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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") and the Securities Exchange Act of 1934 (the "1934 Act") during the third quarter of 2004.

SEC RULEMAKING

SEC Adopts Rules Relating to Disclosure Regarding Portfolio Managers of Registered Management Investment Companies

On August 23, 2004, the SEC adopted final rules relating to disclosure regarding portfolio managers of registered management investment companies. The new rules are intended to expand disclosure provided by registered management investment companies regarding their portfolio managers. The new rules amend Forms N-1A, N-2 and N-3, which are registration forms used by registered management investment companies to register under the Investment Company Act of 1940 and to offer their securities under the Securities Act of 1933. The new rules also amend Form N-CSR which registered management investment companies use to file certified shareholder reports with the SEC. (SEC Release No. 33-8458, August 23, 2004).

The new rules and corresponding amendments require:

- A registered management investment company to provide disclosure in its prospectus identifying each member of the portfolio management team including his name, title, length of service and business experience;

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- The registered management investment company's Statement of Additional Information ("SAI") to include disclosures regarding any accounts managed by any of its portfolio managers, including a description of material conflicts of interest that may arise in connection with simultaneously managing the fund and the other accounts;
- The registered management investment company's SAI must disclose the structure of, and the method used to determine the compensation structure of each manager;
- The registered management investment company's SAI must disclose each portfolio manager's ownership of securities in the investment company;
- A closed-end fund must provide the aforementioned disclosure in its annual reports on Form N-CSR.

All initial registration statements on Forms N-1A, N-2, and N-3, and all post-effective amendments that are annual updates to effective registration statements on these forms, filed on or after February 28, 2005, must include the disclosure required by the amendments. All post-effective amendments that add a new series, filed on or after February 28, 2005, must comply with the amendments with respect to the new series. Every annual report by a closed-end fund on Form N-CSR filed for a fiscal year ending on or after December 31, 2005, and every semi-annual report by a closed-end fund on Form N-CSR filed after the first such annual report, must include the disclosure required by the amendments.

SEC Adopts Rules on Short Sales

The SEC has adopted a new Regulation SHO which defines ownership of securities, specifies aggregation of long and short positions, and requires broker-dealers to mark sales in all equity securities "long," "short," or "short exempt." Regulation SHO also includes a temporary rule that establishes procedures for the Commission to suspend temporarily the operation of the current "tick test" and any short sale price test of any exchange or national securities association, for specified securities. Regulation SHO also requires short sellers in all equity securities to locate securities to borrow before selling, and imposes delivery requirements on broker-dealers for securities in which a substantial number of failures to deliver have occurred. The SEC also adopted amendments that remove the shelf offering exception, and issued interpretive guidance addressing

the sham transactions designed to evade Regulation M. (SEC Release No. 34-50103, July 28, 2004).

The SEC has adopted 1934 Act Rule 200, including subsection:

- (b)(6), which provides that a person holding a long security futures position is not considered to own the underlying security, for Rule 200 purposes, until the security future stops trading and the future will be physically settled; and
- (f), which permits trading unit aggregation if a registered broker dealer meets the following requirements:
    1. the broker-dealer has a written plan of organization that identifies each aggregation unit, specifies its trading objective(s), and supports its independent identity;
    2. each aggregation unit within the firm determines at the time of each sale its net position for every security that it trades;
    3. all traders in an aggregation unit pursue only the trading objectives or strategy(ies) of that aggregation unit; and
    4. individual traders are assigned to only one aggregation unit at a time.
- (d), which incorporates the block-positioner exception and (e) which provides a limited relaxation of the requirement that a person selling a security aggregate of all of the person's positions in that security to determine whether he has a net long position.
- (g), which provides that an order can be marked "long" when the seller owns the security being sold and the security is either in the physical possession or control of the broker-dealer, or it is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than settlement.

The SEC has also adopted Rule 202T which provides procedures for the SEC to suspend any short sale price test for such securities and for such time periods as the SEC deems necessary. By separate order the SEC has established a pilot that includes a subset of securities from a broad-based index. The order identifies the pilot stocks and sets forth the methodology the SEC used in selecting pilot and control group stocks. Rule 202T also establishes a procedure by which the SEC may suspend, on a pilot basis, the tick test of Rule 10a-1 and any SRO short sale price

test during such time periods as the Commission finds necessary or appropriate and consistent with protection of investors.

The SEC has also adopted 1934 Act Rule 203, which requires a broker-dealer, prior to effecting a short sale in any equity security, to "locate" securities available for borrowing. The rule prohibits a broker-dealer from accepting a short sale order in any equity security from another person, or effecting a short sale for the broker-dealer's own account unless he has (1) borrowed the security, or entered into an arrangement to borrow the security, or (2) has reasonable grounds to believe that the security can be borrowed and delivered on the date delivery is due. There are several exceptions to this "locate" requirement specified in new Rule 203(b).

