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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") and other Federal Securities laws during the third quarter of 2010.

SEC Rulemaking

SEC Amends Part 2 of Form ADV

On July 28, 2010, the SEC adopted amendments to Part 2 of Form ADV and related rules under the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act"). **(See SEC Release No. IA-3060).** The amendments require, among other things, registered investment advisers to provide new and prospective clients with a brochure and brochure supplements written in plain English so that new and prospective advisory clients have clearly written, meaningful, current disclosure of the business practices, conflicts of interest and background of the investment adviser and its advisory personnel.

Form ADV Part 2A — Disclosure Items.

As amended, part 2A of Form ADV requires the following disclosure:

- **Item 1. Cover Page** — Disclosure of the name of the firm, its business address, contact information, website, the date of the brochure and a statement that the brochure has not been approved by the SEC.
- **Item 2. Material Changes** — Identification and discussion of the material changes since the last annual update.
- **Item 3. Table of Contents.**
- **Item 4. Advisory Business** — A description of the advisory business, including the types of advisory services offered, advisory service specialty, if any, and the amount of client assets managed.

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- **Item 5. Fees and Compensation** — Disclosure of compensation for advisory services, whether fees are negotiable, whether clients are billed or fees are deducted directly, how often fees are assessed, a description of the fee schedule and a description of the types of other costs, such as brokerage, custody fees and fund expenses that clients may pay for the advisory services provided to them by the adviser.
- **Item 6. Performance-Based Fees and Side-By-Side Management** — Disclosure of whether an adviser charges performance-based fees or has a supervised person who manages an account that pays such fees.
- **Item 7. Types of Clients.**
- **Item 8. Methods of Analysis, Investment Strategies and Risk of Loss** — A description of methods of analysis and investment strategies and disclosure that investing in securities involves risk of loss which clients should be prepared to bear, including specific disclosure of how strategies involving frequent trading can affect investment performance and an explanation of the material or unusual risks involved for each significant investment strategy.
- **Item 9. Disciplinary Information** — Disclosure of material facts about any legal or disciplinary event that is material to a client's (or prospective client's) evaluation of the integrity of the adviser or its management personnel.
- **Item 10. Other Financial Industry Activities and Affiliations** — A description of material relationships or arrangements with related financial industry participants, any material conflicts of interest that these relationships or arrangements create, and how the adviser addresses the conflicts. Disclosure relating to any compensation arrangements or other business relationships between the adviser and such other participants, along with the conflicts created, and an explanation as to how these conflicts are addressed.
- **Item 11. Code of Ethics, Participation or Interest in Client Transactions and Personal Trading** — A description of the adviser's code of ethics, including a statement that a copy of the code is available upon request, any conflicts of interest resulting from the adviser's recommendations to clients relating to securities in which the adviser has a material financial interest and disclosure of personal trading by the adviser and its personnel.
- **Item 12. Brokerage Practices** — A description of how brokers are selected for client transactions and a determination of the reasonableness of brokers' compensation and disclosure of how advisers address conflicts of interest arising from their receipt of soft dollar benefits.

- **Item 13. Review of Accounts.**
- **Item 14. Client Referrals and Other Compensation** — A description of any arrangement under which an adviser compensates another for client referrals and any arrangement under which the adviser receives any economic benefit, including sales awards or prizes, from a person who is not a client for providing advisory services to clients.
- **Item 15. Custody** — An explanation that clients will receive account statements directly from the qualified custodian, such as a bank or broker-dealer that maintains those assets, if applicable, and a statement that clients should carefully review the account statements.
- **Item 16. Investment Discretion** — Disclosure of any discretionary authority over client accounts and any limitations clients may (or customarily do) place on this authority.
- **Item 17. Voting Client Securities** — Disclosure of proxy voting practices.
- **Item 18. Financial Information** — Disclosure of certain material financial information about the adviser.
- **Item 19. Index.**
- **Part 2A Appendix 1: The Wrap Fee Program Brochure** — Advisers that sponsor wrap fee programs are required to prepare a separate, specialized firm brochure (a "wrap fee program brochure" or "wrap brochure") for clients of the wrap fee program in lieu of the sponsor's standard brochure.

