

# Securities Regulation Law Journal

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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 during the third quarter of 2011.*

## SEC Rulemaking

### SEC Adopts Rules to Provide Thresholds for Suspension of the Reporting Obligations of Issuers of Asset-Backed Securities

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Pursuant to Section 94(a) of the Dodd-Frank Act, the reporting obligations under Section 15(d) of the Securities Exchange Act of 1934, as amended (the "1934 Act"), of issuers of asset-backed securities ("ABS") were no longer automatically suspended. Further, the Dodd-Frank Act granted the SEC the authority to issue rules providing for the suspension or termination of the reporting duties under Section 15(d) of the 1934 Act. On August 17, 2011, the SEC adopted rules to provide for the suspension of reporting obligations for ABS issuers under certain circumstances. (**See SEC Release No. 34-65148.**)

Section 15(d) of the 1934 Act provides that any issuer with a class of securities registered pursuant to the Securities Act of 1933, as amended (the "1933 Act") is also subject to reporting requirements under the 1934 Act. Prior to the enactment of the Dodd-Frank Act, however, this reporting duty was automatically suspended for issuers without a class of securities registered under the 1934 Act if the securities of each class to which the registration statement related were held of record by fewer than 300 persons. Those issuers were required to file 1934 Act reports only in the year their registrations became

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effective. Consequently, ABS issuers generally had their reporting obligations automatically suspended after they filed an annual report on Form 10-K because ABS issuers typically had fewer than 300 holders of record. The Dodd-Frank Act eliminated this automatic suspension and instead, gave the SEC the authority to determine when ABS issuers' reporting obligations may be suspended.

### *Suspension of 1934 Act Reporting Obligations*

Rule 15d-22(b), as adopted, provides that an issuer may suspend its duty to file reports under the 1934 Act in the following circumstances: (1) as to any semi-annual fiscal period, if, at the beginning of the semi-annual fiscal period, other than a period in the fiscal year within which the registration statement became effective or, for shelf offerings, the takedown occurred, there are no ABS of such class that were sold in a registered transaction held by non-affiliates of the depositor and a certification on Form 15 has been filed; or (2) when there are no ABS of such class that were sold in a registered transaction still outstanding, immediately upon the filing with the SEC of a certification on Form 15, if the issuer has filed all required reports for its three most recent fiscal years. If the rule had not been adopted, issuers of ABS that filed a registration statement that became effective pursuant to the 1933 Act, or that conducted a takedown off of a shelf registration statement, would have otherwise been required to file periodic reports over the life of the security.

The new rule is effective as of September 22, 2011.

### **SEC Adopts Rule Regarding Large Traders**

On July 26, 2011, the SEC adopted new Rule 13h-1 and corresponding Form 13H which establish new reporting requirements for large traders under the 1934 Act. This rule is meant to improve the SEC's ability to identify and collect information about large traders, and monitor the trading activity of large traders. **(See SEC Release No. 34-64976.)** In response to the sudden May 6, 2010, significant price decline in the United States securities market and continuing market volatility, the SEC believed enhanced monitoring of the market system is critical to protecting investors.

### *Identification and Reporting Requirement*

Rule 13h-1 requires large traders to identify themselves and file Form 13H with the SEC. Rule 13h-1 defines a large trader as "any person that: (i) directly or indirectly, including through other persons controlled by such person, exercises investment discretion over one or more accounts and effects transactions for the purchase or sale of any national market system (NMS) security for or on behalf of such ac-

counts, by or through one or more registered broker-dealers, in an aggregate amount equal to or greater than the identifying activity level; or (ii) voluntarily registers as a large trader by filing electronically with the SEC Form 13H.” The SEC will assign an identification number to each large trader upon receipt of Form 13H. The large trader must in turn provide that identification number to its registered broker-dealers.

