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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions

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This issue's Survey focuses on the Securities and Exchange Commission's ("SEC") rulemaking activities and major federal appellate or other decisions relating to the Securities Act of 1933, as amended, (the "1933 Act"), the Securities Exchange Act of 1934, as amended, (the "1934 Act"), and other Federal Securities laws from October 1, 2013, through December 19, 2013.

SEC Rulemaking

SEC, with Other Agencies, Adopts the Volcker Rule—Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

On December 10, 2013, five federal agencies, including the SEC, issued jointly developed final Rules to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), also known as the "Volcker Rule." **(See SEC Release No. BHCA-1.)**

The final Rules prohibit insured depository institutions and companies affiliated with insured depository institutions ("banking entities") from engaging in short-term proprietary trading of certain securities, derivatives, commodity futures and options on these instruments, for their own account. The final Rules also impose limits on banking entities' investments in, and other relationships with, hedge funds or private equity funds ("covered funds"). The final Rules impose such limits by prohibiting insured depository institutions and their affiliates from: (i) *owning* any interest in a covered fund (under the final Rules, an "ownership interest" is defined broadly and is based on the attributes of the interest and whether the interest provides the banking entity with economic exposure to the profits and losses of the covered fund. As such, both debt and equity interests may be considered an ownership interest under the Rules); or (ii) *"sponsoring"*

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such covered funds. The final Rules define “sponsoring” a covered fund as:

- serving as a general partner, managing partner, or trustee of a covered fund;
- selecting or controlling (or having employees, officers, directors, or agents constituting) a majority of the directors, trustees, or management of a covered fund; or
- sharing the same name of the banking organization or any affiliate or a similar name with the covered fund.

Like Dodd-Frank, the final Rules provide exemptions for certain activities, including market making, underwriting, hedging, trading in government obligations, insurance company activities, and organizing and offering covered funds. The final Rules also clarify that certain activities are not prohibited, including:

- providing advice to covered funds;
- acting as agent, broker, or custodian to a covered fund;
- acquiring or retaining an ownership interest in a covered fund if the banking entity’s investment in a covered fund does not represent more than 3% of the total outstanding ownership interests of such fund (under this exemption, a banking entity many invest no more than 3% of its Tier 1 capital in covered funds); and
- acquiring or maintaining an ownership interest in a covered fund if the covered fund is an issuer of asset-backed securities and assets or holdings of such covered fund are solely comprised of: (i) loans; (ii) contractual rights or assets directly arising from those loans supporting the asset-backed securities; and (iii) certain interest rate or foreign exchange derivatives.

The compliance requirements under the final Rules vary based on the size of the banking entity and the scope of activities conducted. Banking entities with significant trading operations will be required to establish a detailed compliance program and their management will be required to attest that the program is reasonably designed to achieve compliance with the final Rules. Independent testing and analysis of an institution’s compliance program will also be required. The final Rules reduce the burden on smaller, less-complex institutions by limiting their compliance and reporting requirements. Additionally, a banking entity that does not engage in covered trading activities will not need to establish a compliance program.

The Federal Reserve Board announced on December 10, 2013, that banking organizations covered by Section 619 of Dodd-Frank will be required to fully conform their activities and investments by July 21, 2015.

SEC Issues Proposal to Implement Regulation A+ to Increase Access to Capital for Smaller Companies

On December 18, 2013, the SEC proposed rule amendments to Regulation A under the 1933 Act to implement Section 401 of the Jumpstart our Business Startups Act (the "JOBS Act"). Section 401 of the JOBS Act added Section 3(b)(2) to the 1933 Act, which directs the SEC to adopt Rules exempting offerings of up to $50 million of securities annually from the registration requirements of the 1933 Act. The proposed Rules include issuer eligibility requirements, content and filing requirements for offering statements and ongoing reporting requirements for issuers. **(See SEC Release No. 33-9497.)**

The proposed Rule would amend Regulation A to create two tiers of offerings: Tier 1, for offerings of up to $5 million in a 12-month period, and Tier 2, for offerings of up to $50 million in a 12-month period. Both Tiers would be subject to basic requirements as to issuer eligibility, disclosure, and other matters, drawn from the current provisions of Regulation A and updated in some areas to align Regulation A with current practice for registered offerings. In addition to these basic requirements, Tier 2 offerings would be subject to additional requirements, including the provision of audited financial statements, ongoing reporting obligations, and certain limitations on sales.