Advisers are required to deliver a current brochure before or at the time they enter into an advisory contract with the client. Additionally, no later than 120 days after the end of their fiscal year, advisers must provide to each client to whom they must deliver a brochure either: (i) a copy of the current (updated) brochure that includes or is accompanied by the summary of material changes; or (ii) a summary of material changes that includes an offer to provide a copy of the current brochure.

Form ADV Part 2B — The Brochure Supplement

Additionally, each firm brochure must be accompanied by brochure supplements providing information about the individual advisers on whom the particular client receiving the brochure relies for investment advice. The brochure supplement must include, among other things, information about the educational background, business experience, and disciplinary history (if any) of such persons.

The amendments are effective October 12, 2010.

SEC Adopts Rules Relating to "Pay to Play" Practices

On July 1, 2010, the SEC adopted rules addressing "pay to play" practices by investment advisers. **(See SEC Release No. IA-3043).** Specifically, the rules prohibit an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates.

Advisory Services to Government Clients

The rules prohibit an investment adviser from receiving compensation for providing advisory services to officials of government entities within two years after a contribution by the investment adviser or by any of its covered associates. The rules do not ban political contributions and do not limit the amount of any political contribution.

Officials and Government Entities

An official includes an incumbent, candidate or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser. Government entities include all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds, including participant-directed plans such as 403(b), 457, and 529 plans.

Contributions

A contribution includes a gift, subscription, loan, advance, deposit of money, or anything of value made for the purpose of influencing an election for a federal, state or local office, including any payments for debts incurred in such an election. Contributions are not limited to the investment adviser; they can also be made by "covered associates."

Covered Associates

Covered associates include (i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee controlled by the investment adviser or by any of its covered associates.

The rule includes adviser contributions made by a person within two years (or, in some cases, six months) of becoming a covered associate of that adviser, such that when an employee becomes a covered associate, the adviser must "look back" in time to that employee's contributions to determine whether the time out applies to the adviser.

Exceptions

Individuals may make aggregate contributions without triggering the two-year time out of up to $350 per election to an elected official or candidate for whom the individual is entitled to vote, and up to $150 per election to an elected official or candidate for whom the individual is not entitled to vote. These de minimis exceptions are available only for contributions by individual covered associates, not the investment adviser itself. Contributions that are not de minimis but are discovered within four months of the contribution and returned to the adviser within sixty days of the discovery will not count for purposes of the rule.

Placement Agents

As amended, the rules prohibit any investment adviser or any of the adviser's covered associates to provide or agree to provide, directly or indirectly, payment to any person to solicit government clients for investment advisory services on its behalf. The prohibition is limited to third-party solicitors and does not apply to any of the adviser's employees, general partners, managing members or executive officers.

Soliciting and Coordinating Contributions and Payments

The rules also prohibit advisers and covered persons from coordinating or soliciting any person or political action committee to make (i) any contribution to an official of a government entity to which the adviser is providing or seeking to provide investment advisory services, or (ii) any payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.

The rules are effective September 13, 2010.

SEC Adopts Amendments to Proxy Rules Relating to Director Nominations

On August 25, 2010, the SEC issued final rules relating to the rights of shareholders to nominate directors to a company's board. (**See SEC Release Nos. 33-9136; 34-62764).** Specifically the rules establish a framework for shareholders to nominate individuals to be included in a Company's proxy statement. The SEC also removed restrictions on shareholders' ability to use the shareholder proposal process to establish less restrictive procedures for the inclusion of shareholder director nominations in company proxy materials. The rules were to become effective 60 days after their publication in the Federal Register. **On October 4, 2010, the SEC granted a stay on the effectiveness of the rules pending review of the rules by the United States Court of Appeals (D.C. Cir.).[1] (See SEC Release Nos. 33–9149; 34–63031).**

Rule 14a-11

New Rule 14a-11 requires a company to include in its proxy statement and form of proxy director candidates nominated by a shareholder or a group of shareholders holding in the aggregate at least 3% of a company's outstanding shares entitled to vote on the election of directors. The shares must have been held continuously for at least three years, must be owned through the date of the meeting and the shareholder or group must state its intent to continue to hold such shares after the election. Nominations are due no earlier than 150 and no later than 120 calendar days before the anniversary of the date the company mailed its proxy materials for the prior year's annual meeting.[2] The maximum number of candidates a company must include is 25% of the total number of directors serving on the board.

