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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions

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This issue's Survey focuses on Securities and Exchange Commission ("SEC") rulemaking activities and major federal appellate or other decisions relating to the Securities Act of 1933 (the "1933 Act"), the Securities Exchange Act of 1934 (the "1934 Act"), the Investment Company Act of 1940 (the "1940 Act") and other Federal Securities laws during the first quarter of 2011.

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 a few of the many proposals put forth under the Dodd-Frank Act.

SEC Adopts Amendments Requiring Advisory Shareholder Votes On Executive Compensation and "Golden Parachute" Compensation Arrangements

On January 25, 2011, the SEC adopted 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. 33-9178; 34-63768).** The amendments were generally adopted as proposed, subject to some key changes.

As adopted:

- issuers will be required, not less frequently than once every three years, to provide a shareholder advisory vote to approve the compensation of their named executive officers. The separate

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shareholder vote on executive compensation is 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 required to be included beginning for issuers that are not smaller reporting companies at the first annual or other meeting of shareholders occurring on or after January 21, 2011. In connection with this vote, issuers will also need to briefly explain the general effect of the vote, such as whether the vote is non-binding.

- issuers will be required to address in the CD&A section of their proxy statement whether and, if so, how their compensation policies and decisions have taken into account the results of their most recent shareholder advisory vote on executive compensation.
- issuers will be required, not less frequently than once every six calendar years, to provide a separate shareholder advisory vote to determine whether the shareholder vote on the compensation of executives discussed above will occur every one, two, or three years. This advisory vote is required to be included beginning for issuers that are not smaller reporting companies at the first annual or other meeting of shareholders occurring on or after January 21, 2011. In connection with this vote, issuers will also need to briefly explain the general effect of the vote, such as whether the vote is non-binding.
- issuers will also be required to disclose, on Form 8-K, their decisions regarding how frequently shareholder advisory votes on executive compensation will be conducted. This information will need to be disclosed no later than 150 calendar days after the date of the end of the annual or other meeting in which the votes discussed above are required, but in no event later than 60 calendar days prior to the deadline for the submission of shareholder proposals under Rule 14a-8 of the 1934 Act for the subsequent annual meeting.
- issuers will be required to disclose certain information relating to named executive officers' golden parachute arrangements in both tabular and narrative formats, including quantitative disclosure of the individual elements of compensation that an executive would receive relating to a merger, acquisition, or similar transaction, and the total for each named executive officer. This disclosure is required in connection with materials filed in connection with a merger or similar transaction, including, information statements filed pursuant to Regulation 14C, proxy or consent solicitations that do not contain merger proposals but require disclosure of information under Item 14 of Schedule 14A pursuant to Note A of Schedule 14A, registration statements on Forms S-4 and F-4 containing disclosure relating to mergers and

similar transactions, going private transactions on Schedule 13E-3 and third-party tender offers on Schedule TO and Schedule 14D-9 solicitation/recommendation statements.

- issuers will be required to provide an 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 therein.

Smaller reporting companies are exempt from the amendments discussed above until the first annual or other meeting of shareholders occurring on or after January 21, 2013, with respect to shareholder advisory votes on executive compensation and the frequency of say-on-pay votes only. This exemption is not available for advisory votes on golden parachute compensation in connection with mergers or other extraordinary transactions.

SEC Adopts Rules Relating to Asset-Backed Securities Offerings

On January 20, 2011, the SEC adopted rules relating to representations and warranties disclosure in registered and private asset-backed securities transactions and issuer reviews of the underlying assets in such transactions. **(See SEC Release Nos. 33-9175 and 34-63741 and Nos. 33-9176 and 34-63742).** Generally, these rules require (i) securitizers of an asset-backed security ("ABS") to disclose fulfilled and unfulfilled repurchase requests; (ii) nationally recognized statistical rating organizations to disclose information regarding the representations, warranties and enforcement mechanisms available to investors in an ABS offering in any report accompanying a credit rating issued in connection with such offering; and (iii) issuers registering the offer and sale of an ABS to perform a review of the assets underlying the ABS.