### *Requirements for Broker-Dealers*

Under Rule 13h-1, broker-dealers will be required to maintain records of specified transactions effected by or through the accounts of large traders and unidentified large traders, electronically report transactions by large traders and unidentified large traders to the SEC upon request using the Electronic Blue Sheets system, and, on a limited basis, monitor accounts of large traders and promote awareness of and compliance with Rule 13h-1. Unidentified large trader is defined as each person who has not complied with the self-identification requirements but who a broker-dealer knows or has reason to know is a large trader based on that trader’s transactions in NMS securities effected by or through such broker-dealer.

The compliance date for large traders to register with the SEC by filing Form 13H and to identify themselves as such to registered broker-dealers is December 1, 2011. The deadline for registered broker-dealers to comply with the recordkeeping, reporting and monitoring requirements of the new rule is April 30, 2012.

### **SEC Adopts Amendments Removing References to Credit Ratings in Rules and Forms under the 1933 Act and the 1934 Act**

On July 27, 2011, the SEC adopted amendments removing references to credit ratings in certain forms and rules promulgated under the 1933 Act and the 1934 Act. The amendments were made in connection with Section 939A of the Dodd-Frank Act which mandated that the SEC review which of its regulations require an assessment of the credit-worthiness of a security, and remove and replace any such references to credit-worthiness with a standard deemed appropriate by the SEC. (**See SEC Release No. 33-9245.**) Accordingly, the SEC undertook such a review and amended certain forms and rules to remove references to credit ratings.

In completing its assessment, the SEC noted that credit ratings played a significant part in investors’ decision-making process. The SEC stated further that in removing references to credit ratings, it sought to avoid using the credit ratings in a manner that would suggest it approved any particular credit agency or credit rating, while

maintaining Form S-3 eligibility for widely-followed issuers. The removal of credit ratings also comported with Congressional will.

### *Amendments to Eligibility Requirement under Form S-3 and Form F-3*

Form S-3 and Form F-3 are short forms used by eligible issuers to register offerings of securities under the 1933 Act. An issuer must meet certain eligibility requirements in connection with the issuer's reporting history under the 1934 Act, and at least one of the form's transaction requirements in order to be eligible to use either of the forms. One of these transaction requirements permits a registrant to register primary offerings of non-convertible debt securities if they are rated investment-grade by at least one nationally recognized statistical rating organization. The amendments to General Instruction I.B.2 to these forms removed this transaction requirement.

The SEC amended the instructions to Form S-3 and Form F-3 to provide that an offering of non-convertible debt securities meets the eligibility criteria for registration on Form S-3 and Form F-3 if the issuer: (1) has issued, within 60 days prior to the filing of the registration statement, at least \$1 billion in such non-convertible securities, other than common equity, in primary offerings for cash, registered under the 1933 Act, over the prior three years; or (2) has at least \$750 million of non-convertible securities, other than common equity, issued in primary offerings for cash, registered under the 1933 Act and outstanding, within 60 days prior to the filing of the registration statement; or (3) is a wholly-owned subsidiary of a well-known seasoned issuer<sup>1</sup> as defined in Rule 405 under the 1933 Act; or (4) is a majority-owned operating partnership of a real estate investment trust that qualifies as a well-known seasoned issuer; or (5) discloses in the registration statement that it has a reasonable belief that it would have been eligible to register the securities offerings proposed to be registered under such registration statement pursuant to General Instruction I.B.2 of Form S-3 or Form F-3 in existence prior to the new rules, discloses the basis for such belief, and files the final prospectus for any such offering on or before the date that is three years from the effective date of the amendments.

### *Rescission of Form F-9*

The SEC also rescinded Form F-9 under the 1933 Act, citing its irrelevancy in light of Canadian regulatory changes. Form F-9 permitted Canadian issuers to register investment grade preferred securities or investment grade debt, subject to other requirements. A security was rated investment grade if it had been so rated by at least one nationally recognized statistical rating organization. Due to Canadian

regulatory changes, however, including a new requirement that Canadian issuers prepare their financial statements in accordance with International Financial Reporting Standards, the Form F-9 disclosure requirements will be the same as Form F-10 disclosure requirements.

