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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions

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This issue's Survey focuses on the 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 December 15, 2011, through March 19, 2012.

SEC Rulemaking

SEC Adopts Amendments to Rules Regarding Accredited Investor Standards

Section 413(a) of the Dodd-Frank Act required the SEC to amend the definition of "accredited investor" under the 1933 Act to exclude the value of a person's primary residence for the purposes of determining whether that person qualifies as an "accredited investor" on the basis of having a net worth in excess of $1 million. Issuers to accredited investors have been granted certain exemptions from 1933 Act registration for private and certain limited offerings. On December 21, 2011, the SEC adopted amendments to its rules regarding the standards for determining who is an accredited investor in order to comply with the Dodd-Frank Act. (**See SEC Release Nos. 33-9287; IA-3341; IC-29891.**)

The standards for determining who is an accredited investor are set forth in Rule 501 and Rule 215 of the 1933 Act. Rule 501 defines an accredited investor to include investors who satisfy eight listed categories, one of which is the $1 million individual net worth category, for the purposes of non-public and limited offerings under Rules 504(b)(1)(iii), 505 and 506 of Regulation D. Rule 215 defines an accredited investor under Section 2(a)(15) of the 1933 Act. And together they set the accredited investor standard under Section 4(5) of the 1933 Act. Under Section 4(5) of the 1933 Act, transactions involving offers or sales by an issuer to one or more accredited investors are

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exempt from registration provided that (1) the aggregate offering price does not exceed $5 million (2) there is no public solicitation in connection with the transactions, and (3) the issuer files a notice with the SEC. Regulation D of the 1933 Act provides that an issuer who is conducting a limited offering of securities pursuant to Rules 505 or 506 is exempt from having to comply with certain informational requirements if the offer is made to accredited investors only. Finally, accredited investors are not counted for the purpose of satisfying the 35 purchaser limits under Rules 505 and 506.

Prior to the enactment of the Dodd-Frank Act, the accredited investor standard required that an individual alone, or jointly with their spouse, have a minimum net worth of $1million. This standard could be satisfied by including the value of the investor's primary residence in the net worth calculation. Under Section 413(a) of the Dodd-Frank Act however, the value of the primary residence must be excluded in calculating net worth. Accordingly, the SEC modified the accredited investor standard under Rules 501 and 215 to implement the new standard mandated by the Dodd-Frank Act.

As amended, the definition of accredited investor provides that any natural person whose net worth, individually or jointly with a spouse exceeds $1 million is an accredited investor. Further, (1) the person's primary residence is excluded from the net worth calculation as an asset; (2) debt that is secured by that person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, is excluded as a liability, unless the amount of the debt outstanding at the time of the sale of securities exceeds the amount outstanding 60 days prior to such time, other than as a result of the acquisition of the primary residence, in which case the amount of such excess is accounted for as a liability; and (3) debt secured against the primary residence in excess of the estimated fair market value of the primary residence must be treated as a liability in the net worth calculation. An increase in the amount of debt secured by a primary residence in the 60 days prior to the sale of securities to an individual will be counted as a liability, regardless of whether the estimated value of the primary residence exceeds the aggregate amount of debt secured by that primary residence.

In order to conform with the amendments to the definition of accredited investor, the SEC made technical and conforming amendments. "Principal residence" which is currently referenced in Rule 501(e)(1)(i) of Regulation D has been changed to "primary residence." Additionally, references for Section 4(6) have been amended to refer to Section 4(5) due to renumbering. These amendments became effective on February 27, 2012.

SEC Adopts Amendments to Rules Regarding Mine Safety Disclosure Requirements

On December 21, 2011, the SEC adopted new rules in connection with mine safety disclosure. Section 1503 of the Dodd-Frank Act requires issuers that operate coal mines, or have a subsidiary that operates a coal or other mines, to disclose information regarding health and safety violations, orders and citations, related assessments and legal actions, and mine-related fatalities in its periodic reports filed with the SEC. Additionally, receipt of certain orders and notices from the Mine Safety and Health Administration are required to be filed in a Form 8-K under Section 1503(b). The new rules became effective on January 27, 2012. (**SEC Release Nos. 33-9286; 34-66019**.)

Pursuant to Section 1503 of the Dodd-Frank Act, every issuer that is required to file reports with the SEC in accordance with Section 13(a) or 15(d) of the 1934 Act and that operates, or has a subsidiary that operates a coal mine must provide specified disclosure with regard to health and safety concerns in its periodic and current filings with the SEC. "Operator" is defined in the Federal Mine Safety and Health Act of 1977 (the "Mine Act") as any owner, lessee or other person who operates, controls, or supervises a coal mine or other mine, or any independent contractor performing services or construction at such mine. Under the Mine Act, the U.S. Department of Labor's Mine Safety and Health Administration must inspect surface mines at least twice a year and underground mines must be inspected at least four times a year. Spot inspections are also conducted. Any violations of safety and health standards result in citations or orders to mine operators. These disclosure requirements are currently in effect.