Disclosure Requirements for Securitizers

As adopted, the rules require any securitizer[1] of an ABS to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by such securitizer, so that investors may identify asset originators with clear underwriting deficiencies. Under the new rule, a securitizer will provide this disclosure by filing new Form ABS-15G. Any securitizer that issued ABSs with a repurchase provision during the three-year period ending December 31, 2011, must make an initial filing covering such three-year period no later than February 14, 2012, if any of the ABSs are held by non-affiliates at the end of the period. Securitizers are also required to file quarterly reports for ABSs that contain a repurchase provision beginning in the first calendar quarter of 2012, and each quarter thereafter, if any of the securitizer's ABSs are outstanding and held by non-affiliates during such quarter.

Securitizers must disclose the following information in the prescribed tabular format:

- asset class of the ABS;
- identifying information for the issuing entity;
- information concerning the originator of the underlying assets;
- number, outstanding principal balance and percentage by principal balance of assets originated by each originator that were in the asset pool at the time of securitization; and
- number, outstanding principal balance and percentage by principal balance of assets (including, in the case of number and principal balance of assets, totals by asset class) that:
  - were subject of a demand to repurchase or replace for breach of representations and warranties;
  - were repurchased or replaced for breach of representations and warranties;
  - are pending repurchase or replacement for breach of representations and warranties due to the expiration of a cure period;
  - are pending repurchase or replacement for breach of representations and warranties because the demand is in dispute;
  - were not repurchased or replaced for breach of representations and warranties because the demand was withdrawn; and
  - were not repurchased or replaced for breach of representations and warranties because the demand was rejected.

Disclosure Requirements for Nationally Recognized Statistical Rating Organizations

As adopted, the rules require Nationally Recognized Statistical Rating Organizations to include in any report accompanying a "credit rating" on a 1934 Act registered ABS, a description of the representations, warranties and enforcement mechanisms available to investors and how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities.

Issuer Review of Assets Underlying the ABS

Depositors or sponsors of a securitization, i.e. the "issuer," are also required to conduct a review of the assets underlying the ABS being issued. They must, at a minimum, be able to provide reasonable assurance that the disclosure in the prospectus regarding the pool assets underlying the ABS is accurate in all material respects. They may rely on the third-party's review to satisfy its obligations under this rule, provided the third party is named in the registration statement and consents to being named as an "expert" in accordance with Section 7 of the 1934 Act and Rule 436 of the 1933 Act.

Once the review is complete, the issuer is required to disclose the findings and conclusions of its review, whether performed by the issuer or by a third party. Issuers must also disclose how the assets underlying the ABS deviate from the disclosed underwriting criteria and include data on the amount and characteristics of those assets that did not meet the disclosed standards. Issuers must also disclose the entity (e.g., sponsor, originator, or underwriter) who determined that such assets should be included in the pool, despite not having met the disclosed underwriting standards, and what factors were used to make the determination. Any registered offering of ABS commencing with an initial bona fide offer after December 31, 2011, must comply with the new rules.

SEC Proposes Rules to Suspend Reporting Obligations for Certain Asset-Backed Securities Issuers

On January 6, 2011, the SEC proposed new rules and amendments relating to the suspension of reporting obligations for certain asset backed securities issuers which are intended to implement provisions of the Dodd-Frank Act. **(See Release No. 34-63652.)** Specifically, the SEC is proposing rules and amendments to permit suspension of the reporting obligations for issuers of asset-backed securities ("ABSs") when the ABSs of the class sold in a registered transaction are no longer held by non-affiliates of the depositor. As proposed, the reporting obligations of issuers of ABSs would be suspended if at the beginning of any fiscal year (other than the fiscal year the registration statement of such ABS became effective) there were no longer any ABSs for a given class of ABS held by non-affiliates of the depositor.