### *Amendments to Rules under the 1933 Act*

The SEC also made certain amendments to Rules 138, 139 and 168 under the 1933 Act. Rules 138, 139 and 168 provide that certain communications are deemed not to be an offer for sale or offer to sell a security within the meaning of Sections 2(a)(10) and 5(c) of the 1933 Act when the communications relate to an offering of non-convertible investment grade securities. These communications include a broker's or dealer's publication about securities, distribution of a research report about an issuer or its securities, or dissemination by or on behalf of an issuer with regard to factual business communications. Under these circumstances, the issuers must meet Form F-3 or Form S-3 eligibility. The amendments under Rules 138, 139 and 168 therefore conform these rules with the new eligibility criteria under Form F-3 and Form S-3.

Finally, the SEC removed Rule 134(a)(17) under the 1933 Act. Rule 134(a)(17) had permitted disclosure of security ratings issued by or expected to be issued by a nationally recognized statistical rating organization in certain communications deemed not to be a prospectus or "free writing"<sup>2</sup> prospectus. The Rule had provided a safe harbor which permitted the use of a credit rating by a nationally recognized statistical rating organization.

### **SEC Proposes 1933 Act Rule Implementing Prohibition against Conflicts of Interest in Certain Securitizations**

On September 19, 2011, the SEC proposed a new rule under the 1933 Act in order to implement certain provisions of the Dodd-Frank Act relating to material conflicts of interest in connection with certain securitizations. (See **SEC Release No. 34-65355**.) Section 621 of the Dodd-Frank Act added Section 27B to the 1933 Act and directs the SEC to issue rules implementing the prohibitions detailed in new Section 27B. Section 27B disallows underwriters, placement agents, initial purchasers or sponsors, or any affiliate or subsidiary of any such entity, of ABS, including a synthetic ABS, and regardless of whether the offering of ABS is registered, from participating in any transaction that would either result in or involve certain material conflicts of interest. The prohibition is applicable for a period of one year following the date of the first closing of the sale of the ABS.

Section 27B also provides exceptions from the prohibitions under that section. These exceptions are: (a) risk-mitigating hedging activi-

ties engaged in by an underwriter, placement agent, initial purchaser or sponsor if the risk being hedged is specific to the party's function in the securitization; (b) commitments by any such party to provide liquidity for the asset-backed security; and (c) bona fide market-making.

### *Conditions for Applying the Proposed Rule*

Proposed Rule 127B has five conditions that must be met for the proposed rule to apply. First, the transaction must involve "covered persons." Presently, the SEC defines covered person as an underwriter, placement agent, initial purchaser, sponsor, or any affiliate or subsidiary of such entity. Second, Rule 127B applies to any asset-backed security as defined in Section 3 of the 1934 Act.<sup>3</sup> Third, the time frame during which transactions are prohibited under proposed Rule 127B ends one year after the first closing of the sale of the ABS. Fourth, the proposed rule limits covered conflicts of interest to those conflicts involving an entity participating in a securitization in connection with an ABS, and an investor in the ABS. Moreover, conflicts are limited to those transactions which arose as a result of or in connection with an ABS transaction. Finally, a conflict of interest is material if the relevant party either (a) would benefit directly or indirectly from actual or potential losses on, or from a decline in the market value of the ABS, or (b) would receive fees or other remuneration, or the promise of future business from a third party which is allowed to structure a transaction where the third party would benefit from losses or decline. There must also be a "substantial likelihood" that a "reasonable" investor would consider the conflict important in making his or her investment decision.

