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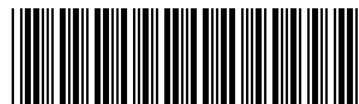

PERIODICALS

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Composite

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 decisions under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act") during the second quarter of 2004.

SEC RULEMAKING

SEC Adopts Rules Relating to Disclosure of Market Timing and Selective Disclosure of Portfolio Holdings

On April 19, 2004, the SEC adopted final rules relating to disclosures of market timing and selective disclosure of portfolio holdings. The new rules amend Form N-1A under the 1933 Act and the Investment Company Act of 1940 to require open-end management investment companies to disclose in their prospectuses both the risks to shareholders of frequent purchases and redemptions of investment company shares, and the investment company's policies and procedures with respect to such frequent purchases and redemptions. The new rules also amend Forms N-3, N-4 and N-6 to require similar prospectus disclosure for insurance company managed separate accounts issuing variable annuity and variable life insurance contracts. (See SEC Release No. 33-8408, April 19, 2004)

The new rules also amend Forms N-1A and N-3 to clarify that open-end management investment companies and insurance company managed separate accounts that offer variable annuities, other than money market funds, are required to explain both the circumstances under which they will use fair value pricing and the effects of using fair value pricing. Lastly, the new rules mandate open-end management investment companies and insurance company managed separate accounts that offer variable annuities to disclose both their policies and procedures with respect

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to the disclosure of their portfolio securities, and any ongoing arrangements to make available information about their portfolio securities. Initial registration statements on Forms N-1A, N-3, N-4 and N-6, as well as all post-effective amendments to effective registration statements on such forms, filed on or after December 5, 2004, must include the disclosure required by the new rules.

SEC Adopts Rules Relating to Disclosure of Breakpoint Discounts by Mutual Funds

On June 7, 2004, the SEC adopted final rules relating to disclosure of breakpoint discounts by mutual funds. The new rules require open-end management investment companies to provide enhanced disclosure relating to breakpoint discounts on front-end sales loads. The new rules mandate open-end management investment companies to describe in their prospectuses any arrangements that result in breakpoints in sales loads and to provide a brief summary of shareholder eligibility requirements. All initial registration statements, and all post-effective amendments that are either annual updates to effective registration statements or that add a new series, filed on Form N-1A on or after September 1, 2004, must include the disclosure required by the new rules. (See SEC Release Nos. 33-8427, 34-49817, June 7, 2004)

SEC Adopts Rules Relating to Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies

On June 28, 2004, the SEC adopted final rules to improve the disclosure provided by registered management investment companies about how their boards of directors evaluate and approve, and recommend shareholder approval of, investment advisory contracts. The amendments require a registered management investment company to disclose in its shareholder reports the material factors and the conclusions that formed the basis for the board's approval of an investment advisory contract. All fund reports to shareholders for periods ending on or after March 31, 2005, and all fund proxy statements on Schedule 14A filed on or after October 31, 2004, are required to comply with these new rules. (See SEC Release Nos. 33-8433, 34-49909, June 23, 2004)

The new rules require funds to disclose the factors considered relating to both the board's selection of the investment adviser, and the board's approval of the advisory fee and any other amounts to be paid under the advisory contract. Conclusory statements or a list of factors is not sufficient disclosure. A fund's discussion must relate the factors to the specific

circumstances of the fund and the investment advisory contract and provide a discussion of how the board evaluated each factor. The new rules require disclosure of at least the following topics: (i) the nature, extent and quality of the services to be provided by the investment adviser; (ii) the investment performance of the fund and the investment adviser; (iii) the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund; (iv) the extent to which economies of scale would be realized as the fund grows; and (v) whether fee levels reflect these economies of scale for the benefit of fund investors. Under the new rules, funds are also required to indicate whether the board relied upon comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, such as contracts of the same and other investment advisers with other registered investment companies or other types of clients. If the board made such comparisons, the fund must disclose the comparisons used and indicate how the comparisons assisted the board in concluding that the contract should be approved.

SEC Proposes Rules Relating to Ownership Reports and Trading by Officers, Directors and Principal Security Holders

On June 21, 2004, the SEC proposed amendments to Rules 16(b)-3 and 16(b)-7 under the 1934 Act. These rules exempt from the short-swing profit recovery provisions of Section 16(b), respectively, "Transactions between an issuer and its officers or directors," and "Mergers, reclassifications, and consolidations." The amendments were intended to clarify the exemptive scope of these rules, consistent with the previous SEC releases. Comments should be received on or before August 9, 2004. (See SEC Release No. 34-49895, June 21, 2004)

Rule 16(b)-3 exempts from Section 16(b) certain transactions between issuers and their officers and directors. In 1996 when the SEC revised Section 16(b)-3, it explicitly stated that "a transaction need not be pursuant to an employee benefit plan or any compensatory program to be exempt, nor need it specifically have a compensatory element.

