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Quarterly Survey of SEC Rulemaking and Major Appellate Decisions

By Victor M. Rosenzweig*

This issue's Survey focuses on SEC rulemaking activities and major appellate decisions under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act") during the first quarter of 2004.

SEC Rulemaking

SEC Adopts Rules Promulgating Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date

A. Introduction.

On March 16, 2004, the Securities and Exchange Commission (the "SEC") adopted final rules in response to the "real time issuer disclosure" mandate contained in Section 409 of the Sarbanes-Oxley Act of 2002.[1] These new rules apply to all companies filing periodic reports with the SEC except foreign private issuers. Generally, the new rules:

(i) add eight new items to the list of events required to be disclosed on Form 8-K;

(ii) move to Form 8-K two items currently required to be disclosed in quarterly or annual reports;

(iii) revise several existing Form 8-K items to include additional disclosures;

(iv) shorten the current filing deadlines for most Form 8-K filings to four business days; and

(v) provide a limited safe harbor from liability under Section 10(b) of the Securities Exchange Act of 1934, as amended (the "1934 Act"), and Rule 10b-5 thereunder for failure to timely file select Form 8-K reports.

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Although the SEC abandoned its proposal to require management's analysis of the effect of certain of the reported items on the company, the new rules indicate that the general rule prohibiting material omissions that make the contents of a disclosure materially misleading continues to apply. Companies must comply with the new rules as of August 23, 2004.

B. New and Revised Disclosure Items.

Item 1.01. Entry into a Material Definitive Agreement.

Disclosure is required under this item if a company enters into a material definitive agreement[2] not made in the ordinary course of business.[3] The required disclosures include the date of, the parties to and a brief description of the agreement. The company must report similar information regarding any material amendments to these agreements.

Item 1.02. Termination of a Material Definitive Agreement.

Disclosure is required under this item if a company terminates a material definitive agreement not made in the ordinary course of business.[4] The required disclosures include similar disclosures to those required by Item 1.01, as well as a brief description of the material circumstances surrounding the termination and any material early termination penalties.

Item 2.03. Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement.

Disclosure is required under this item if a company becomes materially obligated under a direct financial obligation or if a company becomes directly or contingently liable for a material obligation arising out of an off-balance sheet arrangement.[5] The required disclosures include: (1) the date the company becomes obligated or contingently liable, (2) a brief description of the transaction or agreement that creates the obligation or the off-balance sheet arrangement, (3) the amount of the obligation and (4) a brief description of the material terms under which the obligation or arrangement may be accelerated or increased or by which an off-balance sheet arrangement may become a direct obligation of the company.

Item 2.04. Events Triggering a Material Direct or Contingent Financial Obligation.

Disclosure is required under this item if a "triggering event" occurs causing the increase or acceleration of a direct financial obligation or an obligation under an off-balance sheet arrangement, or a company's contingent obligation under an off-balance sheet arrangement to become a direct financial obligation of the company and, in each case, the consequences of the event

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are material to the company.[6] The required disclosures include: (1) the date and a brief description of the triggering event, (2) the amount of the obligation and terms of payment or acceleration that apply and (3) any other material obligations of the company that may arise, increase, be accelerated or become direct financial obligations as a result of the triggering event, the increase or acceleration of the direct financial obligation or obligation under the off-balance sheet arrangement or the arrangement becoming a direct financial obligation of the company.

Item 2.05. Costs Associated with Exit or Disposal Activities.

Disclosure is required under this item if the board of directors, a board committee or an authorized officer commits the company to an exit or disposal plan or otherwise disposes of a long-lived asset or terminates employees under a plan of termination described in paragraph 8 of FASB Statement of Financial Accounting Standards No. 146 Accounting for Costs Associated with Exit or Disposal Activities, under which material charges will be incurred under generally accepted accounting principles ("GAAP"). The required disclosures include: (1) the date of commitment to and a description of the facts and circumstances leading to the expected action and the expected completion date, (2) an estimate of the total amount or range of amounts expected to be incurred in connection with the action, in the aggregate and broken out by major type of cost and (3) an estimate of the amount or range of amounts of the charge that will result in future cash expenditures.

Item 2.06. Material Impairments.

