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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions

By Victor M. Rosenzweig

[*] This issue's Survey focuses on Securities and Exchange Commission ("SEC") rulemaking activities and major federal appellate decisions under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act") during the fourth quarter of 2005.

SEC Rulemaking

SEC Adopts Final Rules Revising the Definition of an Accelerated Filer and Accelerated Filer Deadlines for Periodic Reports

On December 21, 2005, the SEC issued final rules revising the definition of an accelerated filer and accelerated filer deadlines for periodic reports. **(See SEC Release Nos. 33-8644, 34-52989.)** Specifically, the amendments:

- create a new category of companies called "large accelerated filers";
- redefine the category of "accelerated filers";
- establish longer Form 10-K annual report and Form 10-Q quarterly report deadlines for accelerated filers;
- provide that only large accelerated filers will be subject to a final phase-in of the 60-day Form 10-K annual report deadline beginning with fiscal years ending on or after December 15, 2006;
- modify the requirements for exiting out of accelerated filer status; and
- establish requirements for exiting out of large accelerated filer status.

In 2002, the SEC adopted rules that subjected companies with $75 million or more in public float to accelerated deadlines for their annual re-

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ports on Form 10-K and quarterly reports on Form 10-Q. The accelerated deadlines were to be phased-in gradually over a three-year period. In 2004, the SEC postponed the final phase-in of the accelerated deadlines. Currently, an accelerated filer's annual report on Form 10-K is due within 75 days after fiscal year-end and its quarterly reports on Form 10-Q are due within 40 days after fiscal quarter-end. Beginning with the annual reports for the fiscal years ending on or after December 15, 2005, an accelerated filer's annual report on Form 10-K would have been due within 60 days after fiscal year-end and its quarterly reports on Form 10-Q would have been due within 35 days after fiscal quarter-end.

The new rules create a new category of large accelerated filers that include companies with a public float of $700 million or more. The new rules also redefine "accelerated filers" as companies that have at least $75 million, but less than $700 million, in public float.

The new rules change the filing deadlines as follows:

- large accelerated filers will be subject to a 60-day Form 10-K annual report deadline starting in fiscal years ending on or after December 15, 2006 (the new deadline is pushed back one year), and to a 75-day deadline until then;
- large accelerated filers will be subject to a 40-day Form 10-Q quarterly report deadline;
- the redefined accelerated filers will be subject to a 75-day Form 10-K annual report deadline; and
- the redefined accelerated filers will be subject to a 40-day Form 10-Q quarterly report deadline.

The periodic report filing deadlines for the other reporting companies remain unchanged. Nonaccelerated filers will continue to file their annual reports on Form 10-K or l0-KSB under the 90-day deadline and quarterly reports on Form 10-Q or 10-QSB under the 45-day deadline.

The new rules also modify the exit requirements out of accelerated filer status by permitting an accelerated filer whose public float has dropped below $50 million to file an annual report on a nonaccelerated basis for the same fiscal year that the determination of public float is made. The new rules provide for similar requirements for exiting out of large accelerated filer status, permitting a large accelerated filer to exit promptly out of large accelerated filer status once its public float has dropped below $500 million.

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SEC Proposes Interpretive Guidance on the Scope of Section 28(e)

On October 19, 2005, the SEC issued a proposed interpretive release providing guidance on the scope of the brokerage-allocation ("soft dollar") safe harbor in Section 28(e) of the 1934 Act. **(See SEC Release No. 34-52635, October 19, 2005.)** The release provides additional guidance and reaffirms some of the SEC's prior positions on: (i) the appropriate framework for analyzing "brokerage and research services" under the safe harbor, (ii) eligible research services, (iii) eligible brokerage services, (iv) treatment of mixed-use items, (v) good-faith determinations, and (vi) third-party research and commission-sharing arrangements.