SEC Proposes Amendments to Accredited Investor Standards

On January 25, 2011, the SEC proposed amendments to the accredited investor standards of the 1933 Act. **(See SEC Release No. 33-9177.)** As proposed, the amendments would clarify the definition of "accredited investor" to exclude the value of a person's primary residence for purposes of determining whether such person qualifies as an "accredited investor." Specifically, the SEC is proposing that indebtedness secured by an investor's primary residence would be netted against the value of the primary residence only up to the fair market value of the property. Accordingly, for purposes of determining whether an investor qualifies as an "accredited investor," an investor's net worth would be reduced by the amount of net equity in their primary residence.

SEC Proposes New Rules Relating to Reporting by Private Fund Advisers

On January 26, 2011, the SEC proposed rules to implement certain provisions of the Dodd-Frank Act to require investment advisers registered with the SEC that advise one or more private funds to file Form PF with the SEC. **(See SEC Release No. IA-3145.)** Form PF is intended to collect information about the basic operations and strategies of private funds in an effort to obtain a baseline picture of potential systemic risk across the private fund industry.

As proposed, the rules would require any investment adviser registered or required to register with the SEC that advises one or more private funds to file a Form PF. Funds that are not "Large Private Fund Advisers"[2] would only be required to provide certain basic information regarding any hedge funds they advise in addition to information about their private fund assets under management and more generally about their funds' performance and use of leverage. Funds that are "Large Private Fund Advisers" would provide additional information as follows:

Large Private Hedge Fund Advisers

For each hedge fund advised, Large Private Hedge Fund Advisers would be required to include, among other things, certain information about such hedge fund, including risk metrics, financing information and investor information, the duration of fixed income portfolio holdings and a geographic breakdown of investments held.

Large Private Liquidity Advisers

For each liquidity fund managed, Large Private Liquidity Advisers would be required to include, among other things, information concerning the applicable valuation method and such liquidity fund's portfolio and borrowing information.

Large Private Equity Advisers

For each private equity fund managed, Large Private Equity Advisers would be required to include, among other things, certain information about the fund's borrowings and guarantees, the leverage of the portfolio companies in which the fund invests and certain information concerning investments in any financial industry portfolio company.

Reference should be made to SEC Investment Advisers' Act Release 2011-133 (June 22, 2011) adopting new rules and thresholds regarding investment adviser registrations including reporting requirements for advisers who will be exempt from federal registration. The deadline for registration by advisers who are not exempt was extended to march 30, 2012. Such release will be a subject of the next SLRJ quarterly survey.

APPELLATE AND OTHER DECISIONS OF NOTE

Supreme Court Allows Zicam Case to Proceed, Despite Lack of Statistical Significance

Patients using the drug Zicam brought suit against the drug manufacturer, alleging a violation of Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder for failure to disclose adverse reports and a lawsuit concerning the drug.

The drug manufacturer moved to dismiss the complaint on the grounds that it lacked scienter because the number of negative reports were too few and therefore statistically insignificant. The district ruled in favor of the drug manufacturer, finding that statistical significance was necessary to show materiality.

On appeal, the Ninth Circuit reversed the lower court and remanded the matter, finding that plaintiffs properly pled materiality and that statistical significance was a question of fact for the jury.

On March 22, 2011, the Supreme Court affirmed the Circuit Court, allowing plaintiffs to proceed with their claims. Before the Supreme Court, the drug manufacturer argued that in pharmaceutical cases, statistically significant evidence is crucial given the amount of anecdotal reports about such products and that such anecdotal stories do not constitute reliable facts or material information within the meaning of Section 10(b) of the 1934 Act. On behalf of the plaintiffs, the Solicitor General argued that a company creates a duty to disclose once it chooses to speak, and that the drug manufacturer's positive statements about the drug, growth, and consumer demand obligated it to disclose the negative reports as well.

The Court rejected the drug manufacturer's argument, commenting that it rests on the flawed premise "that statistical significance is the only reliable indication of causation." Comparing the perspectives of the medical industry and investors, the Court held "Given that medical professionals and regulators act on the basis of evidence of causation that is not statistically significant, it stands to reason that in certain cases reasonable investors would as well." Further, applying the "total mix of information" standard, the Court held that plaintiffs adequately pled materiality because a reasonable investor would have considered this information as significantly altering the total mix of information available.