SEC Issues Proposal on Crowdfunding

On October 23, 2013, the SEC proposed amendments to Rules under the 1933 Act, to implement "Regulation Crowdfunding" in accordance with Title III of the JOBS Act. **(See SEC Release No. 33-9470.)**

The proposed amendments: (i) create rules governing the offer and sale of securities through an Internet website, including individual investment limits and limits on the aggregate offering size for a crowdfunding transaction and required disclosures that must be made by companies before commencing a transaction (see new Section 4(a)(6) of the 1933 Act), and (ii) provide a framework for the regulation of registered funding portals and broker-dealers that companies are required to use as financial intermediaries in the offer and sale of securities in connection with a crowdfunding transaction (see Section 4A of the 1933 Act).

Under the proposed Rules:

- A company would be able to raise a maximum aggregate amount of $1 million through crowdfunding offerings in a 12-month period.
- Investors, over the course of a 12-month period, would be permitted to invest up to:
    - ○ $2,000 or 5% of their annual income or net worth, whichever

is greater, if both their annual income and net worth are less than $100,000.

- 10% of their annual income or net worth, whichever is greater, if either their annual income *or* net worth is equal to or more than $100,000. During the 12-month period, these investors would not be able to purchase more than $100,000 of securities through crowdfunding.

Certain companies would not be eligible to use the crowdfunding exemption. Ineligible companies include non-U.S. companies, companies that already are SEC reporting companies, certain investment companies, companies that are disqualified under the proposed disqualification rules, companies that have failed to comply with the annual reporting requirements in the proposed rules, and companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies.

As mandated by Title III of the JOBS Act, securities purchased in a crowdfunding transaction could not be resold for a period of one year. The SEC has also proposed an amendment to Section 12(g) of the 1934 Act, to exempt securities sold in a crowdfunding transaction from counting toward the number of shareholders that would require SEC issuer registration.

The SEC is seeking public comment on Regulation Crowdfunding through February 3, 2014. Companies cannot use the proposed crowdfunding Rules until the SEC adopts final rules, anticipated to occur in the first half of 2014.

SEC Provides Guidance on "Bad Actor" Disqualifications in Regulation D Offerings

Earlier this year, and in conjunction with an amendment to Rule 506 under Regulation D of the 1933 Act, the SEC disqualified issuers and others (including the issuers' directors, general partners, managing members, executive officers, 20 percent beneficial owners and promoters) from participating in Rule 506 offerings if, among other things, they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws (see below for a list of disqualifying events). The amended Rule 506 became effective on September 23, 2013. Prior to the amendment, Rule 506 did not impose any such "bad actor" disqualification provisions with respect to securities offerings under Regulation D.

Under Rule 506, disqualifying events include:

- Certain criminal convictions;

- Certain court injunctions and restraining orders;
- Final orders of certain state and federal regulators;
- Certain SEC disciplinary orders;
- Certain SEC cease-and-desist orders;
- SEC stop orders and orders suspending the Regulation A exemption (under the 1933 Act);
- Suspension or expulsion from membership in a self-regulatory organization (SRO), such as FINRA, or from association with an SRO member; and
- U.S. Postal Service false representation orders.

On December 4, 2013, the Division of Corporation Finance of the SEC issued Compliance and Disclosure Interpretations ("CD&Is") addressing several questions that may arise regarding the recently adopted "bad actor" disqualification provisions. The SEC had previously issued some guidance regarding the "bad actor" provisions on September 19, 2013, but the CD&Is released on December 4 are more helpful, and, in particular, with respect to the scope of the term "affiliated issuers," indicate an important reconsideration by the SEC.

With respect to "affiliated issuers," the SEC has clarified that for purposes of Rule 506(d), an "affiliated issuer" is an affiliate of the issuer where such affiliate is itself issuing securities in the same offering. Rule 506(d) includes "affiliated issuer" in its list of potential bad actors; however, "affiliated issuer" is not defined in the Rule. There was widespread concern that this term could capture, amongst other things, controlled portfolio companies of private equity funds or remote affiliates of large, diverse financial services firms, requiring private funds relying on Regulation D to inquire as to the "bad actor" status of a potentially vast number of affiliated entities. The new CD&I gives comfort that an issuer is not required to diligence the bad actor status of affiliates other than those issuing securities in the same offering as the issuer or falling within one of the other enumerated categories of potential bad actors in Rule 506(d).

The December 4 CD&Is pertaining to Rules 506(d) and (e) are available on the SEC's website at http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm#260-14.

Appellate and Other Decisions of Note

Supreme Court to Review Fraud-On-The-Market Presumption

On November 15, 2013, the Supreme Court agreed to review the Fifth Circuit's decision that price impact fraud-on-the-market rebuttal evidence should not be considered at class certification.

In *Erica P. John Fund, Inc. v. Halliburton Co.*, 718 F.3d 423, Fed. Sec. L. Rep. (CCH) ¶ 97409, 85 Fed. R. Serv. 3d 678 (5th Cir. 2013), plaintiffs, shareholders of the Halliburton Company ("Halliburton"), moved for class certification in their lawsuit against Halliburton for securities fraud under § 10(b) of the 1934 Act. Halliburton opposed the shareholder's motion and sought to overcome the fraud-on-the-market presumption, first espoused in *Basic Inc. v. Levinson*, by introducing evidence that its alleged fraud did not affect the company's stock price and was therefore immaterial. Halliburton argued that materiality was a required element under *Basic* and rebuttal evidence of immateriality would be fatal to the shareholders' motion.

The District Court refused to allow Halliburton to present evidence of immateriality, and the Fifth Circuit affirmed. In its opinion, the Fifth Circuit stated that under the Supreme Court's decision in *Amgen*, "[t]he pivotal inquiry is whether proof of materiality is needed to ensure that the questions of law or fact common to the class will predominate over any questions affecting only individual members as the litigation progresses." The Court clarified that at class certification, the inquiry into materiality is not whether the plaintiffs will ultimately fail or succeed, "but whether they will fail or succeed *together*." Therefore, the materiality inquiry focuses on whether (1) the evidence proffered is common to all class members, and (2) a later failure of plaintiffs to prevail on the issue would not create a risk of individual issues overwhelming questions common to the class. Affirmative answers to both inquiries would indicate that the evidence should not be considered at class certification. The Fifth Circuit found first that the price impact evidence applied to all shareholders because a stock's market price "inherently applies to everyone in the class." Second, a later failure of proof on the question of price impact would not create a risk of individual questions predominating over common ones because the price impact evidence was similar to loss causation, a material element of any 10b-5 violation. Thus, shareholders' failure to prevail on the price impact issue would extinguish all fraud claims.

Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 636 (2013).

Ninth Circuit Examines Loss Causation in an Inefficient Bond Market

On September 19, 2013, the Ninth Circuit affirmed a District Court ruling that, under Sections 10(b)(5) and 20(a) of the 1934 Act, a plaintiff purchaser of municipal bonds could not establish loss causation by claiming that, but for misrepresentations in the offering documents, it would not have purchased the bonds, even though the market for the bonds was not efficient.

In 2004, plaintiffs purchased municipal bonds issued by the City of

Alameda, California. The bonds financed the city power authority's improvement of local internet and telecommunication systems. Despite optimistic statements in the offering documents, once launched, the systems encountered greater competition than expected, and in 2008 the power authority sold the system to Comcast at a significant loss. Plaintiffs brought suit alleging violations of, *inter alia*, Sections 10(b)(5) and 20(a). They claimed that the offering documents included misrepresentations overstating the systems, anticipated performance and that these misrepresentations induced plaintiffs to purchase the notes which eventually caused them to suffer losses when the system was sold.

The District Court granted summary judgment, ruling that plaintiffs had failed to establish loss causation. The Ninth Circuit affirmed. In its ruling, the Court differentiated between the two elements of causation under Sections 10(b)(5): transaction causation and loss causation. Transaction causation focuses on what was the "but for" cause of the transaction when it was entered into. Loss causation, on the other hand, requires the plaintiff to show a causal connection between the misrepresentation and the loss. Plaintiffs argued that, because virtually no market existed for the bonds, the loss was caused by the misrepresentation which allegedly induced plaintiffs to purchase the bonds because in the absence of the misrepresentation they would have never suffered a loss. The Circuit rejected this claim because plaintiff's argument confused the elements of transaction causation and loss causation. The Circuit ruled that plaintiffs had failed to show loss causation in that they focused solely on misrepresentations prior to purchase of the bonds. The plaintiffs' loss at the time of the sale of the system was not caused by these misrepresentations, but rather by the decrease in the value of the system.

Nuveen Mun. High Income Opportunity Fund v. City of Alameda, Cal., 730 F.3d 1111, Fed. Sec. L. Rep. (CCH) ¶ 97645 (9th Cir. 2013).

Supreme Court Denies Certiorari to Review Second Circuit Decision on Argentine Bonds

On October 7, 2013, the Supreme Court refused to review a Second Circuit decision that (1) required that the Republic of Argentina pay certain holders of sovereign bonds, (2) fashioned injunctive relief for the payout, and (3) ruled that the injunctive relief did not violate § 1609 of the Foreign Sovereign Immunities Act ("FSIA").

In *NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 246 (2d Cir. 2012), the defendant, the Republic of Argentina, issued a series of bonds (the "1994 Bonds"), which plaintiffs purchased. The 1994 Bonds contained two provisions purporting to protect purchasers from subordination: a "*Pari Passu* Clause" and an "Equal Treatment

Provision." However, Argentina soon defaulted on these bonds and refused to pay on the accrued debt. Instead, it issued new bonds ("Exchange Bonds") which it offered in exchange for the 1994 Bonds, began paying on the Exchange Bonds, and refused to pay on the 1994 Bonds. Plaintiffs refused the exchange and sued Argentina for breach of contract, arguing that it wrongfully subordinated the 1994 Bonds to the Exchange Bonds. Argentina argued that it did not breach its contract; that equitable relief was inappropriate; and that a finding against it would violate the FSIA.

The District Court granted summary judgment to plaintiffs and enjoined Argentina from paying the Exchange Bonds without also paying the 1994 Bonds. The Second Circuit affirmed. In its decision, the Second Circuit stated that a bond is a contract and applied basic principles of contractual interpretation to determine Argentina's rights and responsibilities. The Court focused on the 1994 Bonds' two protective provisions and treated them as imposing separate duties on Argentina. The Court stated that the *Pari Passu* Clause "prohibits Argentina, as a bond issuer, from formally subordinating the bonds by issuing superior debt"; and that the Equal Treatment Provision "prohibits Argentina, as bond payor, from paying on other bonds without paying on the [1994 Bonds]." By issuing the Exchange Bonds and paying on them without paying on the 1994 Bonds, Argentina violated these provisions and therefore breached its duties under the 1994 Bonds.

Moreover, the Second Circuit found that the District Court did not abuse its discretion in issuing an injunction. First, the 1994 Bonds did not contain a clause limiting the remedies available for breach of the agreement. Second, awarding monetary damages was an ineffective remedy because Argentina would "simply refuse to pay any judgments." Third, compliance with the injunction was not illegal because § 1609 of FSIA immunizes property of a foreign state located in the United States only from attachment, arrest, and execution; the injunctive relief did not affect any of the above. Finally, the balance of equities favored the holders of the 1994 Bonds.

Republic of Argentina v. NML Capital, Ltd., 134 S. Ct. 201 (2013).

Tenth Circuit Holds that Notes were Securities under the *Reves* Test

On October 4, 2013, the Tenth Circuit affirmed the granting of partial summary judgment, *inter alia*, holding that "notes" issued by a company to further its investment activities were securities under the Supreme Court's test in *Reves v. Ernst & Young*, 494 U.S. 56, 79, 110 S. Ct. 945, 108 L. Ed. 2d 47, Blue Sky L. Rep. (CCH) ¶ 73213, Fed. Sec. L. Rep. (CCH) ¶ 94939 (1990).

