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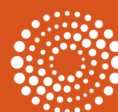

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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions

By Victor M. Rosenzweig[*]

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 April 1, 2014, through June 26, 2014.

SEC Rulemaking

SEC Issues Proposal on Recordkeeping and Reporting Requirements for Swap Dealers

On April 17, 2014, the SEC proposed new recordkeeping, reporting, and notification requirements for security-based swap dealers ("SBSDs"), major security-based swap participants ("MSBSPs"), and registered broker-dealers that enter into security-based swaps ("broker-dealer SBSDs" and "broker-dealer MSBSPs"). The application of the proposed rules depends on whether the SBSDs and MSBSPs are subject to oversight by a prudential regulator[1] ("bank SBSDs" and "bank MSBSPs"), or are without prudential regulators and are not registered as broker-dealers ("stand-alone SBSDs" and "stand-alone MSBSPs"). The proposal is part of the SEC's wider effort to implement the recordkeeping, reporting, and notification requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. **(See SEC Release No. 34-71958.)**

The proposal requires all SBSDs and MSBSPs to file proposed Form SBS monthly with the SEC, which requests information about the financial and operational condition of the entity, such as a computation of net capital and exposure to over-the-counter derivatives.

The proposed amendments for broker-dealer SBSDs and MSBSPs are largely technical in nature, modeled on the existing broker-dealer rules for recordkeeping (Rules 17a-3 and 17a-4), reporting (Rule 17a-5), notification (Rule 17a-11), and the FOCUS Report (form of financial report).

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[*]Member, New York Bar. Of Counsel, Olshan Frome Wolosky LLP. Associate Elias Berman assisted the author.

Bank and stand-alone SBSDs and MSBSPs must keep certain additional records, including: (1) daily trading records of security-based swaps; (2) daily trading records for each counterparty; and (3) a complete audit trail for conducting comprehensive and accurate trade reconstructions.

Stand-alone SBSDs may also face the following obligations: (1) performance of a securities count each quarter performed by a person whose ordinary duties do not involve direct responsibility for the making or retention of the securities records; and (2) taking of a capital charge for short securities differences that are unresolved for seven days or longer and for long securities differences where the securities are sold before they are sufficiently resolved.

It remains unclear when the SEC will actually begin requiring SBSDs and MSBSPs to register as such. The SEC sought public comment through July 1, 2014.

SEC Issues Proposal on Investment Company Advertising

On April 3, 2014, the SEC proposed rule amendments that would require target date retirement funds ("target date funds") to include in their marketing materials a graph depicting the fund's asset allocation over time, or glide path, based on a standardized measure of fund risk as either a replacement for, or supplement to, the glide path illustration proposed in June 2010 based on asset allocation alone. **(See SEC Release No. 33-9570)**.

A target date fund is designed to make it easier for investors to hold a diversified portfolio of assets that rebalances automatically among asset classes over time. As the investor's retirement date approaches, a target date fund shifts its asset allocation in a manner that generally is intended to become more conservative, for example, by decreasing the percentage allocated to stocks. Target date funds have become more prevalent in 401(k) plans as a result of their designation as qualified default investment alternatives by the Department of Labor under the Pension Protection Act of 2006. The assets of target date funds registered with the SEC exceed $500 billion, having grown from about $250 billion at the beginning of 2010.

In April 2013, the Investor Advisory Committee[2] ("Committee") opined that a glide path illustration based on an appropriate, standardized measure of fund risk would be more accurate than an illustration based on asset allocation alone. The Committee stated that choices made within the various asset classes could have a significant impact on fund risk levels, particularly when asset classes are defined broadly.

The Committee did not recommend a particular risk measure but

suggested the SEC focus on factors such as volatility of returns or maximum exposure to loss, which are directly relevant to the primary concerns of those approaching retirement. The SEC sought public comment through June 9, 2014.

Appellate and Other Decisions of Note

Second Circuit Vacates Rejection of Citigroup Settlement

On June 4, the U.S. Court of Appeals for the Second Circuit vacated and remanded a lower court ruling that rejected a $285 million settlement agreement between the SEC and Citigroup Global Markets, Inc. ("Citigroup"), *SEC v. Citigroup Global Mkts. Inc.*, 827 F. Supp.2d 328 (S.D.N.Y. 2011).

The settlement agreement at issue stemmed from a complaint that the SEC filed in October 2011 against Citigroup. The complaint alleged that Citigroup negligently misrepresented its role and economic interest in structuring and marketing a billion-dollar fund (the "Fund") and violated Sections 17(a)(2) and (3) of the 1933 Act. Shortly after filing its complaint, the SEC filed a proposed consent judgment in which Citigroup agreed to, *inter alia*, disgorgement of $160 million, which the SEC asserted were Citigroup's ill-gotten net profits, prejudgment interest of $30 million, and a civil penalty of $95 million. The consent decree did not include a stipulation of facts or Citigroup's admission of guilt.

