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# Quarterly Survey of SEC Rulemaking and Major Appellate Decisions

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*This issue's Survey focuses on Securities and Exchange Commission ("SEC") rulemaking activities and major federal appellate decisions under the Securities Act of 1933 (the "1933 Act"), the Securities Exchange Act of 1934 (the "1934 Act") and other Federal Securities laws during the third quarter of 2007.*

### SEC RULEMAKING

#### SEC Adopts Anti-Fraud Rule Relating to Certain Pooled Investment Vehicles

On August 3, 2007 the SEC adopted Rule 206(4)-8 relating to the prohibition of fraud by advisers to certain pooled investment vehicles. **(See SEC Release No. IA-2628)**. The rule applies to both registered and unregistered investment advisers and prohibits advisers to pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in the pooled investment vehicles. The rule is designed to clarify, in light of a recent opinion of the Court of Appeals for the D.C. Circuit (*Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006)) the SEC's ability to bring enforcement actions against investment advisers who defraud investors or prospective investors in a hedge fund or other pooled investment vehicle. The rule became effective September 10, 2007.

#### SEC Adopts Final Rules Relating to the Mandatory Internet Availability of Proxy Materials and Annual Reports

On July 26, 2007 the SEC adopted final rules amending Rules 14a-3, 14a-7, 14a-16, 14a-101, 14b-1, 14b-2, 14c-2 and 14c-3 under the 1934 Act requiring issuers to post proxy materials and annual reports on a publicly available website. **(See SEC Release No. 34-56135).** Issuers have the option of disseminating the materials either by sending shareholders a notice that proxy

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materials are available on the Internet or by delivering the proxy materials in traditional paper form together with information about the Internet availability of the materials. Issuers that are "large accelerated filers" must comply commencing on or after January 1, 2008. Issuers that are not large accelerated filers, registered investment companies and dissident solicitors must comply commencing on or after January 1, 2009. The rules do not apply to proxy solicitations in connection with business combination transactions.

## SEC Adopts Amendments to Regulation M regarding Short Selling in Connection with a Public Offering

On August 6, 2007, the SEC adopted rules eliminating the covering element of Rule 105 under the 1934 Act. **(See SEC Release No. 34-56206).** The amendments, subject to certain exceptions, generally prohibit the purchasing of securities from an underwriter or broker-dealer participating in a firm commitment offering if the subject securities had been sold short during the restricted period as defined in Rule 105. The amendments became effective October 9, 2007.

## Bona Fide Purchaser Exception

The amendments include an exception to allow restricted period short sellers to purchase the offered securities if they make a bona fide purchase of the same security no later than the business day preceding the day of pricing. Whether a purchase is bona fide will depend on the facts and circumstances of the transaction. In addition, the purchase must be at least equivalent in quantity to the entire amount of the Rule 105 restricted period short sale and must be made during regular trading hours, not including the 30 minutes before the close of regular trading hours on the business day before the day of pricing.

## Separate Accounts Exception

The amendments also include an exception that permits buyers of the offered security to purchase the security even if they sold the security short during the restricted period as long as the "short sale" account is a separate account, i.e. an account without coordination of trading or cooperation. Accounts are considered separate and operating without coordination of trading or cooperation if the accounts have:

- Separate and distinct investment and trading strategies and objectives;
- Personnel, including no one with oversight or managerial responsibility over related accounts that has the authority to execute or preapprove trades in each of the accounts;
- Informational barriers;
- Separate profit and loss statements; and

- Separate allocations of securities.

This list is not dispositive and, depending on the facts and circumstances, accounts not satisfying the above conditions may fall within the exception if the accounts can be shown to be separate and operating without coordination of trading or cooperation.

**Investment Company Exception**

The amendments also provide an exception for individual funds that are part of a fund complex or series of funds to purchase an offered security if another fund within the same complex or different series sold the security short during the restricted period.

**SEC Adopts Amendments to Regulation SHO under the 1934 Act**

On August 7, 2007, the SEC adopted amendments to Rules 203(b)(3) and 200(e) of Regulation SHO eliminating the grandfather provision, amending the close-out requirement and updating the market decline limitation. **(See SEC Release No. 34-56212)** The amendments became effective October 15, 2007.

**Grandfather Provision**

The amendments eliminated the grandfather provision of Regulation SHO that allowed any fail to deliver positions established before a security became a threshold security[1] to avoid being subject to close-out requirements. The amendment eliminating the grandfather provision is intended to reduce the number of persistent fails to deliver in certain equity securities. All fail to deliver positions, including those that existed before the security became a threshold security, will now be required to close within 13 consecutive settlement days, with the exception of previously granfathered positions. The amendment includes a 35-day phase-in period to allow time to comply with the new close-out requirements.