## **APPELLATE AND OTHER DECISIONS OF NOTE**

### **D.C. Circuit Vacates SEC's New Rules Requiring Companies to Include Shareholder Nominations for Directors in Proxy Materials**

On July 22, 2011, the D.C. Circuit vacated Rule 14a-11 promulgated by the SEC for purposes of requiring companies to include shareholder nominated director candidates in their proxy solicitation materials. Under the proposed new rule (which the SEC had stayed implementation of), a company, including an investment company, was obligated to include in its proxy materials information about candidates for director positions nominated by shareholders holding at least 3% of the company's voting power.

The D.C. Circuit stated that "[w]e agree with the petitioners and

hold the Commission acted arbitrarily and capriciously for having failed once again . . . adequately to assess the economic effects of the new rule.” The Circuit found that “the Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.”

On September 6, 2011, SEC Chairman Mary Schapiro stated that the SEC will not seek rehearing or appeal of the D.C. Circuit’s ruling. *See Statement by SEC Chairman Mary L. Schapiro on Proxy Access Litigation*, available at <http://www.sec.gov/news/press/2011/2011-179.htm>. The SEC will instead continue to review the Circuit Court’s opinion and the comments previously received to try to revise Rule 14a-11. The D.C. Circuit’s ruling did not affect the SEC’s amendments to Rule 14a-8, which took effect on September 20, 2011. *See SEC Press Release “Facilitating Shareholder Director Nominations,”* available at <http://www.sec.gov/rules/final/2011/33-9259.pdf>. The amendments to Rule 14a-8 “require companies to include in their proxy materials, under certain circumstances, shareholder proposals that seek to establish a procedure in the company’s governing documents for the inclusion of one or more shareholder director nominees in the company’s proxy materials.” *Id.*

*Business Roundtable v. S.E.C.*, 647 F.3d 1144, Fed. Sec. L. Rep. (CCH) ¶ 96358 (D.C. Cir. 2011).

### **The Southern District of New York Applies Supreme Court’s Janus Ruling to Dismiss Claims Under 1934 Act Rule 10b-5(a) and (c) and 1933 Act Section 17(a)**

The Southern District of New York, on September 22, 2011, in an apparent case of first impression, applied the Supreme Court’s ruling in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 180 L. Ed. 2d 166, Fed. Sec. L. Rep. (CCH) ¶ 96327 (2011) to dismiss the SEC’s claims under Section 17(a) of the 1933 Act and Rule 10b-5 promulgated under the 1934 Act.

Defendants were executives at AOL when the company allegedly artificially inflated its reported online advertising revenue. The SEC had asserted charges against defendants, *inter alia*, under Sections 17(a) and 10(b) and Rule 10b-5. Following the Supreme Court’s decision in *Janus*, defendants moved for judgment on the pleadings dismissing those claims because the individual defendants did not “make” the alleged misstatements under the holding in *Janus*.

The SEC conceded that, after *Janus*, it could no longer maintain its

claims under paragraph (b) of the 1934 Act Rule 10b-5, but instead argued that it could maintain claims for “scheme liability” under paragraphs (a) and (c) of that Rule. The District Court rejected this argument on the grounds that, where the alleged deceptive act is only deceptive because of subsequent public misrepresentations, the SEC cannot use paragraphs (a) and (c) as a backdoor into liability under paragraph (b). In this case, there is nothing inherently deceptive about a transaction where a counterparty purchases advertising from AOL; the conduct was only made deceptive because of AOL’s allegedly improper recognition of advertising revenue. To hold otherwise, would violate the Supreme Court’s stated intent to preserve the bright line between primary liability and secondary liability under the securities laws.

The district court also applied the *Janus* holding to dismiss the SEC’s claims under Section 17(a) because the elements of misstatement and scheme liability under that Section are the same as those under Rule 10b-5.

*SEC v. Kelly*, No. 08-cv-4612 (S.D.N.Y. Sept. 22, 2011).

### **Purchase and Sale of Different Series of Stock Cannot be Paired with One Another to Establish Short-Swing Trading Liability**

On August 8, 2011, the Southern District of New York rejected “an apparently novel theory of liability” under section 16(b) of the 1934 Act, whereby plaintiff alleged that defendant’s purchase of Series A common stock around the same time as its sale of Series C common stock constituted a prohibited short swing transaction.