Rule 16(b)-3(a) provides that "A transaction between the issuer (including an employee benefit plan sponsored by the issuer) and an officer or director of the issuer that involves issuer equity securities shall be exempt from [S]ection 16(b) of the Act if the transaction satisfies the applicable conditions set forth in this section." The only requirements for the exemption in transactions between the issuer and its officer or director are

the objective conditions set forth in later subsections of the rule, each of which applies to a different category of transactions.

To eliminate the uncertainty generated by recent case law (See Levy v. Sterling Holding Company, LLC, 314 F.3d 106 (3d. Cir. 2002), the SEC proposes to amend Rule 16(b)-3(d). As amended, this paragraph would be entitled “Acquisitions from the issuer,” and would provide that any transaction involving an acquisition from the issuer (other than a discretionary transaction), including without limitation a grant or award, will be exempt if any one of the rule’s three existing alternative conditions is satisfied. These conditions require:

- approval of the transaction by the issuer’s board of directors, or board committee composed solely of two or more non-employee directors;
- approval or ratification of the transaction, in compliance with 1934 Act Section 14, by the issuer’s shareholders; or
- the officer or director to hold the acquired securities for a period of six months following the date of acquisition.

Rule 16(b)-3(e) exempts an officer’s or director’s disposition to the issuer of issuer equity securities that is approved in advance in the manner prescribed by Rule 16(b)-3(d)(1) (by the issuer’s board of directors, or board committee composed solely of two or more non-employee directors) or Rule 16(b)-3(d)(2) (by the issuer’s shareholders in compliance with 1934 Act Section 14). Because these exemptive conditions of Rules 16(b)-3(d) and 16(b)-3(e) are identical and were intended to operate the same way, the SEC believes that clarification should apply to both Rules 16(b)-3(d) and 16(b)-3(e). Accordingly, the SEC proposes to further amend Rule 16(b)-3 by adding Note 4, to state:

> The exemptions provided by paragraphs (d) and (e) of this section apply to any securities transaction by the issuer with an officer or director of the issuer that satisfies the specified conditions of paragraph (d) or (e) of this section, as applicable. These exemptions are not conditioned on the transaction being intended for a compensatory or other particular purpose.

Rule 16(b)-7, entitled “Mergers, reclassifications, and consolidations,” exempts from Section 16(b) certain transactions that do not involve a significant change in the issuer’s business or assets. The rule is typically relied upon in situations where a company reincorporates in a different

state or reorganizes its corporate structure. Rule 16(b)-7(a)(1) provides that the acquisition of a security pursuant to a merger or consolidation is not subject to Section 16(b) if the security relinquished in exchange is of a company that, before the merger or consolidation, owned:

- 85% or more of the equity securities of all other companies party to the merger or consolidation, or
- 85% or more of the combined assets of all companies undergoing merger or consolidation.

Rule 16(b)-7(a)(2) exempts the corresponding disposition, pursuant to a merger or consolidation, of a security of an issuer that before the merger or consolidation satisfied either of these 85% ownership tests. Although Rule 16(b)-7 as originally adopted in 1952 only applied to "mergers" and "consolidations," the SEC staff construed it as also applying to reclassifications.

Although the rule does not contain specific standards for exempting reclassifications, the staff has applied to reclassifications the same standards as for mergers and consolidations. In relevant respects a reclassification is little different from a merger exempted by Rule 16(b)-7. In a merger exempted by the rule, the transaction satisfies either 85% ownership standard, so that the merger effects no major change in the issuer's business or assets. Similarly, in a reclassification the issuer owns all assets involved in the transaction and remains the same, with no change in its business or assets.

SEC Adopts Rule Revision Concerning Holding Period and Disclosure Requirements for SEC Members' and Employees' Investment Company Transactions

On April 14, 2004, the SEC adopted final rules amending its rule covering SEC members' and employees' securities transactions. The new rules update the definition of money market fund to comport with the language used by the Division of Investment Management in other contexts. The prior rules provided that all securities purchased by an SEC member or employee must be held for a minimum of six months, subject to limited exceptions. One of the exceptions provided that the holding period is not applicable to "shares of a unit investment trust having a term of less than six months." The new rules remove this exception. (See SEC Release No. 34-49562, April 14, 2004)

Pursuant to the prior rules, another exception provided that the six-month holding period is not applicable to "the transferring of funds with-

in a family of registered investment companies." The new rules amend this exception to provide that the six-month holding period is not applicable to the transferring of funds that have been held as shares in a registered investment company for a minimum of 30-days to another registered company within the same family of registered investment companies. This 30-day holding period does not apply to money market fund shares, which were already fully exempted from the six-month holding period.