Despite ruling in favor of plaintiffs, however, the Court made clear that it did not believe that adverse reports must necessarily be disclosed and that the extent of a company's disclosure depends on what has been affirmatively disclosed in the past.

Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 179 L. Ed. 2d 398, Fed. Sec. L. Rep. (CCH) P 96249 (2011)

Portfolio Omissions May be Material, According to Second Circuit

Investors brought this action in connection with asset manager Blackstone Group's IPO, alleging that the registration and prospectus contained false and/or misleading information in violation of Sections 11, 12(a)(2) and 15 of the 1933 Act. Investors specifically identified certain troubled investments that the company failed to disclose information about, namely certainly portfolio companies and its real estate fund investment.

On February 20, 2011, the Second Circuit vacated and remanded the lower court's dismissal, finding that investors adequately alleged that omitted information about the asset manager's investments were material to its operations.

Item 303 of Regulation S-K, 17 C.F.R. § 229.303(a)(3)(11) governs the disclosure obligations and requires that the company "describe any known trends or uncertainties . . . that the registrant reasonably expects will have a material . . . unfavorable impact on . . . revenues or income from continuing operations."

The district court had dismissed the action for failure to adequately allege materiality of the omitted information. The district court analyzed the scale or quantative materiality of the omissions and the drop in revenues as compared to total revenues. The Second Circuit disagreed, analyzing the individual investments identified by plaintiffs. First, the Circuit Court noted that although certain transactions were reported in the press, the total mix of information available to an investor may include data in the public domain: "case law does not support the sweeping proposition that an issuer of securities is never required to disclose publicly available information." The Court distinguished between the public information, which disclosed the "mere fact" of the company's investment, and the company's disclosure requirement under Item 303 to state whether and to what extent these factors were reasonably likely to impact future revenues. The Court also noted that the company "is not permitted, in assessing materiality, to aggregate negative and positive effects on its performance fees in order to avoid disclosure of a particular material negative event." Finally, the Court emphasized the purpose of the disclosure requirements: "That is all Item 303 requires in order to trigger a disclosure obligation . . . a known trend that Blackstone reasonably expected would affect its investment and revenues."

Litwin v. Blackstone Group, L.P., 634 F.3d 706, Fed. Sec. L. Rep. (CCH) P 96033 (2d Cir. 2011)

Challenge to SEC Disclosure Rules Not Ripe For Review

On February 4, 2011, the U.S. Court of Appeals for the District of Columbia held that a hedge fund adviser's suit against certain SEC disclosure requirements was not ripe for review.

Section 13(f) of the 1934 Act requires institutional investment managers to file quarterly reports with the SEC, disclosing their holdings. This information is made public unless one the exemptions under Sections 13(f)(2) or 13(f)(3) applies. The hedge fund adviser sought an exemption under Section 13(f)(2), claiming that its investment positions were trade secrets, and under Section 13(f)(3) for confidential treatment. The adviser also asserted a First and Fifth Amendment argument that the disclosure requirements improperly compelled it to speak.

The SEC denied this request on the grounds that the adviser did not provide adequate factual support necessary under Section 13(f)(3) and that an exemption under Section 13(f)(2) is not granted "absent extraordinary circumstances" unless the adviser first seeks confidential treatment under Section 13(f)(3). As the adviser failed to seek and obtain confidential treatment pursuant to Section 13(f)(3) first, its request for an exemption under Section 13(f)(2) is denied.

The adviser appealed the SEC's determination, repeating its contentions under the First and Fifth Amendments. The Circuit Court rejected the appeal, affirming the SEC's conclusion, and held that the matter is not ripe for judicial review. The adviser must supplement the factual support provided to the SEC so that the SEC can make a determination of the adviser's claim for exemption. The Court noted that the adviser must wait until the SEC denies relief before seeking judicial intervention, and that the adviser suffered no hardship in the delay since no allegedly proprietary information had been disclosed.