**Sales of Securities Pursuant to Rule 144**

The amendments also extend the close out requirement from 13 to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144. In addition the amendments also extend Regulation SHO's pre-borrow requirement. For any fail to deliver positions for Rule 144 securities that persist for more than 35 consecutive settlement days, participants of a registered clearing agency, including the broker-dealers for which it clears transactions, will not be able to accept any short sale orders of that particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow the security until the participant closes out the entire fail to deliver position.

## Market Decline Limitation

The amendments also provide that the market decline regulation referenced in Regulation SHO will now reference the New York Stock Exchange Composite Index instead of the Dow Jones Industrial Average. The amendments further provide that the two percent market decline limitation is to be calculated in accordance to the New York Stock Exchange Rule 80A, so that market participants need refer to only one index in connection with restrictions regarding index arbitrage trading.

## SEC Adopts Temporary Rule Regarding Principal Trades for Investment Advisors Dually Registered as Broker-Dealers Under Section 203 of the Investment Advisors Act of 1940

On September 24, 2007, the SEC adopted a temporary rule under the Investment Advisors Act of 1940 (the "1940 Act") to provide limited relief for investment advisors that are dually registered as broker-dealers from principal trading restrictions under Section 206(3) of the 1940 Act. **(See SEC Release No. IA-2653)**. The rule was adopted in response to a recent decision by the DC Circuit Court invalidating 1940 Act Rule 202(a)(11)-1 that had permitted broker-dealers to receive fee-based compensation without registering as investment advisors.

The temporary rule permits investment advisors who are registered broker-dealers relief from the requirements of Section 206(3) of the 1940 Act if they, among other things:

- Provide their clients with written prospective notice with respect to principal transactions with non-discretionary advisory accounts. The written notice must include disclosures about the circumstances under which the investment advisor may engage in principal transactions and conflicts of interest;
- Obtain their clients' written revocable consent in response to the prospective notice.
- Provide oral notice to and obtain oral consent from their clients regarding their actions as principal on a transaction by transaction basis.
- Send their client a written confirmation disclosing the capacity in which they acted. The confirmation must also disclose the fact that they may act in a principal capacity and that the transaction had been authorized by the client.
- Deliver an annual report of principal trades effected for the year to their clients.

Relief under the temporary rule is available for principal transactions in securities other than (i) securities issued by the investment advisor or its affiliates or (ii) securities underwritten by the investment advisor or its affiliates except in the case of certain investment-grade debt securities. The rule became effective on October 1, 2007 and remains effective until December 31, 2009.

## APPELLATE DECISIONS OF NOTE

### Sarbanes-Oxley Certification In and of Itself Does Not Satisfy Scienter Requirement

The Court of Appeals for the Fifth Circuit held on August 21, 2007 that Sarbanes-Oxley certifications alone do not indicate scienter or the intent to defraud. The Court dismissed the class action securities case and held that plaintiff "does not clearly explain the link between these statements about the internal controls and the actual accounting and reporting problems that arose." The Court further held that plaintiff's "confidential source statements lack sufficient detail to credit them as bases for a strong inference of scienter with respect to the particular allegations of fraud" in the complaint.

Plaintiff, a stockholder, brought this action against the electrical contracting services company, its President and CEO, and its CFO, alleging violations of Sections 10(b) and 20(a) of the 1934 Act, and Rule 10(b)(5) promulgated thereunder. Plaintiff alleges that the company made false or misleading financial statements that inflated the company's market price. In support of its argument, plaintiff primarily relied upon (i) GAAP violations, public statements, and the restatement; (ii) confidential sources; and (iii) Sarbanes-Oxley certifications. The Fifth Circuit rejected plaintiff's arguments, finding that GAAP violations and Sarbanes-Oxley certifications do not constitute an inference of scienter and that the confidential sources lack the requisite particularity.

The Court noted that the recent Supreme Court decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007) did not require a finding of scienter based on the Sarbanes-Oxley certifications alone. There is scienter only when the person signing the certification "had reason to know, or should have suspected, due to glaring accounting irregularities or other 'red flags,' that the financial statements contained material misstatements or omissions." There were no such circumstances in this case.

*Central Laborers' Pension Fund v. Integrated Electrical Services, Inc.,* 497 F.3d 546 (5th Cir. 2007).

### Insurer, As Assignee of a Security, Lacks Standing as a Purchaser Under Section 10(b) of the 1934 Act

Plaintiff is an insurer of municipal bonds, who became the owner of the bonds after a default. Plaintiff alleged a violation of Rule 10b-5 under the

1934 Act against the underwriter, defendant Stephens, as well as state law claims of fraud and negligent misrepresentations against all defendants.

