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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's ("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 July 1, 2013, through September 30, 2013.

SEC Rulemaking

SEC Adopts Rules to Disqualify Felons and Other "Bad Actors" from Rule 506 Offerings

On July 10, 2013, the SEC adopted amendments to its rules to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Section 926 of Dodd-Frank requires the SEC to adopt rules that disqualify securities offerings involving certain "felons and other 'bad actors' " from reliance on Rule 506 of Regulation D, which is considered a "safe harbor" for the private offering exemption of Section 4(2) of the 1933 Act. **(See Release No. 33-9414)**

The new Rule, as adopted, disqualifies certain "covered persons," as defined in the Rule. The following are the disqualifying events under the Rule:

(i) Criminal convictions;
(ii) Court injunctions and restraining orders;
(iii) Final orders (as defined in Rule 501(g)) of certain state regulators and federal regulators;
(iv) SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers and investment companies and their associated persons;
(v) Certain SEC cease and desist orders;
(vi) Suspension or expulsion from membership in, or suspension

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or barring from association with a member of, a securities self-regulatory organization (SRO);

(vii) SEC stop orders and orders suspending a Regulation A exemption; and

(viii) U.S. Postal Service false representation orders.

SEC Eliminates the Ban on General Solicitations

On July 10, 2013, the SEC adopted amendments to Rule 506 of Regulation D and Rule 144A under the 1933 Act to implement Section 201(a) of the Jumpstart Our Business Startups Act. Under the amended rules, general advertising of private offerings will be permitted, provided that sales are limited to accredited investors, in the case of Rule 506 offerings, and to "qualified institutional buyers" (or "QIBs") in the case of Rule 144A offerings, and an issuer takes reasonable steps to verify that all purchasers of the securities have the required status. **(See Release No. 33-9415)**.

The amendment to Rule 506 permits an issuer to engage in general solicitation, or general advertising, when offering and selling securities pursuant to Rule 506, provided that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that such purchasers are accredited investors. The amendment to Rule 506 also includes a non-exclusive list of methods that issuers may use to satisfy the verification requirement for purchasers who are natural persons.

The amendment to Rule 144A provides that securities may be offered pursuant to Rule 144A to persons other than QIBs, including by means of general solicitation or general advertising, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs. Under current Rule 144A, offers of securities may only be made to QIBs.

The SEC also revised Form D to require issuers to indicate whether they are relying on the provision that permits general solicitation or general advertising in a Rule 506 offering.

SEC Adopts Financial Responsibility Rules for Broker-Dealers

On July 30, 2013, the SEC adopted amendments to the net capital, customer protection, books and records, and notification rules for broker-dealers promulgated under the 1934 Act. These amendments are designed to address several areas of concern regarding the financial responsibility requirements for broker-dealers. **(See Release No. 34-70072)**.

Most notably, the SEC adopted changes to Rule 15c3-1 under the

1934 Act, (the "Net Capital Rule"). The Net Capital Rule is the principal SEC rule governing regulatory capital requirements for securities broker-dealers in the United States. The Net Capital Rule permits broker-dealers to follow either a "basic" method or an "alternative" method in order to comply with the rule. The "basic" method requires a broker-dealer to first compute its "aggregate indebtedness" and then generally limits such aggregate indebtedness to 800% of the broker-dealer's net capital in its first year of business, and 1,500% thereafter. Under the "alternative" method, a broker-dealer may not permit its net capital to be less than the greater of (a) $250,000 or (b) 2% of aggregate debit items, computed in accordance with the customer protection rule. A broker-dealer must affirmatively elect to use the alternative method for computing net capital, and must notify its Designated Examining Authority ("DEA") (usually FINRA) of that election. The amendments to Rule 15c3-1 essentially make the following changes:

(i) A broker-dealer must adjust its net worth by including in that calculation liabilities assumed by a third party (typically, although not always, an affiliate) if that third party lacks the resources to pay those liabilities. The broker-dealer can exclude those liabilities if it can demonstrate that the third party has the resources (independent of the broker-dealer) to pay the liabilities;

(ii) A broker-dealer now must treat as a liability any capital contribution made by an investor who has a right to withdraw that contribution, or the intention to withdraw it, within one year. Any capital contribution withdrawn within one year of its making (unless withdrawn pursuant to written permission from the broker-dealer's DEA) will be treated as having been made with the intention to withdraw it within one year;

