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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 decisions under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act") during the fourth quarter of 2006.

SEC RULEMAKING

SEC Adopts Amendments to Tender Offer "Best-Price Rule"

On November 1, 2006, the SEC issued final rules amending the tender offer, best-price rule. **(See SEC Release Nos. 34-54684, IC-27542)**. The new rules, which became effective December 8, 2006, provide that the best-price rule, which requires that all tendering security holders be paid the same consideration in a tender offer, applies only to the consideration offered and paid for tendered securities. The new rules further provide that the best-price rule does not apply to employment compensation, severance, or other employee benefit arrangements entered into with certain of the subject company's security holders in connection with a tender offer. Finally, the new rules provide a specific, but non-exclusive, safe harbor for compensatory arrangements approved by the compensation committee or another committee of independent directors of the bidder or subject company.

Amendments to the Best-Price Rule

The best-price rule has been amended so that no one may make a tender offer unless the consideration paid for securities tendered in the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer. As a result, the best-price rule applies to consideration paid in exchange for securities tendered and not to consideration paid with respect to aspects of the acquisition transaction other than payment for the tendered securities to persons who happen to be security holders.

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Compensatory Arrangements Exception

As amended, the best-price rule contains a specific exemption for amounts offered or paid in accordance with employment compensation, severance or other employee benefit arrangements so long as such amounts:

- are being paid solely for past services performed or future services to be performed by the security holder (which may include non-competition agreements); and
- are not based on the number of securities the security holder owns or tenders.

The exemption applies to (i) third-party tender offer arrangements entered into between any security holder and the bidder or subject company, and (ii) issuer self-tender offer arrangements entered into between any security holder and the issuer or any affiliate.

Compensatory Arrangements Safe Harbor

The new rules also provide a non-exclusive safe harbor for employment compensation, severance or other employee benefit arrangements that are approved by the compensation committee (or a committee performing similar functions) of the board of directors of the target company in the tender offer, regardless of whether the target company is itself party to the arrangement, or of the bidder's board, if the bidder is party to the arrangement. If neither the target nor the bidder has a compensation or similar committee, or if the committee members are not independent, either the target or the bidder may form a special committee of independent directors to approve the arrangement.

All of the members of the approving committee must be independent, as defined in the instructions to the amended best-price rule. For U.S. issuers, "independence" will generally be defined by reference to listing standards. For foreign private issuers, the approving committee must be authorized to approve employment compensation, severance or other employee benefit arrangements under applicable foreign law.

SEC Extends Sarbanes-Oxley Act Section 404 Compliance Dates

On December 15, 2006, the SEC issued final rules relating to the compliance dates for Section 404 of the Sarbanes-Oxley Act for smaller public companies. **(See SEC Release Nos. 33-8760, 34-54942).** The new rules are intended to give non-accelerated filers and newly public companies, when filing their annual reports, additional time to comply with re-

quirements related to (i) the management's report on internal control over financial reporting, and (ii) the auditor's attestation report.

Non-Accelerated Filers

The new rules set forth the following compliance dates for non-accelerated filers:

- For domestic or foreign issuers who are non-accelerated filers, annual reports for fiscal years ending on or after December 15, 2007 must contain management's report on internal control over financial reporting.
- Domestic or foreign issuers who are non-accelerated filers, must file an auditor's attestation report with their annual reports for fiscal years ending on or after December 15, 2008.

A non-accelerated filer is an issuer who does not meet any of the following conditions as of the end of its fiscal year:

- The issuer had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $75 million or more, but less than $700 million, as of the last business day of the issuer's most recently completed second fiscal quarter;
- The issuer has been subject to the requirements of Section 13(a) or 15(d) of the 1934 Act for a period of at least twelve calendar months;
- The issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the 1934 Act; and
- The issuer is not eligible to use Forms 10-KSB and 10-QSB for its annual and quarterly reports.

Newly Public Company

The amended rules also allow newly public companies to wait to include management's report on internal control over financial reporting or the auditor's attestation report until their second annual report. Additionally, a new public company may wait until it files an annual report that contains management's report on the effectiveness of the company's internal control over financial reporting to include the portion of introductory language in paragraph 4, as well as language in paragraph 4(b), of the certification required by the 1934 Act Rules 13a-14(a) and 15d-14(a), that refers to the certifying officers' responsibility for designing, establishing and maintaining internal control over financial reporting of the company. Finally, newly

public companies relying on this rule when filing their first annual report must include a statement stating that the report does not include management's assessment report or the auditor's attestation report.

The transition period applies to companies conducting an initial public offering (equity or debt) or a registered exchange offer or that otherwise have, for the first time, become subject to the 1934 Act reporting requirements. For the purposes of this rule, newly public companies that have filed a transition report on Form 10-K, 10-KSB, 20-F, or 40-F under the 1934 Act Rule 13a-10 or Rule 15d-10 are considered to have filed an annual report and must fully comply with the internal control over financial reporting requirements when filing the annual report for its next fiscal year.

SEC Adopts Amendments to Stock-Based Compensation Disclosure Rules

On December 22, 2006, the SEC issued final rules amending the disclosure requirements for executive and director compensation. **(See SEC Release Nos. 33-8765, 34-55009).** The new rules became effective following their publication in the Federal Register and will apply to the 2007 proxy season.

The SEC had previously amended the executive compensation disclosure rules in August 2006. The original amendments required stock and option awards to be reported in the Summary Compensation Table at their full grant date fair value. This diverged from Financial Accounting Standard 123 ("FAS 123R"), which generally required such awards to be recognized over the period in which they were to be awarded for financial reporting purposes. In response to concerns over this difference, the SEC amended the disclosure requirements for executive and director compensation to bring the SEC reporting requirements in line with the requirements of FAS 123R. The latest amendments require stock and option awards to be reported in both the Summary Compensation Table and Director Compensation Table in an amount equal to the dollar amount recognized for financial statement reporting purposes for such awards for the fiscal year in accordance with FAS 123R.

In addition, the new rules:

- require companies to report the amount of stock-based compensation in the relevant period under FAS 123R in new column "l" of the Grant of Plan-Based Awards Table;
- require companies to disclose the compensation costs of stock and options awards in the Stock Awards and Option Awards col-

umns in the Summary Compensation Table over the vesting period, instead of immediately reflecting the cost in full in the year the award was granted;

- require companies to disclose the full grant date fair value of stock-based awards on a grant-by-grant basis in the Grant of Plan-Based Awards Table;
- require companies that account for stock-based awards on a liability basis to reflect increases and decreases in the value of the company's stock on a mark-to-market basis from year to year,
- require companies to disclose, in the Summary Compensation Table, actual, not estimated, forfeitures related to service-based vesting conditions in the period the award is forfeited;
- require companies to disclose adjustments to performance-based awards over the vesting period, as computed under FAS 123R; and
- require companies to use FAS 123R modified prospective transition methods for Item 402 disclosure purposes and record any resulting adjustments in the Summary Compensation Table.

The new rules also provide for corresponding changes to the Director Compensation Table.

APPELLATE DECISIONS OF NOTE

Application of 1933 Act, Section 17(b) Does Not Violate the First Amendment

The radio host of an investment show contended that the requirements of Section 17(b) of the '33 Act that promoters disclose the fact and amount of payments received violates the First Amendment and are unconstitutionally vague. On October 26, 2006, the Court of Appeals for the Tenth Circuit affirmed the lower court's finding that the radio host violated Section 17(b) of the '33 Act for failing to inform his listeners that he received compensation from a company for promoting the stock on his program. Treating Section 17(b) as commercial speech and citing the government's interest in protecting investors from being misled, the Court held that the provision was enacted to prevent fraud and did not violate the First Amendment. Further, the Court noted that the burden of disclosing the amount of compensation was minimal. Additionally, the Court held that Section 17(b) is not unconstitutionally vague. *United States v. Wenger*, 2005 WL 2767182 (10th Cir. 2005).

Court is Authorized to Enforce SEC Order Although Based on NASD Judgment

Defendant is an investment broker and dealer who solicited customers to purchase limited partnership interests without the knowledge or approval of his employer brokerage firm. The NASD issued a judgment against the defendant for violations of its rules of conduct. The SEC agreed that the censure and bar were appropriate, but reduced the fine imposed on the defendant. The SEC sought to enforce its order under Section 21(e) of the 1934 Act. The defendant argued that Section 21(e) only authorized the SEC to enforce orders in connection with the SEC's direct enforcement activities and did not authorize the SEC to enforce an order of the NASD. On October 12, 2006, the Court of Appeals of the Sixth Circuit affirmed the district court's decision that the SEC may look to the courts to enforce orders issued pursuant to its authority, under Section 19, to oversee the NASD. The Court noted that the SEC was seeking to enforce its own order and not to enforce NASD rules. The Court also reasoned that the language in Section 21(e) referring to "this title" applies to the '34 Act as a whole, and not solely to Section 21. Further, the Sixth Circuit held that the SEC's enforcement rights were not precluded by Section 21(f), which prevents the SEC from usurping the NASD's self-regulatory role. The Court noted that the NASD did fulfill its self-regulatory role by taking action against the defendant. *SEC v. Mohn*, 465 F.3d 647 (6th Cir. 2006).

No Sufficient Pleading of "Scienter" Where Based Solely on Sarbanes-Oxley Certifications

An institutional investor brought suit against a health information company and several of its directors and the company's outside auditor for alleged fraud under Sections 10(b) and 20(a) of the '34 Act, and Rule 10b-5 promulgated thereunder. On October 12, 2006, the Court of Appeals for the Eleventh Circuit affirmed the lower court's dismissal of the original and amended complaints for failure to plead fraud with particularity, as required by Rule 9(b) of the Federal Rules of Civil Procedure and the Private Securities Litigation Reform Act of 1995 ("PSLRA"). Specifically the Court helf that an officer's signature to the Sarbanes-Oxley Act certification did not satisfy the scienter requirement, stating that "[t]he plain language of Sarbanes-Oxley evidences no congressional intent to alter the pleading requirements set forth in the PSLRA." The exception to this rule is when the person signing the certification is severely reckless in certifying the statements and had reason to know, because of "red flags", that the financial statements contained mis-

statements or omissions. The Court held that the second amended complaint did not allege any such red flags existed in this case.