Disclosure is required under this item if the board of directors, a board committee or an authorized officer concludes that a material charge for impairment to one or more of its assets, including an impairment of securities or goodwill, is required under GAAP.[7] The required disclosures include: (1) the date of the conclusion that a material charge is required, a description of the impaired asset or assets and the facts and circumstances leading to the conclusion that the charge for impairment is required, (2) an estimate of the amount or range of amounts of the impairment charge and (3) an estimate of the amount or range of amounts of the impairment charge that will result in future cash expenditures.

Item 3.01. Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing.

Disclosure is required under this item if:

(i) a company receives notice from a national securities exchange or national securities association that maintains the principal listing for

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the company's common stock that the company does not satisfy a continued listing requirement or that the exchange or association has submitted an application or taken all necessary steps to delist the company's common stock;

(ii) a company has notified the exchange or association that the company is aware of any material noncompliance with a continued listing requirement;

(iii) the exchange or association issues a public reprimand letter indicating that the company has violated a continued listing requirement; or

(iv) the board of directors, a board committee or an authorized officer or officers takes definitive action to cause the listing of the company's common stock to be withdrawn or terminated.

In the case of a notice to or from a national stock exchange or securities association, the required disclosures include the date the notice was sent or received by the company, the continued listing standard that the company has failed to satisfy and any action that the company has decided to take in response to the notice or relating to its noncompliance. In the case of a public reprimand letter, the company must disclose a summary of the contents of the letter. In the case of withdrawing or terminating the listing of common stock, the company must describe the actions taken.

Item 3.02. Unregistered Sales of Equity Securities.

Subject to a one percent *de minimis* exception, disclosure is required under this item if the company sells equity securities in a transaction that is not registered under the 1933 Act.[8] Filing requirements are triggered when the company enters into an agreement enforceable against it, whether or not subject to conditions, under which the equity securities are to be sold. If no such agreement exists, the company must provide the disclosure within four business days after the occurrence of the closing or settlement of the transaction or arrangement pursuant to which the equity securities are sold.

Item 3.03. Material Modification to Rights of Security Holders.

Disclosure is required under this item if a company materially modifies the rights of the holders of any class of the company's registered securities. Upon the effective date of the new rules, this disclosure, currently required by Items 2(a) and (b) of Form 10-Q, will no longer be a Form 10-Q disclosure item.

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Item 4.02. Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review.

Disclosure is required under this item if the board of directors, a board committee or an authorized officer concludes that any previously issued financial statements covering one or more years or interim periods should no longer be relied on because of an error in those financial statements as addressed in Accounting Principles Board Opinion No. 20.

Disclosure is also required under this item if the company is advised by, or receives notice from, its independent accountant that disclosure should be made or action should be taken to prevent future reliance on a previously issued audit report or completed interim review related to previously issued financial statements. The company must provide the independent accountant with a copy of the disclosures no later than the same day it files the Form 8-K. The independent accountant must then provide the company with a letter addressed to the SEC stating whether the accountant agrees with the statements made by the company and, if not, stating the respects in which he or she does not agree. The company must then amend its Form 8-K by filing the independent accountant's letter as an exhibit within two business days of receipt of this letter.

Item 5.02. Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers.

The new rules expand required disclosures relating to the departure of a director and extend disclosure obligations to the appointment of directors and the departure and appointment of principal officers.

Disclosure is required under this item if a director has resigned or refuses to stand for reelection because of a disagreement with the company known to an executive officer of the company on any matter relating to the company's operations, policies or practices, or if a director has been removed for cause.[9] The required disclosures include a brief description of the circumstances of the disagreement that the company believes caused the director's departure.[10] The company must provide the director with a copy of the disclosures no later than the same day the company files the Form 8-K. The company must also provide the director with an opportunity to provide a letter to the company stating whether he or she agrees with the company's disclosures and, if not, the respects in which he or she disagrees. The director's response, if any, must be filed as an exhibit to an amended Form 8-K within two business days after receipt by the company.

Disclosure is also required under this item if the company's principal executive officer, president, principal financial officer, principal accounting of-

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ficer, principal operating officer or any person performing similar functions retires, resigns or is terminated from his or her position. Disclosure is also required under this item if the company appoints a new principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer or person performing similar functions. Lastly, disclosure is required under this item if a new director is added to the board, other than by a vote of shareholders at an annual meeting or special meeting convened for such purpose.

Item 5.03. Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year.

The final rules combine the existing item relating to a change in a company's fiscal year with a new requirement to disclose amendments to a company's articles of incorporation or bylaws.

