as a result of the company's subsequent disclosures correcting such statements, and the market's following decline.

The district court denied class certification, holding that plaintiff failed to show that the correction of the false statements caused the stock price to fall and therefore caused the investors' losses. On February 12, 2010, the Fifth Circuit affirmed the district court's denial of class certification. The Circuit Court held plaintiff needed to establish loss causation by a preponderance of the evidence in order to trigger the fraud-on-the-market presumption. Therefore, plaintiff was required to show that the alleged false statements actually moved the market. Specifically, since plaintiff relied on negative movement in stock price following the truth or correction of an earlier misstatement to support its claims, the Court noted that plaintiff needed to show that "its loss resulted directly because of the correction to a prior misleading statement; otherwise there would be no inference raised that the original, allegedly false statement caused an inflation in the price to begin with." The Court disregarded plaintiff's proof on the grounds that the disclosures were not actually corrective of earlier misleading statements, and only confirmatory information that would not necessarily affect the stock price.

*Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330, 2010 WL 481407 (5th Cir. 2010)

### SEC Provides the Second Circuit With Its Views on Safe Harbor Application for Forward-Looking Statements

Investors filed suit against a publicly traded financial services corporation, alleging that the company and certain individual officers knowingly issued false and misleading statements, in violation of Sections 10(b) and 20(a) of the 1934 Act and Rule 10b-5 promulgated thereafter.

The district court dismissed the amended complaint for failure to state a claim, finding that plaintiffs did not plead facts sufficient to give rise to a strong inference of scienter. Plaintiffs appealed the district court's dismissal only with respect to their allegations regarding the company's statements in its Form 10-Q.

On January 21, 2010, the Securities and Exchange Commission filed an amicus brief, at the request of the Second Circuit, providing the following responses to specific inquiries on the scope of Section 21E of the 1934 Act, concerning safe harbor:

1. A forward-looking statement made in the Management's Discussion and Analysis section of a Form 10-Q is not excluded from the safe harbor provision under Section 21E of the 1934 Act.

2. A statement need not be included under a separate "Forward-Looking Statements" section or specifically labeled as forward-looking to be considered forward-looking.

3. The company's statement that "potential deterioration in the high-yield sector . . . could result in further losses in [American Express subsidiary's] investment portfolio" is not a meaningful cautionary statement, as defined in Section 21E of the 1934 Act, because at the time defendants knew there was deterioration already occurring.

4. A forward-looking statement is made with "actual knowledge" when the speaker makes the statement with the knowledge that he or she had no reasonable basis, or no basis at all, upon which to make it.

*The brief in* Slayton v. American Express Co., No. 08-5442*, can be found at* *http://www.sec.gov/litigation/briefs/2010/slayton0110.pdf, which appeals the district court's decision in Slayton v. American Express Co.*, 2008 WL 4501928 (S.D.N.Y. Sept. 26, 2008)

**SEC Argues in the Fifth Circuit that District Court Should Have Given Deference to Commission Rule**

The SEC brought an action against an entrepreneur for trading on confidential nonpublic information about a corporation, Mamma.com, that he agreed to maintain in confidence. As a result of his trading, defendant avoided losses in excess of $750,000, in violation of Section 17(a) of the 1933 Act, Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereafter.

The district court granted defendant's motion to dismiss, finding that the SEC failed to allege that defendant owed a duty not to use the confidential information, and therefore that the subsequent trading was not deceptive. The district court distinguished between non-disclosure and non-use of confidential information and held that defendant only agreed to non-disclosure.

On January 22, 2010, the Securities and Exchange Commission filed its Fifth Circuit appellate brief in *SEC v. Cuban, No. 09-10996*, arguing that the district court erred in holding that an agreement to keep information confidential does not mean an agreement not to trade and that the district court failed to give proper deference to a Commission Rule that specifically provided that an agreement to maintain information in confidence gives rise to a duty that makes trading on such confidential information deceptive. The SEC also contends that the complaint sufficiently alleges that defendant agreed both not to use and not to trade on the confidential information, thus making the subsequent trading deceptive.

The brief in *SEC v. Cuban, No. 09-10996*, can be found at http://www.sec.gov/litigation/briefs/2010/cubanbrief0110.pdf, which appeals the district court's decision in *SEC v. Cuban*, 634 F. Supp.2d 713 (N.D. Tx. 2009)

## NOTES:

[1] A trading center is defined as "a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent."