Annual Review of Federal Securities Regulation

By the Subcommittee on Annual Review, Committee on Federal Regulation of Securities, ABA Section of Business Law*

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INTRODUCTION

This Annual Review (“Review”) was prepared by the Subcommittee on Annual Review of the Committee on Federal Regulation of Securities of the ABA Section of Business Law. The Review covers significant developments in federal securities law and regulation during 2010. The Review is divided into three sections: regulatory actions, accounting statements, and caselaw developments.

The Review is written from the perspective of practitioners in the fields of corporate and securities law. This results in an emphasis on significant developments under the federal securities laws relating to companies, shareholders, and their respective counsel. Our discussion is limited to those developments that are of greatest interest to a wide range of practitioners.

Given the significance of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), the regulatory section of this year’s Review is organized in two parts, one focused on the principal rulemakings and studies required to be undertaken by the U.S. Securities and Exchange Commission (“SEC”), and the second focused on all of the many activities undertaken during 2010 by the SEC unrelated to the Dodd-Frank Act. Many of the actions taken by the SEC during 2010 unrelated to the Dodd-Frank Act nonetheless addressed perceived weaknesses that were revealed during the financial crisis. For example, during 2010, the SEC undertook further action relating to the regulation of shorting activity, reexamined the practices and disclosures related to securitization, and considered the presentation by issuers of disclosures related to their liquidity. The SEC also remained focused on compensation and shareholder access issues.

Generally, the Review does not discuss proposed regulations or rules that are narrowly focused. For example, as discussed further below, under the Dodd-Frank Act, the SEC, working in conjunction with the U.S. Commodities Futures Trading Commission, must impose a new regime for regulating over-the-counter (“OTC”) derivatives, including defining swaps and swaps dealers and registering dealers and a new marketplace. The Review does not address the OTC derivatives-related rulemakings. Additionally, cases are chosen for both their legal concepts as well as factual background. While the Subcommittee tries to avoid making editorial comments regarding regulations, rules, or cases, we have attempted to provide a practical analysis of the impact of the developments in the law and regulations on the day-to-day practice of securities lawyers.

I. DODD-FRANK ACT: AN OVERVIEW AND RULEMAKING

A. GENERAL OVERVIEW

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act” or “Dodd-Frank Act”)
1 has been referred to as the most significant legislation affecting financial markets and securities since the adoption of the Securities Act of 1933 (the “Securities Act”) and the Securities Exchange Act of 1934 (the “Exchange Act”). Like any reform legislation, the Act targets the perceived evils that presumably were root causes of the financial crisis. Underlying the various measures we discuss below are certain important prevailing views: that our financial institutions must maintain higher regulatory capital levels; that financial institutions should limit the use of leverage; that “simpler” financial products with a more significant equity component will be more loss absorbent during financial downturns; that certain financing activities, including proprietary trading, securities lending, derivatives, and securitization, are inherently “risky”; and that market participants should be subject to greater oversight, especially with respect to their interactions with retail investors.

The Dodd-Frank Act also introduces a number of new agencies and regulators, including the Bureau of Consumer Financial Protection. 2 In order to address systemic risk, the Act creates the Financial Stability Oversight Council and endows the Council with responsibility for monitoring risk. 3 The Council also must designate those entities that are deemed “systemically important” and that, by virtue of such designation, become subject to more stringent regulation and oversight. 4 Certain entities, including those that provide payment systems, settlement and clearance, and similar services, will be deemed financial market utilities that are systemically important. 5 The Dodd-Frank Act also gives regulators new authority to address the too-big-to-fail conundrum. 6

The Act enhances the supervision and oversight of financial institutions. Non-bank financial companies engaged predominantly in financial activities will also become subject to significant new regulations. Many nonbank financial compa-

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6. Id.
nies will be subject to oversight by the Federal Reserve Board. The Act requires that bank regulators establish heightened prudential standards for risk-based capital, leverage, liquidity, and contingent capital. Systemically important institutions, which include the largest bank holding companies, will be subject to more onerous regulatory capital, leverage, and other requirements, including a maximum debt-to-equity ratio of fifteen-to-one. The Collins Amendment provisions included in the Act require the establishment of minimum leverage and risk-based capital requirements. These are set, as a floor, at the risk-based capital requirements and Tier 1 to total assets standard currently applicable to insured depository institutions under the prompt corrective action provisions of the Federal Deposit Insurance Act. Final regulatory capital ratios will not be set for some time. The legislation limits regulatory discretion in adopting Basel III requirements in the United States and raises the possibility of additional capital requirements for activities determined to be “risky,” including, but not limited to, derivatives, securitization, and securities lending. Consistent with the emerging guidance relating to the Basel III framework, the Act no longer permits bank holding companies to include certain hybrids, like trust preferred securities, within the numerator of Tier 1 capital.

The Dodd-Frank Act also subjects transactions between certain affiliates of banks to more onerous restrictions. The Act amends sections 23A and 23B of the Federal Reserve Act, which establish parameters for a bank to conduct “covered transactions” with its affiliates, with the goal of limiting risk to the insured bank in order to prevent the bank from transferring to its affiliates the benefits of the federal “safety net.” The Act broadens the definition of “affiliate” and expands “covered transactions” to include, among other things, derivatives transactions and securities lending transactions. Covered transactions will be subject to enhanced collateral requirements and tightened qualitative safeguards. These new restrictions will serve to limit a financial institution’s flexibility and may limit its participation in certain markets.

The Dodd-Frank Act targets activities viewed as “risky” and markets perceived to have been lacking in transparency and suffering from insufficient regulatory oversight. In this context, the Act implements the Volcker Rule, which imposes

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11. Id. § 171(a)(1)(A), 124 Stat. at 1435 (to be codified at 12 U.S.C. § 5371(a)(1)(A)). These regulatory capital requirements set out in the Collins Amendment impose the current requirements applicable to insured depository institutions (banks) to insured depository institution holding companies and certain other entities.
12. Id. § 171(b)(7)(A) & (B), 124 Stat. at 1438 (to be codified at 12 U.S.C. § 5371(b)(7)(A) & (B)).
13. Id. § 174, 124 Stat. at 1441.
15. Id.
16. Id.
certain prohibitions on proprietary trading and fund activities. Except for certain permitted activities, the Volcker Rule provides that a "banking entity" cannot (1) engage in proprietary trading, or (2) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or private equity fund (collectively "fund activities"). A "nonbank financial company" supervised by the Federal Reserve may engage in proprietary trading or fund activities, but, to the extent that it does so, it will be subject to additional capital requirements and quantitative limits, to be established by rule. A banking entity may make and retain an investment in a fund that the banking entity organizes and offers, provided that its investment is within the "de minimis" standards set out in the rule. A banking entity also may engage in a specified list of "permitted activities." Fiduciary, or asset management, activities are within this exclusive list. While there are certain areas of ambiguity in connection with the Volcker Rule provisions, it is clear that the intent is to remove banking entities from proprietary trading.

The Dodd-Frank Act creates a new regulatory structure for over-the-counter ("OTC") derivatives over which the U.S. Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") share oversight responsibilities. The Act requires registration of swap dealers and major swap participants, subjects most swaps to central clearing, subjects swap dealers and major swap participants to heightened margin requirements, imposes new minimum capital requirements, establishes broader position limits, and creates new business conduct standards for participants in this market. The Act also includes the Lincoln "swaps push out" provisions, which provide that no federal assistance will go to an insured depository institution unless it limits its swap activities to certain permitted activities, which include hedging and risk mitigation activities and swap activities involving certain rates and reference assets, such as foreign exchange, precious metals, government and GSE obligations, and investment grade corporate debt.

To the extent that financial institutions and other market participants have relied on securitization as a financing tool, the Dodd-Frank Act also will result in significant changes. The Act includes a number of provisions that affect the

17. Id. § 619, 124 Stat. at 1620–31 (to be codified at 12 U.S.C. § 1851). The Volcker Rule, named for Paul Volcker, limits the ability of banks to engage in proprietary trading and other speculative activities.
18. Id.
25. Id. § 725(c), 124 Stat. at 1689 (amending 7 U.S.C. § 7a-1(c)(2)(D)(iv)).
27. Id. § 737, 124 Stat. at 1722–25 (amending 7 U.S.C. § 6a(a)).
28. Id. § 725(c), 124 Stat. at 1688–92 (amending 7 U.S.C. § 7a-1(c)).
The securitization market. These focus on “credit risk retention” and require originators and securitizers of financial assets to retain a portion of the credit risk of securitized financial assets or, in more popular terms, to have “skin in the game.” The Act generally requires credit risk retention of 5 percent of any asset included in a securitization, or less than 5 percent if the assets meet underwriting standards established by regulation.30 Risk retention requirements also will be required for collateralized debt obligations, securities collateralized by collateralized debt obligations, and similar instruments collateralized by other asset-backed securities.31 The Dodd-Frank Act prohibits a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset unless regulations to be adopted specify otherwise.32

Credit rating agencies will become subject to more extensive regulation under the Dodd-Frank Act.33 The Act also introduces a number of measures that are aimed at strengthening investor protection through a new whistleblower program,34 greater focus on disclosures provided to retail investors, and an enhanced duty of care for broker-dealers that provide retail investment advice.35 The Act also includes a number of corporate governance and compensation provisions that require enhanced proxy statement disclosure, potential changes to compensation committee composition and operation, advisory votes on executive compensation and golden parachute payments, and the adoption or revision of certain governance policies.36

Since the Dodd-Frank Act was passed in July 2010, the SEC’s attention has been focused on the many studies and rulemakings required to be undertaken by the agency. The SEC must impose a new regime for regulating OTC derivatives, including defining swaps and swaps dealers and registering dealers and a new marketplace.37 It also must tackle new rules for credit-rating agencies38 and municipal bond advisers.39 In addition, the SEC has to contend with the Volcker Rule,40 executive compensation,41 and a study on fiduciary duties for broker-dealers.42 In late July 2010, shortly after the legislation’s enactment, the SEC established a public comment process for market participants to contribute their views on

30. Id. § 941(b), 124 Stat. at 1891–92 (to be codified at 12 U.S.C. § 78o-11(c)).
31. Id.
32. Id.
34. Id. § 922, 124 Stat. at 1841–49 (to be codified at 12 U.S.C. § 78u-6).
38. See supra note 33 and accompanying text.
40. See supra notes 17–22 and accompanying text.
41. See supra note 36 and accompanying text.
42. See supra note 35 and accompanying text.
these rulemaking initiatives.43 In September 2010, the SEC published a rulemaking timetable.44 Since then, the agency has been hard at work tackling the overwhelming rulemaking agenda.

B. DODD-FRANK SECTIONS RELATED TO SECURITIES OFFERINGS AND FUNDS

1. Private Placements

The Dodd-Frank Act provides that, upon enactment and for four years following enactment, the net worth threshold for “accredited investor” status will be $1 million, excluding the equity value (if any) of the investor’s primary residence.45 One year after enactment, the SEC is authorized to review the definition of “accredited investor” (as it is applied to natural persons) and to adopt rules that adjust the definition, except for modifying the net worth threshold.46 Four years after enactment, and every four years thereafter, the SEC must review the “accredited investor” definition as applied to natural persons, including adjusting the threshold, although it may not be lowered below $1 million.47

The SEC provided additional guidance regarding the net worth standard in a Compliance and Disclosure Interpretation (“C&DI”). The C&DI notes that:

Section 413(a) of the Dodd-Frank Act does not define the term “value,” nor does it address the treatment of mortgage and other indebtedness secured by the residence for purposes of the net worth calculation. As required by Section 413(a) of the Dodd-Frank Act, the Commission will issue amendments to its rules to conform them to the adjustment to the accredited investor net worth standard made by the Act. However, Section 413(a) provides that the adjustment is effective upon enactment of the Act. When determining net worth for purposes of Securities Act Rules 215 and 501(a)(5), the value of the person’s primary residence must be excluded. Pending implementation of the changes to the Commission’s rules required by the Act, the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded. Indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor’s net worth.48

The Dodd-Frank Act requires the SEC to promulgate rules, within one year of enactment, disqualifying persons determined to be “bad actors” from eligibility

46. Id. § 413(b)(1), 124 Stat. at 1577–78.
47. Id. § 413(b)(2), 124 Stat. at 1578.
to use Rule 506 under Regulation D.49 A “bad actor” includes any person who is subject to a final order by a state securities, banking, or insurance authority, a federal banking regulator, or the National Credit Union Administration that bars the person from: (1) associating with any entity regulated by such authority, (2) engaging in the business of securities, insurance, or banking, or (3) engaging in savings association or credit union activities; or who is subject to a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the ten-year period ending on the filing date of the Form D relating to the offer or sale; or who has been convicted of any felony or misdemeanor in connection with the purchase or sale of a security or involving the making of any false filing with the SEC.50

2. Provisions Relating to Advisers of Private Funds, Venture Capital Funds, and Family Offices

a. Private Adviser Exemption (15 Client Exemption) Removed

The Dodd-Frank Act repealed a key provision from the Investment Advisers Act of 1940 (the “Advisers Act”) that exempted certain private advisers from registration as investment advisers.51 Section 203(b)(3) of the Advisers Act provided an exemption from registration for any adviser that had fewer than fifteen clients in the preceding twelve months and neither held itself out to the public as an investment adviser nor advised any registered investment company or business development company (commonly referred to as the “private adviser exemption” or the “15 client rule”).52 By removing this exemption, private advisers will be required to register with, and therefore be regulated by, the SEC as of July 21, 2011.53 The Dodd-Frank Act carved out exemptions for advisers to (1) family offices,54 (2) private funds with less than $150 million in assets under management,55 and (3) venture capital funds.56 The Dodd-Frank Act did not, however, define family offices, private funds, or venture capital funds. The SEC has released for comment proposed rules to define each of these terms.57

50. Id.
51. Id. § 403, 124 Stat. at 1571 (amending 15 U.S.C. § 80b-3(b)).
53. Advisers relying upon the private fund adviser exemption or venture capital fund adviser exemption may still be subject to registration with state securities authorities. However, because the Dodd-Frank Act excluded “family office” from the definition of “investment adviser,” see infra note 58, an adviser relying upon the family office exception will not be subject to the provisions of the Advisers Act at the state or federal level.
57. See infra notes 58–139 and accompanying text.
b. Family Offices

The Dodd-Frank Act codified a new section 202(a)(11)(G) of the Investment Advisers Act that excludes family offices, as defined by the SEC, from the definition of “investment adviser,” without regard to the number of clients advised by the adviser. The SEC’s proposed definition for family office is generally consistent with the previous exemptions relied upon under the soon-to-be repealed section 203(b)(3) of the Advisers Act.

The proposed rules would limit the availability of the family office exemption to an investment adviser who (1) provides investment advice solely to “family clients” (mainly “family members” and “key employees”), (2) does not hold itself out to the public as an investment adviser, and (3) maintains a family office that is wholly owned and controlled by the “family members.” The proposed rules will not extend to any investment adviser who advises multiple families.

The SEC proposes to define “family member” as an “individual and his or her spouse or spousal equivalent for whose benefit the family office was established and any of their subsequent spouses or spousal equivalents, their parents, their lineal descendants (including by adoption and stepchildren), and such lineal descendants’ spouses or spousal equivalents.” The proposed rules define “spousal equivalent” as “a cohabitant occupying a relationship generally equivalent to that of a spouse.” The SEC highlights the inclusion of adoptive children and stepchildren, as well as the founding family member’s parents, siblings, and the sibling's lineal descendants.

The SEC also proposes to include in the definition of “family client” charitable foundations, trusts, and entities formed for the benefit of the family office. Specifically, the SEC proposes to include “any charitable foundation, charitable organization, or charitable trust established and funded exclusively by one or more family members, and any trust or estate existing for the sole benefit of one or more family clients” as well as “any company, including a pooled investment vehicle, that is wholly owned and controlled, directly or indirectly, by one or more family clients and operated for the sole benefit of family clients.” The SEC’s proposed rules require that any trust, charitable organization, pooled investment vehicle, or business entity be wholly owned by the “family clients.”

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59. Id.
61. Id. at 63756.
62. Id. at 63755, 63763 (to be codified at 17 C.F.R. § 275.202(a)(11)(G)-1(d)(3)).
63. Id. (to be codified at 17 C.F.R. § 275.202(a)(11)(G)-1(d)(7)).
64. Id. at 63755–56, 63763 (to be codified at 17 C.F.R. § 275.202(a)(11)(G)-1(d)(3)).
65. Id. at 63757, 63762 (to be codified at 17 C.F.R. § 275.202(a)(11)(G)-1(d)(2)).
66. Id. at 63757 (footnotes omitted).
67. Id.
The proposed rules include allowances for transitions caused by death or divorce of a family member: former spouses, spousal equivalents, and stepchildren may retain any investments held through the family office at the time they became a former family member. 68 However, former family members would be limited from making new investments. 69 The SEC proposes a limited transition period for what it deems “involuntary transfers” to non-family clients, for example through a trust instrument that transfers assets to a charity that did not qualify as a “family client” upon the death of a “family member.” 70 The proposed rules permit an investment adviser to continue providing investment advice to former “family clients” for up to four months after the involuntary transfer, to allow for the client to transition to a new investment adviser or seek exemptive relief without affecting the family office’s exempt status. 71

The Dodd-Frank Act requires that certain “key employees” be permitted to invest alongside “family members.” 72 Accordingly, the SEC has proposed rules that would permit the family office to provide investment advice to any natural person (including persons who hold joint and community property with their spouse) who is (i) an executive officer, director, trustee, general partner, or person serving a similar capacity of the family office, or (ii) any other employee of the family office (other than an employee performing solely clerical, secretarial, or administrative functions) who, in connection with his or her regular duties, has participated in the investment activities of the family office, or similar functions or duties, for or on behalf of another company, for at least twelve months. 73

The proposed rules would essentially treat “key employees” of the family office as family members so that they may receive investment advice from, and participate in investment opportunities provided by, the family office. A “key employee” would be permitted to structure his or her investments through trusts and other entities that are wholly owned by the family office. 74 Upon the conclusion of employment, “key employees” would be permitted to maintain their investments with the family office and without any time constraints, but would not be able to make any additional investments through the family office. 75

Finally, the Dodd-Frank Act prohibits the SEC from excluding from the definition of “family office” persons not registered or required to register with the SEC as of January 1, 2010. 76 As such, advisers may continue to rely upon previously issued exemptive orders.