Disclosure is required under this item if a company with a class of equity securities registered under Section 12 of the 1934 Act amends its articles of incorporation or bylaws. The company must file the text of the amendment as an exhibit to the Form 8-K. The restated articles of incorporation or bylaws need only be filed as an exhibit to the company's next periodic report or registration statement.

Disclosure is also required under this item if the company changes its fiscal year from the one used in its most recent SEC filing other than by submission to a vote of security holders or by an amendment to its articles of incorporation or bylaws.

C. Limited Safe Harbor in Certain Cases.

The final rules provide a limited safe harbor from all claims under 1934 Act Section 10(b) and Rule 10b-5 thereunder. Accordingly, failure to timely file a Form 8-K relating to selected new disclosure requirements will not be deemed to be a violation of Section 10(b) and Rule 10b-5. This safe harbor only applies to the failure to file certain reports, not to material misstatements or omissions. The safe harbor's protection only extends until the due date of the company's next periodic report for the period in which the Form 8-K was not timely filed. The safe harbor applies to the following items:

(i) Item 1.01. Entry into a Material Definitive Agreement;

(ii) Item 1.02. Termination of a Material Definitive Agreement;

(iii) Item 2.03. Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant;

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(iv) Item 2.04. Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement;

(v) Item 2.05. Costs Associated with Exit or Disposal Activities;

(vi) Item 2.06. Material Impairments; and

(vii) Item 4.02(a). Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review (in the case where a company makes the determination and does not receive an Item 4.02(b) notice from its accountant)

D. Eligibility to Use Forms S-2 And S-3 and to Rely on Rule 144.

Currently, to be eligible to use Form S-2 or Form S-3, a company must have timely filed all reports required to be filed under 1934 Act Section 13(a) or 15(d) during the 12 months prior to filing the registration statement. The new rules amend Form S-2 and Form S-3 to provide that failure to timely file reports on Form 8-K relating to the same items to which the Rule 10b-5 safe harbor applies will not result in a loss of eligibility to use these forms. A company must, however, be current in its Form 8-K filings (including the items to which the safe harbor applies) at the time it files a Form S-2 or Form S-3.[11] Rule 144 under the 1933 Act has also been amended to clarify that a company need not have filed all required Form 8-K reports during the 12 months preceding a sale of securities pursuant to Rule 144 to satisfy the rule's condition relating to current public information.

E. "Filed" vs. "Furnished" Status of Exhibits.

The SEC clarified its position that all exhibits to a Form 8-K containing disclosures under Item 2.02, Results of Operations and Financial Condition, or Item 7.01, Regulation FD Disclosure, whether or not they contain disclosures regarding other items, will be deemed "furnished," and not "filed," unless the company specifies under Item 9.01, Financial Statements and Exhibits, the exhibits or portions of exhibits intended to be deemed filed rather than furnished. Exhibits or portions of exhibits that are deemed furnished rather than filed are not automatically incorporated by reference into the company's 1933 Act registration statements, thereby avoiding potential liability under Section 11 of the 1933 Act and Section 18 of the 1934 Act.

F. Section 906 Certifications Not Required.

The SEC has clarified that the certification requirement of Section 906 of the Sarbanes-Oxley Act of 2002 does not apply to Form 8-K filings.

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SEC Adopts Rules Extending the Compliance Date for Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in 1934 Act Periodic Reports

On February 24, 2004, the SEC adopted final rules extending the compliance dates published on June 18, 2003 in Release No. 33-8238 for certain amendments to Rules 13a-15 and 15d-15 under the 1934 Act, Items 308(a) and (b) of Regulations S-K and S-B and the corresponding provisions in Forms 20-F and 40-F.[12] These new rules require companies, other than registered investment companies, to include in their annual reports a report of management on the company's internal control over financial reporting, and to evaluate, as of the end of each fiscal period, any change in the company's internal control over financial reporting that occurred during the period that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting. Accelerated filers must comply as of the first fiscal year ending on or after November 15, 2004. Non-accelerated filers and foreign private issuers must comply as of the first fiscal year ending on or after July 15, 2005. The SEC also extended the compliance dates for amendments to certain representations that must be included in the certifications required by 1934 Act Rules 13a-14 and 15d-14, regarding the company's internal control over financial reporting.[13]

SEC Adopts Rules Regarding Enhanced Disclosure in Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies

On February 27, 2004, the SEC adopted final rules to improve the periodic disclosure provided by registered management investment companies relating to their costs, portfolio investments, and past performance.[14] The new rules require registered open-end management investment companies to include in their shareholder reports disclosure of fund expenses borne by shareholders during the reporting period. The new rules also permit all registered management investment companies (both open-end and closed-end funds) to include a summary portfolio schedule of investments in their reports to shareholders, provided that the complete schedule is filed with the SEC and is provided to shareholders upon request, free of charge.[15] In addition, all registered management investment companies are required to include a tabular or graphic presentation of their portfolio holdings in their reports to shareholders. The new rules also require all registered management investment companies to disclose their complete portfolio schedule on a quarterly basis in filings with the SEC that will be certified by the company's principal executive and financial officers and are available on the SEC's

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Electronic Data Gathering, Analysis, and Retrieval System. Finally, registered open-end management investment companies are required to include Management's Discussion of Fund Performance in their annual reports to shareholders.

SEC Adopts Rules Amending the Rules of Practice and Delegations of Authority of the Commission

On March 12, 2004, the SEC adopted final rules amending its Rules of Practice and certain of its delegations of authority to the staff in light of the Sarbanes-Oxley Act of 2002.[16] The Sarbanes-Oxley Act, among other things, authorizes the SEC to review disciplinary actions of the Public Company Accounting Oversight Board and to create "Fair Funds" (which are disgorged and disbursed to victims) in SEC administrative proceedings. These new rules also amend other provisions of the Rules of Practice and the SEC's delegations as a result of the SEC's experience with those rules and to correct certain citations. The new rules enhance the transparency and facilitate parties' understanding of the applicability of the review process to Public Company Accounting Oversight Board proceedings.

APPELLATE DECISIONS OF NOTE

Short-Swing Profits – Tolling of Statute of Limitations Permitted

A chapter 7 trustee sought to recover short-swing profits allegedly realized by equity shareholders. The Court of Appeals for the Second Circuit held that: 1) the two-year limitations period of Section 16(b) of the 1934 Act to bring an action to recover short-swing profits was subject to equitable tolling when a director, officer, or beneficial owner of more than 10 percent of a class of registered equity securities failed to disclose all securities transactions to the Commission through failure to file proper forms; and 2) the equitable tolling of the statute of limitations continued only until the potential claimant or company received actual notice that the covered person had realized specific short-swing profits. ***Litzler v. CC Investments, L.D.C.*, 362 F.3d 203, Fed. Sec. L. Rep. (CCH) P 92725 (2d Cir. 2004).**

Short-Swing Profit – Violation Not Possible

A chapter 7 trustee brought an action for, among other things, a violation of Section 16(b) of the 1934 Act based on the theory that the "conversion cap" in convertible preferred shares should have been ignored. The preferred holders received $47 million worth of common stock in exchange for their $40 million investment and then sold their common stock within six months of obtaining it. The Court of Appeals for the Ninth Circuit held that this was

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not a short-swing sale, because the conversion cap at all times barred conversion into more than 4.9% of the company's shares and therefore the preferred holders were not and could not have been beneficial owners of more than 10% when they acquired their common stock. ***Decker v. Advantage Fund, Ltd.*****, 362 F.3d 593, 42 Bankr. Ct. Dec. (CRR) 224, Bankr. L. Rep. (CCH) P 80077 (9th Cir. 2004).**

"Investment Security" Found Under 1933 and 1934 Acts

On January 13, 2004, the Supreme Court held that an investment scheme promising a fixed rate of return may be an investment contract and thus a security subject to the 1933 and 1934 Acts. In so holding the Supreme Court reversed a decision of the 11th Circuit and held that the test for determining whether a particular scheme is an investment contract is "whether the scheme involves investment of money in a common enterprise with profits to come solely from the efforts of others and that promise a fixed rate of return." ***S.E.C. v. Edwards*****, 124 S. Ct. 892, 157 L. Ed. 2d 813, Fed. Sec. L. Rep. (CCH) P 92656 (U.S. 2004).**

Statute of Limitations Bars Action On Unregistered Offering

Claims that a company and its officers made a public offering of unregistered securities under Section 12(a)(1) of the 1933 Acts were barred by the statute of limitations. The investor failed to bring its claims within the three-year limitation period. Citing amicus briefing from the Securities and Exchange Commission and congressional intent, on January 12, 2004 the Second Circuit panel held that this three-year repose period began when the unregistered securities were first offered to the public. ***P. Stolz Family Partnership L.P. v. Daum*****, 355 F.3d 92, Fed. Sec. L. Rep. (CCH) P 92657, 57 Fed. R. Serv. 3d 1188 (2d Cir. 2004).**