The new rules also increase the reporting requirements for SEC members and employees. The prior rules required, subject to limited exceptions, that members and employees report every acquisition or sale of any security. One exception exempted mutual fund transactions occurring after the initial purchase has been reported. The new rules amended this exception to require SEC members and employees to report every purchase or sale of investment company shares, other than money market fund shares. With respect to money market fund shares, SEC members and employees are now required to report the initial purchase and final sale of such shares.

SEC Adopts Rules Exempting Foreign Banks from the Insider Lending Prohibition of 1934 Act Section 13(k)

On April 26, 2004, the SEC adopted final rules exempting qualified foreign banks from the insider lending prohibition provided in Section 13(k) of 1934 Act, as added by Section 402 of the Sarbanes-Oxley Act of 2002 (the "Act"). (See Release No. 34-49616, April 26, 2004) The effective date for the new rules was April 30, 2004. Section 402 of the Act prohibits both domestic and foreign issuers from making or arranging for loans to their directors and executive officers unless the loans fall within certain specified exemptions. One exemption permits certain insider lending by a bank or other depository institution that is insured under the Federal Deposit Insurance Act. Foreign banks whose securities are registered with the SEC are not eligible for the bank exemption under Section 13(k). The new rules exempt from Section 13(k)'s insider lending prohibition those foreign banks that satisfy certain specified criteria similar to those that qualify domestic banks for the statutory exemption. Among other criteria, the laws of the foreign bank's home jurisdiction must require the bank to insure its deposits or be subject to a deposit guarantee or protection scheme and the bank's loan must comply with certain insider lending restrictions regardless of whether the laws of the bank's home jurisdiction impose such restrictions.

SEC Adopts Rules Updating the Edgar Filer Manual

On April 19, 2004 the SEC adopted final rules revising the EDGAR Filer Manual to reflect updates to the EDGAR system. The EDGAR Filer Manual contains technical specifications for filers to submit filings using the EDGAR system. The effective date for the new rules was April 26, 2004. (See SEC Release Nos. 33-8409, 34-49580, April 19, 2004)

The revisions to the EDGAR Filer Manual were made primarily to support the mandatory electronic filing of Form ID, the application for access codes to file on EDGAR, via a new EDGAR Filer Management Web site and to support the initial period of the proposal to expand the information that the SEC requires certain open-end management investment companies and insurance company separate accounts to submit electronically via EDGAR regarding their series and classes (or contracts, in the case of separate accounts).

SEC Adopts Rules Mandating Electronic Filing for Form ID

On April 21, 2004, the SEC adopted final rules mandating the electronic filing of Form ID on a new on-line system. (See SEC Release Nos. 33-8410, 34-49585, April 21, 2004) Form ID is the application for access codes to file on the SEC's Electronic Data Gathering, Analysis and Retrieval System ("EDGAR") EDGAR. The effective date for the new rules was April 26, 2004. Prior to the effective date of these new rules, new issuers and other applicants applying for access codes to file on EDGAR were required to file a Form ID via fax.

New issuers and other applicants who are new filers are required to file Forms ID. Applicants must access the EDGAR Filer Management website to fill out and submit the forms, as EDGARLink filing is not available for submission of these forms. In addition, the SEC requires new filers to file an authenticating fax confirming the authenticity of the Form ID. Other types of filers (i.e., those who are not new filers) seeking to obtain access codes may obtain such codes via the EDGAR Filer Management website or the current EDGAR Filer or Online Forms websites without filing a Form ID.

To access and file Forms ID via the EDGAR Filer Management website, each applicant must provide all of the required information within a given session as the system does not provide a means to save an incomplete form. The system will validate for data type and required fields. Applicants will have the chance to correct errors and verify the accuracy of the information prior to submission. An on-line help function is also available to assist the user. The applicant will be able to add attachments

before submission and print the information submitted after submission. Modifications to EDGAR in connection with establishing the EDGAR Filer Management website will require applicants who file Form ID as well as users who log onto EDGAR for filing for the first time on or after the effective date to choose a passphrase.