- In calculating the 3% ownership requirement, ownership is reduced by any shares that a nominating shareholder has sold in a short sale. Shares borrowed by a nominating shareholder are excluded from the calculation, but shares loaned to others count towards the total, provided that the lender has the right to recall such shares and will do so upon being notified that its shareholder nominee(s) will be included in the company's proxy statement.
- The three-year holding period is measured from the date the shareholder files notification of its intent to nominate directors pursuant to Rule 14a-11.
- Any continuing directors who are not up for election in a given year, but were elected as a shareholder nominee pursuant to Rule 14a-11, will count toward the 25% maximum.
- The securities cannot be held with the purpose, or with the effect, of changing control of the company or to gain a number of seats on the board that exceeds the maximum number of nominees the company is required to include in its proxy materials.
- The nominee's candidacy or election cannot violate federal, state or foreign law or the rules of a national securities exchange or association.
- Shareholders who wish to submit a nominee for inclusion in a company's proxy statement are required to provide notice to the company of their intent on a new Schedule 14N. This Schedule is filed with the SEC and is publicly available.

If multiple shareholders or groups propose candidates, the nominees of the nominating shareholder or group with the highest qualifying voting power percentage will be included. If that number of nominees is less than the maximum number that must be included, the nominee(s) of the next largest shareholder or group must be included, and so on until the maximum number of nominees is included. If, prior to the printing of proxy materials, a director candidate is disqualified or becomes unavailable, the same order of priority must be used to identify a replacement candidate.

The nominating shareholder or group will also have the opportunity to provide a statement of support, to be included in the company's proxy materials, of up to 500 words per nominee.

Rule 14a-8

The SEC also revised Rule 14a-8 relating to shareholder proposals to enable shareholders to submit proposals to establish a procedure in a company's governing documents for the inclusion of one or more shareholder nominees for director in the company's proxy materials.

Companies will still be able to exclude shareholder proposals that:

- Would disqualify a nominee who is standing for election;
- Would remove a director from office before his or her term expired;
- Question the competence, business judgment, or character of one or more nominees or directors;
- Seek to include a specific individual in the company's proxy materials for election to the board of directors; or
- Otherwise could affect the outcome of the upcoming election of directors.

SEC Proposes New Rules Relating to Mutual Fund Distribution Fees and Disclosure

On July 21, 2010, the SEC proposed new rules relating to mutual fund distribution fees, charges and disclosure of sales charges. **(See SEC Release Nos. 33-9128; 34-62544).** The proposed rules are designed to protect individual investors from paying disproportionate amounts of sales charges in certain share classes, promote investor understanding of fees, eliminate outdated requirements, provide a more appropriate role for fund directors and allow greater competition among funds and intermediaries in setting sales loads and distribution fees generally.

Marketing and Service Fee

The SEC is proposing to permit funds, with respect to any class of fund shares, to deduct a fee of up to the NASD service fee limit (which is 25 basis points or 0.25 percent annually) from fund assets to pay for distribution activities, without being subject to the limitations on the proposed sales loads. The proposed rule would permit funds to bear expenses similar to those that fund boards generally approved pursuant to original Rule 12b-1. Fund boards would have the ability to authorize the use of fund assets to finance distribution activities consistent with the limits of the rule and their fiduciary obligations to the fund and fund shareholders. The marketing and service fee would be specifically identified and fully disclosed in the fund prospectus fee table as a type of operating expense. Under the proposed rule, the marketing and service fee could not, on an annual basis, exceed the limits on service fees prescribed by the NASD sales charge rule (currently 0.25 percent of fund net assets annually). Any charge in excess of 0.25 percent per year would be considered an asset-based sales charge and subject to the overall sales load limitations established by the NASD sales charge rule and other requirements.

Ongoing Sales Charges

The SEC has proposed to permit funds to deduct asset-based distribution fees in excess of the amount permitted (i.e., 25 basis points annually), provided that the excess amount is considered an "ongoing sales charge" subject to certain sales charge restrictions. Under the proposed provision, a fund could deduct an ongoing sales charge to finance distribution activities at a rate established by the fund, provided that the cumulative amount of sales charges the investor pays on any purchase of fund shares does not exceed the amount of the highest front-end load that the investor would have paid had the investor invested in another class of shares of the same fund.