"Group-Pleading" Doctrine Disallowed Where Fraud Alleged

Investors, relying on the group-pleading doctrine, brought a securities fraud class action against the company and its executive officers under the Private Securities Litigation Reform Act ("PSLRA"). The group-pleading doctrine allows plaintiffs to rely on a presumption that statements in prospectuses, registration statements, annual reports, press releases, or other group-published information, are the collective work of those individuals with direct involvement in the everyday business of the company.

The Court of Appeals for the Fifth Circuit rejected the group-pleading doctrine and held that the PSLRA requires the plaintiffs to "distinguish among those they sue and enlighten *each defendant* as to his or her particu-

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lar part in the alleged fraud." **Southland Securities Corp. v. INSpire Ins. Solutions, Inc., 2004 WL 626721 (5th Cir. 2004).**

Pleading Dismissed Under PSLRA

Addressing an issue of first impression, on January 20, 2004 the Second Circuit Court held that the PSLRA's heightened pleading standard also applies to claims brought under Sections 11 and 12(a)(2), insofar as the claims are premised on allegations of fraud. The Court concluded that various Section 11 claims based on the allegedly misleading registration statement of a golf course company sounded in fraud, and affirmed the district court's findings that the claims were not pleaded with sufficient particularity. Dismissal of claims under Sections 11 and 12(a)(2) that sounded in negligence was also affirmed, as the statements in question were protected by the "bespeaks caution" doctrine and by the safe harbor for forward-looking statements contained in the PSLRA. ***Rombach v. Chang*, 355 F.3d 164, Fed. Sec. L. Rep. (CCH) P 92664 (2d Cir. 2004).**

NOTES:

1. See SEC Release No. 33-8400*: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date*.

2. A material definitive agreement is an agreement that provides for obligations that are material to and enforceable against the company, or rights that are material to the company and enforceable by the company against one or more other parties to the agreement, in each case whether or not subject to conditions.

3. A material definitive agreement subject to customary closing conditions must be disclosed. The company is not required to disclose information relating to letters of intent or other non-binding agreements.

4. Disclosure is not required if the agreement expires or terminates as a result of all of the parties completing their obligations.

5. If a company enters into a facility or similar agreement that creates or may create a direct material financial obligation in connection with multiple transactions, the company must disclose this as well as any other obligations as they arise under the facility or arrangement.

6. Disclosure is not required until a triggering event has occurred in accordance with the terms of the transaction, including the company's receipt of a notice of the occurrence of a triggering event and the satisfaction of all conditions to such occurrence, except the passage of time. Disclosure is also not required if the company believes that no triggering event has occurred, unless the company has received notice of the occurrence of a triggering event.

7. A filing is not required if the conclusion regarding the material charge is made in connection with the preparation, review or audit of financial statements required to be included in the next 1934 Act periodic report, the report is filed on a timely basis and the conclusion is disclosed in the report.

8. Under the new rules, the Form 10-Q disclosure requirement will be limited to issuances that have not been reported on Form 8-K and the Form 10-K disclosure requirement will be limited to issuances that have not been reported on Form 8-K or Form 10-Q.

9. If a director retires, resigns, is removed or declines to stand for re-election in circumstances other than those noted above, the event and the date of occurrence must be disclosed.

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[10] If the director furnishes the company with any written correspondence concerning the circumstances surrounding his or her resignation, the company must file a copy of the correspondence as an exhibit to the Form 8-K.

[11] The company can become current by including the appropriate disclosure in its periodic report for the period in which the Form 8-K disclosure was not timely made or, if such disclosure was not included in the periodic report, by amending the annual or quarterly report to include the disclosure.

[12] See SEC Release No. 33-8392: *Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*.

[13] The companies subject to these certification provisions include registered investment companies.

[14] See SEC Release No. 33-8393: *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*.

[15] Money market funds are exempt from the requirement to include a portfolio schedule in their reports to shareholders, provided that the complete portfolio schedule is filed with the SEC on Form N-CSR semi-annually and is provided to shareholders upon request, free of charge.

[16] See SEC Release No. 34-49412: *Adoption of Amendments to the Rules of Practice and Delegations of Authority of the Commission*.

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