# Securities Regulation Law Journal

Volume 37 Number 3 Fall 2009

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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 (the "1933 Act"), the Securities Exchange Act of 1934 (the "1934 Act") and other Federal Securities laws during the second quarter of 2009.*

## SEC Rulemaking

### SEC Proposes Amendments to Rules Relating to Shareholders' Rights to Nominate and Elect Directors to Company Boards of Directors

On June 10, 2009, the SEC proposed amendments enhance the ability of shareholders to nominate and solicit proxies for the election of their director nominees. **(See SEC Release No. 33-9046).** Foremost, the proposed rules would require most publicly traded companies to include in their proxy materials (i) a limited number of shareholder nominees under certain circumstances and (ii) shareholder proposals to amend the company's governing documents regarding nomination procedures or disclosures related to shareholder nominations.

As proposed, the rules would require shareholders to meet certain conditions to be eligible to have their nominees included in a company's proxy materials:

- **Tiered ownership threshold** — A shareholder, or group of shareholders, would need to hold an aggregate of at least 1, 3 or 5 percent of a company's voting securities, depending on the size of the company;[1]
- **Holding period** — Shareholders would be required to have held their shares for at least one year;
- **Continued ownership** — Shareholders would be required to sign a statement declaring their intention to continue to own their shares through the annual meeting; and
- **Change of control** — Shareholders would be required to certify that they are not holding their stock for the purpose of changing

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control of the company, or to obtain more than minority representation on the board.

The amendments, as proposed, include several other key provisions:

- **Limitation on number of nominees** — No more than one shareholder nominee, or that number of nominees that represents up to 25 percent of the company's board of directors, whichever is greater, would be includable in the company's proxy materials. In the event a company were to receive shareholder nominations of more candidates than it was required to include in its proxy materials, the company would only need to include the candidate(s) that were first nominated;
- **Independence** — The shareholder nominees would need to satisfy the independence standards of the national securities exchange on which the company is traded;
- **Nomination agreements** — The nominating shareholder could not have any direct or indirect agreement with the company regarding the nomination of the nominee;
- **Preexisting right to nominate directors** — If the applicable state law or the company's governing documents prohibited shareholders from nominating directors, a company would not be required to include shareholder nominees in its proxy materials. When a company's governing documents prohibit nomination rights, shareholders who wish to nominate would have to first amend the governing documents through a shareholder proposal;
- **New Schedule 14N** — The nominating shareholder would be required to file with the SEC a new Schedule 14N that would contain information concerning the nominating shareholder and its nominees. The Schedule 14N would disclose, among other things, the amount and duration of ownership of securities owned by the nominating shareholder, the nominating shareholder's intention to own securities through the date of the annual meeting and a certification that the nominating shareholder is only seeking to elect a minority slate and is not seeking to change control of the company; and
- **Schedule 13G eligibility** — Nominating shareholders who own more than 5% of a company's securities would not lose their Schedule 13G eligibility solely as a result of submitting nominations or conducting a solicitation in favor of its nominees.

The proposed rules would also require a company, under certain circumstances, to include in its proxy materials shareholder proposals submitted under Rule 14a-8 that would amend, or request an amendment to, the company's governing documents to address its nomination procedures or other director nomination disclosure provisions (so long as such amendments did not conflict with SEC rules).

The SEC is seeking comment on the proposed amendments on or before August 17, 2009.

## SEC Proposes Amendments to Regulation SHO

On June 10, 2009, the SEC proposed amendments to Regulation SHO regarding the restriction of short selling activities based upon certain security market price trends. **(See SEC Release Nos. 34-59748).** Specifically the SEC is proposing two approaches to restrictions on short selling: (i) the short sale price test approach, which is a price test that would apply on a market wide and permanent basis and (ii) the circuit breaker approach, which is a price test that would apply only to a particular security during severe market declines in that security.