Defendant, a director at Discovery Communications Inc. (“Discovery”) made 10 purchases of Discovery’s Series A voting common stock and nine sales of Discovery’s Series C non-voting common stock between December 5 and December 17, 2008. Plaintiff argued that the plain language of Section 16(b) allows transactions in voting and non-voting common stock to be paired with one another to result in a prohibited short-swing transaction.

The Court rejected plaintiff’s reading of Section 16(b). The Court noted that the text of the statute limits the ability to profit from “the purchase and sale, or sale and purchase, of any equity security of the issuer.” By specifically choosing to group “purchase and sale” and “sale and purchase” into single compound units, the drafters indicated that the transactions at issue must be directed at the same equity security. In addition, the use of the word “any” is in reference to the fact that the statute applies to “any” of the types of equity securities listed in the statutory definition of equity securities.

The Court also found that the two series of stocks were not in the same class simply because both were considered common stock under Discovery's Articles of Incorporation. To the contrary, Discovery's Series A and Series C stock are properly classified as different classes of equity securities because they have different voting rights, different stock dividend preferences, are not convertible to one another, and differ as to whether an options market exists for each series.

*Gibbons v. Malone*, No. 10-cv-8640, 2011 WL 3516065 (S.D. N.Y. Aug. 8, 2011).

### **Second Circuit Finds that Calculations of Goodwill and Loan Loss Reserves are Opinions and Thus Not Actionable Under Sections 11 and 12 of the 1933 Act**

On August 23, 2011, the Second Circuit affirmed a District Court holding that statements concerning goodwill and loan loss reserves in a registration statement are statements of opinion and not objective facts and thus could not form the basis of liability under Sections 11 and 12 of the 1933 Act.

In November 2006, defendant Regions Financial Corporation ("Regions") acquired another bank holding company, AmSouth Bancorporation ("AmSouth"). In its 2007 10-K, Regions reported \$6.6 billion of goodwill attributable to the AmSouth acquisition, and loan loss reserves of \$555 million. Thereafter, in its fourth-quarter 2008 results Regions announced a \$6 billion charge for impairment of goodwill and doubled its loan loss reserve to \$1.15 billion. Plaintiffs brought a class action alleging that given the banking conditions in 2007, Regions overstated the goodwill from the AmSouth acquisition and failed to sufficiently increase its loan loss reserves at the time of acquisition.

The Southern District of New York dismissed the complaint for failure to plausibly allege a false statement and the Second Circuit affirmed. Sections 11 and 12 impose liability where a registration statement or prospectus contains misstatements or omissions of objective material facts. The Second Circuit held that an estimate of goodwill depends on management's determination of the fair value of assets and liabilities, and thus is a subjective determination based on management's opinion of those assets and liabilities. Similarly, the determination of a loan loss reserve is not a matter of objective fact, but also a reflection of management's opinion, this time about what, if any, portion of the amounts due on loans will ultimately not be collectible. The Court found that absent plausible allegations that Regions did not believe the statements regarding goodwill and loan loss reserve at the time they were made, those statements were not

false statements of objective fact, and thus were not actionable under Sections 11 and 12 of the 1933 Act.

*Fait v. Regions Financial Corp.*, 655 F.3d 105, Fed. Sec. L. Rep. (CCH) ¶ 96517 (2d Cir. 2011).

### **Ninth Circuit Holds Contractual Promise to Comply with Industry Standards is Forward Looking Statement**

The Ninth Circuit, on June 29, 2011, reversed the District Court and held that an obligation in a contract attached to SEC filings to conduct oil operations in accordance with industry standards, was forward-looking and could not form the basis of claims under Sections 10(b) and 20(a) of the 1934 Act and Rule 10b-5 thereunder.