Judge Jed S. Rakoff, presiding in the Southern District of New York, rejected the proposed consent decree and ordered the parties to prepare for trial. The Court analyzed the sufficiency of the settlement for whether the Court, "even after giving substantial deference to the views of the administrative agency . . . is not being used as a tool to enforce an agreement that is unfair, unreasonable, inadequate, or in contravention of the public interest." The Court determined that it could not make that assessment because of the absence of a sufficient evidentiary record. Therefore, the decree was "neither fair, nor reasonable, nor adequate, nor in the public interest" and had to be rejected.

The Second Circuit overturned the District Court's ruling, finding that the rejection constituted an abuse of discretion. The Court of Appeals "clarif[ied]" that the proper standard for reviewing a consent decree is whether it is "fair and reasonable [and] that the public interest would not be disserved." It also removed the "adequacy" requirement. The Court held that "[a]bsent a substantial basis in the record for concluding that the proposed decree does not meet the requirements, the District Court is required to enter the order." The Second Circuit remanded the case for further proceedings in accor-

dance with its opinion.[3]

SEC v. Citigroup Global Markets, Inc., 752 F.3d 285 (2d Cir. June 4, 2014).

U.S. Supreme Court Declines Review of Ruling that *Morrison* Applies to Criminal Cases

On May 27, 2014, the U.S. Supreme Court declined to review the Second Circuit's holding that *Morrison v. Nat'l Australia Bank Ltd.*, 561 U.S. 247 (2010) applies to criminal liability under Section 10(b) of the 1934 Act in connection with an extraterritorial purchase or sale of securities.

Alberto Vilar and Gary Tanaka petitioned the Supreme Court to review their criminal convictions of, *inter alia*, conspiracy, securities fraud, and investment adviser fraud. Over the course of twenty years, the two, investment managers and advisors, misrepresented their highly speculative investments in technology and biotechnology stocks as investments in safe, fixed-income securities. Some of these investments were made through Vilar's and Tanaka's entities formed in the United Kingdom and Panama. Vilar and Tanaka argued that, under *Morrison*, their convictions were improper.

The Second Circuit wrote that *Morrison* applies to criminal as well as civil cases: a defendant may be convicted of securities fraud under Section 10(b) and Rule 10b-5 only if he has engaged in fraud in connection with (1) a security listed on an American exchange, or (2) a security purchased or sold in the United States. However, the evidence demonstrated that Vilar and Tanaka engaged in fraud in connection with a domestic purchase or sale of securities because their investment fraud scheme involved at least some domestic misconduct.

Vilar v. United States, 134 S. Ct. 2684 (May 27, 2014).

Court of Appeals Rules that Conflict Minerals Law, SEC Regulation Violate First Amendment

On April 14, the U.S. Court of Appeals for the District of Columbia Circuit held that the SEC's conflict minerals regulation, 77 Fed. Reg. at 56,362–65, and the relevant portion of the statute authorizing it, Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 78m(p)(1)(A)(ii), violated the First Amendment.

Congress enacted the conflict minerals statute at issue in response to the "war and humanitarian catastrophe" in the Democratic Republic of the Congo (the "DRC"). The statute requires firms using "conflict minerals" to investigate and disclose to the SEC the origin of those

minerals in a multi-step process. This process involves disclosing whether minerals originated in the DRC or an adjoining country ("covered countries"); if so, submitting a report to the SEC describing measures taken to establish the "source and chain of custody" of the minerals; and listing "the products manufactured or contracted to be manufactured that are or are not DRC conflict free." A product is not "DRC conflict free" if it contains conflict minerals that are "necessary to the functionality" of a product or "necessary to the production" of a product.

The SEC adopted a three-step process in its final rules. First, a firm must determine if the Rule covers it. The final Rule applies only to securities issuers who file with the SEC under Section 13(a) or 15(d) of the 1934 Act. The Rule excludes issuers if conflict minerals are not necessary to the production or functionality of their products. Second, it requires an issuer subject to the Rule to determine whether an issuer's necessary conflict minerals originated in covered countries. If so, an issuer must file a conflict minerals report. The report must describe the issuer's due diligence efforts and describe those products that have not been found to be "DRC conflict free." The issuer must also post this information on its website.

Petitioner's First Amendment claim challenged only the requirement that an issuer describe its product as not "DRC conflict free" in the report it files with the SEC and must post on its website (15 U.S.C. § 78m(p)(1)(A)(ii)) arguing that it unconstitutionally compels speech. The Court of Appeals agreed, holding that the challenged portions of the Rule and statute did not pass intermediate scrutiny, as set forth in *Central Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n of New York*, 447 U.S. 557 (1980). Under *Central Hudson*, the government must show (1) a substantial government interest that is (2) directly and materially advanced by the restriction and (3) that the restriction is narrowly tailored. Here, the Court held that the government could not satisfy intermediate scrutiny because the SEC presented no evidence that a less restrictive means to achieving the statute's purpose would fail.