68. Id. at 63757, 63763 (to be codified at 17 C.F.R. § 257.202(a)(11)(G)-1(d)(4)).
69. Id. at 63757, 63762 (to be codified at 17 C.F.R. § 257.202(a)(11)(G)-1(d)(2)(vi)).
70. Id. at 63756–57, 63762 (to be codified at 17 C.F.R. § 257.202(a)(11)(G)-1(b)(1)).
71. Id.
74. Id. at 63758.
75. Id. at 63758, 63763 (to be codified at 17 C.F.R. § 257.202(a)(11)(G)-1(d)(2)(vii)).
c. Venture Capital Funds

The Dodd-Frank Act creates new section 203(l) that exempts from registration investment advisers that solely advise venture capital funds.\(^{77}\) The SEC proposes to define a venture capital fund as a private fund that:

(i) Invests in equity securities of private companies in order to provide operating and business expansion capital (i.e., “qualifying portfolio companies,” which are discussed below) and at least 80 percent of each company’s securities owned by the fund were acquired directly from the qualifying portfolio company; (ii) directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company; (iii) does not borrow or otherwise incur leverage (other than limited short-term borrowing); (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (v) represents itself as a venture capital fund to investors; and (vi) is not registered under the Investment Company Act [of 1940, as amended (the “Investment Company Act”)] and has not elected to be treated as a BDC [business development company as defined by the Investment Company Act and the Investment Advisers Act].\(^{78}\)

The SEC would require advisers relying upon the exemption solely to advise venture capital funds or to rely on grandfathering provisions.\(^{79}\)

(i) Qualifying Portfolio Companies

The SEC proposes to define a “qualifying portfolio company” as a company that “(i) is not publicly traded; (ii) does not incur leverage in connection with the investment by the private fund; (iii) uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors; and (iv) is not itself a fund (i.e., is an operating company).”\(^{80}\)

Private companies. In order to qualify for the venture capital fund exemption, the venture capital fund cannot invest in any company that is “publicly traded nor could it control, be controlled by, or be under common control with, a publicly traded company.”\(^{81}\) However, the proposed rule permit a venture capital fund to continue to hold securities of a portfolio company that ultimately becomes a public company.\(^{82}\) The rule proposal permits the venture capital fund to utilize bridge financing, provided that the bridge financing does not include debt instru-

\(^{77}\) Id. § 40 7, 124 Stat. at 1574–75 (amending 15 U.S.C. § 80b-3).
\(^{79}\) Id. at 77193.
\(^{80}\) Id. at 77193, 77226 (to be codified at 17 C.F.R. § 275.203(l)-1(c)(4)).
\(^{81}\) Id. (to be codified at 17 C.F.R. § 275.203(l)-1(c)(4)(i)).
\(^{82}\) Id. at 77193.
ments. There is no limitation on investing in a venture capital fund investing outside the United States.

**Equity securities, cash and cash equivalents, and short-term U.S. Treasuries.** A venture capital fund may invest in equity securities issued by qualifying portfolio companies, cash and cash equivalents, and U.S. Treasuries with a remaining maturity of sixty days or less. A fund would not qualify for the venture capital fund exemption if it invested in debt instruments of a portfolio company or loaned money to a portfolio company.

The SEC would rely upon Exchange Act § 3(a)(11) and Rule 3a11-1 for the definition of “equity securities.” “Equity securities” include common stock, preferred stock, warrants, convertible securities, and limited partnership interests. Cash and cash equivalents are defined with reference to portions of Rule 2a51-1(b)(7) of the Investment Company Act. The definition includes currencies, including foreign currencies, bank deposits, certificates of deposit, bankers’ acceptances, and similar bank instruments. The SEC proposes to exclude two aspects of Rule 2a51-1(b)(7) from the definition of venture capital financing; those are (1) the reference to cash and cash equivalents being held for investment purposes, and (2) the use of the net cash surrender value of an insurance policy as a cash equivalent.

**Portfolio company leverage.** The SEC proposes to define a “qualifying portfolio company” as “one that does not borrow, issue debt obligations or otherwise incur leverage in connection with the venture capital fund’s investments.”

**Use and source of capital.** The proposed rule reflect the distinction between a venture capital fund, which typically utilizes investment assets for business and operating purposes, and a leveraged buyout fund, which typically acquires a controlling interest in operating companies through the buyout of existing security holders.

The SEC proposes to define a venture capital fund as “a fund that holds equity securities of qualifying portfolio companies, and at least 80 percent of each company’s equity securities owned by the venture capital fund were acquired directly from each such qualifying portfolio company.” A venture capital fund may not redeem or repurchase outstanding securities in connection with a venture capital fund.
fund’s investment. In addition, a qualifying portfolio company may not distribute company assets to other security holders in connection with the venture capital fund’s investment in the company (i.e., an indirect buyout). The remaining 20 percent of each company’s equity securities may be purchased from existing investors.

Operating companies. Under the proposed rules, a qualifying portfolio company excludes private funds, commodity pools, investment companies, and other pooled vehicles.

(iii) Management Involvement

A venture capital fund or its investment adviser would be required to “(i) have an arrangement under which it offers to provide significant guidance and counsel concerning the management, operations or business objectives and policies of the portfolio company (and, if accepted, actually provides the guidance and counsel) or (ii) control the portfolio company.”

(iii) Limitations on Leverage

A venture capital fund would not be permitted to “borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the fund’s capital contributions or uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days.”

(iv) No Redemption Rights

The proposed rules prohibit a venture capital fund from issuing securities to investors with redemption rights absent extraordinary circumstances. However, funds may typically return capital and profits to investors through pro rata distributions.

(v) Represent Itself as a Venture Capital Fund

A fund relying on the exemption must hold itself out to investors as a venture capital fund.

(vi) Grandfathering Provisions

The SEC proposes to grandfather certain private funds for purposes of the new venture capital fund exemption. The SEC proposes to include in the definition
of a venture capital fund any private fund that “(i) [r]epresented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund; (ii) has sold securities to one or more investors prior to December 31, 2010; and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011.”105

d. Exemptions for Investment Advisers Solely to Private Funds with Less than $150 Million in Assets Under Management

The Dodd-Frank Act exempts certain investment advisers to private funds from registration under new section 203(m) of the Advisers Act.106 This exemption includes advisers that solely advise private funds and have less than $150 million in assets under management in the United States (hereinafter referred to as a “private fund adviser”).107

(i) Advises Solely Private Funds

A private fund is an entity that would be an investment company under the Investment Company Act but for the exception in section 3(c)(1) or 3(c)(7) of the Investment Company Act.108 An adviser could advise an unlimited number of private funds, provided the aggregate assets under management do not exceed $150 million.109

(ii) Private Fund Assets and Assets Under Management Calculation

The SEC has proposed new rules for calculating assets under management. As noted above, an adviser can rely upon the private fund adviser exemption only if it maintains less than $150 million in assets under management in the United States.110 A subadviser would have to count only the portion of the private fund assets for which it has responsibility.111 The proposed rules would require an adviser to aggregate the “fair value” (as opposed to cost basis) of all assets under management in the United States.112 Assets under management would include all assets on the firm’s balance sheet, including uncalled capital commitments and assets for which the adviser is not compensated.113

The SEC proposes that each adviser assess the amount of funds under management on a quarterly basis.114 This assessment would permit an adviser to de-

105. Id.
106. Dodd-Frank Act, supra note 1, § 408, 124 Stat. at 1575 (to be codified at 15 U.S.C. § 80b-3(m)).
109. Id. at 77206, 77226 (to be codified at 17 C.F.R. § 275.203(m)-1(a)).
110. See supra note 55 and accompanying text.
112. Id. at 77207, 77226 (to be codified at 17 C.F.R. § 275.203(m)-1(c)).
113. Id. at 77207.
114. Id. at 77207, 77226 (to be codified at 17 C.F.R. § 275.203(m)-1(c)).
termine whether it continued to qualify for the private fund adviser exemption, and would give the adviser one quarter to transition to a registered adviser if the exemption is no longer available.115

(iii) Assets Managed “Within the United States”

The proposed rules define principal office and place of business to mean:

- adviser’s executive office from which the officers, partners, or managers of the adviser direct, control, and coordinate the adviser’s activities;
- an office where the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and
- any other location that it holds out to the general public as a place where those activities take place.116

The SEC proposes that an adviser with a principal office and place of business within the United States could consider all assets under management as “within the United States,” without regard to the client’s residency.117 For advisers with a principal office and place of business outside of the United States (a “non-U.S. adviser”), the SEC will consider assets managed from a United States place of business for purposes of the exemption.118

A non-U.S. adviser could not rely upon the exemption if it advised any client that is a “United States person” other than a client fund.119 In other words, a non-U.S. adviser would qualify for the private fund adviser exemption only if all of its United States assets under management were qualifying private funds.120 In addition, a non-U.S. adviser would only count private funds it manages from a United States principal office or place of business toward the $150 million asset limit.121

(iv) United States Person

The proposed rules refer to Regulation S for the definition of a United States person.122 Regulation S looks to residency of an individual to determine whether he or she is a United States person.123 Regulation S treats partnerships and corporations as United States persons if they are organized or incorporated within the United States.124 Regulation S treats discretionary accounts generally as United States persons if the fiduciary is a resident of the United States.125 Under

115. Id. at 77207.
116. Id. at 77213, 77227 (to be codified at 17 C.F.R. § 275.203(m)-1(e)(3)).
117. Id. at 77213.
118. Id. at 77213, 77226 (to be codified at 17 C.F.R. § 275.203(m)-1(b)).
119. Id. at 77213.
120. Id.
121. Id.
122. Id. at 77209, 77227 (to be codified at 17 C.F.R. § 275.203(m)-1(e)(8)). Regulation S is codified at 17 C.F.R. §§ 230.901–.905 (2010).
123. 17 C.F.R. § 230.902(k).
124. Id. § 230.902(k)(viii).
125. Id. § 230.902(k)(vii).
the proposed rules, “an adviser must treat a discretionary or other fiduciary account as a United States person if the account is held for the benefit of a United States person by a non-U.S. fiduciary who is a related person of the adviser.”

**e. Foreign Private Advisers**

The Dodd-Frank Act replaced the current private adviser exemption with a new exemption for a foreign private adviser under section 203(b)(3) of the Investment Advisers Act.

The Dodd-Frank Act defines the term “foreign private adviser” under section 202(a)(30) as an investment adviser that:

1. has no place of business in the United States;
2. has, in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the investment adviser;
3. has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25,000,000 . . . ; and
4. . . . [does not] hold itself out generally to the public in the United States as an investment adviser . . . .

Section 202(a)(30) provides the SEC with authority to increase the $25 million threshold “in accordance with the purposes of this title.”

(i) **Place of Business**

An adviser relying on the foreign private adviser exemption is not permitted to have an office or place of business in the United States.

(ii) **In the United States**

The foreign private adviser exemption refers to “in the United States” to qualify the adviser’s clients and investors, assets under management, and place of business. The proposed rules would permit a person to continue to be treated as not “in the United States” even after the person is “in the United States” if such person were not in the United States at the time the person became a client or at the time the investor acquired the securities issued by the private fund.

(iii) **Clients and Private Fund Investors**

The SEC proposes to count clients for the purposes of the foreign private adviser exemption in the same manner as currently counted under Rule 203(b)(3)-1. The proposed rules

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127. Dodd-Frank Act, supra note 1, § 403, 124 Stat. at 1571 (amending 15 U.S.C. § 80b-3(b)).
128. Id. § 402(a), 124 Stat. at 1570 (to be codified at 15 U.S.C. § 80b-2(a)(30)).
129. Id. (to be codified at 15 U.S.C. § 80b-2(a)(30)(C)).
131. Id. at 77222.
132. Id. at 77222, 77225–26 (to be codified at 17 C.F.R. § 275.202(a)(30)-1(c)(2)).
133. Id. at 77210.
An adviser could also count as a single client “(i) a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization to which the adviser provides investment advice based on the organization’s investment objectives, and (ii) two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.”

However, an adviser would not be able to exclude from its calculation of clients those clients for whom the adviser provides services without compensation. In addition, private funds would no longer be able to count each private fund as a single client. Instead of counting the fund as a client, the SEC proposes that the adviser count the number of investors in the fund for purposes of this exemption.

The SEC proposes to define “investor” in a private fund as “any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the Investment Company Act, or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of that Act.”

3. Rating Agencies

   With respect to credit rating agencies, the Dodd-Frank Act provides for improved regulation by mandating increased accountability, stronger internal controls to avoid conflicts of interest and to ensure the accuracy of ratings, elimination of reliance on ratings by federal agencies, and enhanced transparency to allow investors and other users to evaluate accuracy and to compare the performance of different agencies.

   As indicated below, many of the requirements to be imposed have been left by Congress to regulations to be prescribed by the SEC, and many actions that had been proposed in Congress have been relegated to studies to be conducted over

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134. Id. at 77210, 77225 (to be codified at 17 C.F.R. § 275.202(a)(30)-1(a)(1)).
135. Id. at 77210–11, 77225 (to be codified at 17 C.F.R. § 275.202(a)(30)-1(a)(2)).
136. Id. at 77211.
137. Id.
138. Id. at 77211, 77225 (to be codified at 17 C.F.R. § 275.202(a)(30)-1(b)(4)).
139. Id. (to be codified at 17 C.F.R. § 275.202(a)(30)-1(c)(1)).
the next several years. Generally, the SEC is required to issue final regulations with respect to credit rating agencies within one year of the date of enactment of the Dodd-Frank Act, which is July 21, 2011.\footnote{141} The immediate effectiveness of certain provisions of the Dodd-Frank Act raised a number of practical challenges for practitioners and required intervention by the SEC in order to avoid having the offering market shut down.\footnote{142}

\subsection*{b. Accountability}

\begin{itemize}
\item[(i)] Liability for Information Filed

Under § 15E of the Exchange Act, which covers the registration of Nationally Recognized Statistical Rating Organizations ("NRSROs") with the SEC, NRSROs are now required to "file" information that previously needed only to be "furnished."\footnote{143} Accordingly, NRSROs will be subject to liability under § 18 of the Exchange Act in the event that any such filings contain false or misleading statements of material fact.\footnote{144}

\item[(ii)] "Accuracy"

The Dodd-Frank Act also empowers the SEC temporarily to suspend or permanently to revoke the registration of an NRSRO with respect to a particular class of securities if the SEC finds that the NRSRO has failed to produce "accurate" ratings for that class for a sustained period of time.\footnote{145} There is no indication as to how the SEC will make that determination.

\item[(iii)] "Expert" Liability

Rule 436(g) under the Securities Act, which had provided that credit ratings assigned by an NRSRO would not be considered part of a registration statement prepared or certified by an expert, was immediately nullified by the Dodd-Frank Act.\footnote{146} Written consent of an NRSRO must thus be obtained by a registrant in order to include a credit rating in a registration statement,\footnote{147} and NRSROs are therefore subject to liability under § 11 of the Securities Act for misstatements or omissions of material facts in connection with credit rating disclosure.\footnote{148}

In response to these measures, each of Moody’s, Standard & Poor’s, Fitch, and DBRS issued statements indicating that it was unwilling to provide the required

\footnotesize{\begin{itemize}
\item[141] Id. § 937, 124 Stat. at 1885 (to be codified at 15 U.S.C. § 78o-7 note).
\item[142] See Melissa Aguilar, SEC Guidance and No-Action Address 436(g) Repeal Issues, COMPLIANCE Wk., July 23, 2010 (on file with The Business Lawyer); Danielle Carbone, The Impact of the Dodd-Frank Act’s Credit Rating Agency Reforms on Public Companies, INSIGHTS, Sept. 2010, at 1, 1–2.
\item[145] Dodd-Frank Act, supra note 1, § 932(a), 124 Stat. at 1874 (to be codified at 15 U.S.C. § 78o-7(d)(1)).
\item[146] Id. § 939G, 124 Stat. at 1890.
\item[147] Rule 436(g) was repealed, which has the effect of exposing the NRSROs to § 11 liability. Now, the inclusion of a rating in a registration statement or prospectus is a statement by an expert and an expert must consent to be named. See Securities Act § 11(a)(4), 15 U.S.C. § 77k(a)(4) (2006).
\end{itemize}}
This left issuers subject to Regulation AB ("Reg AB") disclosure requirements in a catch-22 situation, since credit rating disclosure is required under Reg AB when the issuance of offered securities is conditioned upon receipt of a certain rating. In order to resolve the problem and provide the industry with a transition period in which to adapt to the new statutory requirements, the SEC issued a no-action letter on July 22, 2010, allowing issuers to omit credit ratings from registration statements until January 24, 2011. On November 23, 2010, the SEC issued a replacement no-action letter to extend indefinitely the transition period.