Account-Level Sales Charges

The SEC has also proposed providing funds with an alternative approach to distributing fund shares through dealers. As proposed, a fund (or a class of the fund) could issue shares at net asset value and dealers could impose their own sales charges based on their own schedules and in light of the value investors place on the dealer's services.

Improved Disclosure

The SEC has also proposed new disclosure requirements to improve the transparency of sales loads and asset-based distribution fees. The amendments are designed to improve investors' understanding of the distribution related charges they would directly and indirectly incur as a result of investing in a fund.

Amendments to Form N-1A

As proposed, the rules would amend the Form N-1A to include:

- Disclosure of whether a fund charges marketing and service fees or ongoing sales charges and the rates of the fee and the purposes for which the fee is used, if applicable;
- Disclosure of the nature and extent of services provided in exchange for any marketing and service fee or ongoing sales charge deducted from fund assets;
- Disclosure of the amount of time until the shares automatically convert to another class without a charge and after which the shareholder would cease paying the charge, if applicable; and
- Disclosure, by funds that offer multiple classes of shares in a single prospectus, of the general circumstances under which an investment in one class of shares may be more advantageous than investment in another class of shares.

Mutual Fund Transaction Confirmations

As proposed, the rules would require mutual fund transaction confirmations to set forth the following information:

- The amount of any sales charge that the customer incurred at the time of purchase, in percentage and dollar terms, along with the net dollar amount invested in the security and the amount of any applicable breakpoint or similar threshold used to calculate the sales charge;
- The maximum amount of any deferred sales charge that the customer may pay in the future (expressed as a percentage of net asset value);
- The annual amount of that charge or fee, expressed as a percentage of net asset value;
- The aggregate amount of the ongoing sales charge that may be incurred over time, expressed as a percentage of net asset value;
- The maximum number of months or years that the customer will incur the ongoing sales charge; and
- The following statement: "In addition to ongoing sales charges and marketing and service fees, you will also incur additional fees and expenses in connection with owning this mutual fund, as set forth in the fee table in the mutual fund prospectus; these typically will include management fees and other expenses. Such fees and expenses are generally paid from the assets of the mutual fund in which you are investing. Therefore, these costs are indirectly paid by you."

SEC Proposes Amendments Relating to Short-Term Borrowing Disclosure

On September 17, 2010, the SEC proposed amendments relating to disclosure that issuers provide regarding their short-term borrowings. **(See SEC Release Nos. 33-9143; 34-62932).** Specifically, the SEC is proposing to require that issuers provide, in a separately captioned subsection of Management's Discussion and Analysis of Financial Condition and Results of Operations, a comprehensive explanation of their short-term borrowings, including both quantitative and qualitative information. As proposed, the amendments would apply to annual and quarterly reports, proxy or information statements that include financial statements and registration statements under the 1934 Act and the 1933 Act. The proposed amendments are designed to enhance investor understanding of an issuer's financial position and liquidity and are not intended as a substitute for management's current discussion and analysis of an issuer's financial condition and results of operations.

APPELLATE AND OTHER DECISIONS OF NOTE

Supreme Court Adopts "Transactional Test" and Dismisses Foreign-Cubed Action

On June 24, 2010, the Supreme Court affirmed and clarified the Second Circuit Court's dismissal of a foreign-cubed action, as previously discussed in this Journal (Vol 38 Issue 1 Securities Regulation Law Journal 5 pp. 80–81). In its ruling, however, the Supreme Court, rejected the Circuit Court's rationale and adopted a new standard.

Plaintiffs are shareholders of National Australia Bank ("NAB") who alleged that defendant NAB, a foreign company, made fraudulent statements from its headquarters in Australia in violation of Sections 10(b) and 20(a) of the 1934 Act and Rule 10b-5 promulgated thereafter. The alleged fraudulent statements concerned NAB's subsidiary, a mortgage service provider based in Florida. The mortgage service provider allegedly manipulated its books and records, and then provided those false numbers to NAB in Australia, who in turn incorporated them into the company's public filings and statements. NAB then revealed that certain interest assumptions in the mortgage service provider's valuation model were incorrect. As a result of the subsequent write-downs, NAB's stock price declined.