Defendants established the company to carry on business activities in China. In order to raise capital, defendants decided to invest in a number of dubious investment schemes that guaranteed fixed monthly returns. In order to raise the capital to make these investments, defendants began offering six-month "promissory notes" that guaranteed fixed monthly interest payments. Even though these notes were supposedly targeted to qualified investors, defendants eventually sold the notes through seminars at shopping malls, and claimed that the notes were "more conservative than a 401(k) [or a] mortgage." In total, defendants sold 138 notes to approximately 60 holders. The SEC brought an enforcement action and obtained an injunction to prevent the further issuance of notes.

The District Court granted the SEC's motion for partial summary judgment, holding that the notes were "securities" under the definition of that term in Section 2(1) of the 1933 Act. The Tenth Circuit affirmed. The Circuit applied a test it referred to as the "family resemblance" test set out by the Supreme Court in *Reves.* Under that test, a note is presumptively held to be a security unless it resembles a "family" of transactions that are not considered notes (*e.g.*, bank mortgages). In order to evaluate whether the note resembles a sale of securities, the *Reves* Court provided a four factor test: (1) was there a profit motivation that would prompt a reasonable seller and buyer to enter into the transaction; (2) was there a plan of distribution for the instrument or did others trade in the instrument for speculation or investment; (3) what were the reasonable expectations of the investing public; and (4) do other factors such as a regulatory scheme reduce the risk of the instrument. In applying these factors, the Circuit emphasized that defendants had sold the notes by advertising strong guaranteed returns and that the notes were explicitly made in order to further defendants' company's investment activities. The Court also found particularly persuasive the fact that the notes were sold as part of a scheme which involved one borrower and many lenders. Based on this analysis, the Circuit concluded that the sale of the notes resembled a company selling securities rather than a private loan transaction, and as such, the notes should be treated as securities.

S.E.C. v. Thompson, 732 F.3d 1151, 1157, Fed. Sec. L. Rep. (CCH) ¶ 97675 (10th Cir. 2013).

SEC Settles Alleged Custody Rule Violation of the Investment Advisers Act

On October 28, 2013, the SEC announced in separate press releases that three investment advisers had agreed to settle administrative charges of violating Section 206(4)-2 of the Investment Advisers Act of 1940 (the "1940 Act") and Rule 206(4)-2 promulgated thereunder (the "Custody Rule" or "Rule").

The Custody Rule requires registered investment advisers with custody of client funds or securities to undertake certain actions to protect those assets from loss, misappropriation, misuse, or the adviser's insolvency. The Rule mandates, with limited exceptions, that these advisers maintain client assets with a "qualified custodian," which the adviser must have a reasonable basis for believing sends an account statement, at least quarterly, to each client for which the qualified custodian maintains funds or securities. Moreover, the adviser must, *inter alia*, undergo an annual surprise examination by an independent public accountant to verify client assets.

The SEC's press releases indicate that the investment advisers violated the Custody Rule in several ways. The advisers failed to plan for annual surprise inspections, to maintain adequate records of their clients' assets, and to implement procedures to safeguard those assets. In one instance, an adviser's failure to comply with the Custody Rule facilitated third party fraud totaling $290,000. In another, the adviser's failure to ensure that adequate records were kept and delivered to clients resulted in fraudulent and self-interested transactions going unnoticed.

In settling the claims against them, the advisers agreed to comply with several conditions imposed on them by the SEC. These conditions include paying penalties to the SEC, reimbursing clients for certain costs, allowing for surprise audits to be conducted annually, training, hiring, and retaining independent consultants to ensure compliance with the Custody Rule, and signing sworn statements that they are complying with the Rule and settlement agreement.

The SEC press releases are available at:

http://www.sec.gov/litigation/admin/2013/ia-3706.pdf, http://www.sec.gov/litigation/admin/2013/ia-3705.pdf, http://www.sec.gov/litigation/admin/2013/34-70759.pdf.