(iii) Broker-dealers must cease their business upon the occurrence of certain insolvency events, including bankruptcy, appointment of a receiver, a general assignment for the benefit of creditors, admission of insolvency, or the inability to establish compliance with Rules 15c3-1 and 15c3-3. Rule 15c3-1(a) (requiring that broker-dealer must not be "insolvent", among other things) and Rule 15c3- 1(c)(16) (defining "insolvent"); and

(iv) The SEC also amended its power under Rule 15c3-1(e)(3) to prevent, temporarily, a broker-dealer from withdrawing capital, or making loans or advances to owners, officers, directors and affiliates. The new rule eliminates the quantitative standards and instead permits the SEC to exercise this authority when it deems necessary or appropriate to protect the financial integrity of the broker-dealer.

The rule changes also amend Rule 15c3-3 under the 1934 Act, (the "Customer Protection Rule"), which is the principal SEC rule requiring segregation of customer assets. Although a number of highly technical changes are made to the Customer Protection Rule, the most important modification to the Customer Protection Rule involves regulatory codification of existing SEC guidance regarding the treatment of proprietary accounts of broker-dealers that are held by other broker-dealers.

SEC Amends Broker-Dealer Reporting Requirements

On July 30, 2013, the SEC, under the 1934 Act, amended certain broker-dealer annual reporting, audit, and notification requirements. The amendments include a requirement that broker-dealer audits be conducted in accordance with standards of the Public Company Accounting Oversight Board ("PCAOB") in light of explicit oversight authority provided to the PCAOB by Dodd-Frank to oversee such audits. **(See Release No. 34-70073)**.

The amendments further require a broker-dealer that clears transactions or carries customer accounts to agree to allow representatives of the SEC or the broker-dealer's DEA to review the documentation associated with certain reports of the broker-dealer's independent public accountant, and to allow the accountant to discuss material findings relating to the reports in connection with a regulatory examination. Finally, the amendments require a broker-dealer to file a new form with its DEA that elicits information about the broker-dealer's practices with respect to the custody of securities and funds of customers and non-customers.

SEC Adopts Final Rules for Municipal Advisors

On September 20, 2013, the SEC approved final rules that require municipal advisors to permanently register with the SEC. **(See Release No. 34-70462)**.

Prior to passage of Dodd-Frank in July 2010, individuals and firms providing advice relating to the issuance of municipal securities were unregulated; they were not required to register with the SEC or otherwise comply with specifically tailored SEC rules. Citing concern that municipalities should be able to rely on advisors who must comply with standards for training, qualification and conduct, Section 975 of Dodd-Frank requires the SEC to adopt rules that would require municipal advisors to register with the SEC and follow a regulatory regime overseen by the Municipal Securities Rulemaking Board ("MSRB").

According to the new Rules, a "municipal advisor" is a person who provides advice to a municipal entity or "obligated person" with respect to the issuance of municipal securities, about certain "investment strategies" or on municipal derivatives. The MSRB determines whether "advice" is being provided by examining all the surrounding facts and circumstances, including whether such counsel involves a "recommendation" to a municipal entity, is particularized to the specific needs of a municipal entity or relates to municipal financial products or the issuance of municipal securities.

All firms who are considered by the MSRB to consist of one or more "municipal advisors" as defined above must register with the SEC by filing forms through the SEC's EDGAR public online filing system, including Form MA to register as a municipal advisor and Form MA-1 for each individual associated with the firm who provides municipal advisory services. All such registration information will be publically available.

SEC Proposes Amendments to Regulation D, Form D and Rule 156 under the 1933 Act

On July 10, 2013, the SEC published for comment a number of proposed amendments to Regulation D,[1] Form D and Rule 156 under the 1933 Act. These proposed amendments are intended to enhance the SEC's ability to evaluate the development of market practices in Rule 506 offerings and to address concerns that may arise in connection with permitting issuers to engage in general solicitation and general advertising under new paragraph (c) of Rule 506.[2] **(See Release No. 33-9416)**.

The proposed amendments to Regulation D, which provides certain issuers with exemptions from registration requirements, would require: (i) the filing of a Form D in Rule 506(c) offerings before the issuer engages in general solicitation; (ii) require the filing of a closing amendment to Form D after the termination of any Rule 506 offering; (iii) require written general solicitation materials used in Rule 506(c) offerings to include certain legends and other disclosures; (iv) require the submission, on a temporary basis, of written general solicitation materials used in Rule 506(c) offerings to the SEC before the issuer uses such materials in general soliciatation; and (v) disqualify an issuer from relying on Rule 506 for one year for future offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five years, with Form D filing requirements in a Rule 506 offering. The proposed amendments to Form D would require an issuer to include additional information about offerings conducted in reliance on Regulation D.