The release provides that:

- Research must be "an expression of reasoning and knowledge" to qualify as "eligible research" under Section 28(e)'s safe harbor;
- To rely on Section 28(e), an investment manager must differentiate between computer hardware that receives the delivery of the research (non-eligible) and the software applications that are an expression of reasoning and knowledge (eligible);
- "Eligible Brokerage" begins when an order is transmitted to the broker-dealer, and ends at the conclusion of clearance and settlement of the transaction; and
- Prior positions on mixed-use items, third-party research and commission-sharing arrangements are reaffirmed by the SEC.

The Scope of Section 28(e)'s Safe Harbor

The release sets forth a three-step analysis to determine whether a product or service falls within Section 28(e)'s safe harbor. In making such a determination, the investment manager should:

- determine whether the product or service falls within the specific statutory limits of Section 28(e)(3) (i.e., whether it involves an eligible product or service);
- determine whether the product or service provides lawful and appropriate assistance in the performance of the investment manager's investment decision-making responsibilities; and
- make a good-faith determination that the amount of client commissions paid is reasonable in light of the value of the products or services provided by the broker-dealer.

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In determining whether a product or service qualifies as "eligible research," an investment manager must conclude that the product or service reflects an expression of reasoning or knowledge and relates to the following subject matter:

- advice as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities;
- analyses or reports regarding issuers, industries, securities, economic factors or trends, portfolio strategy, or the performance of accounts;
- consultants advising on portfolio strategy (not the manager's operations);
- market or economic data services satisfying the subject matter in Section 28(e)(3)(A) or (B);
- quantitative analytical software and software that provides, analyses of securities portfolios; and
- seminars or conferences where the content satisfies Section 28(e)(3)(A) or (B).

The SEC specifically stated that a data service could fall within the scope of the safe harbor provided it satisfies the subject matter criteria set forth in Section 28(e). The SEC emphasized that when an investment manager makes a determination, the manager must differentiate between the computer hardware that receives the delivery of the research and the software application that is an expression of reasoning and knowledge. The SEC explicitly stated that computer hardware and computer accessories, while assisting in the delivery of research, would not be eligible "research services" because they do not reflect substantive content related to making investment decisions.

The SEC noted that the following products and services are not "eligible research" within the scope of 28(e):

- telecommunications lines;
- transatlantic cables;
- telephone lines;
- office equipment;

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- travel expenses, entertainment and meals associated with attending an eligible seminar; and
- other operational overhead.

The final criterion for determining if a product or service falls within the safe harbor of Section 28(e) is whether the product or service provides the investment manager with lawful and appropriate assistance in making investment decisions. The SEC noted that although a product or service might satisfy the criteria set forth in Section 28(e), that product or service would not fall within the safe harbor of Section 28(e) if it were used for marketing purposes.

In addition, the SEC stated that the delivery mechanism (e.g., paper or electronic) of the research is not a factor when determining whether a product or service qualifies as "eligible research."

In addition to eligible research, certain brokerage products and services are also eligible for safe harbor protection under Section 28(e). In implementing a temporal standard for what constitutes eligible brokerage, the SEC stated that execution of transactions is a process, and that services related to the execution of securities transactions begin when an order is transmitted to the broker-dealer and end at the conclusion of clearance and settlement of the transaction.

The release provides the following examples of eligible brokerage:

- dedicated lines between the broker-dealer and the investment manager's order management system;
- lines between the broker-dealer and order management systems operated by a third-party vendor;
- dedicated lines providing direct dial-up service between the investment manager and the trading desk of the broker-dealer, and the message services used to transmit orders to broker-dealers for execution;
- software operated by a broker-dealer that routes orders to market centers; and
- algorithmic trading software.

The release also provides the following list of ineligible brokerage services:

- order management systems and hardware;

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- telephones or computer terminals;
- trade analytics;
- surveillance systems;
- compliance programs; and
- error correction trades and related services in connection with errors by investment managers.

Brokerage services will be eligible for Section 28(e)'s safe harbor only if the services provide the investment manager with lawful and appropriate assistance in carrying out the manager's responsibility, and the manager makes a good-faith determination that the amount of commissions paid is reasonable in relation to the value of the research and brokerage product or service received.