The SEC Division of Corporation Finance also posted CD&Is to provide guidance for issuers not subject to Reg AB as to when consent of an NRSRO is required for disclosure of a credit rating. The SEC also clarified that for issuers not subject to Reg AB disclosure requirements, consent of an NRSRO is not required if a credit rating is included in a registration statement or § 10(a) prospectus in connection with disclosure of a credit rating change, the liquidity of the registrant, the cost of funds for a registrant, or terms of agreements. In addition, the SEC clarified that ratings information included in a Rule 433 free writing prospectus or communications in compliance with Rule 134 do not require NRSRO consent.

c. Internal Controls

Section 15E of the Exchange Act has also been amended to require NRSROs to "establish, maintain, enforce and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings."

Annual report requirement. The SEC must prescribe rules requiring NRSROs to submit to the SEC annual internal controls reports describing the responsibility of the NRSRO’s management in establishing and maintaining internal controls,
assessing the effectiveness of the internal control structures, and containing an attestation of the CEO.  

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\( \text{id.} \) (to be codified at 15 U.S.C. § 78o-7(c)(3)(B)).

\[ 158 \]

Id., 124 Stat. at 1874 (to be codified at 15 U.S.C. § 78o-7(h)(3)).

\[ 159 \]

Id. (to be codified at 15 U.S.C. § 78o-7(h)(3)(B)(i)).

\[ 160 \]

Id. (to be codified at 15 U.S.C. § 78o-7(h)(3)(B)(ii)).

\[ 161 \]

Id. (to be codified at 15 U.S.C. § 78o-7(h)(4)(A)).

\[ 162 \]

Id. (to be codified at 15 U.S.C. § 78o-7(h)(4)(B)).

\[ 163 \]

Id. (to be codified at 15 U.S.C. § 78o-7(h)(5)).

\[ 164 \]

Id. § 939H, 124 Stat. at 1890.

\[ d. \] Conflicts of Interest

(i) Separation of Ratings from Sales and Marketing

The SEC is required to issue rules to prevent sales and marketing considerations from influencing the production of ratings.  

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The rules must provide an exception for small NRSROs where separation of sales and marketing is not practical.  

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NRSROs will be subject to suspension or revocation of their registration if, upon notice and hearing, the SEC finds that these rules have been violated in a way that affected a rating.

(ii) Look-back Requirement

NRSROs will be required to put in place procedures reasonably designed to ensure that, if any employee of an issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating had previously been employed by the NRSRO and participated in determining a credit rating of that entity during the one-year period before the rating action, the NRSRO will conduct reviews to determine whether conflicts of interest influenced the rating, and will revise the rating as appropriate.  

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The SEC will be required periodically to review the look-back procedures and code of ethics policies of each NRSRO.

(iii) Employment Transitions

NRSROs will be required to report to the SEC (and the SEC will be required to disclose to the public) when an individual who had been an employee of the NRSRO within the previous five years becomes employed by an obligor, issuer, underwriter, or sponsor of a security or money market instrument that was rated by the NRSRO during the twelve months before the employee transitioned to his or her new position, in cases where the employee was a senior officer of the NRSRO or participated in or supervised someone participating in rating the obligor, issuer, underwriter, or sponsor.

(iv) Rule to Prevent Conflicts of Interest

The Dodd-Frank Act sets forth the intent of Congress that the SEC should exercise its rulemaking authority to prevent improper conflicts of interest arising from NRSRO employees providing services to issuers, including consulting and advisory services, in addition to providing credit ratings to those issuers.
e. Corporate Governance

(i) Independent Board

Each NRSRO must have a board of directors, at least half but no fewer than two members of whom are “independent.”\(^{165}\) To be independent, a board member may not, other than in the capacity of member of the board, accept a fee from the NRSRO, be associated with the NRSRO or any affiliated company, or be involved in determining a rating in which he or she has a financial interest.\(^{166}\) Some of the independent members must be users of NRSRO ratings.\(^{167}\)

(ii) Duties of Board

The NRSRO board of directors will be required to oversee “the establishment, maintenance, and enforcement of policies and procedures for determining credit ratings” and addressing and dealing with conflicts of interest, the effectiveness of the internal control system, and compensation and promotion policies.\(^{168}\)

If the SEC determines that compliance with these provisions is an unreasonable burden for a small NRSRO, the SEC may permit that NRSRO to delegate these responsibilities to a committee including at least one person who is a user of NRSRO ratings.\(^{169}\)

f. Regulation of NRSROs: Office of Credit Ratings

The Dodd-Frank Act requires the SEC to establish an Office of Credit Ratings within the SEC to administer rules regarding the practice of determining ratings, promoting rating accuracy, and ensuring that ratings are not influenced by conflicts of interest.\(^{170}\)

g. Examinations

The Office of Credit Ratings will be required to conduct examinations of NRSROs at least annually to review management of conflicts of interest, internal controls, governance, and implementation of its policies, procedures, and rating methodologies.\(^{171}\)

h. Inspection Reports

The SEC will make available to the public a summary of its findings with regard to material regulatory deficiencies, including whether the NRSRO has appropriately addressed recommendations of the SEC and any responses by the NRSRO.\(^{172}\)

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165. Id. § 932(a)(8), 124 Stat. at 1882 (to be codified at 15 U.S.C. § 78o-7(t)(2)).
166. Id.
167. Id.
169. Id., 124 Stat. at 1883 (to be codified at 15 U.S.C. § 78o-7(t)(4)).
170. Id., 124 Stat. at 1877 (to be codified at 15 U.S.C. § 78o-7(p)(1)).
171. Id., 124 Stat. at 1877–78 (to be codified at 15 U.S.C. § 78o-7(p)(3)).
172. Id., 124 Stat. at 1878 (to be codified at 15 U.S.C. § 78o-7(p)(3)(C)).
i. Penalties

The SEC will be required to establish fines and other penalties applicable to NRSROs violating the provisions of § 15E of the Exchange Act.\(^{173}\)

j. Private Right of Action

**Statements made by credit rating agencies.** Section 15E(m) of the Exchange Act is amended so that the penalty and enforcement provisions of the Exchange Act “apply to statements made by a credit rating agency in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws.”\(^{174}\) These statements are not deemed to be forward-looking statements for purposes of the safe harbor pursuant to § 21E of the Exchange Act.\(^{175}\) There is no longer a bar against private rights of action as there previously had been under § 15E(m).\(^{176}\)

**State of mind.** Section 21D(b)(2) of the Exchange Act is amended so that, with respect to private securities fraud actions for money damages against a rating agency or a controlling person, it is sufficient that “a complaint state with particularity the facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed—(i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or (ii) to obtain reasonable verification of such factual elements . . . from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.”\(^{177}\)

**Duty to report tips alleging material violations of the law.** Each NRSRO must report to the appropriate authority any credible information it receives alleging that an issuer of securities rated by the NRSRO has committed or is committing a material violation of law.\(^{178}\)

k. Enhanced Disclosure Requirements

(i) SEC Rules as to Disclosure

The SEC must issue rules requiring NRSROs to disclose information publicly on the initial credit rating given to each obligor, security, and money market instrument, and on any subsequent rating change.\(^{179}\)

\(^{173}\) *Id.* (to be codified at 15 U.S.C. § 78o-7(p)(4)).

\(^{174}\) *Id.* § 933(a), 124 Stat. at 1883 (to be codified at 15 U.S.C. § 78o-7(m)).

\(^{175}\) *Id.*

\(^{176}\) *Id.*

\(^{177}\) *Id.* § 933(b), 124 Stat. at 1883–84 (to be codified at 15 U.S.C. § 78u-4(b)(2)).

\(^{178}\) *Id.* § 934, 124 Stat. at 1884 (to be codified at 15 U.S.C. § 78o-7(u)).

\(^{179}\) *Id.* § 932(a)(8), 124 Stat. at 1878 (to be codified at 15 U.S.C. § 78o-7(q)(1)).
(ii) Content and Type of Disclosure

The disclosures made by each NRSRO must (i) be similar so that users can compare credit rating performance across NRSROs, (ii) be clear and informative, (iii) include performance information over a range of years and for a variety of types of credit ratings, including for withdrawn credit ratings, (iv) be freely available and easily accessible on its website, and (v) include an attestation that the rating is based solely on an independent evaluation of the risks and merits of the instrument being rated.\textsuperscript{180}

(iii) Form Accompanying Ratings

The SEC will require each NRSRO to prescribe a form to accompany each publication of a credit rating that is easy to use, comparable across security type, and readily available to credit rating users.\textsuperscript{181}

(iv) Qualitative Content

The form will be required to include disclosure of (i) the credit rating, (ii) the main assumptions and data used in making the rating determination, (iii) potential limitations of the credit rating, (iv) information on the reliability, accuracy, and quality of the data used in making the credit rating determination, (v) information as to limitations of essential data such as limits on the scope of historical data and accessibility to certain documents, (vi) whether and to what extent third-party due diligence services were used by the NRSRO, a description of the information that the third party reviewed, and a description of the third party’s conclusions, and (vii) information as to conflicts of interest.\textsuperscript{182}

(v) Quantitative Content

The form will also be required to include disclosure of (i) factors that could lead to a change in the credit rating and the magnitude of change to be expected under various market conditions, (ii) information on the content of the rating, including the historical performance of the rating, and the expected probability of default and consequent loss, and (iii) information on the sensitivity of the rating to assumptions made in the rating process.\textsuperscript{183}

(vi) Third-Party Due Diligence

The issuer or underwriter of any asset-backed security will be required to make publicly available the findings and conclusions of any third-party due diligence report it obtains.\textsuperscript{184} Any third-party due diligence provider employed by an NRSRO, issuer, or underwriter must provide written certification to the NRSRO that it conducted a thorough review of the data and documentation used by the NRSRO

\textsuperscript{180} Id., 124 Stat. at 1878–79 (to be codified at 15 U.S.C. § 78o-7(q)(2)).
\textsuperscript{181} Id., 124 Stat. at 1879–80 (to be codified at 15 U.S.C. § 78o-7(s)(1)–(2)).
\textsuperscript{182} Id., 124 Stat. at 1880–81 (to be codified at 15 U.S.C. § 78o-7(s)(3)(A)).
\textsuperscript{183} Id., 124 Stat. at 1881 (to be codified at 15 U.S.C. § 78o-7(s)(3)(B)).
\textsuperscript{184} Id. (to be codified at 15 U.S.C. § 78o-7(s)(4)(A)).
to make a rating determination in a form to be established by the SEC, and the NRSRO will be required to disclose the certification to the public.\textsuperscript{185} While the scope of the “third-party due diligence report” is somewhat unclear, a review of the legislative history of the Dodd-Frank Act indicates that it is meant to refer to the type of loan-level diligence done by third-party diligence contractors.\textsuperscript{186} No distinction is made between public and private deals in connection with this disclosure requirement, and there is no indication whether the SEC will make any such distinction.

\textbf{(vii) Elimination of Regulation FD Exemption}

Under Regulation FD, if an issuer or any person acting on behalf of an issuer discloses material nonpublic information about the issuer or its securities to certain enumerated entities, the issuer must make such disclosure public.\textsuperscript{187} The rule had exempted disclosures made to credit rating agencies.\textsuperscript{188} Under section 939B of the Dodd-Frank Act, the SEC was required to remove the exemption for disclosures to credit rating agencies.\textsuperscript{189} The SEC issued a rule implementing this requirement that became effective on October 4, 2010.\textsuperscript{190}

Credit rating agencies have stated that they will work with issuers to ensure that they may continue to receive confidential information as part of the rating process.\textsuperscript{191} Issuers may be able to continue to provide such information to credit rating agencies without making the information public based on an exception for disclosures made to persons who expressly agree to maintain the disclosed information in confidence by having the credit rating agency sign a confidentiality agreement.\textsuperscript{192} Credit rating agencies could also argue that they may receive confidential information based on the exception for disclosures made to persons who owe a duty of trust or confidence to the issuer. These issues are likely to be addressed by the SEC rules to be promulgated in accordance with the Dodd-Frank Act.

\textsuperscript{185} Id., 124 Stat. at 1881–82 (to be codified at 15 U.S.C. § 78o-7(s)(4)(B)–(D)).
\textsuperscript{186} S. REP. NO. 111-176, at 121 (2010).
\textsuperscript{187} 17 C.F.R. § 243.100(a) (2010).
\textsuperscript{188} Id. § 243.100(b)(2)(iii).
\textsuperscript{192} See Fitch Press Release, supra note 191.
(viii) SEC Rules as to Procedures and Methodologies

The SEC must prescribe rules requiring NRSROs to:

- ensure that credit ratings are determined using procedures and methodologies that are approved by the board of the NRSRO and in accordance with the NRSRO’s policies and procedures;
- ensure that a material change to credit rating procedures and methodologies are applied consistently to all credit ratings, as applicable, within a reasonable period of time, and that the reasons for the change are publicly disclosed; and
- notify credit rating users of the version of a procedure or methodology used to determine a particular rating, when a material change to a procedure is made, when an error is identified, and the likelihood that a material change in procedure will result in a rating change.193

(ix) Use of Information from Outside Sources

NRSROs must “consider information about an issuer that . . . [it] receives from a source other than the issuer or underwriter” when producing a rating, if the NRSRO finds the information “credible and potentially significant to a rating decision.”194

(x) Qualifications for Credit Rating Analysts

The SEC must “issue rules reasonably designed to ensure that any person employed by an [NRSRO] to perform credit ratings—(i) meets standards of training, experience, and competence necessary to produce accurate ratings . . . ; and (2) is tested for knowledge of the credit rating process.”195

(xi) Universal Rating Symbols

The SEC must require NRSROs to “establish, maintain, and enforce written policies and procedures that” (i) assess the likelihood that an issuer of a security or money market instrument will default or fail to make payments in a timely manner in accordance with the terms of the instrument, (ii) clearly define the symbol used to denote the credit rating, and (iii) apply credit rating symbols in a consistent manner.196

I. Removal of Statutory References to Credit Ratings

Certain statutory references to credit ratings are required to be removed by July 21, 2012.197 Regulatory bodies will be required to develop their own standards of creditworthiness to replace these references.198

193. Dodd-Frank Act, supra note 1, § 932(a)(8), 124 Stat. at 1879 (to be codified at 15 U.S.C. § 78o-7(r)).
194. Id. § 935, 124 Stat. at 1884 (to be codified at 15 U.S.C. § 78o-7(v)).
196. Id. § 938, 124 Stat. at 1885 (to be codified at 15 U.S.C. § 78o-8).
197. Id. § 939, 124 Stat. at 1885–87.
198. Id.
m. Review and Modification of Federal Agency Reliance on Ratings

Each federal agency is required to review and modify its regulations to remove references to credit ratings and substitute its own standard of creditworthiness.199

n. Studies

The Dodd-Frank Act mandates that several studies be conducted to determine how best to implement further regulatory reforms.