The Dodd-Frank Act authorizes the SEC to issue any rules or regulations necessary to protect investors and carry out the purposes of Section 1503. Accordingly, the SEC adopted rules with regard to disclosure requirements. The new disclosure requirements stipulate such disclosure be included as an exhibit to the annual and quarterly reports filed by mining companies which are subject to the Mine Act. Information, including any citations or orders issued, failure to comply with any laws, and the number of flagrant violations under the Mine Act must be included. Additionally, a new item 1.04, which has been added to Form 8-K, will require mining companies to file an 8-K within four business days after receiving (1) a notice of imminent danger order under Section 107(a) of the Mine Act, (2) a notice of pattern of violations under Section 104(e) of the Mine Act, or (3) notice of the potential to have a pattern of violations. These amendments are effective thirty days after publication in the *Federal Register*.

SEC Adopts Amendments to Rule Regarding Investment Adviser Performance Compensation

Under the Investment Advisers Act of 1940 (the "Advisers Act"), investment advisers are permitted to charge compensation based on their performance to qualified clients. On February 15, 2012, the SEC adopted amendments to Rule 205-3 which will codify revisions that it had issued by Order on July 12, 2011, to adjust the dollar amount thresholds when determining who is a qualified client. Further, the amendments (1) mandate that the SEC issue an order every five years adjusting the dollar amount thresholds to account for inflation, (2) provide that an investor's primary residence and associated debt are excluded from the definition of net worth in considering whether that investor is a qualified client, and (3) add transition provisions to the rule. The Amendments are effective May 22, 2012. **(SEC Release No. IA-3372.)**

Pursuant to Section 205(a)(1) of the Advisers Act, an investment adviser is not permitted to enter into, renew, or extend an investment advisory contract that provides the adviser may be compensated based on a share of capital gains on or capital appreciation of, the funds of a client. Prior to the Order and the Amendment, these performance-based compensation fees were permitted if the client had at least $500,000 under management with an adviser immediately after entering into the advisory contract, or if the adviser reasonably believed the client had a net worth of more than $1 million at the time. These amounts were later revised to $750,000 and $1,500,000 respectively to reflect inflation adjustments.

The SEC's Order and Amendment revised the threshold of the client's assets-under-management test to $1 million and the net worth test was changed to $2 million. With regard to the net worth test to determine which investors are qualified clients, the value of the investor's residence cannot be used.

Investment advisers who currently have performance-based compensation arrangements in effect that would otherwise violate this new rule are permitted to maintain the existing fee arrangement, provided that those clients met the definition of "qualified client" at the time they entered into the agreement. Restrictions on performance fees are applicable only to new contractual arrangements and do not impact new investments by clients who were considered qualified clients when they entered into the advisory contract, regardless of whether they subsequently fail to meet the dollar thresholds.

SEC Adopts Amendments to Rule 146 to Designate Certain Securities on the BATS Exchange, Inc. as Covered Securities

On January 20, 2012, the SEC adopted an amendment to Rule 146 under Section 18 of the 1933 Act to designate certain securities listed, or authorized for listing, on BATS Exchange, Inc. ("BATS") as covered securities for purposes of Section 18. BATS, which stands for Better Alternative Trading System, is a newly created market for trading. Under Section 18 of the 1933 Act, covered securities are exempt from state law registration requirements. The amendments are effective 30 days from publication in the *Federal Register*. **(SEC Release No. 33-9295.)**

Section 18(b)(1) of the 1933 Act defines covered securities as those securities listed, or authorized for listing, on the Named Markets, or securities listed, or authorized for listing, on a national securities exchange that has listing standards which the SEC has determined has rules which are substantially similar to those of the Named Markets. Named Markets are the New York Stock Exchange, the American Stock Exchange, and the National Market System of the NASDAQ Stock Market, LLC. Rule 146(b) contains a list of national securities exchanges which the SEC has determined has listing standards which are substantially similar to those of the Named Markets.

BATS petitioned the SEC to designate certain securities listed on its exchange as covered securities. The SEC determined, based on approved BATS listing standards, that the BATS listing standards for Tier I and Tier II securities are substantially similar to the listing standards of the Named Markets. It therefore amended Rule 146(b) to designate securities listed, or authorized for listing, on Tier I and Tier II of BATS as covered securities under Section 18(b)(1) of the Securities Act. These securities are exempt from state law registration requirements.