Full Value Advisors, LLC v. S.E.C., 633 F.3d 1101 (D.C. Cir. 2011), *cert. denied*, 2011 WL 1750530 (U.S. 2011)

Insurance Representative Not an Investment Adviser Subject to Investment Adviser Act's Fiduciary Standard

Plaintiffs are a couple who purchased life insurance from a Metropolitan Life Insurance Company representative. The representative advised the couple without disclosing that he had a financial interest in selling Metropolitan Life products. The couple brought suit, alleging a violation of Section 10(b) of the 1934 Act and that the representative was an "investment adviser" subject to the regulations of the Investment Advisers Act of 1940 ("IAA") and thus the representative's actions constituted a violation of fiduciary duty under the IAA.

The district court held that the representative's actions fell within the broker-dealer exemption and was not held to the IAA's fiduciary standard. Further, plaintiffs' claims under the 1934 Act were dismissed for lack of standing. Plaintiffs' appealed the ruling with respect to their claims under the IAA. On February 2, 2011, the Tenth Circuit affirmed the lower court's decision.

The broker-dealer exemption of the IAA applies to brokers and dealers who give advice and (i) the advice is incidental to their conduct as brokers and dealers; and (ii) they receive no special compensation for their advice. Analyzing the meaning of the terms "incidental" and "special compensation," the Court interpreted the exemption to mean that:

> [T]he IAA excludes a broker-dealer who provides advice that is attendant to, or given in connection with, the broker-dealer's conduct as a broker or dealer, so long as he does not receive compensation that is (1) received specifically in exchange for the investment advice, as opposed to for the sale of the product, and (2) distinct from a commission or analogous transaction-based form of compensation for the sale of a product.

Based on this interpretation, the Court held the representative's advice in this case was given in connection with his conduct as a broker or dealer, that he did not receive compensation in exchange for his advice and the compensation was distinct from traditional, transaction-based compensation. Specifically, the Court noted that compensation was tied to selling products, not giving investment advice.

Thomas v. Metropolitan Life Ins. Co., 631 F.3d 1153 (10th Cir. 2011)

Failure to Disclose Does Not Necessarily Constitute Securities Fraud

Shareholders alleged that the company and two of its senior executives intentionally withheld information about regulatory changes and also made misrepresentations about the slowing of sales, in violation of Sections 10(b) and 20(a) of the 1934 Act and Rule 10b-5 promulgated thereunder. The shareholders further alleged that two senior executives, along with other insiders, sold over $42 million in company stock during the relevant period.

The district court dismissed this action for failure to meet the Private Securities Litigation Reform Act of 1995 ("PSLRA") standard for pleading scienter.

The First Circuit affirmed the lower court's dismissal of this securities class action on January 20, 2011. The Circuit Court noted that the fact that the company did not disclose all non-public information was not securities fraud and that the company reasonably believed that the regulatory changes would not have such an impact on sales as to require disclosure. Accordingly, the Court held that the explanation for nondisclosure was stronger than the inference of scienter. As to the insider trading allegations, the Court did not find the allegations gave rise to a strong inference of scienter because the complaint failed to allege such trades were unusual and lacked information about the executives' trading history.

City of Dearborn Heights Act 345 Police & Fire Retirement System v. Waters Corp., 632 F.3d 751, Fed. Sec. L. Rep. (CCH) P 96018 (1st Cir. 2011)

NOTES:

[1]Under the 1934 Act, a securitizer is either: (A) an issuer of an ABS; or (B) a person who organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer. The SEC considers both the sponsor and the depositor in a securitization transaction to be a "securitizer" for purposes of the Rule.

[2]Large Private Fund Advisers would be classified as (i) Advisers managing hedge funds that collectively have at least $1 billion in assets as of the close of business on any day during the reporting period for the required report ("Large Private Hedge Fund Advisors"); (ii) Advisers managing a liquidity fund and having combined liquidity fund and registered money market fund assets of at least $1 billion as of the close of business on any day during the reporting period for the required report ("Large

Private Liquidity Advisers"); and (iii) Advisers managing private equity funds that collectively have at least $1 billion in assets as of the close of business on the last day of the quarterly reporting period for the required report ("Large Private Equity Advisers").