### The Short Sale Price Test Approach

With respect to the short sale price test approach, the SEC is proposing two separate alternatives:

- **The Modified Uptick Rule** — This would impose a bid price test requiring a "trading center" (as defined in Rule 600 of Regulation NMS) to maintain policies and procedures reasonably designed to prevent the execution or display of a short sale order at a "down-bid price," unless the order is marked "short exempt." In other words, if the current national best bid were to be below the last differently priced national best bid, a trading center would be required to have policies and procedures reasonably designed to prevent it from executing or displaying the order unless the order is priced above the current national best bid. A short sale would, however, be permitted without an uptick in the after-hours market; and
- **Uptick Rule** — Under this proposal, a short sale either below the price of the last sale or at the same price as the last sale would be prohibited, except when such price is above the next preceding different sale price. In other words, under the proposed uptick rule no short sale would be able to be effected if the short sale was below the last sale price. However an order would be permitted to be marked "short exempt" if the seller relies on an exception from the sale price test.

### The Circuit-Breaker Approach

With respect to the circuit-breaker approach, the SEC is also proposing two separate alternatives:

- **Circuit Breaker Halt Rule** — As proposed, a short sale would be prohibited if the price of a security, wherever traded, decreases by 10% or more from the last price reported for the security on the prior day, except when the price decrease occurs within 30

minutes of the end of regular trading hours. Exceptions would be available for market making, hedging, and certain transactions in options. Additionally, the circuit-breaker halt rule, as proposed, would include exceptions that are substantially identical to the exceptions included in the SEC's Short Sale Ban Emergency Order, as amended; and

- **Short Sale Price Tests** — This proposal would incorporate the Modified Uptick Rule and the Uptick Rule to the circuit-breaker approach. Under this proposal, if the price of a security were to decrease by 10% or more from the last price reported for the security on the prior day, except when the price decrease occurs within 30 minutes of the end of the regular trading hours, the "modified uptick rule" or the "uptick rule" would be implemented. In other words, a prohibition on short sales would be triggered when the price of a security, wherever traded, decreased by 10% or more from the last price reported for the security on the prior day, except when the price decrease occurs within 30 minutes of the end of regular trading hours.

### SEC Proposes Amendments to the Custody Rule Under the Investment Advisers Act of 1940 and Related Forms

On May 20, 2009, the SEC proposed amendments to the custody rule under the Investment Advisers Act of 1940 and related forms. **(See SEC Release No. IA-2876).** Under the proposed amendments the SEC would require all registered investment advisers that have custody of client funds or securities to undergo an annual surprise examination by an independent public accountant to verify client funds and securities. The amendments extend protection to clients when their funds and securities are not held with an independent custodian but rather with the adviser itself or indirectly through a related person.

As proposed, investment advisers subject to the rule would have to enter into a written agreement with the independent public accountant conducting the surprise examination to require the public accountant to, among other things, notify the SEC within one business day of finding material discrepancies and to submit Form ADV-E to the SEC accompanied by a certificate within 120 days of the time chosen by the accountant for the surprise examination stating that it has examined the funds and securities describing the nature and extent of the examination.

Finally, the SEC is also proposing amendments to Form ADV in order to provide more information about the custody practices of advisers registered with the Commission and to provide the SEC with additional data to improve its ability to identify compliance risks.

Comments are to be received by the SEC on or before July 28, 2009.

## APPELLATE AND OTHER DECISIONS OF NOTE

### Eighth Circuit Defines Fiduciary Duties of Mutual Fund Advisers Under Investment Company Act

On April 8, 2009, the Eighth Circuit reversed the District Court's grant of summary judgment in favor of an investment adviser and remanded the case for further consideration. Plaintiffs are shareholders of mutual funds, alleging that defendant breached its fiduciary duty under Section 36(b) of the Investment Company Act of 1940 by misleading the board of directors during fee negotiations.

The Court held that while the District Court properly applied the *Gartenberg* rationale, *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), in determining whether the fee itself constituted a breach of fiduciary duty, it should have also performed a comparison between the fees charged to mutual fund clients and institutional clients: "The district court concluded that Ameriprise did not breach its fiduciary duty in one way (by setting a fee that was exorbitant relative to that of other advisers), but it should have also considered other possible violations of § 36(b)."

Specifically, the Court found that a Section 36(b) violation could arise from (i) improprieties by an adviser during fee negotiations; or (ii) excessive fees. In order to evaluate whether such violation occurred, the appropriate standard of review includes a review of the adviser's conduct and a comparison of fees charged.