With respect to its claims against the outside auditor, the Eleventh Circuit held that plaintiff failed to establish scienter because the amended complaint failed to assert knowledge of wrongdoing or reckless disregard upon discovery of the problem. *Garfield v. NDC Health Corp.*, 466 F.3d 1255 (11th Cir. 2006).

Exercise of Hybrid Option and Subsequent Purchase Do Not Constitute a Sale and Purchase Subject to Section 16(b) of the 1934 Act

The U.S. Supreme Court has denied certiorari from the Second Circuit's decision in *At Home Corp. v. Cox Communications and Comcast Corp.*, first reported in the Fall 2006 issue of this journal (volume 34, number 3, *Securities Regulation Law Journal*). The Second Circuit had denied a private company's claims against two former shareholders for violations under Section 16(b) of the '34 Act. AT&T obtained sole control over plaintiff by offering a put to defendants, the other two major shareholders, who together owned over seventeen percent of plaintiff's securities. The parties entered into a letter agreement on March 28, 2000 whereby AT&T granted to the defendants a hybrid put option with fixed and floating components in the pricing.

The Second Circuit affirmed the lower court's holding that the transaction was not a sale under Section 16(b) of the '34 Act because the relevant sale date was in 2000, when the options were granted, and not in 2001, when the options were exercised. Applying this analysis, one of the defendants who did not purchase any of plaintiff's shares within six months of that date was not liable under this provision.

The remaining defendant, however, did purchase three cable companies between January and August 2000 that held warrants for plaintiff's stock. The Court affirmed the district court's decision that the subsequent purchase of a third party company did not constitute a Section 16(b) purchase because the transactions could not be matched. The Court held that in the absence of any showing of manipulative intent, a sale of shares in one company cannot be matched to a purchase of shares in another company. Moreover, the Court interpreted the use of the singular ("any equity security" and "such issuer") in Section 16(b) as an indication that there can be no matching of transactions relating to two distinct companies. The Court concluded that there is no great risk of abuse because the profit from the indirect purchase would be offset by the costly purchase of three cable systems. The Court commented that "[i]t would be like speculating in tractors by buying a farm."

On October 10, 2006, the Supreme Court denied plaintiff's petition for a writ of certiorari, effectively upholding the Second Circuit's decision. *At Home Corp. v. Cox Communications and Comcast Corp.*, 446 F.3d 403 (2d Cir. 2006), *cert. denied*, 127 S. Ct. 384 (U.S. Oct. 10, 2006)(No. 06-147).

"Misappropriation" Theory under Section 10(b) of the '34 Act Applied

On November 14, 2006, the Court of Appeals for the First Circuit affirmed the district court's opinion that the wife of an executive who conveys confidential information to her brother may be liable under the "misappropriation" theory, which has been applied under Section 10(b) of the '34 Act and Rule 10b-5, because the wife breached a fiduciary duty owed to her husband, the source of the information, even though she disclosed her intent to her husband beforehand.

Defendants were the wife of an executive who conveyed confidential information about her husband's company, and her two tippees. After questioning her husband about his company, the wife disclosed to him that she intended to share the negative information about disappointing clinical trials with her brother, pursuant to a pre-existing arrangement. Despite her husband's urging not to reveal the information prior to public disclosure, she informed her brother that same day regarding the negative development. The brother then sold his shares on the next trading day. The brother also shared the information with a friend, who also sold his shares prior to any announcement of the bad news.

The First Circuit affirmed the lower court's denial of defendants' motion to dismiss. Defendants sought to rely on *United States v. O'Hagan*, 521 U.S. 642 (1997) as holding that the pre-tip disclosure by the wife to her insider-husband of her intentions negated liability under the misappropriation theory. The First Circuit held that while the district court misread *O'Hagan*, its decision was sound because the wife's disclosure to her husband did not afford any opportunity for remedial action, and as a result of the misappropriation, the husband lost the exclusive use of the information. Further, the wife's disclosure to her husband did not eliminate the element of deception because she committed sequential acts of deception. First, she obtained information from her husband by feigning loyalty to him. Second, she misappropriated the confidential information by sharing it with her brother. Citing *United States v. Carpenter*, 791 F.2d 1024, 1027 (2d Cir. 1986), for the proposition that the "in connection with" requirement is satisfied when a tipper misappropriates information that his tippee later trades on, the Court affirmed the lower court's holding that the wife's deception in obtaining information was "in connection with" the sale of securities. *SEC v. Rocklage*, 2006 WL 3290965 (1st Cir. 2006).