The SEC has also adopted subparagraph (a) of Rule 203, which addresses delivery requirements applicable to long sales of securities, incorporating current 1934 Act Rule 10a-2. Rule 203(a) generally requires that if a broker-dealer knows or should know that a sale of an equity security is marked long, the broker-dealer must make delivery when due and cannot use borrowed securities to do so. There are three circumstances where the delivery obligation does not apply:

- the loan of a security through the medium of a loan to another broker or dealer;
- where the broker or dealer knows or has been reasonably informed by the seller that the seller owns the security and will deliver it to the broker or dealer prior to the scheduled settlement of the transaction and the seller fails to make such delivery; or
- where an exchange or securities association finds, prior to the loan or arrangement to loan any security for delivery, or failure to deliver, that the sale resulted from a good-faith mistake, the broker-dealer exercised due diligence, and either that requiring a buy-in would result in undue hardship or that the sale had been effected at a permissible price.

The SEC, in this release, also adopted an amendment to 1934 Act Rule 105 of Regulation M, which prohibits a short seller from covering short sales with offering securities purchased from an underwriter or broker or dealer participating in the offering, if the short sale occurred during the Rule's restricted period, typically the five days prior to pricing. The SEC has amended Rule 105 to eliminate the shelf offering exception because shelf offerings have many characteristics of non-shelf offerings and equity shelf offerings have become commonplace.

The SEC has also provided guidance in the form of examples of sham transactions that would violate Rule 105.

SEC Adopts Significant Rules on Investment Company Governance

Although not related to the 1933 or 1934 Acts, the SEC has adopted important rules under the Investment Company Act of 1940 mandating that registered investment companies that rely on certain Exemptive Rules ("funds") adopt certain governance practices. (It should be noted that there are pending lawsuits challenging the SEC's statutory authority to promulgate these heightened standards). The following is a summary of the practices that the amendment required to be adopted by funds:

- at least 75 percent of the directors of the fund must be independent directors or, if the fund board has only three directors, all but one of the directors must be independent directors; and
- the chairman of the board must be an independent director; and
- the board must perform a self-assessment at least once annually; and
- the independent directors must meet separately at least once a quarter; and
- the independent directors must be affirmatively authorized to hire their own staff.

In addition to these practices, a fund must retain copies of written materials that the board considers when approving the fund's advisory contract. The amendments to the Exemptive Rules became effective on September 7, 2004 and must be implemented by January 16, 2006. (SEC Release No. IC-26520, July 27, 2004).

SEC Clarifies Rules Relating to Shareholder Reports and Quarterly Portfolio Disclosure of Expenses of Registered Management Investment Companies.

On August 9, 2004, the SEC adopted a technical amendment to Item 21(d)(1) of Form N-1A, which was published in the Federal Register on March 9, 2004 (69 FR 11244). In March, the SEC issued a release adopting amendments to Form N-1A that require registered open-end management investment companies to disclose in their reports to shareholders fund expenses borne by shareholders during the reporting period. The amendments require a shareholder to disclose:

- The cost in dollars associated with an investment of $1,000, based on the fund's actual expenses and return for the period; and
- The cost in dollars associated with an investment of $1,000, based on the fund's actual expenses for the period and an assumed return of 5 percent per year.

The requirement for the expense examples includes an instruction to round all dollar figures to the nearest dollar. In adopting the requirement for an expense example, the SEC required examples to be based on an initial investment of $1,000, rather than $10,000 as proposed, but the SEC did not consider the rounding instruction. After adoption of the rule, the SEC became aware that rounding expenses paid on an $1,000 investment may result in insufficiently precise expense figures. The SEC adopted this technical amendment to Instruction 1(a) of Item 21(d)(1) of Form N-1A to require funds to round all figures in the table of expense examples to the nearest cent, rather than the nearest dollar. (SEC Release Nos. 33-8393A; 34-49333A, August 9, 2004).

SEC Adopts Rule Relating to Covered Securities Pursuant to Section 18 of the Securities Act of 1933

On July 14, 2004, the SEC adopted an amendment to a rule under Section 18 of the Securities Act of 1933; the purpose of the amendment is to designate options listed on the International Securities Exchange, Inc. as covered securities. (SEC Release No. 33-8442, July 14, 2004).

APPELLATE DECISIONS OF NOTE

Private Securities Litigation Reform Act (PSLRA) Safe Harbor Provision Held Effective

Shareholders brought a class action against a corporation's former officers and directors, alleging securities fraud. On August 18, 2004, the Court of Appeals for the First Circuit affirmed the District Court's dismissal of the complaint, holding, among other things, that a press release in which the corporation announced that some of its subsidiaries were filing for bankruptcy protection and expressed the view that the reorganization would help reposition the corporation for successful operations, contained forward looking statements and came within the protection of the safe harbor provisions of the PSLRA. Thus, according to the First Circuit, those statements could not serve as the basis for a section 10(b)(5) securities fraud claim under the '34 Act. ***Baron v. Smith*, 380 F.3d 49 (1st Cir. 2004).**