In 1989 defendant BP Exploration (Alaska) Inc. (“BPXA”) created a business trust for the purpose of distributing royalty interests derived from oil production at a facility in Prudhoe Bay Alaska (the “Trust”). At the inception of the Trust, BPXA and the Standard Oil Company executed an Overriding Royalty Conveyance Agreement (the “Agreement”). The Agreement included a “prudent operator standard” clause (“Prudent Operator Clause”), whereby BPXA agreed to operate Prudhoe Bay with prudent business judgment and in accordance with oil industry standards. BPXA was responsible for making the Trust’s SEC filings and, on behalf of the Trust, it attached the Agreement to quarterly SEC filings.

In 2006, BPXA discovered leaks in two of its pipes, causing significant production delays at Prudhoe Bay. Plaintiffs brought a class action against BPXA. The District Court dismissed most of plaintiffs’ securities claims, but allowed plaintiffs to proceed on the theory that BPXA made a material misstatement when it filed the Agreement while knowing that it was not adhering to industry standards.

The Ninth Circuit reversed, holding that the Agreement would not give a reasonable investor an impression of a state of affairs that differed in a material way from the one that actually existed. The Prudent Operator Clause was deemed to be a forward-looking statement as a promise in a contract. A reasonable investor would not view the periodic filing of the Agreement as a certification of BPXA’s ongoing compliance with the Prudent Operator Clause because that clause is very broad, but was only a minor aspect of the Agreement, and BPXA attached the Agreement to the filings in compliance with unrelated SEC regulations.

*Reese v. BP Exploration (Alaska) Inc.*, 643 F.3d 681, Fed. Sec. L. Rep. (CCH) ¶ 96344 (9th Cir. 2011).

### **SEC Amicus Brief Argues that Sales Contract and Management Agreement is an Investment Contract**

On August 5, 2011, the SEC filed an amicus brief with the Ninth Circuit urging the Court to reverse a district court decision and hold that a sales contract and rental management contract for certain hotel rooms should be analyzed together as a single investment contract.

In or around 2006, defendants, hotel developers, began to sell hotel rooms and suites as “non-residential condominium units.” The sales contracts stated that 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 sued alleging 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. The District Court granted defendants’ motion to dismiss, holding that the sales and rental management agreements were too distant in time to constitute a single transaction, and relied upon language in the agreements that disclaimed any investment intent.

The SEC urged the Ninth Circuit to focus on the economic realities of the transaction, and not on the structure of the contracts to determine whether the agreements were a single investment contract. The SEC cited the Supreme Court’s opinion in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298–99, 66 S. Ct. 1100, 90 L. Ed. 1244, 163 A.L.R. 1043 (1946), to argue that, from the outset of these transactions, it was clear that plaintiffs were entering into sales contracts for the purpose of profiting from defendants’ actions to rent the hotel’s rooms. The SEC argued that the time between the sales and the rental management agreements is immaterial because the hotel was still under construction when the latter was signed.

*Salameh v. Tarsadia Hostel*, No. 11-55479 (9th Cir. Aug. 5, 2011).

The amicus brief can be found at <http://www.sec.gov/litigation/briefs/2011/salameh-tarsadia0811.pdf>.

## **Second Circuit Holds that Sophisticated Investor Could Not Reasonably Rely on a Broker's Guarantees of Liquidity of Auction Rate Securities**

On July 28, 2011, the Second Circuit ruled that, for purposes of a Section 10(b) claim, plaintiff's sophistication made it unreasonable for it to rely on broker-defendant's statements that student loan auction rate securities ("SLARS") had no liquidity risk and that defendant would always create a market if illiquidity occurred.

Plaintiff purchased a number of SLARS in 2007. At that time, defendant stated that these SLARS were safe liquid investments and that, if any instability in the markets for the SLARS occurred, defendant would step in and place sufficient bids to create a market and ensure liquidity. Defendant also stated that the liquidity of the SLARS was assured because of the federal government's guarantee of the underlying student loans. Defendant reiterated these statements several times in 2008 after plaintiff learned that other auction rate securities had become illiquid. When the plaintiff tried to sell the SLARS in 2009 the sales failed because the market for the securities was illiquid.