Mixed-Use Items

The SEC reaffirmed its position taken in its prior release regarding mixed-use items. The prior release stated that where a product has a mixed use, the manager should make a reasonable allocation of the cost in accordance with its uses. In addition, the investment manager should maintain adequate books and records to make and justify its good-faith determination. Finally, the SEC restated its earlier position that an investment manager relying on the Section 28(e) safe harbor must pay its own hard dollars for the ineligible portion when the manager receives both eligible and ineligible products or services for a bundled commission rate.

Good-Faith Determination That Commissions Are Reasonable

The SEC reaffirmed that an investment manager has an obligation under Section 28(e) to make a good faith determination that the commissions paid are reasonable in relation to the value of the brokerage and research services received. The SEC reaffirmed its prior position that "the determinative factor [in selecting a broker-dealer] is not the lowest possible cost but whether the transaction represents the best qualitative execution for the managed accounts."

The SEC also stated that an investment manager satisfies its good faith obligation under Section 28(e) if the manager can demonstrate that:

- the item is eligible under the language of the statute;
- the manager used the item in performing decision-making responsibilities over accounts as to which the manager exercises investment discretion; and

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- in good faith, the manager believes that the amount of commissions paid is reasonable in relation to the value of the research or brokerage product or service received.

Third-Party Research and Commission-Sharing Arrangements

The SEC reaffirmed its position that Section 28(e)'s safe harbor applies equally to in-house research obtained by a full-service broker-dealer as well as to third-party research provided by an executing broker-dealer. Section 28(e) requires that the broker-dealer receiving commissions must provide the brokerage or research services. The SEC continues to permit investment managers to use client commissions to pay for research produced by someone else other than the executing broker-dealer only if the broker-dealer has the direct legal obligation to pay and thus provide for the research.

When relying on Section 28(e)'s safe harbor, a manager must use the same method of analysis in determining whether a product or service is eligible under the safe harbor for third-party research as in-house research.

The SEC reaffirmed its prior view of more than one broker-dealer being involved in a commission sharing arrangement: the "introducing broker [must be] engaged in securities activities of a more extensive nature than merely the receipt of commissions paid to it by other broker-dealers for research services provided to investment managers."

SEC Proposes Amendments to the Tender Offer Best-Price Rule

On December 16, 2005, the SEC issued proposed rules changes to the best price rule for tender offers. **(See SEC Release No. 34-52968, December 16, 2005.)** The new rules are intended to resolve a split between the federal courts of appeals by clarifying that the best price rule applies only to the consideration paid for the securities tendered in connection with the tender offer and not to the payment of employee compensation unrelated to the number of securities held by such employee.

Under the proposed rules, the SEC added an exception to the best price rule for third-party tender offers for the negotiation, execution or amendment of an employee compensation, severance or other employee benefit arrangement, provided the amount payable relates solely to past services performed, future services to be rendered or refrained from rendering and is not based on the number of shares owned or tendered by the employee or director.

The proposed rules also provide for a safe harbor that allows the independent compensation committee or a committee of the target's or bid-

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der's board of directors (depending on which is party to the arrangement) to approve an employment compensation, severance or other employee benefit arrangement. Such approval allows the employee compensation, severance or other employee benefit arrangement to be excluded from the calculation of compensation paid to the holders of securities in connection with the tender offer for the purposes of the exception to the best price rule discussed above.

The proposed rules also provide that there is no specific time restriction on the application of the best price rule. This change is intended to eliminate the time restriction that some courts have applied and to encourage courts and practitioners to focus their analysis on whether payments are made in connection with the tender offer.

SEC Proposes Rules to Reduce the Burden on Foreign Companies Seeking to Leave the United States Markets

On December 23, 2005, the SEC proposed rules to reduce the burden on foreign companies seeking to leave the United States markets by terminating their registration and reporting obligations under 1934 Act Rules 12(g) and 15(d). **(See SEC Release No. 34-53020, December 23, 2005.)** The proposed rules would allow foreign companies to exit the United States if less than 5% of the trading volume of their stock takes place in United States markets, but only if less than 10% of the shares are owned by United States residents. If that figure is less than 5%, the company may leave the United States market regardless of volume. These proposals would supplement the existing thresholds for de-registration under the 1934 Act which continue to be in force.

