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# Quarterly Survey of SEC Rulemaking and Major Appellate Decisions

*By Victor M. Rosenzweig**

*This issue's Survey focuses on Securities and Exchange Commission ("SEC") rulemaking activities and major federal appellate or other decisions relating to the Securities Act of 1933, as amended, (the "1933 Act"), the Securities Exchange Act of 1934, as amended, (the "1934 Act"), and other Federal Securities laws from January 1, 2013, through March 27, 2013.*

## SEC Rulemaking

### SEC Adopts Amendments to Rule 17Ad-17 Regarding Lost Securityholders and Unresponsive Payees

On January 16, 2013, the SEC adopted amendments to Rule 17Ad-17 of the 1934 Act to implement certain requirements under Dodd Frank regarding lost securityholders and unresponsive payees. Section 929W of the Dodd-Frank Act added subsection (g) to Section 17A of the 1934 Act. Section 17A(g), requires the SEC to revise 1934 Act Rule 17Ad-17 to extend the obligation to search for lost securityholders to brokers and dealers in addition to recordkeeping transfer agents. The Commission also adopted an amendment to Rule 17Ad-7(i) and new Rule 15b1-6 which is a technical rule that will assist in notifying brokers and dealers of their new obligations under Section 17A(g) of the 1934 Act and the rules thereunder. The amendments will become effective on March 25, 2013, with a compliance date of January 23, 2014. **(SEC Release No. 34-68668.)**

Rule 17Ad-17(g), Due Diligence for the Delivery of Dividends, Interest, and Other Valuable Property Rights, provides, that in addition to transfer agents, brokers and dealers must also search for lost securityholders. Lost securityholders is defined as a securityholder: "(i) to whom an item of correspondence that was sent to the securityholder at the address contained in the transfer agent's master securityholder file or in the customer security account record of the broker or dealer has been returned as undeliverable; provided,

*Member, New York Bar. Of Counsel, Olshan Frome Wolosky LLP. Associates Camielle Green and Mason Barney assisted the author.

however, that if such item is re-sent within one month to the lost securityholder, the transfer agent, broker, or dealer may deem the securityholder to be a lost securityholder as of the day the re-sent item is returned as undeliverable; and (ii) for whom the transfer agent, broker, or dealer has not received information regarding the securityholder's new address."

In addition, paying agents are required to notify payees who have been unresponsive to their communications, that the paying agent has sent a securityholder a check that has not yet been negotiated. Such a notice must be sent no later than seven months after a check has been sent by the paying agent that has not yet been negotiated. The securityholder is considered "missing" if the check sent to said securityholder is not negotiated before the earlier of the paying agent sending the next regularly scheduled check or the six months has passed since the paying agent sent the not yet negotiated check. Paying agent includes any issuer, transfer agent, broker, dealer, investment adviser, indenture trustee, custodian, or any other person that accepts payments from the issuer of a security and distributes the payments to the holders of the security. If, however, the value of the check is less than $25, the paying agent is not required to send such notification. Further, these notification requirements have no effect on state escheatment laws.

## SEC Adopts Temporary Rule with Respect to Principal Trades with Certain Advisory Clients

On December 20, 2012, the SEC amended Rule 206(3)-3T under the Investment Advisers Act of 1940. That Rule provides, in part, substantive and disclosure requirements for trades between advisers or broker-dealers with their advisory clients. The amendment extends the date on which Rule 206(3)-3T will sunset from December 31, 2012, to December 31, 2014. The SEC originally proposed this amendment on October 9, 2012. The amendments became effective on December 28, 2012, and were discussed in the Quarterly Survey of SEC Rulemaking and Major Appellate Decisions, Spring 2013, Volume 41, No. 1. **(See Release No. IA-3522.)**

## SEC Proposes Regulation With Respect to Systems Compliance and Integrity

On March 7, 2013, the SEC proposed Regulation Systems Compliance and Integrity ("Regulation SCI") under the 1934 Act and conforming amendments under Regulation ATS, also under the 1934 Act. Under the proposed regulation, certain self-regulatory organizations will be required to comply with requirements in connection with their automated systems that support the performance of their regulated

activities. Regulation SCI would replace the SEC's voluntary Automation Review Policy ("ARP") and the policy statements in connection therewith that are currently in place. The SEC is also requesting comments on whether Regulation SCI should include broker-dealers that execute client orders internally. Comments are due on or before May 24, 2013. **(SEC Release No. 34-69077.)**