Finally, the proposed amendments to Rule 156, which interprets the antifraud provisions of the Federal securities laws in connection with sales literature used by investment companies, would extend the antifraud guidance contained in the Rule to the sales literature of private funds.

SEC and Other Agencies Propose Rule Related to Credit Risk Retention

On August 28, 2013, the SEC, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, and Department of Housing and Urban Development (together, the "Agencies") issued a joint proposed rule to implement the credit risk retention requirements of Section 15G of the 1934 Act. This proposed Rule re-proposes with modifications a previously proposed Rule to implement the requirements of Section 941 of Dodd-Frank. The modifications to the previously proposed Rule provide securitizers of asset-backed securities ("ABS") with greater flexibility in meeting the risk retention requirements of Section 15G. **(See Release No. 34-70277)**.

Section 15G, as added by Section 941(b) of Dodd-Frank, generally requires: (i) a securitizer of ABS to retain not less than five percent of the credit risk of the assets underlying such securities (any asset that the securitizer, through the issuance ABS, transfers, sells, or conveys to a third party), and (ii) prohibits a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under Section 15G and the Agencies' implementing rules.

Section 15G exempts certain types of securitization transactions from these risk retention requirements and authorizes the Agencies to exempt or establish a lower risk retention requirement for other types of securitization transactions. For example, Section 15G specifically provides that a securitizer shall not be required to retain any part of the credit risk for an asset that is transferred, sold, or conveyed through the issuance of ABS by the securitizer, if all of the assets that collateralize the ABS are "qualified residential mortgages," as that term is jointly defined by the Agencies.

SEC Proposes Pay Ratio Disclosure Rule

On September 18, 2013, the SEC proposed amendments to Item 402 of Regulation S-K to implement Section 953(b) of the Dodd-Frank. Accordingly, the SEC amended Item 402 to require disclosure of:

- (i) the median of the annual total compensation of all employees of an issuer (excluding the chief executive officer);[3]
- (ii) the annual total compensation of that issuer's chief executive officer; and
- (iii) the ratio of the median of the annual total compensation of all employees to the annual total compensation of the chief exec-

utive officer.[4]

The proposed disclosure would be required in any annual report, proxy or information statement or registration statement that requires executive compensation disclosure pursuant to Item 402 of Regulation S-K. The proposed disclosure requirements would not apply to emerging growth companies, smaller reporting companies or foreign private issuers, as they are defined in the proposed rule. **(See Release No. 33-9452)**.

APPELLATE AND OTHER DECISIONS OF NOTE

Seventh Circuit Questions Whether Section 10(b) Applies to Mutual Funds

On July 22, 2013, the Seventh Circuit reversed and remanded for further briefing a lower court ruling that a general counsel for a mutual fund violated insider trading rules when redeeming shares in the mutual fund.

The defendant was a general counsel for an investment adviser and broker-dealer company. The company managed a series of mutual fund portfolios, including two invested in high yield bonds. Between 1999 and 2000 the bond mutual funds experienced a liquidity crisis due to their inability to sell certain illiquid assets in the face of higher than normal redemption requests. During the crisis, the defendant redeemed all of her shares in the two affected mutual funds. Approximately 10 days later, the mutual funds announced that they were revaluing the funds' assets, which resulted in the per-share price of the mutual funds declining by between 44% and 69% in a single day. The SEC filed suit against, the general counsel alleging insider trading claims under Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act.

Based on the parties stipulation that the defendant was an insider with non-public information at the time that she redeemed her shares, the District Court granted summary judgment to the SEC on the insider trading charges. The Seventh Circuit reversed the District Court. At the District Court the SEC had proceeded under the "classic theory" of insider trading, but on appeal the SEC had switched to the "misappropriation theory" of insider trading. However, the Circuit noted that no Federal court has previously opined on whether insider trading can be applied to mutual fund redemptions and because the parties below had stipulated that insider trading could apply, the "district court was not directly called upon to explain how [the defendant's] alleged conduct may fit under either theory of insider trading." As a result, the Circuit ruled that it could not affirm or deny summary judgment "based on a theory of deception that was not adequately raised in the district court, and an opinion that does not consider that the mutual fund redemption has never been recognized to fit under either theory." Ultimately, the Circuit stated that it was remanding for further briefing but did "not rule out the applicability of § 10(b) to the mutual fund industry" rather it "simply emphasize[d] the need for conceptual clarity to explain how the core elements of insider trading might arise in the trade of mutual fund shares."