On September 18, 2007, the Court of Appeals for the Eleventh Circuit dismissed the claims for lack of standing pursuant to section 10(b) of the 1934 Act, finding that plaintiff failed to satisfy the purchaser-seller requirement. The Court rejected all of plaintiff's arguments, holding that (i) assuming the risk of a transaction does not grant standing; (ii) a guarantor is not a purchaser; and (iii) guaranties do not constitute a security under section 3(a)(10) of the 1934 Act. Moreover, the Court noted that while plaintiff became the owner of the bonds, it did not "acquire" them because it did not have the right to receive interest or principal on the bonds. Finally, the Court rejected plaintiff's subrogation argument on the ground that a subrogee cannot file a complaint based on a harm it suffered itself. Here, plaintiff does not allege harm to the bondholders, but rather harm to itself.

*Financial Security Assurance Inc. v. Stephens, Inc.,* No. 04-14894, 2007 WL 2700280 (Sept. 18, 2007).

**Solicitor General and Securities Industry and Financial Markets Association and Futures Industry Association File Amicus Briefs in U.S. Supreme Court**

The case of *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc. and Motorola Inc.* is on appeal from the Court of Appeals for the Eighth Circuit. The issue before the Supreme Court is whether third-party equipment vendors can be held liable for allegedly assisting a cable television company in committing fraud.

Plaintiffs in this case filed a class securities action, alleging that a cable television company engaged in a scheme to artificially inflate its financial statements. Plaintiffs specifically contend that the cable television company entered into sham transactions with equipment vendors to improve its operating revenue and cash flow, in violation of section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder. The Eighth Circuit affirmed the lower court's dismissal of the action, finding that plaintiffs can only prove, at most, aiding and abetting. Such a claim is barred with respect to private actions, pursuant to the holding in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). Earlier this year, the Supreme Court agreed to hear this matter and on August 15, 2007, both the Solicitor General, on behalf of the United States, and the Securities Industry and Financial Markets Association ("SIFMA") and Futures Industry Association ("FIA") filed amicus briefs in support of the Eighth's Circuit's dismissal.

The government's brief argued that while section 10(b) of the 1934 Act applies to all deceptive or manipulative conduct, dismissal is proper because petitioners failed to plead reliance and loss causation, and there is no private right of action for claims of aiding and abetting. Further, the Solicitor General noted that finding third-parties liable in these circumstances would result in a "sweeping expansion of the judicially inferred private right of action in Section 10(b) and Rule 10b-5, potentially exposing customers, vendors, and other actors far removed from the market to billions of dollars in liability when issuers of securities make misstatements to the market."

The SIFMA and FIA also urged affirming the Eighth Circuit's decision, contending that only the cable television company can be held liable for section 10(b) violations. The brief argues that petitioners fail to attribute any misstatements or representations to the third-parties, and that silence gives rise to fraud liability only when there is a duty to speak (and that there is no such duty in this case). Finally, the amicus brief points out that the Supreme Court need not be concerned that a ruling in favor of respondents will encourage fraud since there are adequate state and federal laws that protect against aiding and abetting.

Texts of the amicus briefs available at *http://www/sifma.org/regulatory/briefs/Stoneridge8-15-07.pdf*

**Growth Projections Are Not Actionable**

Plaintiff shareholder brought suit against a company, its directors, and its accountant, alleging violations of sections 10(b) and 20(a) of the 1934 Act. Plaintiff contends that the company failed to disclose that it overstated its pretax earnings for 2001 by $1.8 million, it incurred a pretax loss of $3.8 million in 2002, and it was in default of the terms of its credit facility with Merrill Lynch.

On September 6, 2007, the Court of Appeals for the Third Circuit dismissed the class action securities fraud claims. The Court held that (i) the statements at issue were projections of the company's growth or general optimism, and therefore, not actionable under section 10(b) of the 1934 Act; and (ii) plaintiff failed to prove scienter. Specifically, the Court held that the company's statements about its financial condition either concerned past performance or constituted "puffery," and that investors reasonably understood them as such.

In his dissent, Judge Garth emphasized the magnitude of the overstatements and opined that they were indicative of fraudulent intent and scienter.

*Key Equity Investors, Inc. v. Sel-Leb Marketing Inc.,* No. 06-1052, 2007 WL 2510385 (Sept. 6, 2007).

## NOTES:

1. A threshold security is any equity security of an issuer (i) registered pursuant to Section 12 of the 1934 Act or (ii) for which the issuer is required to file reports pursuant to Section 15(d) of the 1934 Act. Additionally, there must be an aggregate fail to deliver position for the security for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, equal to at least 0.5% of the issuer's total shares outstanding and the security must be included on a list disseminated to its members by a self-regulatory organization. However, a security shall cease to be a threshold security if the aggregate fail to deliver position at a registered clearing agency does not exceed the level specified above for five consecutive settlement days.