Plaintiff brought a claim under Section 10(b) of the 1934 Act and Rule 10(b)(5) thereunder based on defendant's assurances of liquidity. The Southern District of New York dismissed the complaint, and the Second Circuit affirmed. The appellate court reasoned that plaintiff could have easily discovered that the SLARS had substantial liquidity issues. As a result of an order entered into between it and the SEC, defendant had placed a statement of its auction rate securities practices online that was at odds with what defendant told plaintiff. Based on that statement, plaintiff should have known that the defendant had to routinely step in and place bids to ensure liquidity, but only did so at its discretion and had no obligation to prevent illiquidity of any auction rate securities.

The Second Circuit also rejected, as unreasonable, plaintiff's reliance on defendant's assurances of liquidity due to the federal government's loan guarantees. As sophisticated investors, plaintiff should have known that, even though SLARS are less risky than other auction rate securities because of the loan guarantees, those guarantees did not eliminate the risk that the SLARS could become illiquid.

*Ashland Inc. v. Morgan Stanley & Co., Inc.*, 652 F.3d 333 (2d Cir. 2011).

**Ninth Circuit Requires Additional Deceptive Conduct Beyond a Misrepresentation or Omission for Liability under 1934 Act Rules 10b-5(a) or (c)**

On August 23, 2011, the Ninth Circuit held that, in order to allege a fraudulent scheme under Rules 10b-5(a) or (c), a plaintiff must allege deceptive conduct beyond just misrepresentations or omissions.

Plaintiff, who was an investor in a closely-held company called Spot Runner, alleged that defendants, including the company, its founders and its executives, fraudulently failed to notify plaintiff that the founders were selling their stock. Plaintiff alleged that, under an agreement executed in conjunction with plaintiff's purchase of stock, defendants were obligated to notify plaintiff of any sale of stock by the founders. In addition to several state law claims, plaintiff claimed that defendants' failure to provide the required notification on multiple occasions, while soliciting further investment from plaintiff, constituted a misrepresentation in violation of the 1934 Act Rule 10b-5(b) and a fraudulent scheme in violation of Rules 10b-5(a) and (c).

The District Court dismissed the complaint and the Ninth Circuit affirmed in part and reversed in part. The Court of Appeals reversed the dismissal of the Rule 10b-5(b) claims, holding that plaintiff provided a strong inference of scienter by alleging that defendants knew about their obligation to provide notice, but failed to do so on multiple occasions while failing to disclose large losses and encouraging outside investment. The Court also concluded that plaintiff sufficiently alleged loss causation by asserting that its shares became worthless after it was revealed that the founders had committed a "pump and dump" scheme because no other investor would want to invest in the company after such revelations.

The Court of Appeals, however, affirmed the dismissal of the Rule 10b-5(a) and (c) claims. "A defendant may only be liable as part of a fraudulent scheme based upon misrepresentations and omissions under Rules 10b-5(a) or (c) when the scheme also encompasses conduct beyond those misrepresentations or omissions." Here plaintiff failed to allege any facts separate from those already alleged in its Rule 10b-5(b) omission claims, and thus did not meet the standard for a separate claim. The Court stated that even though it had not squarely addressed this question previously, it was joining several other courts in so holding.

*WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, Fed. Sec. L. Rep. (CCH) ¶ 96519 (9th Cir. 2011).

### **Supreme Court Grants Certiorari to Review Rationale for Tolling the Statute of Limitations for a Violation of Section 16(b)**

On June 27, 2011, the Supreme Court granted a writ of certiorari to review the question of whether the two-year statute of limitations under Section 16(b) of the 1934 is tolled until the statutory insider makes his or its mandatory disclosure filing under Section 16(a).