SEC v. Bauer, No. 2:03-cv-01427 (7th Cir. July 22, 2013).

Ninth Circuit Rules that Dodd-Frank Pay-For-Play Vote Alone does not Create Federal Jurisdiction

On July 31, 2013, the Ninth Circuit vacated District Court orders and remanded to state court two related shareholder lawsuits alleging that executive compensation policies violated state law.

In 2010, defendant Pico Holdings Inc., reported negative net income, but the company's Board of Directors increased executive compensation that year. The Dodd Frank Act mandates that at least every three years public companies must conduct a non-binding "say-on-pay" shareholder vote. In conformity therewith, the company conducted a shareholder vote on executive compensation in 2011. The shareholders voted against the 2010 executive compensation package, but the board took no action in response to the vote. Plaintiffs filed two shareholder derivative actions in California state court against the company and the board alleging several state law claims including, inter alia, breach of fiduciary duty, gross mismanagement, abusive control, and unjust enrichment. The company removed the case to federal court.

The District Court in each of the cases dismissed one count that it thought presented a federal question, and remanded the remaining claims to state court. The Ninth Circuit reversed, holding that none of the claims establish federal subject matter jurisdiction under the well pleaded complaint rule. The Circuit rejected defendant's argument that "congressional desire to preclude liability [for companies as a result of say-on-pay votes] is a significant federal issue conferring federal jurisdiction." Any such argument was merely a defense, and thus, could not confer jurisdiction. The Circuit also rejected defendant's arguments under Section 27 of the 1934 Act, which grants subject matter jurisdiction to the federal courts where claims are "brought to enforce any liability or duty created by [the Exchange Act] or the rules and regulations thereunder." The Circuit held that, because each of the claims in the complaint alleged violations of state law, the claims were not "brought to enforce any liability or duty" under federal law. Lastly, the Circuit also rejected defendant's argument that Congress had completely preempted, and conferred exclusive federal jurisdiction, for securities law issues.

Dennis v. Hart, Nos. 12-55241, 12-55266, 12-55282, 12-55291 (9th Cir. July 31, 2013).

Ninth Circuit Rules that Real Estate Contract Could Not be Considered Securities Transaction

On August 13, 2013, the Ninth Circuit affirmed the District Court's dismissal of claims under Section 12(a)(2) of the 1933 Act and Section 10(b) of the 1934 Act relating to a real estate transaction because plaintiffs had failed to allege a sale of securities under federal or state law.

In or around 2006, defendants, hotel developers, began to sell hotel rooms and suites as "non-residential condominium units." The sales contracts stated plaintiff-purchasers were not acquiring the rooms as investment opportunities. However, at the time of each sale, defendants required that plaintiffs also sign an agreement that limited plaintiffs' use of the rooms, required defendants' approval of any program to rent the rooms and granted defendants the exclusive right to permit access to guests. A year later, in 2007, while the hotel was still under construction, defendants offered plaintiffs a rental management agreement that authorized defendants to serve as the exclusive authority to manage and rent the hotel rooms.

Plaintiffs had alleged that defendants were liable under Section 12(a)(2) of the 1933 Act and violated Section 10(b) of the 1934 Act and Rule 10b-5 thereunder. In affirming the dismissal of the complaint, the Circuit stated that "when determining whether a real estate transaction is a security: substance governs, not name or label or form . . .. So long as money is invested in a common enterprise with profits anticipated by virtue of others work, there may be an investment contract." Nonetheless, here the sales and rental management agreements were too distant in time, and absent allegations that the agreements were offered as a package, "the economic reality . . . is that these two transactions were distinct." As a result, plaintiffs did not allege a sale of securities and could not state a claim for relief under federal or state securities laws.

Salameh v. Tarsadia Hotel, No. 11-55479 (9th Cir. Aug. 13, 2013).

Second Circuit Holds that Section 10(b) Criminal Liability Does Not Apply Extraterritorially

On August 30, 2013, the Second Circuit reversed in part and affirmed in part the criminal convictions of two defendants because it held that criminal liability under Section 10(b) of the 1934 Act, and Rule 10b-5 thereunder, cannot extend "to conduct in connection with an extraterritorial purchase or sale of securities."