APPELLATE AND OTHER DECISIONS OF NOTE

First Circuit Finds that Sarbanes-Oxley Whistleblower Protection does not Protect Employees of Private Contractors

On February 3, 2011, on a question of first impression, the First Circuit reversed a district court ruling and held that employees of private contractors that provide services to a publicly traded mutual fund are not covered by the whistleblower protection provided in the Sarbanes-Oxley Act ("SOX").

The plaintiffs were employees of private companies that contracted to manage and advise publicly traded Fidelity mutual funds. The two plaintiffs claimed that they were either terminated or constructively terminated after raising concerns regarding inaccuracies in draft registration statements and in cost accounting methodologies. Plaintiffs sued under 18 U.S.C.A. § 1514A(a), the Section of SOX entitled "[w]histleblower protection for employees of publicly traded companies."

Section 1514A(a) provides in relevant part that "no company with a class of securities registered under Section 12 of the [1934 Act] . . ., or that is required to file reports under Section 15(d) of the [1934 Act] . . ., or any officer, employee, *contractor, subcontractor*, or agent of such company, *may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee* in terms and conditions of employment because of any lawful act done by *the employee* . . ." (emphasis supplied by the court). Plaintiffs claimed that the "employee" given whistleblower protection by this Section includes both employees of publicly traded companies and employees of those publicly traded companies contractors, subcontractors or agents. Defendants argued that the terms "contractor, subcontractor, or agent" only identify who is barred from taking retaliatory actions against employees of public companies.

The District Court denied the defendants motion to dismiss, holding that, so long as the employee was reporting violations relating to fraud against shareholders, the provisions of § 1514A(a) extended to employees of private contractors, subcontractors and agents of public companies. A divided panel of the First Circuit reversed, holding that "the more natural reading is the one advanced by the defendants." The Circuit also noted that the title of both § 1514A(a) and SOX § 806, within which § 1514A(a) is housed, make reference only to "protection for employees of publicly traded companies." In addition, the Circuit also cited other SOX provisions where it claimed Congress made clear that the provision applied to both publicly traded and private companies. Similarly, unlike § 1514A(a), other earlier federal whistleblower statutes were explicit when they extended coverage to employees of contractors of regulated entities. Finally, the Circuit found that the legislative history of § 1514A(a) and post enactment legislative activity both supported the conclusion that Congress never intended to have whistleblower protection cover private contractors.

The dissent took issue with the majority's statutory construction, stating that, when boiled down to its relevant syntactic elements, § 1514A(a) provides that "no . . . contractor . . . may discharge . . . an employee." The dissent also argued that none of the legislative history actually evidences a Congressional intent to limit the scope of whistleblower protection and that the majority should have been more deferential to the interpretation applied by the Department of Labor as it has adjudicatory authority over SOX whistleblower complaints.

Lawson v. FMR LLC, 670 F.3d 61, 33 I.E.R. Cas. (BNA) 457, 95 Empl. Prac. Dec. (CCH) P 44417, Fed. Sec. L. Rep. (CCH) P 96721 (1st Cir. 2012).

Southern District of New York Applies *Morrison* Holding to Cover Claims Under the 1933 Act

On January 27, 2012, the District Court for the Southern District of New York held that the Supreme Court's holding in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869, 177 L. Ed. 2d 535, Fed. Sec. L. Rep. (CCH) P 95776, R.I.C.O. Bus. Disp. Guide (CCH) P 11932, 76 Fed. R. Serv. 3d 1330 (2010), dismissing claims under the 1934 Act against foreign issuers, also applies to claims under the 1933 Act.

In July 2009, individual plaintiffs—who were not included in the larger class certified in *In re Vivendi Universal, S.A.*, 242 F.R.D. 76 (S.D. N.Y. 2007)—brought claims against Vivendi Universal pursuant to, *inter alia,* §§ 10(b) and 20(a) of the 1934 Act and §§ 11, 12(a)(2) and 15 of the 1933 Act. In June 2010, the Supreme Court issued its opinion in *Morrison* concluding that § 10(b) of the 1934 Act does not apply extraterritorially and only applies to the purchase or sale of securities listed on U.S. stock exchanges or any other securities in the U.S. Thereafter, Vivendi asked the district court to dismiss the plaintiffs' claims pursuant to Rule 12(c) of the Federal Rules of Civil Procedure because all the claims were based on Vivendi ordinary shares, "which are not listed for trading purposes on any U.S. exchange."