(i) NRSRO Independence

By July 21, 2013, the SEC must conduct a study of the independence of NRSROs.200 The SEC must evaluate management of conflicts of interest raised by an NRSRO providing both rating and non-rating services, and the potential impact of rules prohibiting an NRSRO from providing such non-rating services to issuers it rates.201

(ii) Alternative Business Models

By December 21, 2012, the U.S. Government Accountability Office (“GAO”) must conduct a study on alternative means for compensating NRSROs to create incentives for NRSROs to provide more accurate credit ratings.202

(iii) Creation of Independent Professional Analyst Organization

By July 21, 2011, the GAO must “conduct a study on the feasibility and merits of creating an independent professional organization for [NRSRO] rating analysts . . . that would be responsible for” overseeing the profession in general and for establishing a code of ethical conduct and independent standards for governing the profession.203

(iv) Assigned Credit Ratings Study and Rulemaking

Study. By July 21, 2012, the SEC must conduct a study of (i) “the credit rating process for structured finance products and the conflicts of interest associated with issuer-pay and subscriber-pay models”; (ii) the feasibility of establishing a system whereby NRSROs are assigned to determine credit ratings of structured finance products, including “an assessment of potential mechanisms for determining fees, . . . appropriate methods for paying fees, . . . and the extent to which the creation of such a system could be viewed as the creation of a moral hazard by the Federal Government”; (iii) “the range of metrics that could be used to determine the accuracy of credit ratings”; and (iv) alternative compensation schemes that would incentivize more accurate credit ratings.204

200. Id. § 939C, 124 Stat. at 1888.
201. Id.
203. Id. § 939E, 124 Stat. at 1888–89.
Establishment of assignment system. After submission of the report, the SEC must, as it “determines is necessary or appropriate, . . . establish a system for the assignment of [NRSROs] to determine the initial credit ratings of structured finance products, in a manner that prevents the issuer, sponsor, or underwriter of the structured finance product” from selecting the NSRSO. 205 “Section 15E(w) of the Exchange Act, as that provision would have been added by Section 939D of H.R. 4173 (111th Congress), as passed by the Senate on May 20, 2010” (otherwise known as the “Franken Amendment”), would have established a system whereby a self-regulated Credit Rating Agency Board would assign NRSROs to determine initial credit ratings of structured finance products. 206 The SEC must implement the system described in § 15E(w) unless it determines that an alternative system would better serve the public interest and the protection of investors. 207


a. The SEC’s Say-on-Pay Rule Proposals and Transition Guidance

(i) Dodd-Frank Act Section 951

Section 951 of the Dodd-Frank Act requires that companies include a resolution in their proxy statements asking shareholders to approve, in a non-binding vote, the compensation of their executive officers, as disclosed under Item 402 of Regulation S-K (the “Say-on-Pay” vote). 208 A separate resolution is also required to determine whether this Say-on-Pay vote takes place every one, two, or three years (the “Say-on-Frequency” vote). 209 If any golden parachute compensation has not been approved as part of a Say-on-Pay vote, the Dodd-Frank Act requires that companies solicit shareholder approval of golden parachute compensation through a separate nonbinding vote at the meeting where the shareholders are asked to approve a merger or similar extraordinary transaction that would trigger “golden parachute” payments (the “Say-on-Golden Parachute” vote). 210 The Dodd-Frank Act requires that any proxy statement used for soliciting the Say-on-Golden Parachute vote include clear and simple disclosure of the golden parachute arrangements or understandings and the amounts payable. 211

On October 18, 2010, the SEC proposed rules to implement the shareholder advisory votes on executive compensation and golden parachute arrangements under section 951. 212 Under the proposed rules, public companies subject to the proxy rules would be required to:

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205. Id. § 939F(d), 124 Stat. at 1889–90 (to be codified at 15 U.S.C. § 78o-9(d)).
206. Id.
207. Id.
208. Id. § 951, 124 Stat. at 1899 (to be codified at 15 U.S.C. § 78n-1(a)(1)).
209. Id. (to be codified at 15 U.S.C. § 78n-1(a)(2)).
210. Id. at 1899–90 (to be codified at 15 U.S.C. § 78n-1(b)).
211. Id.
• provide their shareholders with a Say-on-Pay vote and a Say-on-Frequency vote, along with additional disclosure about the Say-on-Frequency vote;
• provide shareholders with a Say-on-Golden Parachute vote; and
• provide additional disclosure of golden parachute arrangements in merger proxy statements (and potentially in proxy statements seeking a Say-on-Pay vote). 213

(ii) Timing and Transition 214

Companies must include separate resolutions for the Say-on-Pay and the Say-on-Frequency vote in any preliminary or definitive proxy statement filed for an annual meeting occurring on or after January 21, 2011. 215 This effective date applies regardless of whether the SEC’s proposed rules have been adopted by such time. 216 The Say-on-Golden Parachute compensation will not be required to be included in proxy statements seeking shareholder approval of a covered corporate transaction until the effective date of the final SEC rules. 217

The SEC notes the following important transition issues:

• Until the SEC takes final action to amend Rule 14a-6, the SEC will not object if an issuer does not file a preliminary proxy statement when the only matter that would trigger such a preliminary proxy statement filing is a Say-on-Pay or Say-on-Frequency vote. 218
• Until the SEC takes final action to amend Rule 14a-4, the SEC will not object if the form of proxy used by an issuer for a shareholder vote on a Say-on-Frequency resolution “provides means whereby the person solicited is afforded an opportunity to specify by boxes a choice among 1, 2 or 3 years, or abstain.” 219 Further, if proxy services such as Broadridge are unable to accommodate the four choices in time for the vote, the SEC will not object if the solicited persons are afforded the opportunity to specify by boxes a choice among one, two, or three years, and proxies are not voted on the Say-on-Frequency matter if a solicited person does not select one of the three choices. 220
• For calendar year-end issuers, the rules will be effective for many of them as they begin filing proxy statements for annual meetings beginning in

213. Id. at 66592.
216. Id.
217. Id. at 66591–92.
218. Id. at 66596–97.
219. Id. at 66605.
220. Id. at 66605–06.
April 2011. These issuers should continue to monitor the developments with respect to the rule proposal, and use the proposed rules as a guide for drafting 2011 proxy statement disclosures.

b. Drafting the Say-on-Pay Proposal and Related Disclosure

The SEC proposes a new Rule 14a-21 to address the implementation of the advisory votes on executive compensation matters mandated by section 951 of the Dodd-Frank Act. In many cases, the SEC took a similar approach to the rules that it adopted under the Emergency Economic Stabilization Act (the “EESA”), which required that financial institutions receiving government assistance submit a Say-on-Pay vote to their shareholders.

(i) Form of the Say-on-Pay Resolution and Related Disclosure

(a) What Is Covered by the Resolution?

Under proposed Rule 14a-21(a), issuers that have a class of equity securities registered under § 12 of the Exchange Act and are subject to the proxy rules “would be required, not less frequently than once every three years, to provide a separate shareholder advisory vote in proxy statements to approve the compensation” of their “named executive officers, as defined in Item 402(a)(3) of Regulation S-K, . . . as such compensation is disclosed in Item 402 of Regulation S-K, including the Compensation Discussion and Analysis (the ‘CD&A’), the compensation tables and other narrative executive compensation disclosures required by Item 402.”

(b) What Is Not Covered by the Resolution?

The shareholder advisory vote would not cover:

- The compensation of directors; and
- “[I]f an issuer includes disclosure pursuant to Item 402(s) of Regulation S-K about the issuer’s compensation policies and practices as they relate to risk management and risk-taking incentives, these policies and practices would not be subject to the shareholder advisory vote . . . as they relate to the issuer’s compensation for employees generally. . . . [H]owever, to the extent that risk considerations are a material aspect of the issuer’s compensation policies or decisions for named executive officers, the issuer is required to discuss them as part of the CD&A, and therefore such disclosure would be considered by shareholders when they are voting on” the Say-on-Pay resolution.

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221. Id. at 66592–93, 66618 (to be codified at 17 C.F.R. § 240.14a-21).
222. Id. at 66592.
223. Id. (footnotes omitted).
224. Id.
(c) Wording of the Resolution

Proposed Rule 14a-21 does not require issuers to use specific language or a form of a resolution to be voted on by shareholders.\textsuperscript{225} However, the SEC cautions that the statute requires a vote “to approve the compensation of executives, as disclosed pursuant to [Item 402 of Regulation S-K] or any successor thereto.”\textsuperscript{226} Thus, “a vote to approve a proposal on a different subject matter, such as a vote to approve the compensation policies and procedures” of the issuer, would not satisfy the requirement for a Say-on-Pay vote.\textsuperscript{227}

(ii) Broker Discretionary Voting

The Proposing Release notes that section 957 of the Dodd-Frank Act “amends Section 6(b) of the Exchange Act to prohibit broker discretionary voting of uninstructed shares in . . . shareholder votes on executive compensation.”\textsuperscript{228} The SEC notes that the exchanges have begun to amend their rules to implement this requirement, and as a result of these rule changes, broker discretionary voting would not be permitted for a Say-on-Pay vote or a Say-on-Frequency vote.\textsuperscript{229}

(iii) The Impact on Compensation Discussion and Analysis and Other Disclosures

(a) Additional Disclosure Item for the Proxy Statement

Proposed Item 24 of Schedule 14A would require disclosure in the proxy statement that the issuer is providing a separate shareholder vote on executive compensation, along with a brief explanation of the general effect of the vote, such as whether the vote is nonbinding.\textsuperscript{230}

(b) Additional CD&A Disclosure

The SEC proposes to amend Item 402(b) of Regulation S-K to require that issuers address in their CD&A whether, and if so how, their compensation policies and decisions have taken into account the results of shareholder advisory votes on executive compensation.\textsuperscript{231}

(c) EESA Requirements

For those issuers that have received financial assistance under the Troubled Asset Relief Program (“TARP”) and that have indebtedness outstanding under TARP, the SEC indicates in the Proposing Release that the vote to approve executive compensation under Rule 14a-20 (which the SEC adopted in 2009) would satisfy the requirement for a Say-on-Pay vote under Rule 14a-21(a).\textsuperscript{232} Once these

\begin{flushleft}
\textsuperscript{225} Id. \\
\textsuperscript{226} Id. \\
\textsuperscript{227} Id. \\
\textsuperscript{228} Id. at 66597. \\
\textsuperscript{229} Id. \\
\textsuperscript{230} Id. at 66593. \\
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\textsuperscript{232} Id. at 66597.
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issuers have repaid all outstanding indebtedness under TARP, they would have to include a Say-on-Pay vote under the Dodd-Frank Act and proposed Rule 14a-21(a) in a proxy statement for the first annual meeting after the indebtedness is repaid. These issuers would also not have to provide for a Say-on-Frequency vote as long as they still have indebtedness outstanding under TARP, given that the EESA already requires an annual Say-on-Pay vote.

(c) Drafting the Say-on-Frequency Proposal and Related Disclosure

“Under proposed Rule 14a-21(b), issuers would be required, not less frequently than once every six years, to provide a separate shareholder advisory vote in proxy statements for annual meetings to determine whether the . . . [Say-on-Pay vote] will occur every one, two, or three years” (beginning with meetings occurring on or after January 21, 2011). The proposed rules would clarify that the separate Say-on-Frequency vote “would be required only in a proxy statement solicited for an annual or other meeting of shareholders for which [SEC] rules require [executive] compensation disclosure.”

(i) Form of the Say-on-Frequency Resolution and Related Disclosure: Four Choices for the Say-on-Frequency Vote

The SEC proposes that under the Say-on-Frequency vote contemplated by Item 14a-21(b), shareholders would be given four choices: to vote on executive compensation every one, two, or three years, or to abstain from voting on this matter. The SEC expresses its view that section 951 of the Dodd-Frank Act “does not allow for alternative formulations . . . , such as proposals that would provide shareholders with two substantive choices (e.g., to hold a . . . [Say-on-Pay vote] every year or less frequently) or only one choice (e.g., a company proposal to hold the . . . [Say-on-Pay vote] every two years).” The SEC does note, however, that it expects the board of directors to include a recommendation as to how shareholders should vote on the Say-on-Frequency proposal, provided that the proxy card clearly provides the four choices referenced above and that shareholders are not specifically voting on the board’s recommendation.

In order to permit the Say-on-Frequency vote with four choices, the SEC proposes to amend Rule 14a-4 to allow proxy cards including a Say-on-Frequency vote to reflect the choice of one, two, or three years, or abstention.

233. Id.
234. Id.
235. Id. at 66594, 66618 (to be codified at 17 C.F.R. § 240.14a-21(b)).
236. Id.
237. Id. (to be codified at 17 C.F.R. § 240.14a-4(b)(3)).
238. Id. at 66594.
239. Id. at 66594–95.
240. Id. at 66595, 66618 (to be codified at 17 C.F.R. § 240.14a-4(b)(3)).
(ii) Considerations for the Frequency of the Say-on-Pay Vote

Most companies should consider the following factors when deciding which alternative to recommend to their shareholders:

- Whether their executive compensation program contains one or more “problematic pay practices” or there is a pay-for-performance “disconnect” as determined by Institutional Shareholder Services (“ISS”). Generally, under its 2010 Policy Updates, ISS will first apply its compensation-related voting recommendation to a Say-on-Pay vote. If no Say-on-Pay vote is being conducted, the presence of a problematic pay practice or failing ISS’s “Pay-for-Performance” test may result in a “withhold vote” or an “against” vote recommendation for compensation committee members.

- Consequently, if a company’s program contains a problematic pay practice or a company is considering revising its program in the near future to add a feature that ISS or a major shareholder may not like, the absence of a Say-on-Pay vote may put the company’s compensation committee members at risk.

- Whether the company’s compensation committee members have received a high level of “withhold” or “against” votes in the past three years. For the reasons discussed in the previous bullet, this situation may put these directors at greater risk of not being re-elected in a year where no Say-on-Pay vote is being held.

- Whether the company is planning to adopt new change-in-control arrangements for its executive officers (or materially modify existing arrangements) in the next three years. The absence of a Say-on-Pay vote during 2012 and 2013 means that the company will not be able to avail itself of the exception to the Say-on-Golden-Parachute vote for these arrangements if it engages in an acquisition transaction before the 2014 annual meeting of shareholders.

- Whether the company is planning to adopt a new equity compensation plan or seek an increase to the share reserve of an existing plan in the next three years. Investors are likely to tolerate a periodic Say-on-Pay vote if they will have the opportunity to register their views of the company’s executive compensation program through their plan vote. Conversely, as this vote will have actual consequences, the company may not be willing to treat it as a “substitute” Say-on-Pay vote during an “off” year.

- Whether the company’s peers or other companies in the same industry sector are holding their Say-on-Pay votes annually, biennially, or triennially.


242. See id.
• The policy position of the company’s major shareholders on the frequency of Say-on-Pay votes by portfolio companies. ISS has announced that it will recommend that its clients vote for annual frequency.

• The likely impact of new section 957 of the Dodd-Frank Act (which prohibits broker voting of uninstructed shares on executive compensation matters) on the company’s Say-on-Pay vote.

These factors will play out differently for each company. Consequently, it will be important for each board of directors, in making its specific recommendation in 2011, to explain the rationale for the alternative that it is supporting.

(iii) Required Vote

(a) Voting Standard for Say-on-Frequency Votes

The SEC notes that, given the advisory nature of the Say-on-Frequency proposal, it is not necessary to prescribe a standard for determining which frequency has been adopted by shareholders, except that for the purpose of implementing the proposed amendments to Rule 14a-8 discussed below, the SEC proposes that a plurality-of-votes-cast standard be utilized to determine which one of the substantive choices has been selected.

(b) Amendment to Rule 14a-8’s Substantially Implemented Standard

The SEC proposes to add a note to Rule 14a-8(i)(10) that would clarify that shareholder proposals seeking an advisory shareholder vote on executive compensation or relating to the frequency of shareholder votes approving compensation could be excluded from an issuer’s proxy statement as “substantially implemented” if the issuer “has adopted a policy on the frequency of [S]ay-on-[P]ay votes that is consistent with the plurality of votes cast in the most recent [shareholder] vote [taken] in accordance with proposed Rule 14a-21(b).” The SEC solicits comments on whether this proposed basis for exclusion is appropriate, whether it should be expanded, whether the plurality standard should be used, and whether the instruction to Rule 14a-8(i)(10) should be available if an issuer has materially changed its compensation program since the most recent Say-on-Pay vote or Say-on-Frequency vote.

(c) Periodic Report Disclosure Regarding Say-on-Frequency Votes

The SEC proposes to amend Item 9B of Form 10-K and to add new Item 5(c) to Part II of Form 10-Q to “require an issuer to disclose, in the quarterly report

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244. Dodd-Frank Act, supra note 1, § 957, 124 Stat. at 1906–07 (to be codified at 15 U.S.C. § 78f(b)).
246. Id. at 66595.
247. Id. at 66596.
on Form 10-Q covering the period during which the shareholder advisory vote occurs, or in the annual report on Form 10-K if the advisory vote occurs during the issuer’s fourth quarter, its decision regarding how frequently it will conduct a Say-on-Pay vote in light of the results of the Say-on-Frequency vote.248 The SEC solicits comment on whether this disclosure is necessary and would provide timely notice to shareholders.249 As an interpretative matter, the SEC notes that the Form 8-K required under Item 5.07 could include additional disclosure regarding any shareholder votes required by section 951 of the Dodd-Frank Act and how the results of these votes affect an issuer’s plans for the future.250

d. Considering the Say-on-Golden Parachute Requirement

(i) Disclosure Considerations

The SEC proposes new paragraph (t) of Item 402 of Regulation S-K, which would require disclosure regarding golden parachute arrangements in proxy statements, consent solicitation statements, and other forms relating to “an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all” of a company’s assets, as well as in annual meeting proxy statements when an issuer is seeking to rely on the exception from a separate merger proxy shareholder vote by including the proposed Item 402(t) disclosure in the annual meeting proxy statement soliciting a Say-on-Pay vote.251

“[P]roposed Item 402(t) of Regulation S-K would require disclosure of named executive officers’ golden parachute arrangements in both tabular and narrative formats.”252 The SEC is proposing the following new table:

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The proposed table would quantify cash severance, equity awards that are accelerated or cashed out, pension and nonqualified deferred compensation en-

248. Id.
249. Id.
250. Id. at 66596 n.67.
251. Id. at 66599, 66615–16 (to be codified at 17 C.F.R. § 240.402(t)).
252. Id.
hancements, perquisites, and tax reimbursements. In addition, the proposed table would require disclosure and quantification of the value of any other compensation related to the transaction. The table would not require separate disclosure or quantification with respect to compensation disclosed in the Pension Benefits Table or Nonqualified Deferred Compensation Table, previously vested equity awards, or compensation from bona fide post-transaction employment agreements to be entered into in connection with the merger or acquisition transaction. As proposed by the SEC, “the table would require separate footnote identification of amounts attributable to ‘single-trigger’ arrangements and amounts attributable to ‘double-trigger’ arrangements, so that shareholders can readily discern these amounts.” The tabular disclosure required by Item 402(t) would require quantification with respect to any agreements or understandings, whether written or unwritten, between each named executive officer and the acquiring company or the target company, concerning any type of compensation, whether present, deferred or contingent, that is based on or otherwise relates to an acquisition, merger, consolidation, sale or other disposition of all or substantially all assets.

Proposed Item 402(t) of Regulation S-K would also require issuers “to describe any material conditions or obligations applicable to the receipt of payment, including but not limited to non-compete, non-solicitation, non-disparagement or confidentiality agreements, their duration, and provisions regarding waiver or breach.” The SEC has also proposed a requirement “to provide a description of the specific circumstances that would trigger payment, whether the payments would or could be lump sum, or annual, and their duration, and by whom the payments would be provided, and any material factors regarding each agreement.” The SEC notes that “[t]hese proposed narrative items are modeled on the narrative disclosure currently required with respect to termination and change-in-control agreements.