APPELLATE DECISIONS OF NOTE

State Court Securities Actions May Be Remanded to Bankruptcy Court

On May 11, 2004, the Court of Appeals for the Second Circuit held that the district court properly removed state court securities fraud actions brought by a pension fund against a Chapter 11 debtor's officers and directors under the 1933 Act. Addressing an issue of apparent first impression, the Second Circuit held that the non-removal provision under Section 22 of the 1933 Act does not preclude removal of an action that is "related to" an ongoing bankruptcy proceeding. ***California Public Employees' Retirement System v. WorldCom, Inc.*, 368 F.3d 86 (2d Cir. 2004)**.

Court Requires Additional Showing Before Determining That Payments Are Extraordinary Under Sarbanes-Oxley

The SEC sought a determination that termination payments made by a corporation to its officers constituted "extraordinary payments" under the Sarbanes-Oxley Act. Such a determination would allow the SEC to continue escrowing these payments for the duration of a pending fraud action against the corporation's former officers. The district court agreed with the SEC and held that the payments were extraordinary payments within the meaning of section 1103 of Sarbanes-Oxley. On May 12, 2004, as a matter of first impression, the Ninth Circuit remanded, holding that payments are not deemed to be extraordinary simply by virtue of their amount, or the fact that an agreement on payments required extended negotiations, or because a corporation chose to report termination payments in Form 8-K filings. The Ninth Circuit instructed the district court that it first must make a determination of what would constitute "ordinary" payments in similar circumstances before it could determine what would be extraordinary. ***Securities and Exchange Commission v. Gemstar TV Guide International*, 367 F.3d 1087 (9th Cir. 2004)**.

Additional Findings Required To Support Class Certification

Investors sued Grant Thorton LLP under § 10(b) and Rule 10b-5 of the 1934 Act for securities violations in connection with the demise of a bank. On May 12, 2004, the Fourth Circuit Court of Appeals vacated the class certification and remanded to the district court, holding that the district court improperly concluded that the "fraud-on-the-market" presumption would preclude the necessity for individual determinations of reliance. The Court held that the district count improperly accepted at face value investors' claims that the reliance element could be presumed under the "fraud-on-the-market" theory in order to satisfy the requirement that common issues predominated. The Court found that a drop in stock price of a bank after its closure by the Controller of the Currency was not alone sufficient evidence to support a finding of market efficiency and hence a presumption of reliance under the "fraud-on-the-market" theory. The Court held that the district court must take a "close look" at the relevant matters, conduct vigorous analysis, and make findings to determine whether requirements for certification of a class action had been satisfied. ***Gariety v. Grant Thorton, LLP*, 368 F.3d 356 (4th Cir. 2004)**.

High Court To Review Loss-Causation Standard

In a somewhat related case, on June 28, 2004, the United States Supreme Court agreed to review a Ninth Circuit ruling, which held that "loss causation does not require pleading a stock price drop following a corrective disclosure or otherwise. It merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause." *Broudo v. Dura Pharmaceuticals, Inc*. 339 F.3d 933, 938 (9th Cir. 2003). In their December 24, 2003, certiorari petition, the defendants argued that the appeals court decision was inconsistent with the views of other Federal appeals courts and not practically viable. The Justice Department and the SEC, in an *amicus curia* brief, also urged the high court to review the matter, arguing that in order to plead "loss causation" in a securities fraud class action under the "fraud-in-the-market" theory, the plaintiff must allege a causal connection between the alleged fraud and the decline in the price of the security. ***Broudo v. Dura Pharmaceuticals, Inc.,* U.S., No. 03-932**.

Interlocutory Appeal Allowed To Determine If Fraud-on-the-Market Presumption Applied to Research Analyst

A state-employee pension fund, as lead plaintiff for a proposed class of investors, brought a securities fraud action under Rule 10b-5 against,

among others, Salomon Smith Barney ("SSB") and its research analyst Jack Grubman. The district court certified the class. Defendants SSB and Grubman sought leave to bring an interlocutory appeal. On May 7, 2004, the Second Circuit Court of Appeals allowed the appeal because it raised a novel legal question with a compelling need for immediate resolution, i.e., whether the "fraud-on-the-market" presumption, allowing plaintiffs to satisfy the element of reliance in securities fraud claims under the 1934 Act, could be applied to a research analyst's opinions without first finding that these opinions had affected the market price of the relevant securities. The Second Circuit held that the district court's decision extending, for the first time, the fraud-on-the-market presumption to analysts was significant because the decision would extend the potentially coercive effect of securities class actions to a new group of corporate and individual defendants—*i.e.*, to research analysts and their employers. ***Hevesi v. Citigroup Inc*****., 366 F.3d 70 (2d Cir. 2004)**.