The U.S. Court of Appeals for the Second Circuit affirmed the lower court's dismissal, finding no subject matter jurisdiction over an action involving foreign plaintiffs, foreign issuers of securities, and where the transaction occurred outside of the country (known as a "foreign-cubed" action). The Circuit Court applied the "conduct test," where subject matter jurisdiction exists when "defendant's conduct in the United States was more than merely preparatory to the fraud, and particular acts or culpable failures to act within the United States directly caused losses to foreign investors abroad." Based on this standard, the Circuit Court concluded that it was the responsibility of the corporate headquarters, not the subsidiary in Florida, to report to its shareholders and the financial community and ensure the accuracy of the information distributed.

The Supreme Court held that the extraterritorial application of a U.S. statute, namely Section 10(b), is not an issue of subject matter jurisdiction but instead goes to the merits of the case. The Court then found that a presumption against extraterritoriality applied since the 1934 Act was silent on the issue. Further, the Court emphasized that the "focus of the Exchange Act is *not* upon the place where the deception originated, but upon purchases and sales of securities in the United States."

Based on the presumption against extraterritoriality and the text of Section 10(b), the Court adopted a bright-line "transactional test," holding that Section 10(b) can be applied *only* when "the purchase or sale is made in the United States, or involves a security listed on a domestic exchange." Applying this transactional test, the Court found that the shares at issue were traded on foreign exchanges and the relevant purchases and sales did not occur in the United States. Accordingly, the Court dismissed the case for failure to state a claim.

Morrison v. National Australia Bank, No. 08-1191 (U.S. June 24, 2010)

SEC's Case Against Entrepreneur for Deceptive Conduct Under Rule 10b-5 is Revived

On September 21, 2010, the Fifth Circuit reinstated the Securities and Exchange Commission's ("SEC") case against Mark Cuban, reversing and vacating the district court's dismissal.

As previously discussed in this Journal (Vol 38 Issue 3 Securities Regulation Law Journal 5 p. 293 and Vol 38 Issue 2 Securities Regulation Law Journal 6 pp. 174–175), the SEC brought an action against Cuban for allegedly trading on confidential nonpublic information about a corporation, Mamma.com, that he had agreed to maintain in confidence. As a result of his trading, the SEC argued that 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 thereunder. The District Court for the Northern District of Texas dismissed the action, and the SEC appealed to the Fifth Circuit.

Noting that Cuban only received the confidential information after he stated "I can't sell," the Court held that "the allegations, taken in their entirety, provide more than a plausible basis to find that the understanding between the CEO and Cuban was that he was not to trade, that it was more than a simple confidentiality agreement." Further, the Court remanded the case back to the district court for discovery.

SEC v. Cuban, No. 09-10996, 2010 WL 3633059 (5th Cir. Sept. 21, 2010)

Third Circuit Rejects "Fraud-Created-the-Market" Theory

Plaintiff, who purchased notes which were rendered worthless during the subprime mortgage crisis, brought suit against the accounting firm that assisted the issuer, alleging that the firm defrauded plaintiff and other investors by providing deficient audit opinions used to register the notes. Plaintiff's claims were brought under Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder.

The district court denied class certification, finding that plaintiff failed to establish a presumption of reliance, as required under the "fraud-created-the-market" theory (in lieu of proof of actual reliance), and therefore could not satisfy the predominance requirement for class certification under Rule 23(b)(3) of the Federal Rules of Civil Procedure. Plaintiff appealed.

A fraud-created-the-market theory provides that an investor can rely on the integrity of the market to the extent that the securities available on the market are properly entitled to be there. A presumption of reliance is established when plaintiff can show that defendant engaged in a scheme to fraudulently market securities that would not have been marketable if there had been full disclosure.

On August 16, 2010, the Third Circuit affirmed the district court's denial of class certification, and further rejected the fraud-created-the-market theory as a whole. The Court emphasized that the district court conducted a thorough analysis of the fraud-created-the-market theory and whether any of the approaches would give plaintiff a presumption of reliance.