(ii) Shareholder Approval of Golden Parachutes

The SEC’s proposed Rule 14a-21(c) would provide that “[i]f a solicitation is made by an [issuer] for a meeting of shareholders at which shareholders are asked to approve an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the assets of the [issuer],” then the issuer must “provide a separate shareholder vote to approve any agreements or understandings and compensation disclosed pursuant to Item 402(t) of Regulation S-K . . . ,

253. Id. at 66599–600.
254. Id. at 66600.
255. Id. at 66600–01.
256. Id. at 66600.
257. Id.
258. Id. at 66601.
259. Id.
260. Id.
unless such agreements or understandings have been subject to a shareholder advisory vote under [Rule 14a-21(a)].” 261 In accordance with § 14A(b) of the Exchange Act, Rule 14a-21(c) notes that “any agreements or understandings between an acquiring company and the named executive officers of the [issuer], where the [issuer] is not the acquiring company, are not required to be subject to the separate shareholder advisory vote.” 262

Additional amendments are also proposed to various rules and forms in order to accommodate the Say-on-Golden Parachute vote.

The SEC does not propose any specific “language or form of resolution” for the Say-on-Golden Parachute vote and clarifies the advisory nature of such votes. 263 The SEC notes that the Item 402(t) disclosure would have to be provided at the time of the Say-on-Pay vote if an issuer is seeking to rely on the exception for a separate Say-on-Golden Parachute vote at the time of a merger or other extraordinary transaction, and that the exception would be available only to the extent the same golden parachutes previously subject to a Say-on-Pay vote remain in effect. 264

e. Impact of Say-on-Pay on Smaller Reporting Companies

The SEC has not proposed to exempt smaller reporting companies from the Say-on-Pay, Say-on-Frequency, or Say-on-Golden Parachute vote requirements, although the SEC does solicit comments on whether such an exemption would be appropriate. 265 The SEC has proposed an instruction to Rule 14a-21 providing that smaller reporting companies that are eligible to provide scaled disclosure in accordance with Item 402(l) of Regulation S-K are not required to include a CD&A in their proxy statements to comply with proposed Rule 14a-21. 266 The instruction would further provide that for smaller reporting companies, the Say-on-Pay vote required by proposed Rule 14a-21(a) “must be to approve the compensation of the named executive officers as disclosed pursuant to Items 402(m) through (q) of Regulation S-K” (which represent the scaled disclosure requirements). 267

The SEC notes that “pursuant to Item 402(o) of Regulation S-K, smaller reporting companies are required to provide a narrative description of any material factors necessary to an understanding of the information disclosed in the Summary Compensation Table,” and “[i]f consideration of prior executive compensation advisory votes is such a factor for a particular issuer, disclosure would be required pursuant to [the preexisting requirements] of Item 402(o).” 268

261. Id. at 66603, 66618 (to be codified at 17 C.F.R. § 240.14a-21(c)).
262. Id.
263. Id. at 66603.
264. Id.
265. Id. at 66604–05.
266. Id. at 66605, 66618 (to be codified at Instructions to 17 C.F.R. § 240.14a-21).
267. Id.
268. Id. at 66594 (citing 17 C.F.R. § 229.402(o)).
The proposed rules would “require quantification of golden parachute arrangements in merger proxies” for smaller reporting companies, even though such issuers “are not required to provide this quantification under current Item 402(q) [of Regulation S-K] in annual meeting proxy statements, and would not be required to do so under [the SEC’s] proposals unless they seek to qualify for the exception for . . . [the Say-on-Golden Parachute vote] in a later merger [or similar] transaction.”

f. Preparing for Say-on-Pay Disclosure

The initial Say-on-Pay vote will be pivotal, as it will set the tone for future votes, and will be the subject of close scrutiny by the media, investors, and regulators. Perhaps more than any other development since the SEC first introduced the CD&A in 2006, the mandatory Say-on-Pay vote is likely to motivate companies to revisit their CD&A to simplify and streamline their disclosure message. Moreover, companies should carefully reconsider the length and complexity of their CD&A to determine if they can make the presentations clearer and more compelling so that they will garner sufficient support for their executive compensation programs. This is likely to involve greater use of graphics to present critical information and a badly needed de-emphasis of descriptive information that has become “boilerplate.” Initially, the main focus of the CD&A needs to be on the analysis of a company’s key executive compensation actions and decisions, and, for that purpose, companies should focus on whether they are using the best analytic tools for evaluating their compensation programs, including a wealth accumulative analysis with full “walk-away” numbers.


Section 913 of the Dodd-Frank Act requires that the SEC conduct a study to examine the effectiveness of current legal and regulatory standards of care for broker-dealers, investment advisers, and associated persons when providing personalized investment advice to retail investors. Under current law, investment advisers owe a fiduciary duty to their clients. Broker-dealers are generally not subject to a fiduciary standard of care. They are subject to other requirements, including an obligation to recommend only securities that are suitable for their clients.274

269. Id. at 66605.
273. Id. at iv.
274. Id.
The SEC Chairman and some members of Congress have expressed support for the principle of harmonizing regulatory standards for broker-dealers and investment advisers. While the Dodd-Frank Act does not mandate adoption of a fiduciary standard for broker-dealers, it authorizes the SEC to commence rulemaking based on the results of its study. In addition, it expressly empowers the SEC to adopt rules that would require broker-dealers to comply with the standards of conduct applicable to investment advisers when providing personalized investment advice to retail clients.

During the course of the SEC study, members of the securities industry have submitted public comment letters noting potential pitfalls if a strict fiduciary standard is adopted. Such letters have expressed concern about a broker-dealer’s ability to engage in principal transactions, including initial public offerings, with retail customers. Other letters have noted that any fiduciary standard should be sufficiently flexible to accommodate the variety of relationships between broker-dealers and retail customers. The SEC submitted its report to Congress in January 2011.

6. Additional Investor Protection Provisions in the Dodd-Frank Act

The Dodd-Frank Act implemented a number of investor protection provisions in addition to the potential fiduciary duty for broker-dealers. Section 913 directs the SEC to “facilitate the provision of simple and clear disclosures to [retail] investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest.” This directive reflects concerns resulting from studies that found a high level of confusion among retail investors regarding the nature of their relationship with their brokers and investment advisers. The SEC is also authorized to require specific disclosures and customer consents if a broker-dealer provides only a limited range of investment products. Section 919 of the Dodd-Frank Act authorizes the SEC


277. Id. § 913(g), 124 Stat. at 1828 (to be codified at 15 U.S.C. § 78o(k)(1)).

278. See INVESTMENT ADVISERS AND BROKER-DEALERS STUDY, supra note 272, at 4–5.

279. See id.

280. See id.


282. Dodd-Frank Act, supra note 1, § 913(g)(1), 124 Stat. at 1828 (to be codified at 15 U.S.C. § 78o(f)(1)).


284. Dodd-Frank Act, supra note 1, § 913(g)(1), 124 Stat. at 1828 (to be codified at 15 U.S.C. § 78o(k)(2)).
to adopt “point of sale” disclosure requirements regarding investment objectives and risks as well as regarding financial incentives the broker may have to sell a particular product.\textsuperscript{285}

Section 913 also requires the SEC to examine and adopt, if necessary, “rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the [SEC] deems contrary to the public interest or the protection of investors.”\textsuperscript{286} Section 921 empowers the SEC to restrict or prohibit the use of mandatory arbitration provisions in customer agreements with broker-dealers and investment advisers.\textsuperscript{287}

Sections 911\textsuperscript{288} and 915\textsuperscript{289} of the Dodd-Frank Act establish within the SEC an Office of Investor Advocate and an Investor Advisory Committee. Both are charged with the responsibility of enhancing investor protections on an ongoing basis.


The Dodd-Frank Act includes incentive provisions designed to encourage whistleblowers to report violations of the securities laws to the SEC.\textsuperscript{290} The Dodd-Frank Act also includes anti-retaliation provisions that enhance existing protections for whistleblowers.\textsuperscript{291} The SEC estimates that the new whistleblower incentive and protection provisions will yield approximately 30,000 tips, complaints, or referrals annually.\textsuperscript{292}

In November 2010, the SEC released and sought comment on proposed Regulation 21F (the “proposed rules”), which clarifies the Dodd-Frank Act’s statutory terms and provisions.\textsuperscript{293} The proposed rules attempt to balance three main policy considerations: (1) the potential for monetary incentives to “reduce the effectiveness of companies’ existing compliance, legal, audit, and similar internal processes for investigating and responding to potential violations of the Federal securities laws”; (2) the potential for monetary incentives to invite submissions from compliance personnel—and other persons with professional obligations who play a critical role in achieving compliance with the securities laws—who use information obtained through their positions to make whistleblower claims; and (3) the desire to “maximize the submission of high-quality tips and enhance

\begin{itemize}
  \item 285. Id. § 919, 124 Stat. at 1837 (to be codified at 15 U.S.C. § 78o(n)).
  \item 286. Id. § 913(g)(1), 124 Stat. at 1828 (to be codified at 15 U.S.C. § 78o(l)(2)).
  \item 287. Id. § 921, 124 Stat. at 1841 (to be codified at 15 U.S.C. § 78o(o)).
  \item 289. Id. § 915, 124 Stat. at 1830–32 (to be codified at 15 U.S.C. § 78d(g)).
  \item 290. Id. § 922, 124 Stat. at 1841–49 (to be codified at 15 U.S.C. § 78u-6).
  \item 291. Id., 124 Stat. at 1845–47 (to be codified at 15 U.S.C. § 78u-6(g)).
  \item 293. Id. at 70488.
\end{itemize}
the utility of information reported” to the SEC.\textsuperscript{294} The comment period closed in December 2010, and final rules and regulations implementing the whistleblower program are due no later than April 21, 2011.\textsuperscript{295}

\textit{a. Whistleblower Incentive Provisions}

Before the Dodd-Frank Act, the SEC’s authority to pay bounties to whistleblowers was limited to insider trading cases. Section 21A(e) of the Exchange Act authorized the SEC to award up to 10 percent of the civil penalties collected in insider trading cases to whistleblowers who provided information contributing to successful prosecutions.\textsuperscript{296} The Dodd-Frank Act amends the Exchange Act by adding § 21F: Securities Whistleblower Incentives and Protection.\textsuperscript{297} Section 21F repeals § 21A(e) and requires the SEC to pay a bounty to one or more whistleblowers who voluntarily provide original information that results in successful prosecution of a federal court or administrative action in which the SEC obtains monetary sanctions over $1 million.\textsuperscript{298} Successful whistleblowers will receive a bounty totaling between 10 percent and 30 percent of the monetary sanctions.\textsuperscript{299} The SEC will also pay bounties based on amounts collected in “related actions,” which include judicial and administrative actions brought by the U.S. Department of Justice, a state attorney general in a criminal case, a self-regulatory organization, or other government agency.\textsuperscript{300}

The bounty amount is determined at the discretion of the SEC, which “shall take into consideration” the “significance of the information to the success” of the enforcement action, “the degree of assistance provided by the whistleblower,” and “the programmatic interest . . . in deterring violations of the securities laws.”\textsuperscript{301} The proposed rules further add that the SEC may take into consideration the potential for the award to otherwise enhance the SEC’s “ability to enforce the Federal securities laws, protect investors, and encourage the submission of [similarly] high quality tips.”\textsuperscript{302}

\begin{thebibliography}{9}
\bibitem{294} Id. at 70488–89.
\bibitem{295} Id. at 70488.
\bibitem{297} Dodd-Frank Act, supra note 1, § 922, 124 Stat. at 1841–49 (to be codified at 15 U.S.C. § 78u-6). In addition, the Dodd-Frank Act amended the Commodity Exchange Act to create an incentive program and whistleblower provisions similar to those provided by § 21F of the Exchange Act. Dodd-Frank Act, supra note 1, § 748, 124 Stat. at 1739 (to be codified at 7 U.S.C. § 26). The Dodd-Frank Act also amended the anti-retaliation provisions of the False Claims Act, 31 U.S.C. § 3730(h), by expanding coverage of protected conduct to include associational discrimination and by clarifying the statute of limitations for actions brought under the False Claims Act. Dodd-Frank Act, supra note 1, § 1079A, 124 Stat. at 2077–79 (to be codified at 31 U.S.C. § 3730(h)).
\bibitem{298} Dodd-Frank Act, supra note 1, § 922(a), 124 Stat. at 1841–42 (to be codified at 15 U.S.C. § 78u-6(a)).
\bibitem{299} Id., 124 Stat. at 1842 (to be codified at 15 U.S.C. § 78u-6(b)).
\bibitem{300} Id.
\bibitem{301} Id., 124 Stat. at 1842–43 (to be codified at 15 U.S.C. § 78u-6(c)).
\end{thebibliography}
(i) Who Qualifies as a Whistleblower?

The Dodd-Frank Act broadly defines “whistleblower” to include any individual, or two or more individuals acting jointly, who provide(s) “original information” to the SEC regarding a violation of the securities laws. 303 Whistleblowers may submit information to the SEC anonymously if represented by counsel, but their identities must be disclosed before receiving a bounty. 304 A company’s officers, directors, employees, shareholders, business competitors, agents, consultants, distributors, vendors, contractors, service providers, or customers can qualify as whistleblowers, subject to certain exclusions discussed below. 305 The proposed rules clarify that whistleblowers must be natural persons and that their information need only relate to a “potential violation” of the securities laws. 306 To ensure reliability and quality of tips, the proposed rules also require whistleblowers to submit a declaration to the SEC under penalty of perjury and to comply with other procedural requirements. 307

The whistleblower provisions do not prohibit persons who themselves violate the securities laws from collecting a bounty, unless a culpable whistleblower has been criminally convicted of a violation related to the misconduct underlying the award. 308 In determining whether the required $1 million threshold has been satisfied, however, the proposed rules prohibit the SEC from considering “monetary sanctions that the [culpable] whistleblower is ordered to pay, or that are ordered against any entity whose liability is based substantially on conduct that the whistleblower directed, planned, or initiated.” 309

(ii) Who Does Not Qualify as a Whistleblower?

The Dodd-Frank Act prohibits certain individuals from receiving bounties as whistleblowers, including individuals convicted of crimes related to the violation, individuals who learn of the disclosed information by performing audits of financial statements as required by the securities laws, certain federal regulatory and law enforcement employees, and individuals who knowingly provide false, fictitious, or fraudulent information. 310 The proposed rules further exclude (1) persons who provide information after the company has received any formal or informal request, inquiry, or demand from the SEC (unless the company fails to provide the documents or information within a “reasonable time”); (2) per-
sons who provide information obtained through communications protected by the attorney-client privilege, or information obtained in connection with the legal representation of a client (whether privileged or not); (3) persons who provide information obtained in connection with the performance of an engagement required under the securities laws by an independent public accountant; (4) persons with legal, compliance, audit, supervisory, or governance responsibilities to whom information about potential misconduct was communicated with the reasonable expectation that they would take appropriate steps to respond to the alleged violation (unless the company does not disclose the information to the SEC within a “reasonable time” or proceeds in “bad faith”); (5) persons who obtained the provided information in a manner that violates federal or state criminal law; and (6) persons who provide information obtained from those who would otherwise be excluded under any of the above limitations.  

(iii) What Constitutes “Original Information”?  