Regulation SCI, which would be applicable to certain self-regulatory organizations, including registered clearing agencies, alternative trading systems ("ATSs"), plan processors, and exempt clearing agencies (collectively, "SCI entities"), would require, among other things, that these entities establish written policies and procedures that are reasonably designed to ensure their systems are in optimal operational condition. Further, under the proposed regulation, in addition to proposing that SCI entities maintain books and records, the SEC has proposed a Form SCI which would enable SCI entities to submit notices and reports to the SEC regarding certain "SCI events" and material system changes. An SCI event would include systems disruptions, compliance issues and system intrusions. In addition, proposed Regulation SCI would require that SCI entities: (1) circulate information regarding certain SCI events to members or participants of the SCI entity; (2) report material systems changes to the SEC; (3) conduct an SCI review of its systems at least once each calendar year; (4) submit certain periodic reports to the SEC, which reports will include the SCI review, together with any response by senior management; (5) establish mandatory, scheduled testing of the operation of their business continuity and disaster recovery plans and coordinate the mandatory scheduled testing of their systems on an industry- or sector-wide basis with other SCI entities; and (6) make, keep, and preserve records relating to the matters covered by Regulation SCI, and provide them to the SEC upon request.

A significant component of the proposed Regulation SCI concerns ATSs. Presently, ATSs are regulated under Regulation ATS. Pursuant to Regulation ATS, certain aspects of the ARP policy statements are mandatory for significant-volume ATSs. However, as there are no such significant-volume ATSs, there are no ATSs that must report to the SEC pursuant to ARP policy. Under the proposed Regulation SCI, the reporting threshold has been lowered, therefore bringing ATSs under regulation. Specifically, under the proposed definition, (1) average daily dollar volume thresholds would replace average daily volume thresholds for ATSs that trade national market system ("NMS") stocks or equity securities that are not NMS stocks; (2) alternative average daily dollar and transaction volume-based tests for ATSs that trade municipal or corporate debt securities would be used; and (3) volume thresholds for ATSs for each category of asset class would be lowered. An ATS meeting the significant-volume thresholds would fall

under the definition of "SCI entity" and would therefore be subject to the requirements of Regulation SCI. Further, the proposal contemplates moving ATS regulation from Regulation ATS to Regulation SCI.

## APPELLATE AND OTHER DECISIONS OF NOTE

### Supreme Court Rules that Materiality Need Not be Proven to Certify a Class

On February 27, 2013, the Supreme Court affirmed the Ninth Circuit holding that materiality of false statements is not a prerequisite to class certification in a securities-fraud class action for violation of Section 10(b) of the 1934 Act and Rule 10b-5.

Plaintiffs claimed that Amgen Inc. ("Amgen") made false statements regarding the effectiveness of certain drugs and that members of the class had relied on these statements under a fraud-on-the-market theory. Amgen argued that at the class certification stage, in order to show that "the questions of law or fact common to class member predominate" under Rule 23(b)(3), plaintiffs must prove, rather than plausibly plead, that the misrepresentations materially affected the company's stock price.

The Ninth Circuit disagreed with Amgen and held that plaintiffs need only plead materiality because the element of materiality is always common to all class members. The Supreme Court affirmed. The Court focused on the requirement in Rule 23 "that *questions* common to the class predominate, not that those questions will be answered, on the merits, in favor of the class." Thereafter, the court noted that materiality "is judged according to an objective standard" and thus is common to all members of the class, therefore, whether the misstatements were "material or immaterial, would be so equally for all investors composing the class."

*Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, 133 S. Ct. 1184, Fed. Sec. L. Rep. (CCH) P 97300 (2013)

### Supreme Court Holds Discovery Rule does not Apply to SEC Civil Enforcement Actions

On February 27, 2013, the Supreme Court held that the five-year statute of limitations found in 28 U.S.C.A. § 2462 is not tolled by the discovery rule when the SEC seeks to enforce civil penalties.

In 2008 the SEC brought a civil enforcement action against the defendants Alpert and Gabelli, claiming that they aided and abetted investment adviser fraud from 1999 until 2002. The defendants moved to dismiss the action as untimely under Section 2462. The SEC argued

that the common law discovery rule should apply to toll the statute of limitations until the fraudulent actions were discovered or could have been discovered.

The District Court disagreed with the SEC and dismissed the action as time barred. The Second Circuit reversed, holding that because the limitations period under Section 2462 begins to run "from the date when the claim first accrued" the discovery rule should apply. The Supreme Court reversed the Second Circuit and dismissed the complaint. The Supreme Court ruled that the limitations period begins to run when the fraud occurs. The Court reasoned that "[u]nlike the private party who has no reason to suspect fraud, the SEC's very purpose is to root it out, and it has many legal tools at hand to aid in that pursuit." Furthermore, the rationale behind the discovery rule is to ensure that victims are compensated, not to aid the government in seeking penalties to punish. However, it should be noted that, at oral argument, both sides agreed that the five-year limitations period under Section 2462 does not apply to equitable remedies such as disgorgement or injunctive relief, and the Supreme Court did not address such actions.