No Fiduciary Duty to Disclose to Warrant Holder

The Small Business Administration (the "SBA"), as holder of a common stock purchase warrant issued by a closely held corporation, brought a section 10(b)(5) a securities fraud action under the '34 Act against the corporation's officers and directors. The SBA claimed that the defendants breached their fiduciary duties by failing to disclose a third party's offer to purchase outstanding shares of the corporation's outstanding common stock. On August 12, 2004, the Third Circuit Court of Appeals held that the officers and directors of the closely held corporation did not have a fiduciary duty to disclose this information to the SBA, as the SBA was not a stockholder. The Court thus affirmed the District Court's order of summary judgment. ***United States Small Business Administration v. Katawczik*, No. 03-3474, 2004 WL 1799343 (3d Cir. August 12, 2004).**

No Dismissal Under PSLRA Safe Harbor Provision Without More Discovery

An investor brought a class action under the '33 Act and the '34 act against a corporation and individual officers of the corporation, alleging artificial inflation of the corporation's stock price prior to an acquisition. On July 29, 2004, the Court of Appeals for the Seventh Circuit reversed the District Court's dismissal of the complaint, holding that although the cautionary language in the company's Form 10-K potentially brought the allegedly misleading statements within the PSLRA's safe harbor provision, more discovery was needed to determine whether the corporation had known of certain specific risks that came to fruition but had not been disclosed. Those risks included that: (1) the corporation's Renal Division had not met its internal budgets in years; (2) the economic instability in Latin America adversely affected the corporation's sales in that part of the world; and (3) the corporation had closed certain plants which had been its principal source of low-cost dialysis products. ***Asher v. Baxter International Inc.*, 377 F.3d 727 (7th Cir. 2004).**

SEC Must Show "Extreme Recklessness" For Aider And Abettor Liability

A broker petitioned for the review of an SEC order imposing sanctions on the broker under Rule 10(b)(5) of the '34 Act for aiding and abetting alleged securities laws violations committed in the course of closing private placement offerings of common stock. On July 30, 2004, the Court of Appeals for the D.C. Circuit held that the SEC erred when it applied a recklessness standard to determine scienter. The Court held that the SEC should have applied an "extreme recklessness" standard, which may be

found if the alleged aider and abettor encountered "red flags," or "suspicious events creating reasons for doubt" that should have alerted him to the improper conduct of the primary violator, or if there was "a danger ... so obvious that the actor must have been aware of" the danger. The Court also held that there was insufficient evidence that the broker acted with extreme recklessness. ***Howard v. S.E.C.*, 376 F.3d 1136 (D.C. Cir. 2004).**

Alleged Misrepresentation Regarding "Gray Market" May Be Actionable

Shareholders, as representatives of an uncertified class, sued a golf club manufacturer and its officers, directors, and lead underwriters for manufacturer's IPO, alleging that the manufacturer's IPO registration statement and prospectus were materially false and misleading in violation of Section 11 and 12(a)(2) of the '33 Act. The manufacturer had represented that it sold its equipment exclusively to authorized retailers and that the golf industry was flourishing. The complaint alleged that the manufacturer had failed to disclose: (1) the existence of a so-called "gray market," in which unauthorized retailers were selling the equipment; and (2) that the entire industry had an oversupply of golf equipment. On August 25, 2004, the Court of Appeals for the Third Circuit reversed in part the District Court's dismissal and held that the materiality of the "gray market" issue could not be resolved at the pleading stage. The Court did, however, dismiss the claims regarding the oversupply of golf equipment as they were not materially misleading. ***In re Adams Golf, Inc. Securities Litigation*, 381 F.3d 267 (3d Cir. 2004).**

Alleged Fraudulent Statement Protected As Opinion Or Historical Fact

On August 17, 2004, in an unpublished summary order, the Court of Appeals for the Second Circuit affirmed the dismissal of a proposed Section 10(b)(5) class securities fraud suit challenging projections made by Duane Reade Inc. during an April 2002 conference call with stock analysts. According to the complaint, Duane Reade management knew that, at the time of the call, it was highly unlikely that the company would fulfill certain projections made during the call. In affirming the dismissal the Court held that the alleged fraudulent statements were either protected statements of opinion or accurate statements of historical fact and thus not actionable. ***Capstone Asset Management Co. v. Duane Reade Inc.*, No. 03-9352 (2d Cir. 2004).**

Recusal By SEC Chairman Satisfies Due Process And Eliminates Impropriety

A brokerage firm petitioned the Second Circuit Court of Appeals for a review of an order issued by the SEC terminating the broker's NYSE membership. On August 16, 2004, the Court held that any impropriety or appearance of impropriety stemming from personal conflicts of interest held by outgoing and incoming chairmen of the SEC was cured, and due process satisfied, by their personal recusals from the brokerage firm's application for review by the SEC of the NYSE termination. The Court also held that the brokerage firm waived this argument by failing to raise it before the SEC. ***MFS Securities Corp. v. SEC*, 380 F.3d 611 (2d Cir. 2004).**