Under the Dodd-Frank Act, to qualify as “original,” information must be (a) “derived from the independent knowledge or analysis of a whistleblower”; (b) “not known to the [SEC] from any other source, unless the whistleblower is the original source of the information”; and (c) “not exclusively derived from an allegation made in a judicial or administrative hearing, in a government report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information.” 312 The proposed definition of “independent knowledge” clarifies that whistleblowers do not need to have direct or first-hand knowledge of potential violations, but may obtain independent knowledge from any of their experiences, observations, or communications with third parties, such as co-workers. 313 “Independent analysis” includes circumstances where whistleblowers review publicly available information and “through their additional evaluation and analysis, provide vital assistance to the [SEC] staff in understanding complex schemes and identifying securities violations.” 314


In addition to the incentive provisions, the Dodd-Frank Act significantly enhances whistleblower protections. Under the Dodd-Frank Act, employers are prohibited from discharging, demoting, suspending, threatening, harassing, or otherwise discriminating against whistleblowers who provide information to enforcement authorities. 315 The Dodd-Frank Act creates a new private right of action

311. Proposed Whistleblower Rules, supra note 292, 75 Fed. Reg. at 70490, 70492–94, 70520–21 (to be codified at 17 C.F.R. § 240.21F-4(b)).
312. Dodd-Frank Act, supra note 1, § 922(a), 124 Stat. at 1841–42 (to be codified at 15 U.S.C. § 78u-6(a)(3)).
314. Id.
315. Dodd-Frank Act, supra note 1, § 922(a), 124 Stat. at 1845–46 (to be codified at 15 U.S.C. § 78u-6(h)).
for employees who experience retaliation as a result of any lawful act done by the whistleblower: (i) in providing information to the SEC; (ii) in initiating, testifying in, or assisting in an SEC investigation or an action based upon or related to provided information; or (iii) in making disclosures required or protected under the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”), the Exchange Act, or any other law, rule, or regulation subject to the SEC’s jurisdiction.\footnote{316}{Id. The Dodd-Frank Act also creates a private right of action for employees in the financial services industry who experience retaliation in connection with their disclosure of information regarding fraudulent or unlawful conduct related to the offering or provision of a consumer financial product or service. Id. § 1057, 124 Stat. at 2031–35 (to be codified at 12 U.S.C. § 5567).}

The proposed rules clarify that the availability of the protections does not “depend on an ultimate adjudication, finding or conclusion that the conduct identified by the whistleblower constituted a violation of the securities laws.”\footnote{317}{Proposed Whistleblower Rules, supra note 292, 75 Fed. Reg. at 70489.} In addition, the protections apply whether or not a whistleblower satisfies all the procedures and conditions necessary to receive a bounty under the incentive provisions.\footnote{318}{Id.}

(i) Expanded Remedies and Statute of Limitations

The Dodd-Frank Act expands the remedies available to whistleblowers. First, employees can now bypass administrative remedies and bring their claim in federal court from the outset.\footnote{319}{Id.} Second, in addition to reinstatement without loss of seniority and litigation costs, employees can now recover double their lost wages with interest, instead of just lost wages.\footnote{320}{Id.} Third, employees now have six years from the date of the violation to bring suit, or three years from the date when the employee knew or should reasonably have known of facts material to the right of action.\footnote{321}{Id.} No action, however, may be brought more than ten years after the date of the violation.\footnote{322}{Id.}

(ii) Amendments to Sarbanes-Oxley’s Anti-Retaliation Provisions

The Dodd-Frank Act also contains provisions amending and strengthening existing Sarbanes-Oxley Act anti-retaliation protections. These provisions broaden the scope of coverage, extend the statute of limitations, exempt employee claims from arbitration, and clarify that claims removed to federal court can be tried before a jury. The Dodd-Frank Act amends section 806 of the Sarbanes-Oxley Act to broaden the scope of coverage by clarifying that section 806’s whistleblower provisions apply to employees of subsidiaries of publicly traded parent companies “whose financial information is included in the consolidated financial statement of [parent companies].”\footnote{323}{Id. § 929A, 124 Stat. at 1852 (amending 18 U.S.C. § 1514A).} In addition to employees of subsidiaries, the Dodd-
Frank Act further expands the reach of the Sarbanes-Oxley Act to include protection for employees of nationally recognized statistical ratings organizations.\textsuperscript{324} Additionally, instead of a ninety-day statute of limitations, employees now have 180 days to initiate a Sarbanes-Oxley Act action.\textsuperscript{325} Employees may also elect to try their cases in federal court before a jury.\textsuperscript{326}

(iii) Confidentiality of Submissions

Under the proposed rules, the SEC will not reveal the whistleblower’s identity, or disclose other information reasonably expected to reveal his or her identity, except under limited circumstances—for example, when disclosure is required to a defendant or respondent in an SEC-initiated federal court or administrative action.\textsuperscript{327} The SEC may share information with other domestic and foreign regulatory and law enforcement agencies “when [it] determines that [disclosure] is necessary to accomplish the purposes of the Exchange Act and to protect investors.”\textsuperscript{328} In these circumstances, domestic agencies are required to maintain the same level of confidentiality as the SEC, and foreign agencies must provide the SEC with appropriate assurances of confidentiality.\textsuperscript{329}

(iv) Communications with Whistleblowers

The proposed rules prohibit any person from taking any action that “impedes” a whistleblower from communicating directly with the SEC about a potential violation of the securities laws.\textsuperscript{330} This prohibition includes enforcing or threatening to enforce a confidentiality agreement against a whistleblower, unless the confidentiality agreement deals with information excluded because it was obtained through communications protected by the attorney-client privilege or in connection with legal representation.\textsuperscript{331} To ensure unobstructed communication between the SEC and the whistleblower, the proposed rules authorize SEC staff to communicate directly with the whistleblower, without first seeking the consent of company counsel.\textsuperscript{332} This is the case even for communications with high-ranking officers and directors to whom company counsel’s representation ordinarily would attach to preclude direct contact.\textsuperscript{333}

(v) Amnesty and Culpable Individuals

The proposed rules do not grant amnesty to whistleblowers who provide information to the SEC.\textsuperscript{334} Whistleblowers who participate in misconduct are not

\begin{itemize}
\item \textsuperscript{324} Id. § 922(b), 124 Stat. at 1848 (amending 18 U.S.C. § 1514(A(a)).
\item \textsuperscript{325} Id. § 922(c), 124 Stat. at 1848 (amending 18 U.S.C. § 1514A(b)(2)(D)).
\item \textsuperscript{326} Id. (amending 18 U.S.C. § 1514A(b)(2)(E)).
\item \textsuperscript{327} Proposed Whistleblower Rules, supra note 292, 75 Fed. Reg. at 70500–01, 70521–22 (to be codified at 17 C.F.R. § 240.21F-7).
\item \textsuperscript{328} Id.
\item \textsuperscript{329} Id.
\item \textsuperscript{330} Id. at 70510, 70525 (to be codified at 17 C.F.R. § 240.21F-16).
\item \textsuperscript{331} Id.
\item \textsuperscript{332} Id.
\item \textsuperscript{333} Id.
\item \textsuperscript{334} Id. at 70509, 70525 (to be codified at 17 C.F.R. § 240.21F-14).
\end{itemize}
immune from prosecution or enforcement actions.\textsuperscript{335} They may, however, receive credit under existing SEC cooperation policies, and if not criminally convicted, may even receive an award.\textsuperscript{336}

Even though final rules are not due until April 21, 2011, the SEC has begun implementing the Dodd-Frank Act’s whistleblower provisions, made its first report to Congress,\textsuperscript{337} and established a fund of $450 million to pay bounties.\textsuperscript{338} Recent whistleblower payouts under similar legislation, including a $96 million bounty awarded to a former pharmaceutical company employee under the False Claims Act, have reinforced concerns about the potential impact of the Dodd-Frank Act whistleblower provisions.\textsuperscript{339}

The proposed rules attempt to balance the competing policy goals of encouraging whistleblowers to provide information regarding potential violations of the securities laws to the SEC without undermining the effectiveness of companies’ internal compliance and ethics programs. They do not, however, require whistleblowers to report suspected or potential violations internally to be eligible as a whistleblower, or provide any meaningful disincentive for employees to bypass internal reporting procedures.

If adopted in their current form, the whistleblower provisions and implementing regulations may weaken companies’ compliance programs. To minimize the risks presented by the Dodd-Frank Act whistleblower provisions, companies should consider doing more to ensure that their compliance systems are robust and state-of-the-art, and to demonstrate prompt, sincere attention to employee concerns. Companies should review their compliance and ethics programs to ensure that they identify, investigate, and handle potential misconduct quickly and effectively.


Section 989G of the Dodd-Frank Act provides SEC reporting companies that qualify as “non-accelerated filers” with an exemption from the auditor attestation requirements of the internal control over financial reporting provisions of the Sarbanes-Oxley Act.\textsuperscript{340} On September 21, 2010, the SEC issued a rulemaking release to adopt amendments to its rules and forms in order to implement section 989G of the Dodd-Frank Act.\textsuperscript{341} “Prior to enactment of the Dodd-Frank Act, a non-accelerated filer would have been required, under existing [SEC]...
rules, to include an attestation report of its registered public accounting firm on internal control over financial reporting in the filer’s annual report filed with the [SEC] for fiscal years ending on or after June 15, 2010.342 Non-accelerated filers are still required to comply with the management assessment and reporting requirements of section 404(a) of the Sarbanes-Oxley Act.343

Section 989G of the Dodd-Frank Act added subsection (c) to section 404 of the Sarbanes-Oxley Act to provide the aforementioned exemption for “non-accelerated filers.”344 “Non-accelerated filer” is not defined by SEC rules, but such term is used to describe issuers that fall below the thresholds set forth in the definitions of “large accelerated filer” and “accelerated filer” in Rule 12b-2 under the Exchange Act.345 Generally, “accelerated filers” are issuers with a public float of voting and non-voting common equity securities of $75 million or more, but less than $700 million, and “large accelerated filers” are issuers with a public float of voting and non-voting common equity securities of greater than $700 million.346 In addition, to qualify as either an “accelerated filer” or “large accelerated filer,” an issuer must have been a reporting company for at least twelve months and must have filed at least one annual report.347 Also, as discussed further below, section 989G of the Dodd-Frank Act mandated the SEC to publish a study not less than nine months after the enactment of the Act to determine how the SEC could reduce the burden of complying with the auditor attestation requirements of section 404(b) of the Sarbanes-Oxley Act for public companies with market capitalizations of between $75 million and $250 million while maintaining adequate investor protection, and “whether any such methods of reducing the compliance burden or a complete exemption for such companies” from the auditor attestation requirement in section 404(b) “would encourage companies to list on exchanges in the United States in their initial public offerings.”348

In order to implement section 989G of the Dodd-Frank Act, the SEC amended Item 308 of Regulation S-K,349 Item 15 of Part II of Form 20-F,350 and General Instruction B to Form 40-F351 to remove the requirement for a non-accelerated filer to include in its annual report an auditor’s attestation report on the issuer’s

342. Id. at 57385–86 (footnote omitted).
343. Id. at 57386.
344. Dodd-Frank Act, supra note 1, § 989G, 124 Stat. at 1948 (to be codified at 15 U.S.C. § 7262(c)).
346. Id.
347. Id.
348. Dodd-Frank Act, supra note 1, § 989G(b), 124 Stat. at 1948. On October 20, 2010, the SEC published a release requesting public comment related to the study of how to reduce the compliance burden of the auditor attestation requirement, while maintaining investor protections. Study Required by Section 989G(b) of the Dodd-Frank Act Regarding Compliance with Section 404(b) of the Sarbanes-Oxley Act, Exchange Act Release No. 34-63108, 75 Fed. Reg. 64773 (Oct. 20, 2010) [hereinafter Section 404(b) Compliance Study Release].
349. 17 C.F.R. § 229.308 (2010).
350. Id. § 249.220f (the full text of Form 20-F does not appear in the Code of Federal Regulations).
351. Id. § 249.240f (the full text of Form 40-F does not appear in the Code of Federal Regulations).
internal control over financial reporting. In addition, the amendments require a non-accelerated filer’s management report on internal control over financial reporting to include the statement that the registered public accounting firm that audited the issuer’s financial statements has issued an attestation reporting on the issuer’s internal control over financial reporting only if such attestation report have been issued. Finally, the SEC amended Rule 2-02 of Regulation S-X to clarify that an auditor of a non-accelerated filer need not include in its audit report an assessment of the issuer’s internal control over financial reporting. The effective date of these amendments was September 21, 2010.

9. Section 989G of the Dodd-Frank Act

As mentioned above, the SEC issued a release (the “Release”) on October 20, 2010, requesting comments on a proposed study as required under section 989G. The SEC noted in the Release that section 989G(b) does not define the term “market capitalization.” Accordingly, the SEC, for purposes of the study, determined that it would measure the market capitalization of issuers based on the issuer’s public float—“the aggregate worldwide market value of an issuer’s voting and non-voting common equity held by its non-affiliates.” This is the same measure used in the SEC rules for determining “accelerated filer” and “large accelerated filer” status. In the study proposal, the SEC solicited written comments from interested parties on any one or more of twenty-two topics discussed by the SEC in the Release. Comments were due by December 6, 2010. To date, the SEC has not released further details regarding the proposed study.

10. Securitization-Related Provisions

a. Dodd-Frank Act Securitization Reforms

Securitization in its most common form is a technique that enables lenders to obtain funding by issuing securities (commonly referred to as “asset-backed securities” or “ABS”) that are supported by and paid out of cash receipts on their financial assets, such as residential mortgage loans, credit card receivables,

353. Id. at 57386.
355. Internal Control Release, supra note 341, 75 Fed. Reg. at 57387 (to be codified at 17 C.F.R. § 210.2-02(f)).
356. Id. at 57385.
357. Section 404(b) Compliance Study Release, supra note 348, 75 Fed. Reg. at 64773.
358. Id. at 64774.
359. Id.
360. Id.; see supra note 346 and accompanying text.
361. Section 404(b) Compliance Study Release, supra note 348, 75 Fed. Reg. at 64774–75.
362. Id. at 64773.
small business loans, and auto loans or leases. Commentators have asserted that—during the financial crisis—originators of the assets (and sponsors of the transactions in which the assets were securitized) had no incentive to adhere to underwriting guidelines because they retained no “risk” of loss if the assets did not meet underwriting guidelines; that sponsors, issuers, and the credit rating agencies that issued credit ratings on residential mortgage-backed securities (“RMBS”) conducted inadequate due diligence and allowed themselves to be influenced by conflicts of interest, resulting in the assignment of inaccurate ratings on RMBS; investors received insufficient disclosure about the characteristics of the securitized assets at the time of closing and about the performance of the assets thereafter; and investors failed to conduct their own due diligence, instead relying too heavily on the ratings assigned by credit rating agencies.

Such perceptions are evident in the securitization reforms Congress enacted as Subtitle D (Improvements to the Asset-Backed Securitization Process) of Title IX (Investor Protections and Improvements to the Regulation of Securities) of the Dodd-Frank Act. Subtitle D requires the SEC (and in some cases other federal regulatory agencies) to adopt rules (1) mandating the retention of a portion of the credit risk in each ABS transaction (so called “risk retention” or “skin-in-the-game” rules), (2) requiring issuers to conduct reviews of the assets backing any

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364. ABA SECURITIZATION WHITE PAPER, supra note 363, at 14–23.


366. Id. § 941. 124 Stat. at 1891–96 (to be codified at 15 U.S.C. § 78o-11). Under section 941 of the Dodd-Frank Act, the risk retention or “skin in the game” rules are to be adopted jointly by the SEC and certain other federal agencies. Congress also created a new definition of “asset-backed securities”—referred to hereinafter, and in the rules the SEC has proposed to implement certain provisions of the Dodd-Frank Act, as “Exchange Act-ABS”—by adding a new § 3(a)(77) to the Exchange Act, which states as follows:

The term “asset-backed security”—

(A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including—

(i) a collateralized mortgage obligation;

(ii) a collateralized debt obligation;

(iii) a collateralized bond obligation;

(iv) a collateralized debt obligation of asset-backed securities;

(v) a collateralized debt obligation of collateralized debt obligations; and

(vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and
publicly registered ABS and disclose the nature of such reviews,367 (3) requiring additional disclosures with respect to the characteristics of the assets368 and the representations and warranties on the assets provided by the ABS transaction documents,369 and (4) requiring disclosures with respect to demands for repurchase of assets relating to breaches of representations and warranties.370 Subtitle D also eliminates the exemption from ongoing Exchange Act reporting for ABS issued pursuant to an effective registration statement under the Securities Act (referred to herein as “publicly registered ABS”), but grants rulemaking authority to the SEC to establish suspension or termination rules for ABS.371 In addition, as discussed above, Subtitle C of the Dodd-Frank Act, which addresses regulation of credit rating agencies by establishing new reporting, due diligence, professional standards, and other requirements, also requires the SEC to adopt rules requiring issuers, underwriters, and rating agencies to disclose publicly information regarding asset due diligence reviews provided by third-party diligence providers.372 Finally, the SEC must issue rules pursuant to section 621 of the Dodd-Frank Act prohibiting certain “conflicts of interest” among specified ABS participants and investors in ABS.373

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367. Dodd-Frank Act, supra note 1, § 945, 124 Stat. at 1898 (to be codified at 15 U.S.C. § 77g(d)).
368. Id. § 942(b), 124 Stat. at 1897 (to be codified at 15 U.S.C. § 77g(c)).
370. Id.
372. Id. § 932(a)(8), 124 Stat. at 1881–82 (to be codified at 15 U.S.C. § 78o-2(a)).
373. Id. § 621, 124 Stat. at 1631–32 (to be codified at 15 U.S.C. § 77z–2a). Other provisions of the Dodd-Frank Act also impact ABS transactions. For example, as discussed in more detail below, the effective repeal of the SEC’s Rule 436(g) (which contained an express exemption from liability under §§ 7 and 11 of the Securities Act for credit ratings in registered offerings of securities) by section 939G of the Dodd-Frank Act had an almost immediate impact on new issuances of publicly registered ABS. See id. § 939G, 124 Stat. at 1890. Because it is not unusual for ABS transactions to utilize interest rate swap agreements or other derivatives, the rules implementing the regulation of
Each of these securitization reforms is discussed in more detail below. \(^{374}\)

### b. Risk Retention

Section 941 of the Dodd-Frank Act adds a new § 15G to the Exchange Act, which directs the SEC, together with the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (the “Board”), and the Federal Deposit Insurance Corporation (the “FDIC”) (collectively, the “Federal banking agencies”), within 270 days following the enactment of the Dodd-Frank Act, to “jointly prescribe regulations to require any securitizer of an Exchange Act-ABS to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party.” \(^{376}\) Section 15G contains explicit guidance about what the SEC and the Federal banking agencies must include, or at least consider, in the rulemakings under this section.

#### (i) Minimum Standards

At a minimum, the regulations must include the following provisions (subject to any permitted exemptions adopted by the SEC and the Federal banking agencies).

A securitizer must retain at least 5 percent of the credit risk for any asset transferred, sold, or conveyed through the issuance of ABS by the securitizer, unless all

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\(^{374}\) Although not discussed herein because it is typically not relied on by ABS issuers, the remaining section of Subtitle D, section 944, eliminates an existing exemption from registration under § 4(5) of the Securities Act for some mortgage-backed securities (transactions involving offers or sales of one or more promissory notes directly secured by a first lien on a parcel of real estate upon which is located a residential or commercial structure, subject to certain conditions). Dodd-Frank Act, supra note 1, § 944, 124 Stat. at 1897–98 (amending 15 U.S.C. § 77d).