In its decision, the Circuit Court noted that this issue is one of first impression for the Court, but that the fraud-created-the-market theory lacks common sense. First, the Court rejected the notion that a security's availability on the market is indicative of its genuineness and would therefore satisfy the reliance requirement because such availability does not guarantee that the security is free from fraud. The Court stated that some entity must act as a "bulwark against fraud" but those self-interested entities who bring a security to market cannot be relied upon to prevent fraud. Second, the Court held that even if it recognized the fraud-created-the-market theory, plaintiff still could not prove reliance because had the deficiencies in the audit been disclosed, the SEC would still have permitted the notes on the market. Finally, the Court also cited policy considerations in its holding.

Malack v. BDO Seidman LLP, No. 03-4475, 2010 WL 3211088 (3d Cir. Aug. 16, 2010)

Class Certification Based on "Fraud-on-the-Market" Theory

The Seventh Circuit affirmed and upheld the district court's class certification based on the "fraud-on-the-market" theory (absent proof of individual reliance) on August 20, 2010. Shareholders brought suit against a company's managers (their claims against the company itself were discharged in bankruptcy), alleging fraud in violation of Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder.

An element of a claim under Section 10(b) of the 1934 Act and Rule 10b-5 is reliance. In *Basic Inc. v. Levinson*, 544 U.S. 224 (1988), the Supreme Court articulated the fraud-on-the-market doctrine, which provides that the price of a well-followed and frequently traded stock would reflect the public information about a company, and thus, all investors essentially possess the same supply of information. This theory replaces the reliance element. Based on *Basic*, the district court granted class certification.

Defendants appealed, arguing that (i) their company does not qualify for fraud-on-the-market treatment because the alleged false statements at issue did not increase stock prices; (ii) before certification, the court must determine that the allegedly fraudulent statements caused a change in the stock price; and (iii) individual damages questions still predominated, thereby prohibiting class certification.

The Court rejected all of defendants' contentions. First, the Court noted that the fraud-on-the-market theory applies "whether the numbers are black or red" because "the fraud lies in an intentionally false or misleading statement, and the loss is realized when the truth turns out to be worse than the statement implied." Thus, it is "irrelevant" that this alleged fraud arises from efforts to slow or avoid declining prices instead of the more typical case of boosting prices. The Court also rejected defendant's argument that short sellers don't rely on the market price, and found that the presence of both long and short sellers does not affect class certification as both are "affected by news that influences the price they pay or receive." Second, the Court held that the determination of whether the statements at issue were false or whether they were material were questions on the merits that should not be addressed in certification. Further, the Court found that it was possible to certify a class even if the statements had only minor effects on the prices. Certification was permissible regardless of the chance of success. Finally, the Court pointed out that the possibility of individual determinations of damages did not preclude certification.

Schleicher v. Wendt, No. 1:02-cv-1332, 2010 WL 3271964 (7th Cir. Aug. 20, 2010)

Second Circuit Declines to Reconsider Refco Fraud Action

On July 26, 2010, the Second Circuit declined to reconsider its recent decision affirming the district court's dismissal of a securities class action against Mayer Brown LLP and one of its former partners, thus rejecting the arguments of the SEC, as previously discussed in this Journal (Vol 38 Issue 3 Securities Regulation Law Journal 5 pp. 295–96 and Vol 37 Issue 4 Securities Regulation Law Journal 5 p. 402).

Plaintiff alleged violations of Sections 10(b) and 20(a) of the 1934 Act and Rule 10b-5 promulgated thereunder, brought against Mayer Brown LLP and a former partner over their alleged roles in the Refco fraud. The district court dismissed the case, finding no primary violation. Plaintiff then appealed and the SEC submitted an amicus brief, arguing that one can be a primary violator by attribution or by intentionally creating a misstatement.

On April 27, 2010, the Court held that secondary actors can only be liable for false statements attributable to them at the time of dissemination of the false statement. Otherwise, the Court reasoned, plaintiffs cannot show they relied on defendants' false statements. At the time of dissemination, all of the statements were attributable to the broker and not the law firm or its lawyers.

Plaintiff had sought a rehearing before the Second Circuit, asserting that the dismissal imposes an additional condition for secondary liability, which conflicts with precedent.

Pacific Investment Management Co., LLC v. Mayer Brown LLP, No. 09-1619-vc (2d Cir. July 26, 2010)

No Private Right of Action Under Section 13(a) of the Investment Company Act

On August 12, 2010, the Ninth Circuit held that there was no private right of action under Section 13(a) of the Investment Company Act of 1940 ("ICA"), thus reversing the lower court.