The district court first dismissed all claims under the 1934 Act, rejecting the plaintiffs' bare argument that *Morrison* was wrongly decided. The district court next joined two other judges from the Southern District of New York and applied *Morrison* to dismiss the claims under the 1933 Act. The court stated that the Supreme Court in *Morrison* had specifically noted that the 1933 Act and 1934 Act were enacted by the same Congress and thus "form part of the same comprehensive regulation of securities trading" and that the SEC has found that the registration requirement mandated by the 1933 Act does not apply to "sales that occur outside the United States."

In re Vivendi Universal, S.A., Securities Litigation, Fed. Sec. L. Rep. (CCH) P 96724, 2012 WL 280252 (S.D. N.Y. 2012).

Second Circuit Affirms that Investors Cannot Recover on Aiding and Abetting Grounds from a Brokerage Firm that Employed a Fraud Scheme

The Second Circuit, on January 19, 2012, affirmed the district court's dismissal of claims for aiding and abetting fraud against the brokerage firm Morgan Keegan & Co. Inc. ("Morgan Keegan") for failure to allege that Morgan Keegan had actual knowledge of its brokerage customer's fraud.

The plaintiffs claimed to be victims of a fraudulent scheme perpetrated by Charles Cathcart, a principal at Derivium Capital LLC ("Derivium"), whereby the plaintiffs would receive favorable tax treatment when Derivium took the plaintiffs' securities and purported to loan back to plaintiffs an amount equal to 90% of the value of those securities. As part of the scheme, Derivium told plaintiffs that, through its management of the securities, plaintiffs' portfolio continued to receive interest payments. In reality, however, plaintiffs allege that Derivium employed Morgan Keegan to sell the securities and then used the proceeds to pay the 90% value to the plaintiffs and funnel the remaining 10% into personal business ventures. The plaintiffs alleged that when Morgan Keegan sold the securities it aided and abetted Derivium in committing fraud, conversion and in breaching its fiduciary duty.

The Southern District of New York dismissed the claim because the complaint failed to allege facts giving rise to a strong inference that Morgan Keegan had actual knowledge of the fraudulent scheme. The Second Circuit then affirmed the dismissal. Among other things, the Circuit found that Morgan Keegan's "Know Your Customer" obligations, standing alone, were far from sufficient to support the required strong inference of actual knowledge of the fraudulent scheme. The plaintiffs failed to identify any particular monitoring obligation on the part of Morgan Keegan that would have alerted it to Derivium's scheme. Moreover, the monitoring obligations at most could only show that Morgan Keegan should have known about the fraud, not that it had actual knowledge of the fraud. The Circuit also found that even if Morgan Keegan had actual knowledge of the fraud, the complaint also failed to allege that Morgan Keegan had provided substantial assistance to the fraudulent scheme. The mere fact that Derivium used its accounts at Morgan Keegan to sell the stock, without more, does not rise to the required level of substantial assistance.

Berman v. Morgan Keegan & Co., Inc., 2012 WL 147907 (2d Cir. 2012).

Second Circuit Holds that PIPE Transaction by Insider Funds was not Exempt from Section 16(b) Liability

On January 20, 2012, the Second Circuit upheld a district court ruling that private equity funds, which owned more than 10% of a public company and were solicited by the company to engage in a private investment in public equity ("PIPE") transaction, were obligated under Section 16(b) of the 1934 Act to disgorge their short swing profits.

Through a previous PIPE transaction two private equity funds (the "Funds") each acquired more than 10% of WPCS International Inc. ("WPCS"), a publicly traded company. Between December 2005 and January 2006, the Funds sold WPCS shares on the open market. In

March 2006, WPCS approached the Funds about entering into another PIPE transaction whereby the company would issue shares to the Funds at a 7% discount. The parties entered into the PIPE transaction in April 2006. WPCS shareholders then brought a derivative action against the Funds arguing that they were required by Section 16(b) to disgorge their short swing profits (*i.e.*, the difference between the price at which the Funds sold WPCS shares from December 2005 to January 2006 and the lower purchase price paid in April 2006).

The Southern District of New York granted summary judgment to the plaintiffs. The Second Circuit affirmed this ruling. The Circuit rejected the Funds' argument that, because the PIPE transaction had been negotiated with and approved by the WPCS board, it should be exempt from the strict liability imposed under Section 16(b) because the Fund had no speculative advantage over the company as both parties had access to the same information. The Circuit reasoned that, because this was a wholly volitional capital infusion and because the Funds had access to insider information, the PIPE transaction was not the type of "borderline" transaction that courts sometimes exempt from liability, and nothing about the transaction foreclosed the funds' potential influence over WPCS. The Circuit also found fault with the Funds' assertion that because they had invested all investment authority in their general partners, only those general partners were "beneficial owners" for purposes of disgorgement liability under Section 16(b). The general partners were agents for their partnerships, and thus, the general partners' actions were attributable to the Funds. The Circuit also noted that under the Funds' logic the vast majority of limited partnership investment vehicles would be exempt from disgorgement liability under Section 16(b).