Plaintiff originally brought fifty-four separate derivative cases against investment banks that allegedly violated the short-swing profit restrictions in Section 16(b) when they acted as lead underwriters in a number of initial public offerings. In each case plaintiff alleged that the investment banks coordinated their activities with insiders at the issuers to boost the post-IPO increase in price of the issuer's stock. The Western District of Washington dismissed all the cases, holding that in thirty of the cases plaintiff had failed to provide a proper demand to the companies, and that the remaining twenty-four cases were brought after the two-year statute of limitations had run.

The Ninth Circuit, in *Simmonds v. Credit Suisse Securities (USA) LLC*, 42 SRLR 2254 (Dec. 10, 2010), affirmed in part and reversed in part. It agreed with the lower court that plaintiff had failed to provide a proper demand to the companies. However, it disagreed regarding the statute of limitations analysis. The Ninth Circuit noted that there were three competing approaches to Section 16(b)'s statute of limitations: (1) under a strict approach, Section 16(b)'s time restriction can be treated like a statute of repose whereby there can be no tolling; (2) the approach taken by the District Court "under which the time period is tolled until the Corporation had sufficient information to put it on notice of its potential [Section] 16(b) claim"; or (3) a disclosure approach "under which the time period is tolled until the insider discloses the transactions at issue in his mandatory [section] 16(a) report." The Ninth Circuit stated that, consistent with its prior precedent, it would apply the last approach, and therefore, held that since the insiders had never made their mandatory disclosures, the limitations period had been tolled until the action was brought.

The Ninth Circuit's approach differs from that applied by the Second Circuit in *Litzler v. CC Investments, L.D.C.*, 362 F.3d 203, 208, Fed. Sec. L. Rep. (CCH) ¶ 92725 (2d Cir. 2004), where that Court ruled that the statute of limitations was tolled until the plaintiff was placed on actual (not inquiry) notice of the insider trading. In light of this

difference in approach, defendant investment banks petitioned the Supreme Court to review the Ninth Circuit's ruling in *Simmonds*, stating that it conflicts with the Second Circuit's ruling in *Litzler*.

*Credit Suisse Securities (USA) LLC v. Simmonds*, 131 S. Ct. 3064 (2011).

#### NOTES:

<sup>1</sup>Pursuant to Rule 405 of the 1933 Act, an issuer is considered a well-known seasoned issuer, or WKSI, if, among other requirements, it meets the either of the first two eligibility criteria set forth in order to use Form S-3 and Form F-3. In other words the issuer is a WKSI if, as of a date within 60 days of a certain determination date, it (1) has a worldwide market value of its outstanding voting and non-voting common equity held by non-affiliates of \$700 million or more, or (2) has issued in the last three years at least \$1 billion aggregate principal amount of non-convertible securities, other than common equity, in primary offerings for cash, registered under the 1933 Act.

<sup>2</sup>Rule 405 of the 1933 Act defines a free-writing prospectus as any communication that is written, printed, or a radio or television broadcast, or a graphic communication, that constitutes an offer to sell or a solicitation of an offer to buy the securities relating to a registered offering that is used after the registration statement for the offering has been filed (or, in the case of a WKSI, regardless of whether such registration statement has been filed) and is made by means other than: (1) a statutory prospectus (a final prospectus, a preliminary prospectus or certain other categories of prospectus that meet the requirements of Section 10(a) of the 1933 Act); (2) a written communication used in reliance on Rule 167 and Rule 426 (relating to ABS issuers); or (3) a written communication that is delivered together with or after delivery of a final prospectus.

<sup>3</sup>Pursuant to Section 941(a) of the Dodd-Frank Act, Section 3(a)(77) was added to the 1934 Act to define an asset backed security as “a fixed income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a security or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flows from the asset, including—(i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the [SEC], by rule, determines to be an asset-backed security for purposes of this section; and does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.”