Nat'l Ass'n of Mfrs. v. SEC, 748 F.3d 359 (D.C. Cir. 2014).

District Court Dismisses Short-Swing Suit against Facebook and IPO Underwriters

On May 2, 2014, the United States District Court for the Southern District of New York dismissed a consolidated action against Facebook Inc. and certain underwriters involved in the company's IPO. Plaintiff sought disgorgement of "short-swing" profits allegedly earned by the defendants from underwriting activities performed in connection with Facebook's IPO under Section 16(b) of the 1934 Act.

Section 16's requirements apply to a person who is "a beneficial owner of more than ten percent of any class of equity securities" under Section 13(d) of the 1934 Act. Here, plaintiff conceded that no individual shareholder or underwriter met that criterion. Rather, it relied on similar language in Section 13(d) allowing multiple persons to form a group when they "act as a group for the purpose of acquiring, holding, or disposing of securities of an issuer." Plaintiff argued that the shareholders and underwriters formed a group because they acted together for the purpose of acquiring Facebook securities. Specifically, the underwriters and shareholders shared a "common purpose" evidenced by certain lock-up agreements entered into in order to control the supply of Facebook shares available to the market.

The Court held that plaintiff failed to satisfy the "group" definition because the complaint failed to allege that the underwriters combined with the shareholders under the lock-up agreements, or otherwise, to acquire, hold or dispose of securities. The Court found that the lock-up agreements "did not bind the two groups as to either their roles and interests during the IPO, or with respect to their conduct in relation to the Facebook shares." In short, the lock-up agreements did not create any kind of "single unit" for Section 13(d) purposes.

In re Facebook, Inc., IPO Secs. and Derivative Litig., 986 F. Supp.2d 544 (S.D.N.Y. May 2, 2014).

Supreme Court Upholds Fraud-On-The-Market Presumption, But that Presumption May Be Rebutted at Class Certification

On June 23, 2014, the Supreme Court upheld the fraud on the market presumption, first espoused in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). However, the Court also held that defendants could rebut the presumption of reliance at the class certification stage of the proceedings.

As we previously reported in the Spring 2014 issue, 42 Sec. Reg. L. J. 1, at 97–98, in *Erica P. John Fund, Inc. v. Halliburton Co.*, 718 F.3d 423 (5th Cir. 2013), plaintiffs, shareholders of the Halliburton Company ("Halliburton"), moved for class certification in their lawsuit against Halliburton for securities fraud under § 10(b) of the 1934 Act. Halliburton opposed the shareholder's motion and sought to overcome the fraud-on-the-market presumption at the class certification stage of the proceeding. The fraud-on-the-market-presumption is that individual investors rely on material misrepresentations when they trade securities in well-developed markets because "the market price of shares traded on [these] markets reflects all publicly available information, and, hence, any material misrepresentations." Halliburton tried to overcome this presumption by introducing evidence that its alleged

fraud did not affect the company's stock price. The Fifth Circuit affirmed the District Court's holding that such evidence was not appropriate before class certification. Halliburton appealed, arguing (1) that *Basic* should be overruled or substantially modified and (2) even if *Basic* is not overruled, evidence of price impact is appropriate before class certification.

The Supreme Court refused to overturn *Basic*. The Court wrote that overturning "long-settled precedent" requires "special justification, not just an argument that the precedent was wrongly decided." Halliburton failed to make that showing. Therefore, potential plaintiffs will still be able to invoke the fraud-on-the-mark presumption in future securities fraud suits.

However, the Court also ruled that the Fifth Circuit erred in denying defendants the opportunity to rebut the presumption of reliance before class certification: defendants should be allowed to present evidence of lack of price impact. The Court wrote that *Basic*'s entire premise rested on an imperfect proxy for price impact, and "[i]n the absence of price impact, *Basic*'s fraud-on-the-market theory and presumption of reliance collapse." Thus, Halliburton will be allowed an opportunity to present evidence that the misstatements at issue lack price impact and that *Basic*'s presumption does not apply.

Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398 (2014).

NOTES:

[1]The term prudential regulator is defined in Section 1(a)(39) of the Commodity Exchange Act ("CEA") (7 U.S.C.A. § 1(a)(39)). Pursuant to the definition, the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the Farm Credit Administration, or the Federal Housing Finance Agency (collectively, the "prudential regulators") is the prudential regulator of an SBSD, MSBSP, swap participant, or major swap participant if the entity is directly supervised by that agency.

[2]The Investment Advisory Committee, established under Section 39 of the 1934 Act, was introduced by section 911 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Committee advises and consults with the Commission on regulatory priorities, issues, and initiatives and submits findings and recommendations to the Commission. 15 U.S.C.A § 78pp(a). The Commission reviews the findings and recommendations of the Committee and determines what action, if any, to take. 15 U.S.C.A § 78pp(g).

[3]On August 5, 2014 the District Court approved the settlement. *SEC v. Citigroup Global Markets Inc., No. 11–cv-7387*, 2014 WL 3827497.