The Court also noted that while a number of courts have approved the *Gartenberg* standard, the Seventh Circuit explicitly rejected it in *Jones v. Harris Associates*, 527 F.3d 627 (7th Cir. 2008). Citing Judge Posner's *Jones'* dissent and the fact that the Supreme Court has granted certiorari in *Jones*, No. 08-586, 2009 WL 578699 (U.S. Mar. 9, 2009), the Court speculated that a new standard was forthcoming.

*Gallus v. Ameriprise Financial, Inc.*, 561 F.3d 816 (8th Cir. 2009).

### Supreme Court to Consider Commencement of Statute of Limitations on Fraud Claim Against Pharmaceutical Company

Petitioner Merck is the maker and distributor of Vioxx, a prescription medicine that often was used to relieve pain for arthritis patients. The company has been the target of several securities fraud lawsuits, claiming that it misrepresented the drug's risks of heart attack or stroke. Ultimately, Merck withdrew the medicine from the market in September 2004, based on new study results.

Plaintiffs are investors, alleging violations of Sections 11, 12, and 15 of the 1933 Act, Sections 10(b), 20(a) and 20A of the 1934 Act, and Rule 10b-5 promulgated thereunder. Lower courts have held that the

two-year filing period provided under the 1934 Act for such lawsuits begins to run once an investor becomes aware that fraud may have occurred, but those courts are widely split on how to apply that standard.

The District Court dismissed the Plaintiffs' claims, finding that the investors were on inquiry notice for over two years before filing suit, and thus the statute of limitations bars further action. The Court of Appeals, however, reinstated the claims, concluding that the District Court acted prematurely. The Third Circuit held that the investor has no duty to investigate suspicion of fraud, and the two-year filing period does not begin to run until the investor comes upon evidence that the fraud was intentional.

The Supreme Court agreed on May 26, 2009 to review the appeals court decision reinstating the shareholder claim that Merck misrepresented the safety of the pain reliever. The specific issue before the Supreme Court is how to define the deadline for filing a securities fraud lawsuit under federal law and to clarify when an investor must go to court to make a fraud claim.

*Merck & Co., Inc. v. Reynolds, No. 08-905.*

**Second Circuit Certifies Questions of Law to Georgia Supreme Court Regarding Alleged False Research Reports**

In connection with a litigation involving Salomon Smith Barney & Co, and analyst Jack Grubman, the Second Circuit on June 3, 2009 posed the following three certified questions to the Georgia Supreme Court: (i) whether Georgia common law recognizes fraud claims based on forbearance in the sale of publicly traded securities; (ii) is proximate cause adequately pleaded under Georgia law when a plaintiff alleges that his injury was a reasonably foreseeable result of defendant's false or misleading statements but does not allege that the truth concealed by the defendant entered the marketplace, thereby precipitating a drop in the price of the security; and (iii) whether, under Georgia law, a brokerage firm owes a fiduciary duty to the holder of a non-discretionary account.

Plaintiffs had brought suit, alleging losses due to reliance on defendants' allegedly false research reports. The District Court had dismissed plaintiffs' claim brought under Georgia's "blue sky" law, noting that plaintiffs' complaint "neither cited a specific provision of the statute, nor referred to particular false or misleading statements that allegedly violated the statute."

*Holmes v. Grubman*, 2009 WL 1531964 (2d Cir. June 3, 2009).

**Two-Year Statute of Limitations Not Tolled in Action to Recover Short-Swing Profits**

Plaintiff alleges violations of Section 16(b) of the 1934 Act and

contends that the two-year statute of limitations was tolled when defendants filed reports falsely indicating that an exemption applied. Plaintiff brought this action on behalf of the Brocade Communications Systems, Inc., which granted stock options to its top officers, the defendants. Plaintiff contended that defendants each sold the securities within six months of the grant and failed to properly disclose the transactions. The stock options at issue were granted from 1999–2001, but suit was not brought until 2006. Defendants maintained that the transactions were exempt from Section 16(b) of the 1934 Act under Rule 16b-3(d), which provides an exemption for acquisitions from the issuer when the transaction is approved by the board.

On June 5, 2009, the Ninth Circuit affirmed the District Court's dismissal of the suit to recover short-swing profits on statute of limitations grounds. In its ruling, the Ninth Circuit noted that tolling the statute of limitations would be inconsistent with the statutory scheme.