Huppe v. WPCS Intern. Inc., 670 F.3d 214, Fed. Sec. L. Rep. (CCH) P 96714 (2d Cir. 2012).

Second Circuit Reinstates Class Action Holding that Plaintiffs had Sufficiently Alleged Scienter and Materiality

On December 29, 2011, the Second Circuit reversed a district court's dismissal of claims under Section 10(b) of the 1934 Act and Rule 10b-5, finding that the plaintiffs had sufficiently pled scienter because the complaint adequately described three confidential insider witnesses and the information they had provided to senior management, and the statements were material due to their overall impact on the company's critical restructuring efforts.

The plaintiffs alleged that the defendant CEO and CFO of Celestica, Inc. ("Celestica") had knowingly misrepresented the buildup of inventory in Celestica's North American facilities. The district court dismissed the plaintiffs' complaint for failure to plead the requisite scienter.

The Second Circuit reversed the district court's dismissal. The Circuit stated the plaintiffs had both provided the job titles of three confidential witnesses and described how those witnesses had direct knowledge of the CEO and CFO's understanding about the inventory buildup. The plaintiffs also described in detail why the inventory buildup issue was critical to Celestica's major restructuring and why the CEO and CFO would have been alert to concerns about such buildup. In so doing, the plaintiffs provided sufficient information to permit a strong inference of scienter against the CEO, CFO and the company generally. The Circuit also rejected the defendants' arguments that the statements were protected by the PSLRA's "safe harbor" provisions governing future predictions because some of the statements made by the CEO and CFO reported on past or present circumstances. Lastly, the Circuit found that even though the inventory buildup may have been miniscule in comparison to Celestica's global assets and annual revenues, the statements were nonetheless material because (1) they distorted Celestica's assets and earnings and concealed the company's failure to meet analyst predictions; (2) the restructuring efforts were critical to the company's operations and profitability; and (3) Celestica's share price decreased precipitously after the company disclosed the true state of its inventory.

New Orleans Employees Retirement System v. Celestica, Inc., Fed. Sec. L. Rep. (CCH) P 96618, 2011 WL 6823204 (2d Cir. 2011).

Second Circuit establishes test for what constitutes "domestic transactions" pursuant to *Morrison*

On March 1, 2012, the Second Circuit held that in order for a claim under Section 10(b) of the 1934 Act to be a "domestic transaction" under the Supreme Court's ruling in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869, 177 L. Ed. 2d 535, Fed. Sec. L. Rep. (CCH) P 95776, R.I.C.O. Bus. Disp. Guide (CCH) P 11932, 76 Fed. R. Serv. 3d 1330 (2010), the complaint must allege facts suggesting that "either irrevocable liability was incurred or title transferred within the United States."

Plaintiffs were Cayman Islands hedge funds that alleged that several broker-dealers engaged in a variation on the classic "pump-and-dump" scheme involving penny stock securities. Defendants moved to dismiss on various grounds, but the day after the Supreme Court issued its decision in *Morrison*, the Southern District of New York *sua sponte* dismissed the complaint for lack of subject matter jurisdiction pursuant to *Morrison*.

The Second Circuit affirmed in part and reversed in part the district court's ruling. First, the Circuit found that, under *Morrison*, the fact that a securities transaction was not domestic does not divest the District Court of subject matter jurisdiction. Next, noting that *Morrison* left open what constitutes a domestic purchase or sale of securities, the Circuit held that, in order for a securities transaction to be considered domestic, the plaintiffs must allege facts showing that either (1) the purchaser or seller incurred the revocable liability within the United States to take and pay for the securities; or (2) that the parties to the transaction exchanged the title within the United States. In so doing, the Circuit suggested that to satisfy these two prongs plaintiffs could allege facts, including, but not limited to, the location of where the contract was formed, the purchase orders were placed, the title was passed, or the money was exchanged. After establishing this new test, the Circuit found that plaintiffs' complaint had failed to allege facts sufficient to satisfy the test, but granted plaintiffs leave to amend in order to plead such facts.

Absolute Activist Value Master Fund Ltd. v. Ficeto, 2012 WL 661771 (2d Cir. 2012).