\(^{375}\) Id. § 941(a), 124 Stat. at 1891 (to be codified at 15 U.S.C. § 78o-11(a)(1)). In the case of risk retention rules for residential mortgage loans that back ABS, the Secretary of Housing and Urban Development and the Federal Housing Finance Agency also are to be included in the joint rulemakings. Id. (to be codified at 15 U.S.C. § 78o-11(b)(2)). The chair of the Financial Stability Oversight Council is to coordinate the joint rulemakings required by § 15G. Id., 124 Stat. at 1895 (to be codified at 15 U.S.C. § 78o-11(b)).

\(^{376}\) Id., 124 Stat. at 1891 (to be codified at 15 U.S.C. § 78o-11(b)(1)). “Securitizer” is defined in § 15G(a)(3) to mean “(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.” Id. (to be codified at 15 U.S.C. § 78o-11(a)(3)).
of the assets in the ABS transaction constitute “qualified residential mortgages.”

However, the regulations must prescribe different rules for different classes of assets, including residential and commercial mortgages, commercial loans, auto loans, and other classes deemed appropriate by the regulators, and the regulations may permit less than 5 percent risk retention if the originator of the assets meets the underwriting standards to be adopted by the Federal banking agencies for each asset class.

The regulations must specify the permissible forms of risk retention and the minimum duration of the risk retention requirement, and must include specific standards for “collateralized debt obligations, securities collateralized by collateralized debt obligations, and similar instruments” backed by other ABS.

In connection with commercial mortgages, the regulations may provide for a specified percentage of risk retention for the asset; risk retention in the form of a first-loss position held by a third-party purchaser that specifically negotiates for the purchase of such position, has adequate resources to back losses, provides due diligence on all individual assets prior to the issuance of the ABS, and otherwise meets the risk retention standards; a determination that the underwriting standards and controls for the assets are adequate (presumably reducing or negating the requirement for other risk retention); or for the provision of “adequate representations and warranties and related enforcement mechanisms.”

The regulations must “prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk the securitizer is required to retain with respect to an asset.”

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377. Id., 124 Stat. at 1891–92 (to be codified at 15 U.S.C. § 78o-11(c)(1)(B)(i)). The federal banking agencies, the SEC, the Secretary of Housing and Urban Development, and the Federal Housing Finance Agency must jointly issue regulations defining and exempting “qualified residential mortgages” from the risk retention rules. Id., 124 Stat. at 1894 (to be codified at 15 U.S.C. § 78o-11(e)(4)). In defining “qualified residential mortgages,” the agencies must take into consideration “underwriting and product features that historical loan performance data indicate result in a lower risk of default,” such as documentation and verification of the borrower’s financial resources, standards with respect to the borrower’s net income after monthly obligations, the ratio of the loan payments to the borrower’s monthly income, mitigation of the potential payment shock on adjustable rate mortgages, and the existence of mortgage guaranty insurance or credit enhancement on the loan at origination. Id., 124 Stat. at 1894–95 (to be codified at 15 U.S.C. § 78o-11(e)(4)(B)). The agencies must also consider “prohibiting or restricting the use of balloon payments, negative amortization, prepayment penalties, interest-only payments, and other features that have been demonstrated to exhibit a higher risk of borrower default.” Id., 124 Stat. at 1895 (to be codified at 15 U.S.C. § 78o-11(e)(4)(B)(v)). However, the term may not be defined more broadly than the definition of “qualified mortgage” as defined under section 129C(c)(2) of the Truth in Lending Act, as amended by the Consumer Financial Protection Act of 2010 and regulations adopted thereunder. Id. (to be codified at 15 U.S.C. § 78o-11(c)(4)(C)); and ABS that are collateralized by ABS that are backed by qualified residential mortgages cannot be afforded exemption from risk retention. Id. (to be codified at 15 U.S.C. § 78o-11(e)(5)). In addition, the SEC must require each issuer of ABS backed by qualified residential mortgages to certify that it has evaluated the effectiveness of its internal controls for ensuring that all assets backing the ABS are qualified residential mortgages. Id. (to be codified at 15 U.S.C. § 78o-11(e)(6)).


379. Id., 124 Stat. at 1892 (to be codified at 15 U.S.C. § 78o-11(c)(1)(C)).

380. Id. (to be codified at 15 U.S.C. § 78o-11(c)(1)(F)).

381. Id. (to be codified at 15 U.S.C. § 78o-11(c)(1)(E)).

In addition, the regulations may provide for the allocation of risk retention obligations between a securitizer and the originator\textsuperscript{383} of the assets such that the percentage of risk required to be retained by the securitizer is reduced by the percentage of risk retained by the originator\textsuperscript{384}. In determining how to allocate risk retention obligations between the securitizer and the originator, the agencies must consider “(A) whether the assets sold to the securitizer have terms, conditions, and characteristics that reflect low credit risk; (B) whether the form or volume of transactions in securitization creates incentives for imprudent origination of the type of loan or asset . . . ; and (C) the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms.”\textsuperscript{385}

(ii) Exemptions, Exceptions, and Adjustments

While the risk retention rules are to apply to any securitizer of Exchange Act-ABS, regardless of whether the securitizer is an insured depository institution,\textsuperscript{386} the SEC and the Federal banking agencies are given broad authority to provide for total or partial exemptions for certain government issuers\textsuperscript{387} (expressly stating, however, that Fannie Mae and Freddie Mac should not be considered government issuers under this provision) and in other cases where the SEC and the Federal banking agencies determine it is in the public interest and otherwise protects investors.\textsuperscript{388}

In addition, § 15G expressly states that it is not applicable to assets originated, insured, guaranteed, or purchased by an institution supervised by the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation, and any residential, multifamily, or health care facility mortgage loan asset, and securitizations of such assets, insured or guaranteed by the United States or any

\textsuperscript{383} Id., 124 Stat. at 1893 (to be codified at 15 U.S.C. § 78o-11(c)(1)(G)(iv)). Section 15G defines “originator” to mean a person who “(A) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and (B) sells an asset directly or indirectly to a securitizer.” Id., 124 Stat. at 1891 (to be codified at 15 U.S.C. § 78o-11(a)(4)).

\textsuperscript{384} Id., 124 Stat. at 1893 (to be codified at 15 U.S.C. § 78o-11(d)(1)).

\textsuperscript{385} Id., 124 Stat. at 1893–94 (to be codified at 15 U.S.C. § 78o-11(d)(2)).

\textsuperscript{386} Id., 124 Stat. at 1892 (to be codified at 15 U.S.C. § 78o-11(c)(1)(D)).

\textsuperscript{387} Id., 124 Stat. at 1892–93 (to be codified at 15 U.S.C. § 78o-11(c)(1)(G)(i)). Total or partial exemptions may be provided for assets issued or guaranteed by the United States, its agencies (other than Fannie Mae or Freddie Mac, which are not to be considered federal agencies), any State or political subdivision, and certain other government securities, as the SEC and the federal banking agencies determine appropriate in the public interest. Id., 124 Stat. at 1893 (to be codified at 15 U.S.C. § 78o-11(c)(1)(G)(ii)–(iii)).

\textsuperscript{388} Id. Such exemptions may include total or partial exemption of “any securitization, as may be appropriate in the public interest and for the protection of investors,” id., 124 Stat. at 1893 (to be codified at 15 U.S.C. § 78o-11(c)(1)(G)(i)); and exemptions, exceptions, or adjustments “for classes of institutions or assets relating to risk retention and the prohibition on hedging,” so long as such exemptions, exceptions, or adjustments “help ensure high quality underwriting standards for the securitizers and originators of assets” and “encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or are otherwise in the public interest and for the protection of investors. Id., 124 Stat. at 1894 (to be codified at 15 U.S.C. § 78o-11(e)(1)–(2)).
agency of the United States (expressly excluding, however, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks).  

(iii) Effective Date

The risk retention regulations promulgated pursuant to § 15G are to become effective, with respect to securitizers and originators of ABS backed by residential mortgages, one year after the date on which such regulations are published in the Federal Register, and, with respect to securitizers and originators of ABS backed by all other types of assets, two years after such publication date. The SEC and the Federal banking agencies are expected to release their proposed risk retention regulations for comment in the first quarter of 2011. The late release date, coupled with the 270-day deadline for adoption of the final risk retention rules, likely will result in a much shorter comment period than many practitioners would have preferred given the concerns, discussed below, of the impact of the risk retention rules on the securitization markets and the availability of consumer and business credit.

(iv) Risk Retention Studies

Presumably in an effort to inform the rulemaking process, section 941(c) of the Dodd-Frank Act required the Federal Reserve Board, in coordination and in consultation with the heads of the Federal banking agencies and the SEC, to conduct a study of the “combined impact” on various classes of ABS of the new credit risk retention requirements contained in § 15G and Financial Accounting Standards 166 and 167 issued by the Financial Accounting Standards Board, and submit a report on the study to Congress no later than ninety days following the date of enactment of the Dodd-Frank Act. The report was to include the Board’s statutory and regulatory recommendations for eliminating any negative impact on the continued viability of the ABS markets and on the availability of new credit.

The Board concluded its study and submitted the report to Congress on October 19, 2010. After reviewing the securitization structures for various types of assets backing ABS, such as residential mortgage loans, commercial mortgage loans, auto and equipment loans and leases, student loans, collateralized

389. Id. (to be codified at 15 U.S.C. § 78o-11(c)(3)).
390. Id., 124 Stat. at 1896 (to be codified at 15 U.S.C. § 78o-11(i)).
391. However, some have provided preliminary comments to the SEC. See, e.g., Letter from Jeffrey W. Rubin, Chair, Comm. on Fed. Regulation of Sec., Am. Bar Ass’n Section of Bus. Law & Vicki O. Tucker, Chair, Comm. on Securitization & Structured Fin., Am. Bar Ass’n Section of Bus. Law, to U.S. Sec. & Exch. Comm’n (Nov. 17, 2010) (“Request for Public Comment on SEC Regulatory Initiatives Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, Title IX Investor Protection and Improvements to the Regulation of Securities, Subtitle D—Improvements to the Asset-Backed Securitization Process”), available at http://www.sec.gov/comments/df-title-xv/speciﬁc-disclosures/specializeddisclosures-60.pdf [hereinafter Risk Retention Comment Letter]. For additional discussion of issues relating to risk retention, see ABA SECURITIZATION WHITE PAPER, supra note 363, at 23–27.
392. Dodd-Frank Act, supra note 1, § 941(c), 124 Stat. at 1896.
393. Id.
loan obligations, and asset-backed commercial paper, the Board recommended that the rule makers “consider crafting credit risk retention requirements that are tailored to each major class of securitized assets” (consistent with the flexibility provided in section 941) and that the rule makers “recognize differences in market practices and conventions, which in many instances exist for sound reasons related to the inherent nature of the type of asset being securitized.” The report also suggested that the rule makers consider other mechanisms already in place in some structures that could replace or even constitute types of risk retention.

The Board also recommended that consideration be given to the potential for the credit retention rules and the new accounting standards (when combined with new regulatory capital requirements and other regulatory initiatives) to make securitization less attractive and result in less available credit, and urged that the rules be made flexible enough to permit a securitizer to adapt the risk retention rules to meet investor demands in any particular transaction and to allow continued market innovation. If followed in the final risk retention rules, the Board’s recommendations appear to assuage many of the concerns expressed in the ABA Securitization White Paper and in the Risk Retention Comment Letter.

In addition to the study required to be conducted by the Board, section 946 of the Dodd-Frank Act required the Chairman of the Financial Stability Oversight Council to conduct a study (and issue a report of any findings and determinations to Congress no later than the end of the 180-day period beginning on the date of enactment of the Dodd-Frank Act) on the macroeconomic effects of the risk retention requirements of, and the amendments made under, Subtitle D, “with emphasis placed on the potential beneficial effects with respect to stabilizing the real estate market.” Interestingly, the focus of this study is solely on risk retention as it relates to real estate prices and losses, and not to the effect of risk reten-

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395. Id. at 83.
396. Id. at 84. Among the possible structures the Board identified that could be considered forms of risk retention are overcollateralization, subordination, third-party credit enhancements, representations and warranties, and conditional cash flows. Id.
397. Id. at 84–85.
398. See ABA Securitization White Paper, supra note 363; Risk Retention Comment Letter, supra note 391.
399. Dodd-Frank Act, supra note 1, § 946, 124 Stat. at 1898. This study must include
(1) an analysis of the effects of risk retention on real estate asset price bubbles, including a retrospective estimate of what fraction of real estate losses may have been averted had such requirements been in force in recent years; (2) an analysis of the feasibility of minimizing real estate price bubbles by proactively adjusting the percentage of risk retention that must be borne by creditors and securitizers of real estate debt, as a function of regional or national market conditions; (3) a comparable analysis for proactively adjusting mortgage origination requirements; (4) an assessment of whether such proactive adjustments should be made by an independent regulator, or in a formulaic and transparent manner; (5) an assessment of whether such adjustments should take place independently or in concert with monetary policy; and (6) recommendations for implementation and enabling legislation.

Id.
tion requirements for any other class of assets. The study was released in January 2011.400

(v) Other Risk Retention Measures

The SEC’s proposed Regulation AB Amendments (discussed below) and the FDIC’s revised “securitization safe harbor” also incorporate specific risk retention requirements.401 The Regulation AB Amendments propose loan level data disclosures for ABS, changes to the offering process and the conditions for shelf eligibility, and other changes designed to address concerns similar to those addressed by the Dodd-Frank Act securitization provisions.402 Risk retention was proposed specifically as a condition to shelf eligibility.403

The FDIC’s safe harbor rule, which clarifies the conditions that must be satisfied for securitization transfers by an insured depository institution to ensure that the FDIC will respect the transfer if appointed as receiver for the insured depository institution, also attempts to make similar modifications to securitization practices and establishes contractual, disclosure, and risk retention requirements for securitizations by insured depository institutions.404 The FDIC rule expressly provides that, upon the effective date of the Dodd-Frank Act risk retention regulations, such regulations will exclusively govern the risk retention requirements under the safe harbor.405 As discussed in more detail elsewhere in this Review, the period for providing comments to the SEC on the Regulation AB Amendments ended on August 2, 2010,406 but the SEC has yet to issue its final amendments. It is expected by securitization practitioners that the SEC’s final amendments to Regulation AB will defer to or incorporate in some fashion the risk retention rules issued pursuant to the Dodd-Frank Act, thus addressing concerns about possible overlapping and inconsistent risk retention regulatory schemes.

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401. In the proposed Regulation AB Amendments, the SEC proposed a 5 percent “vertical slice” risk retention scheme, whereby sponsors of ABS registered on the SEC’s proposed new Form SF-3 for shelf-registered ABS would be required to retain 5 percent of the securities of each tranche issued in a given transaction or, in the case of revolving asset master trusts, an originator’s interest of a minimum of 5 percent (subject to certain other conditions), in each case net of certain hedge positions. Reg AB Amendments Proposing Release, supra note 366, 75 Fed. Reg. at 23339–40. In the safe harbor, the FDIC specified that risk retention must take the form of either a 5 percent vertical slice (net of certain hedge positions) or “a representative sample of the securitized financial assets equal to but less than five (5) percent of the principal amount of the financial assets at transfer.” Treatment by the Federal Deposit Insurance Corporation, 75 Fed. Reg. 60287, 60294 (Sept. 30, 2010) (to be codified at 12 C.F.R. pt. 360) [hereinafter FDIC Safe Harbor Release].
403. Id.
405. Id. at 60299.
c. Issuer and Third-Party Due Diligence Reviews and Related Disclosures

Section 945 of the Dodd-Frank Act adds a new subsection (d) to § 7 of the Securities Act, directing the SEC to issue regulations, no later than 180 days after the date of enactment of the Dodd-Frank Act, requiring an issuer, in connection with any Exchange Act-ABS issued pursuant to a registration statement under the Securities Act, to perform a “review” of the assets underlying the ABS and to “disclose the nature of [such] review.”

The SEC issued proposed regulations implementing section 945 in October 2010 (the “Asset Review Proposing Release”). The SEC’s proposed new Securities Act Rule 193 closely follows the statutory language of § 7(d), but provides that the issuer may itself conduct the review or employ a third party to perform such review, provided that the third party is named in the registration statement and consents to being named as an expert in accordance with SEC Rule 436 under the Securities Act. In addition, the SEC proposes to amend Item 1111(a) of Regulation AB by adding a new subsection (7), which would require the issuer to disclose in its prospectus “the nature of the review of the assets performed by an issuer or sponsor” and “whether the issuer . . . engaged a third party for purposes of performing [the] review,” as well as disclosure of “the findings and conclusions” of such review. The SEC requested comment on such matters as whether it should define the scope or type of reviews to be done, if so, whether it should adopt different standards for different types of assets, and whether subjecting third-party reviewers to expert liability would improve the quality of such reviews or reduce the number of parties willing to provide such services.