SEC Advisory Committee Proposes Rules To Lessen the Burden of Sarbanes-Oxley on Small Public Companies

The SEC's advisory committee on small business voted to ask the SEC to allow most companies with market values of less than $700 million to avoid having their internal controls certified by auditors. **(See The Preliminary Report of the Internal Controls Subcommittee to the Advisory Committee on smaller public companies at www.sec.gov/info/smallbus/acspc/pr-intcontrol.pdf.)** Such a change would exempt 80% of United States companies from having to comply fully with the Sarbanes-Oxley Act (the "S-O Act") (Pub. L. No. 107-204, 116 Stat. 745, 15 U.S.C.A. §§ 7201-7266). The advisory committee recommended that most companies with market capitalizations under $100 million be exempted totally from the S-O Act. It further recommended that companies with market capitalizations of $100 million to $700 million not face au-

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dits of internal controls. Some companies with large revenues but low market values would still be required to comply with the S-O Act.

SEC Proposes Amendments to Proxy Rules to Permit Internet Availability of Proxy Materials

On December 8, 2005, the SEC released proposed rules to amend the proxy rules under Section 14(a) of the 1934 Act to allow companies to satisfy their Section 14(a) obligations by providing proxy solicitation materials through an electronic medium. **(See SEC Release No. 34-52926.)** The proposed amendments allow issuers to post proxy materials on a publicly-accessible website, and to deliver a notice of the Internet availability of these materials at least 30 days prior to the shareholders' meeting to which the materials relate. The required notice must include:

- a specified prominent legend noting the date, time and location of the shareholder meeting,
- the address of the Internet website where shareholders may access the materials,
- a toll-free phone number and email address where shareholders may request a free paper copy of the materials, and
- clear and impartial descriptions of the matters to be discussed at the meeting with recommendations regarding those matters.

The notice must be written in plain English and may not contain any other information. Issuers are also prohibited from distributing any other shareholder communications with the notice to ensure that the notice is not overwhelmed by other disclosures. Banks, brokers, and other intermediaries are required to forward the notices to the beneficial owners. Issuers must respond to requests for paper copies within two business days.

The proposed amendments present an alternative "notice-and-access" model for both issuers and third parties to communicate with shareholders and are intended to provide more timely and complete access to proxy materials while decreasing the associated costs and barriers. The proposed notice-and-access model would be available in substantially the same form to third parties soliciting proxies other than on behalf of an issuer. Similar to the current proxy rules, a party other than the issuer is not required to solicit all shareholders, but may target specific shareholders, including only those willing to receive proxy materials electronically. Soliciting persons who undertake to deliver paper copies upon request must

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provide the notice within 30 days of the shareholders' meeting or within 10 days of the company filing its proxy materials.

APPELLATE DECISIONS OF NOTE

Distribution of Stock in Publicly-Traded Shell Corporations Violates the Registration Requirements of the '33 Act

The SEC brought an enforcement proceeding against sellers of publicly traded "shell" corporations for, among other, things, failure to comply with the registration requirements of the '33 Act. The United States District Court for the Southern District of New York granted the SEC's motion for summary judgment on liability grounds, and the sellers appealed. On September 27, 2005, the Court of Appeals for the Second Circuit affirmed, finding that the sellers were ineligible for exemption from the registration requirements under either Section 4(1) or Rule 144(k) of the '33 Act. Specifically, because the sales transactions involved underwriters, Section 4(1)'s exemption did not apply; additionally, the sellers were not entitled not Rule 144(k)'s "safe harbor" because the securities they sold had been acquired from affiliates of the issuers within two years, rather than after at least two years. The Court also affirmed the imposition of civil penalties against the sellers pursuant to Section 20(d) of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 because the sellers were aware that their acts involved fraudulent manipulation of the market. ***Securities and Exchange Commission v. Kern*, 425 F.3d 143 (2d Cir. 2005).**