The two defendants were investment managers. The government asserted that the defendants "lied to clients about the nature and quality of certain investments[,]" and improperly used for personal reasons money that had been invested with them. A jury convicted both defendants of, *inter alia*, violations of Section 10(b) and Rule 10b-5, and the defendants appealed. On appeal, the defendants argued that the Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010), in which the Court found that civil liability under Section 10(b) did not apply to extraterritorial transactions, should also be applied to limit Section 10(b) charges in the criminal context.

The Second Circuit agreed with defendants that the holding in *Morrison* applied equally in both the civil and criminal contexts. The Circuit found this because: "(1) the presumption against extraterritoriality applies to criminal statutes, and (2) the presumption against extraterritoriality applies to Section 10(b)." The Circuit simply saw no reason why the same statute should have a different territorial reach in the criminal context than it does in the civil context. Nonetheless, the limited territorial reach of Section 10(b) was not grounds for reversal of the defendant's convictions. The Circuit concluded that, because some securities transactions were entered into in Puerto Rico and New York, those transactions were within the reach of Section 10(b), and thus, could form the basis for the defendants' criminal convictions. The Circuit did, however, remand for re-sentencing because any securities transactions entered into outside of the United States could not be considered criminal "offense[s]" for purposes of calculating the defendants' sentences under the United States Sentencing Guidelines.

U.S. v. Vilar, Nos. 10-521-cr, 10-508-cr, 10-4639-cr (2d Cir. Aug. 30, 2013).

Southern District of New York Refuses to Dismiss Section 16(b) Claim Based on Swap Transactions

On September 5, 2013, the Southern District of New York denied a motion to dismiss, holding that the court, at least at this stage, could not dismiss a shareholder's claim that other shareholders had violated the short-swing profit prohibition of Section 16(b) of the 1934 Act when entering into several swap transactions.

The defendants each hold more than 10% of the stock of LyondellBasell Industries N.V. ("LBI"), and were therefore, subject to the short swing profit prohibition of Section 16(b). The defendants entered into a number of swap agreements with counter parties relating to a basket of specific equities. Under the agreements, the counter party would pay the defendants if the equity in the basket increased in value and the defendants would pay the counter party if the equities decreased. In October and November 2010 the defendants entered into four swap agreements where LBI stock was part of the underlying basket. Subsequently, in November and December, 2010 the defendants sold large quantities of LBI stock. The plaintiff brought suit (after LBI refused to do so itself) alleging that the swap transactions were equivalent to purchases of stock and that, by selling LBI stock less than two months later, defendants were obligated to refund to LBI more than $1.3 million in profits realized on the sales.

The defendants moved to dismiss, but the Southern District of New York denied the motion. The defendants argued that that the swap transaction fell under the exception created by Rule 16a-13 because they had previously owned the shares and only the form of ownership had changed as part of the swaps. The District Court stated that it could not reach the merits of this argument because the defendants relied on a Form 4 filed with the SEC which stated that they owned the stock prior to the swaps, but such documents cannot be considered on a motion to dismiss to prove the truth of their contents. The defendants also argued that their swap transactions did not implicate "Section 16(b)'s Animating Concerns" because they were far afield from profiting from inside information, which is "the evil which Congress sought to prevent" when it enacted Section 16(b). (Internal quotations omitted) However, given that the District Court could not rule on the defendants' Rule 16a-13 exemption argument, there remained "at least the possibility of speculative abuse of insider information" (internal quotations omitted), and as such, the claims could not be dismissed.

Wagner v. The Royal Bank of Scotland Group PLC, No. 12 Civ. 8726 (S.D.N.Y. Sept. 5, 2013).

NOTES:

[1]Regulation D under the 1933 Act contains rules that provide exemptions from the registration requirements of securities issuances. Such exemptions allow certain issuers to offer and sell their securities without having to register the securities with the SEC.

[2]See above summary of rule titled "SEC Eliminates the Ban on General Solicitations".

[3]The proposed rule defines 'employee' as an individual employed as of the last day of the registrant's last completed fiscal year.

[4]Companies will not be locked into a single method of calculating the median employee for purposes of this ratio, but can rely on statistical sampling, estimates and the use of any consistently applied compensation measure to identify the median.