Plaintiff, a registered investment advisory and financial planning firm, alleges a violation of Section 13(a) of the ICA, which governs changes to a funds' stated investment policies. Specifically, plaintiff claims that defendant failed to track the Lehman Brothers U.S. Aggregate Bond Index, which was the objective of the fund, and instead invested in riskier securities, which resulted in a lower return for investors than that of the Lehman Brothers U.S. Aggregate Bond Index.

Defendant moved for dismissal, contending that (i) plaintiff lacked standing to sue on behalf of its clients, who were the actual shareholders in the fund, and (ii) there is no private right of action under Section 13(a). The district court granted the dismissal motion as to the standing issue, but permitted plaintiff to amend its complaint. As to the second point, that there is no private right of action under Section 13(a), the district court denied defendant's motion, finding an implied private right through Section 13(c) of the ICA.

Plaintiff appealed and the Ninth Circuit reversed, holding that there is no evidence of Congressional intent to allow private enforcement. The Court also noted that a recent amendment, Section 13(c)(2)(A), specifically clarifies that nothing in Section 13(c)(1) "shall be construed to create, imply, diminish, change, or affect in any way whether or not" a private right of action exists under Section 13(a).

Northstar Financial Advisors, Inc. v. Schwab Investments, No. 09-16347, 2010 WL 3169400 (9th Cir. Aug. 12, 2010)

Scope of Rule 10(b) of the 1934 Act Includes Credit Default Swaps, but Southern District Dismisses Insider Trading Case

The SEC brought suit against a former hedge fund adviser and a salesman, for alleged insider trading of credit default swaps pursuant to Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder. The SEC alleged that the salesman obtained insider information and disclosed such information to the adviser, who then used this information to trade and ultimately made a profit of $1.2 million.

After a three-week trial, the district court held on June 25, 2010 that the information shared by defendants was neither material nor confidential, and dismissed the case. The district court also noted that the SEC failed to prove scienter as to the salesman. However, the district court concluded that Congress intended to give the SEC jurisdiction over credit default swaps and to bring this action because of the fact that it had expanded the antifraud provisions (Section 10(b) and Rule 10b-5) to include credit default swaps, and not other types of swaps when it passed the Commodity Futures Modernization Act in 2000, Pub. L. No. 106-554, 114 Stat. 2763.

SEC v. Rorech, No. 1:09-cv-4329, 2010 WL 2595111 (S.D.N.Y. June 25, 2010)

Ninth Circuit Clarifies Protection for Forward Looking Statements Under the Safe Harbor Provision

On June 30, 2010, the Ninth Circuit held that allegedly incomplete disclosures about a company's sales staff and allegedly misleading earnings projections did not amount to material omissions in violation of Section 10(b) of the 1934 Act and thus affirmed the lower court's decision.

Investors brought suit against the company, alleging that in January 2007, the company inflated its stock price by failing to disclose on a conference call the extent of the junior sales staff's poor performance and by providing misleading revenue projections. Defendants moved to dismiss, and the district court granted the dismissal, finding no material difference between the disclosures on the conference call and later disclosures. The court also held that the allegedly misleading earnings projections were within the Private Securities Litigation Reform Act's safe harbor protection for forward looking statements.

Plaintiffs appealed and the Ninth Circuit affirmed the dismissal. As to the incomplete disclosures, the Court explained that plaintiffs must allege more than failure to make complete disclosure under Section 10(b) and that Rule 10b-5 prohibits misleading and untrue statements, not incomplete ones. Further, the Court found that the company's earnings projections were forward looking statements that were accompanied by cautionary language, as required by the statute. The Court noted that plaintiffs argued that a sufficiently strong inference of actual knowledge of fraud should overcome safe harbor protection, which the Court deemed contrary to the plain language of the safe harbor statute.

In re Cutera Securities Litig., (Hamilton v. Conners), 610 F.3d 1103 (9th Cir. 2010)

NOTES:

[1]Business Roundtable v. SEC, DC Cir., No. 10–1305.

[2]For example, if a company mailed its proxy materials for its 2010 annual meeting on May 1, shareholders would need to notify the company of their intention to nominate directors at the 2011 annual meeting no earlier than December 2, 2010 and no later than January 1, 2011.