*Roth v. Reyes*, 2009 WL 1564228 (9th Cir. June 5, 2009).

**Supreme Court Will Not Hear Case on Investment Adviser Standing**

On April 20, 2009, the Supreme Court declined to hear a case from the Second Circuit involving an investment adviser's right to sue on behalf of its clients.

Plaintiff alleges that defendants violated Sections 11 and 12(a)(2) of the 1933 Act and Sections 10(b) and 18 of the 1934 Act by preparing, facilitating or certifying misleading and/or inaccurate disclosures. Plaintiff, however, is not an investor but rather an investment adviser who bought securities for its clients. Plaintiff had exclusive power to invest and sue on behalf of its clients. Defendants had sought dismissal on the grounds that plaintiff lacked standing to sue.

The Second Circuit reversed the district court, holding that plaintiff, an investment adviser, lacked standing to sue because acting as power of attorney was insufficient to confer constitutional standing without an accompanying transfer of the entire interest in the title or ownership of the underlying claim, and that plaintiff did not suffer any injury itself. The Court also noted that the adviser's sole interest in the litigation was "the recovery of legal fees, which are a 'byproduct of the suit itself' and cannot serve as a basis for Article III standing."

*W.R. Huff Asset Management Co. v. Deloitte & Touche LLP, No. 08-1112.*

**Late SEC Filing by Issuer Does Not Violate 1939 Trust Indenture Act**

Plaintiff corporation entered into an indenture, which contained default provisions whereby the trustee may accelerate notes (upon

receipt of written notice of default by note holders) and declare the principal and interest due and payable immediately. Plaintiff notified the SEC that its Form 10-K filing would be delayed, which caused certain note holders to inform the trustee that there would be a late filing and therefore a default, which then caused the trustee to trigger accelerated payments.

Plaintiff filed a declaratory judgment seeking a determination that a late filing did not constitute default under the indenture and that there was no violation of Section 314 of the 1939 Trust Indenture Act, which requires an issuer to file copies of annual reports with the trustee.

The District Court granted plaintiff's motion for summary judgment and the Fifth Circuit affirmed the decision on April 16, 2009. In so ruling, the Circuit Court noted that Section 314 required that the issuer provide to the trustee copies of those reports actually filed with the SEC, but did not impose an independent obligation to timely file with the SEC.

*Affiliated Computer Services, Inc. v. Wilmington Trust Co.*, 565 F.3d 924 (5th Cir. 2009).

**Chamber of Commerce Files Brief in Shareholder Proposal Case**

On April 22, 2009, the U.S. Chamber of Commerce filed a brief urging the Second Circuit to affirm the lower court's dismissal of plaintiff Lucian Bebchuk's claims, as previously discussed in this Journal (Vol 37 Issue 2 Securities Regulation Law Journal 6 pp. 195–196).

The case focuses on a shareholder proposal, submitted by plaintiff to Electronic Arts (EA), which required that the EA board submit to a shareholder vote a charter or bylaw amendment that, if adopted, would require the company (to the extent permitted by law) to include in the company's proxy materials qualified proposals for a bylaw amendment. EA excluded the proposal from the company's ballot, and the issue is whether the SEC's shareholder proposal rule (Rule 14a-8 of the 1934 Act) allows the company to do so. The District Court granted summary judgment for EA in a brief bench ruling and sent the case to the Second Circuit.

The Chamber of Commerce argued that plaintiff's proposal is in conflict with the SEC's proxy rules, including Rule 14a-8 of the 1934 Act and that based on recent Supreme Court decisions, shareholder proposal procedures under Rule 14a-8 do not give rise to a private right of action.

*The brief can be found at http://www.law.harvard.edu/faculty/bebchuk/pdfs/Chamber-of-Commerce-Amicus-Brief.pdf.*

## NOTES:

[1]At least 1% for a "large accelerated filer" (a company with a worldwide market value of $700 million or more), or of a registered investment company with net assets of $700 million or more; at least 3% for an "accelerated filer" (a company with a worldwide market value of $75 million or more but less than $700 million), or of a registered investment company with net assets of $75 million or more but less than $700 million; at least 5% for a "non-accelerated filer" (a company with a worldwide market value of less than $75 million), or of a registered investment company with net assets of less than $75 million.