"Any Security" Means "Any Type" of Security

A state-employee pension fund, an investor in a fiber optic supplier, brought a class action against an entity that had a business relationship with the fiber optic supplier. The pension fund claimed that the entity, a telecommunications provider, made misstatements that negatively impacted the fiber optic supplier's stock price. The investor claimed that the language in Section 10(b) and Rule 10b-5 under the 1934 Act referring to fraudulent conduct in connection with purchase or sale of "any security" includes securities of any company affected in some way by the alleged misstatements of the other entity. On May 19, 2004, the Second Circuit Court of Appeals, however, held that the "any security" refers to any type of security, and not any affected company's securities. Accordingly, the Court held that the investors lacked standing to sue under §10(b) and Rule 10b-5 when the company whose stock they purchased was negatively impacted by the material misstatement of the other company (whose stock they did not purchase). ***Ontario Public Service Employees Union Pension Trust v. Nortel Networks Corp*****., 369 F.3d 27 (2d Cir. 2004)**.

Lack of Damages No Bar to Finding Liability

On April 12, 2004, the Fourth Circuit Court of Appeals upheld a jury verdict, finding liability but awarding zero damages. The case grows out of derogatory statements made by employees of Asensio & Company, Inc. ("Asensio") about Chromatics Color Sciences International, Inc. ("CCSI"). Stockholders of CCSI brought this suit under Rule10b-5, alleging that these statements constitute material misstatements, which

Asensio initiated to defraud the market for its benefit, and which caused their CCSI stock to decline in value, resulting in substantial monetary losses to them. The jurors apparently found that plaintiffs offered sufficient evidence that Asensio's misrepresentations constituted one substantial cause of plaintiffs' loss resulting from the decline in value of CCSI stock and so found Asensio liable to plaintiffs. But, the jurors also apparently found, in light of contrary evidence of other market factors causing a price drop, that plaintiffs failed to offer evidence from which the jurors could discern the *amount* of recoverable damages resulting solely from Asensio's misrepresentations. ***Miller v. Asensio & Co., Inc.*, 364 F.3d 223 (4th Cir. 2004)**.

SEC Cease-and-Desist Order Held Invalid

In April 1997, WHX announced a hostile takeover of Dynamics Corporation of America ("DCA"). The tender offer extended only to those shareholders who were holders as of the record date, or who were able to obtain a valid proxy. After the SEC claimed that the record-holder condition violated the All Holders Rule and authorized an enforcement action to enjoin the tender offer, WHX withdrew the record-holder condition. Over a year later, the SEC ordered that WHX cease and desist from committing or causing any violations or future violations of Section 14(d)(4) of the 1934 Act or Rule 14d-10(a)(1) thereunder. WHX challenged this order in the Court of Appeals for the District of Columbia.

On April 9, 2004, the Court held that the imposition of the SEC's cease-and-desist order was arbitrary and capricious given the circumstances of WHX's violation, and vacated the Commission's order. The Court further held that the Commission erred in imposing the cease-and-desist order without a rational explanation of why such a sanction was appropriate under the Commission's own standards. ***WHX Corporation v. Securities and Exchange Commission*, 362 F.3d 854 (D.C. Cir. April 9, 2004)**.

"Proxy Revocation" Held 1934 Act Violation

On April 1, 2004, the Second Circuit unanimously concluded that dissident shareholders violated Federal securities laws by mailing a duplicate copy of MONY management's proxy card to MONY shareholders. The Appellate Court reversed a lower court decision entered on February 11, 2004, and was contrary to the position taken by the SEC. See *MONY Group, Inc. v. Highfields Capital Management*, LP, 2004 WL 253330, slip op. (S.D.N.Y. Feb. 11, 2004). The Second Circuit held that a duplicate copy of the proxy card constitutes a "form of revocation" under the

1934 Act Rule 14a-2(b)(1). Thus, the Court directed the district court to issue a preliminary injunction preventing the dissident shareholders from distributing the duplicate proxy cards. As a result of this decision, the furnishing of a duplicate proxy card must be preceded by the filing of a proxy statement by the dissidents and their compliance with the other requirements for a non-exempt solicitation under the federal proxy rules. ***MONY Group, Inc. v. Highfields Capital Management, LP*, 368 F.3d 138 (2nd Cir. 2004).**

This decision reversed a lower court decision entered on February 11, 2004, and was contrary to the position taken by the SEC. *See MONY Group, Inc. v. Highfields Capital Management, LP,* 2004 WL 253330, slip op. (S.D.N.Y. Feb. 11, 2004).