Supreme Court Declines to Review Ninth Circuit's Interpretation of Section 1103 of the Sarbanes-Oxley Act of 2002

The SEC applied for, and the district court entered, an order pursuant to Section 1103 of the Sarbanes-Oxley Act of 2002, in which it placed in escrow some $37 million of contemplated one-time payments by a corporation to its resigning CEO and CFO. Section 1103 provides that during an SEC investigation covering possible securities violations committed by an issuer of publicly traded securities, and when it appears to the SEC that it is likely that the issuer will make "extraordinary payments" to officers or other controlling persons of the issuer, the SEC may petition a court for a temporary order requiring the issuer to place any such contemplated payments in escrow for 45 days. The CEO and CFO intervened in the action and appealed, claiming that Section 1103 is unconstitutionally vague on its face and as applied to them, and that the district court erred as a matter of law in interpreting the statutory language, "extraordi-

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nary payments." On March 22, 2005, the Court of Appeals for the Ninth Circuit affirmed, finding that "extraordinary" simply means, "out of the ordinary," and to determine whether payments were "extraordinary," a court must look in context at the circumstances, purpose, and size of the payment in comparison to the company's normal behavior. On October 11, 2005, the Supreme Court declined to review the Ninth Circuit's ruling. ***Yuen v. SEC*, U.S., No. 04-1723 (October 11, 2005).**

First Circuit Defines "Efficient Market" as One that Incorporates All Publicly-Available Information into Stock Price

Investors brought a putative class action, alleging securities fraud pursuant to Section 10(b) of the '34 Act and Rule 10b-5 promulgated thereunder, as well as under Section 20(a) of the '34 Act against several medical supply corporations and related defendants. Plaintiffs relied on the fraud-on-the-market theory, which relieves plaintiffs of the burden of showing individualized reliance on a misstatement by the defendant, by setting forth a rebuttable presumption of reliance on the "integrity of the market price" that reflected the misstatement. The fraud-on-the-market theory is premised on an "efficient" market. The district court granted class certification, defining an "efficient" market as one in which "market professionals generally consider most publicly announced material statements about companies," *as opposed to* one in which "a stock price rapidly reflects all publicly available material information." On December 13, 2005, the Court of Appeals for the First Circuit disagreed, determining that an "efficient" market is one in which the market *fully* translates *all publicly available* information available about a particular stock to that stock's price. ***In re PolyMedica Corp. Securities Litigation*, 2005 WL 3384083, 432 F.3d 1 (1st Cir. Dec. 13, 2005).**

In a companion case to *PolyMedica*, *supra*, decided on the same day, the First Circuit employed the same definition of "efficient" market. However, the court clarified the definition by stating that although the stock price had to reflect all publicly available information, it did not have to "perfectly and correctly incorporate it." Thus, the court concluded that the fraud-on-the-market theory's presumption of reliance "does not depend on the accuracy of the market price." ***In re Xcelera.com Securities Litigation*, 430 F.3d 503 (1st Cir. 2005).**

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Claims Properly Dismissed Where Investors Failed to Show Falsity of Analyst Recommendations

Investors brought a class action pursuant to Section 10(b) and Rule 10b-5 of the '34 Act against a financial services firm and its analysts, alleging that the analysts made misleading statements of opinion about a corporation's stock while the firm was trying to acquire the corporation's investment banking business. The district court dismissed the investors' claims, finding that the investors had not met the requirements for pleading subjective falsity in a misstatement of opinion. On December 12, 2005, the Court of Appeals for the First Circuit agreed, concluding that the investors' claims were insufficient to prove that the analysts' reports regarding the corporation differed from the analysts' undisclosed beliefs. Specifically, the First Circuit found that plaintiffs failed to plead subjective falsity with the requisite particularity, because efforts to so plead "merely by identifying an overarching scheme or corrupt environment" are insufficient. ***In re Credit Suisse First Boston Corp. (Agilent Technologies, Inc.) Analyst Reports Securities Litigation*, 431 F.3d 36 (1st Cir. 2005).**

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