*Gabelli v. S.E.C.*, 133 S. Ct. 1216, Fed. Sec. L. Rep. (CCH) P 97299 (2013)

## Second Circuit Refuses to Apply Section 16(b) to Sale and Purchase of Two Different Classes of Stock

On January 7, 2013, the Second Circuit affirmed the Southern District of New York's holding that Section 16(b) of the 1934 Act does not impose liability when insiders sell shares of one type of stock issued by the company and purchase shares of a different type of stock in the same company.

Over the course of two weeks, defendant, a director of Discovery Communications, Inc., engaged in nine sales of the company's "Series C" stock and ten purchases of the company's "Series A" stock. Plaintiffs brought suit under Section 16(b) demanding disgorgement of any profits.

The District Court granted dismissal because Section 16(b) uses the term "any equity security" in the singular. The Second Circuit affirmed, agreeing with the District Court's statutory interpretation and holding that the Section only applies to the purchase and sale or sale and purchase of the same security. The Second Circuit rejected the claim that the two types of stock were the same security because they were "economically equivalent." The Circuit noted that the types of stock were distinguishable in that they were separately traded, could not be converted into one another, had different voting rights, and their prices floated independent of one another. The Court also

rejected the argument that the two types of stock were "sufficiently similar" to be paired under Section 16(b). Even though the Court "acknowledged the plausibility of this interpretation," absent contrary guidance from the SEC, it believed that such an interpretation would undermine Congress' intent to create a mechanical rule that was easily applied.

*Gibbons v. Malone*, 703 F.3d 595, Fed. Sec. L. Rep. (CCH) P 97250 (2d Cir. 2013)

## Second Circuit Holds that Press Release Containing no Omissions was not Misleading

On February 1, 2013, the Second Circuit ruled that a press release that contained no actual falsehoods or omissions that rendered statements misleading could not form the basis of a claim under Section 10(b) of the 1934 Act or Rule 10b-5.

In June 2008, Elan Corporation issued a press release touting "Encouraging Top-line Results" for Phase 2 tests for an Alzheimer's drug. In July 2008, the company issued a release concerning its presentation of the full Phase 2 results at a conference. Thereafter, the company's stock price dropped. An investor sued claiming that the June press release was false and misleading due to certain information omitted from the release.

The Southern District of New York granted a motion to dismiss and the Second Circuit affirmed. The Circuit noted that Section 10(b) "does not create an affirmative duty to disclose any and all material information"; rather a disclosure is only "necessary to make statements made, . . . not misleading." The Circuit held that none of the statements in the June release were affirmatively false. Although the complained of omissions "may be relevant or of interest to a reasonable investor, . . . that circumstance alone does not necessitate its disclosure" because their absence did not render the statements made misleading. Furthermore, simply because the investor took issue with certain analytical methods employed by the company, did not mean that the June release was misleading because it did not provide a full description of the questionable methods. Rather, "where a defendant's competing analysis or interpretation of data is itself reasonable, there is no false statement." The fact that after the July release was issued the stock dropped 42% does not lead to the conclusion that the June release was in some way misleading as there could be many explanations for the stock price before the drop and for why the stock dropped so far.

*Kleinman v. Elan Corp., plc*, 706 F.3d 145, Fed. Sec. L. Rep. (CCH) P 97277 (2d Cir. 2013)

## Eastern District of Pennsylvania Applies 10(b) to Pump and Dump Scheme

On January 25, 2013, the Eastern District of Pennsylvania applied Section 10(b) of the 1934 Act and Rule 10b-5 to a pump and dump scheme to manipulate the float of a stock where the misrepresentations were made to and relied upon by people other than the plaintiffs.

Two companies entered into a reverse merger which resulted in VitaminSpice becoming a publicly traded company. Following the merger, as part of a pump and dump scheme, Jeuda Hand, General Counsel of VitaminSpice, allegedly made a number of false statements in press releases. These false statements inflated the price of the stock, which eventually plummeted when Hand dumped millions of shares under his control. Through complex procedural circumstances, the CEO of VitaminSpice brought a third-party complaint against Hand alleging that, even though the CEO did not purchase shares as part of the pump and dump scheme, he was damaged when the share price plummeted. Hand moved to dismiss the complaint.

The District Court denied the motion to dismiss. Among other things, the Court examined what it believed was a novel question of law: Can the "in connection" and "reliance" elements of a 10(b) claim "be satisfied when *entities other than the plaintiffs* . . . are the ones who executed the purchases or sales of securities"—as part of the pump and dump scheme—in reliance upon Hand's misstatements in the press releases? The court ruled that such allegations were sufficient because the "in connection" and "reliance" elements "should not be read so narrowly as to preclude novel securities fraud actions that are consistent with the purpose of Section 10(b)."

*Advanced Multilevel Concepts, Inc. v. Bukstel*, Fed. Sec. L. Rep. (CCH) P 97270, 2013 WL 300749 (E.D. Pa. 2013)