The Asset Review Proposing Release also includes the SEC’s proposed rules to implement portions of new subsection (s)(4) of § 15E of the Exchange Act (as added by section 932(a)(8) of the Dodd-Frank Act), which requires certain disclosures relating to “third-party” reviews of assets underlying ABS. Section 15E(s)(4)(A) requires that issuers and underwriters of ABS publicly disclose the find-
ings and conclusions of third-party due diligence reports obtained by them.\footnote{414} Under § 15E(s)(4)(B), where any such due diligence report is obtained by an NRSRO or an issuer or underwriter, the person providing the diligence report must provide a “written certification” to the NRSRO issuing a rating to which that report relates.\footnote{415} Subsections (C) and (D) of § 15E(s)(4) direct the SEC to adopt rules specifying the form and content of such certification “to ensure that providers of due diligence services have conducted a thorough review of data, documentation, and other relevant information necessary for a[n] [NRSRO] to provide an accurate rating,” and requiring NRSROs to disclose such certifications “to the public in a manner that allows the public to determine the adequacy and level of due diligence services provided by a third party.”\footnote{416}

In the Asset Review Proposing Release, the SEC’s proposed Exchange Act Rule 15Ga-2 is intended to implement subsection (A) only and does not address the rules required by other portions of § 15E(s)(4).\footnote{417} Rule 15Ga-2 requires the issuer or underwriter of any Exchange Act-ABS to file a new Form ABS-15G that “contain[s] the findings and conclusions of any report of a third party engaged . . . by the issuer or underwriter [to perform a review of the pool assets] five business days prior to the first sale in the [ABS] offering.”\footnote{418} The SEC proposes to make Rule 15Ga-2 applicable to both registered and unregistered issuances of ABS in reliance on § 15E(s)(4)’s amendment of the Exchange Act (unlike section 945 of the Dodd-Frank Act, which amends § 7 of the Securities Act, addressing the requirements for registration statements).\footnote{419} However, Rule 15Ga-2 provides that the issuer in an offering of publicly registered ABS need not file a Form ABS-15G if it has included the same information in its prospectus relating to the ABS filed in accordance with Rule 424(h).\footnote{420}

While subsections (A) and (B) of § 15E(s) do not refer to the adoption of rules implementing those provisions, subsections (C) and (D) expressly require rulemakings (which must be adopted no later than one year after the date of adoption of the Dodd-Frank Act\footnote{421} ) in order to permit compliance.\footnote{422} Because of the interrelationship of the various subsections of § 15E(s)(4), some have argued that it would be more appropriate for the SEC to delay enacting any final rules with
respect to § 15E(s)(4)(A) and re-propose such regulations in conjunction with the regulations implementing subsections (B), (C), and (D) of § 15E(s)(4).  

**d. Asset Data Disclosures**

Section 942(b) of the Dodd-Frank Act amends section 7 of the Securities Act by adding a new subsection (c) requiring the SEC to adopt regulations obligating each issuer of ABS to disclose additional data with respect to the assets backing the ABS.  The implementing regulations must set standards for the format of the data, to the extent feasible, to facilitate comparison of such data across similar securities and include asset-level or loan-level data, if necessary, for investors independently to perform due diligence. Such data can include unique identifiers for each asset, the nature and extent of the compensation to the broker or originator of the assets, and the amount of risk retention by the originator and the securitizer of the assets.

Section 942(b) does not specify the date by which such regulations must be enacted by the SEC, and the SEC has not issued proposed regulations implementing this section. However, in large measure, the subject matter of the regulations required by section 942(b) is already addressed in the SEC’s proposed Regulation AB Amendments, which contain extensive requirements for the disclosure, as well as ongoing reporting, of asset-level data. It is unclear whether the Regulation AB Amendments will be re-proposed; however, it is likely that the final Regulation AB Amendments will include any changes the SEC believes are necessary to comply with section 942(b).

**e. Disclosures with Respect to Representations and Warranties and Repurchase Demands**

(i) **NRSRO Disclosures Regarding Representations and Warranties**

Section 943 of the Dodd-Frank Act requires the SEC to prescribe, no later than 180 days after the enactment of the Act, regulations on the use of representations and warranties in ABS transactions. The regulations must require each NRSRO that is rating an Exchange Act-ABS to include in its ratings report a description of

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423. See Letter from Jeffrey W. Rubin, Chair, Comm. on Fed. Regulation of Sec., Am. Bar Ass’n Section of Bus. Law & Vicki O. Tucker, Chair, Comm. on Securitization & Structured Fin., Am. Bar Ass’n Section of Bus. Law, to U.S. Sec. & Exch. Comm’n 9–10 (Nov. 17, 2010) (File No. S7-26-10; Release Nos. 33-9150; 34-63091; Issuer Review of Assets in Offerings of Asset-Backed Securities), available at http://www.sec.gov/comments/s7-26-10/s72610-50.pdf. The letter also discusses a number of other concerns regarding the scope and possible consequences of proposed Rules 193 and 15Ga-2. Id.

424. Dodd-Frank Act, supra note 1, § 942(b), 124 Stat. at 1897 (to be codified at 15 U.S.C. § 77g(c)).

425. Id.

426. Id.


“the representations, warranties, and enforcement mechanisms available to investors” and “how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities.”

The SEC issued its proposed regulations pursuant to section 943 in October 2010 (“Section 943 Proposing Release”). To implement section 943(1), the SEC proposes to add new Exchange Act Rule 17g-7, the language of which, for the most part, mirrors the statutory language. Proposed Rule 17g-7 would apply to any Exchange Act-ABS, whether or not it is offered in a registered transaction, inasmuch as section 943 refers to the definition of Exchange Act-ABS added by the Dodd-Frank Act. In addition, the SEC notes that section 943(1), by its terms, applies to “any report accompanying a credit rating for an ABS transaction, regardless of when or in what context such reports and credit ratings are issued.” Accordingly, the SEC included a “note” at the end of Rule 17g-7 clarifying that, “for purposes of the proposed rule, a ‘credit rating’ would include any expected or preliminary credit rating issued by an NRSRO” in any “pre-sale” report in connection with the commencement of the offering.

In the Section 943 Proposing Release, the SEC asks for comment on a number of questions about proposed Rule 17g-7, including whether it should define what constitutes “similar securities,” how reports should be disclosed by NRSROs, whether disclosure should include comparisons to industry standards in addition to similar securities, and whether it should require such disclosure, as proposed, for expected or preliminary credit rating reports. The SEC’s questions highlight the practical difficulties of implementing section 943(1); for example, how reports are to be disclosed by NRSROs and the impact public disclosure of such reports on ABS offerings may have on private placement exemptions.
(ii) Disclosure of Repurchase Demands

In addition to regulations requiring an NRSRO to report information with respect to the representations and warranties and related enforcement mechanisms in a transaction in which it rates some or all of the ABS, section 943 of the Dodd-Frank Act directs the SEC to issue regulations that are intended to increase transparency with respect to breaches of representations and warranties and effectiveness of enforcement mechanisms by requiring each securitizer (as that term is defined in section 941 of the Dodd-Frank Act) to “disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer, so that investors may identify asset originators with clear underwriting deficiencies.”

In the Section 943 Proposing Release, the SEC proposes a new Exchange Act Rule 15Ga-1 to implement section 943(2). Rule 15Ga-1 requires a securitizer of Exchange Act-ABS to disclose, in tabular format on proposed Form ABS-15G, for the previous five years for all trusts for which it is the

[As the SEC has acknowledged in footnote 34 in the Proposing Release in connection with the proposed requirement to file Form ABS-15G... requiring public disclosure of information about offerings relying on exemptions from registration can potentially compromise reliance on those exemptions. If the SEC decides to combine the Section 943 NRSRO descriptions and comparisons of representations and warranties into any report that the SEC concludes should be made publicly available with respect to exempt offerings, we request that the SEC revise Proposed Rule 15Ga-1 to clearly provide that the publication of such report would not affect the exempt status of the related offerings or the availability of the applicable statutory or regulatory private offering exemptions or safe harbors.

Id. at 3.


439. Section 943 Proposing Release, supra note 430, 75 Fed. Reg. at 62735–36 (to be codified at 17 C.F.R. § 240.15Ga-1); see id. at 62735 for the form of proposed Form ABS-15G. It should be noted, however, that the form of Form ABS-15G was re-proposed in the SEC’s later proposed rulemaking pursuant to section 932(a)(8) of the Dodd-Frank Act.

440. The SEC refers to the definition of “securitizer” as adopted in section 941 of the Dodd-Frank Act, and notes that with respect to “registered [ABS] transactions” and the definitions of “transaction parties” in Regulation AB, “sponsors and depositors both fall within the statutory definition of securitizer,” and that a transaction may involve a sponsor that initiates the transaction by transferring assets to an affiliated depositor which then transfers the assets to the entity that issues the ABS. Section 943 Proposing Release, supra note 430, 75 Fed. Reg. at 62720–21. Accordingly, “[b]ecause both sponsors and depositors fit within the statutory definition of securitizers, both entities would have the disclosure responsibilities under proposed Rule 15Ga-1.” Id. at 62721.

441. Id. at 62723. The SEC notes that section 943 does not limit the time period for the required disclosures, and proposes to require inclusion only of those ABS transactions that remain outstanding and where any class of the Exchange Act-ABS is held by non-affiliates of the securitizer. Id. The SEC also notes that it “believe[s] Congress intended to provide investors with historical information about repurchase activity so that investors may identify originators with clear underwriting deficiencies,” but in order to “balance the requirements of Section 943 and the burden on securitizers to provide historical disclosures,” the SEC proposes to limit the required disclosures to the last five years of activity. Id. There is some concern, however, that the five-year “look-back” period could be read “to include both the initial five-year look-back period and the ever-increasing period of time that has elapsed since the initial filing.” Section 943 ABA Comment Letter, supra note 436, at 9.
securitizer\textsuperscript{442}: (i) the assets that were the subject of a demand\textsuperscript{443} for repurchase, (ii) the assets that were repurchased or replaced, (iii) the assets that were not repurchased or replaced, and (iv) the assets that are pending repurchase or replacement (including a description of why such action is pending).\textsuperscript{444} A securitizer is required to file Form ABS-15G on EDGAR at the time it first offers an Exchange Act-ABS (or when the securitizer sells or transfers assets to an affiliate to be securitized and the affiliate commences the offering) and on a monthly basis thereafter, even if there have been no demands to repurchase or replace assets with respect to any trust required to be included on the form (until such time as the securitizer has no outstanding Exchange Act-ABS held by non-affiliates).\textsuperscript{445}

Because section 943(b) specifically references Exchange Act-ABS, the securitizer must include on Form ABS-15G both registered and unregistered ABS transactions.\textsuperscript{446} As proposed, Rule 15Ga-1 covers Exchange Act-ABS “issued or guaranteed by a government-sponsored entity, such as Fannie Mae and Freddie Mac,” municipal entities issuing securities backed by a “self-liquidating pool of loans that allow holders of the securities to receive payments that depend primarily on cash flow from those loans,”\textsuperscript{447} and Exchange Act-ABS sold offshore to purchasers as part of a registered or unregistered offering.\textsuperscript{448}

In addition to proposing Rule 15Ga-1, in the Section 943 Proposing Release the SEC also proposes amendments to Items 1104 and 1121 of Regulation AB,\textsuperscript{449} such that issuers would be required to include in prospectuses a portion of the

\textsuperscript{442} Section 943 Proposing Release, supra note 430, 75 Fed. Reg. at 62721. An ABS transaction would only be required to be included in Form ABS-15G, however, if the underlying transaction documents provide “a covenant to repurchase or replace an underlying asset for breach of a representation or warranty.” Id.

\textsuperscript{443} Id. The securitizer must disclose any and all demands, whether made by the party obligated to make such demand under the transaction documents (typically, the trustee) or by an investor to the trustee (and irrespective of the trustee’s determination whether to make a repurchase demand based on the investor’s request). Id. at 62721–22. The securitizer may disclose in a footnote that it was unable to obtain all information “with respect to investor demands to a trustee that occurred prior to the effective date of the proposed rules,” provided the securitizer also states that the disclosures do not contain all demands made prior to such date. Id. at 62722. There is no equivalent ability to disclose unavailability of information on demands made to the securitizer during the same period.

\textsuperscript{444} Id. at 62723, 62735 (to be codified at 17 C.F.R. § 240.15Ga-1). The tabular report must provide such information separately for each trust (showing the name of the issuer for each trust) and for each originator of any of the assets included in each trust, and the information must be reported on an aggregate basis for all trusts of that securitizer, grouped by asset class within the report. See id. at 62735 (to be codified at 17 C.F.R. § 240.15Ga-1). For example, the securitizer would provide the information for each RMBS transaction and a “total” of each column for all RMBS transactions, and then the information for each ABS transaction backed by auto loans and a “total” for each column for all auto-backed ABS, and so on for each asset class for which the securitizer issues ABS.

\textsuperscript{445} Id. at 62735–36 (to be codified at 17 C.F.R. § 240.15Ga-1(c)).

\textsuperscript{446} Id. at 62720.

\textsuperscript{447} Id.

\textsuperscript{448} Id. at 62725–26.

\textsuperscript{449} 17 C.F.R. §§ 229.1104, 229.1121 (2010). The SEC earlier had proposed similar amendments to these items in its proposed Regulation AB Amendments; thus, the changes proposed to be made to the items in the Section 943 Proposing Release constitute re-proposals of the items. Section 943 Proposing Release, supra note 430, 75 Fed. Reg. at 62726.
information required by proposed Rule 15Ga-1.\footnote{450} Under new paragraph (e) of Item 1104, if the transaction documents for an issuance of Exchange Act-ABS “include a covenant to repurchase or replace an underlying asset for a breach of a representation or warranty,” then the issuer must “provide the information required by Rule 15Ga-1(a)” in its prospectus, but in this case the Exchange Act-ABS transactions for which such information is required to be disclosed are limited to those within the prior three years where the underlying assets are of the same asset class.\footnote{451} The issuer must also include a reference to the most recent Form ABS-15G filed by the securitizer.\footnote{452} The SEC also proposes to add a new paragraph (c) to Item 1121 requiring the issuer of such ABS to include in its periodic reports on Form 10-D for the transaction the information required by Rule 15Ga-1(a) concerning all repurchase demands for the transaction (as well as a reference to the most recent Form ABS-15G filed by the securitizer).\footnote{453} The SEC makes clear that the obligation of an issuer to disclose such information in its prospectus and in ongoing Exchange Act reports for an ABS transaction does not eliminate the obligation of the securitizer to prepare and file reports on Form ABS-15G in accordance with Rule 15Ga-1.\footnote{454}

The SEC’s proposals with respect to the reporting and disclosure of repurchase demand activity has raised some concern among practitioners, including the need to file Form ABS-15G for asset classes that have experienced virtually no repurchase demand activity. The Section 943 ABA Comment Letter discusses this concern and other issues relating to the SEC’s proposed Rule 15Ga-1.\footnote{455}

\textbf{f. Ongoing Exchange Act Reporting}

Before enactment of the Dodd-Frank Act, § 15(d) of the Exchange Act provided that an issuer’s obligation to file Exchange Act reports with respect to publicly registered securities is suspended automatically at the beginning of the first fiscal year following the year of issuance in which such securities are held of record by fewer than 300 persons.\footnote{456} Because ABS typically are not widely held,
instead generally concentrated in the hands of a small number of institutional investors, the reporting obligations for a significant portion of issuers of publicly registered ABS (including most RMBS) have been automatically suspended in the first year after issuance.\textsuperscript{457} Section 942 of the Dodd-Frank Act amends § 15(d) of the Exchange Act to exclude ABS from its automatic suspension provisions,\textsuperscript{458} but grants authority to the SEC to issue rules providing for the suspension or termination of the duty of ABS issuers to file ongoing reports under the Exchange Act on such terms and conditions (including requirements for classes of issuers), and for such periods, as the SEC “deems necessary or appropriate in the public interest or for the protection of investors.”\textsuperscript{459}

Requiring ABS issuers to continue to file Exchange Act reports through the life of the transaction (which may be thirty or forty years in the case of an RMBS transaction) will significantly change current market practice for a large percentage of asset classes and increase (perhaps significantly) the cost and expense of securitizations.\textsuperscript{460} Practitioners may be most concerned, however, about the possible retroactive applicability of section 942 to ABS transactions for which Exchange Act reporting has previously been suspended.\textsuperscript{461}

The SEC has not proposed new rules providing for suspension of the reporting obligations for any class of issuers of ABS. In its proposed Regulation AB Amendments, however, the SEC proposed to require an undertaking by ABS issuers to continue periodic Exchange Act reporting, notwithstanding the automatic suspension afforded by § 15(d) as then written, as a new condition for offering ABS under a shelf registration statement.\textsuperscript{462} It is not clear whether the modification of § 15(d) by section 942 of the Dodd-Frank Act moots this proposal. In any event, practitioners expect the SEC to address the circumstances under which suspension of Exchange Act reporting can occur, either in its final amendments to Regulation AB or in an amendment to Rule 15d-22.

g. Conflict of Interest Provisions

Section 621 of the Dodd-Frank Act amended the Securities Act to add a new § 27B, a “conflict of interest” prohibition applicable to any underwriter, placement agent, initial purchaser, or sponsor (and their affiliates or subsidiaries) of an Exchange Act-ABS.\textsuperscript{463} Section 27B prohibits any such entity, during a one-year period following the date of first closing of the sale of any such ABS, from

\textsuperscript{457} For an extensive discussion of the Exchange Act reporting requirements for ABS issuers, see \textsc{ABA Securitization White Paper}, supra note 363, at 30–34.

\textsuperscript{458} Dodd-Frank Act, supra note 1, § 942, 124 Stat. at 1896 (to be codified at 15 U.S.C. § 78o(d)).

\textsuperscript{459} Id. (to be codified at 15 U.S.C. § 78o(d)(2)).

\textsuperscript{460} See \textsc{ABA Securitization White Paper}, supra note 363, at 33–34 & n.83.

\textsuperscript{461} See Risk Retention Comment Letter, supra note 391, at 22.


\textsuperscript{463} Dodd-Frank Act, supra note 1, § 621, 124 Stat. at 1631–32 (to be codified at 15 U.S.C. § 77z-2a).
engaging in “any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.”\textsuperscript{464} Section 27B’s prohibitions do not apply, however, to: (1) “risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of [the ABS], provided that such activities are designed to reduce the specific risks . . . [of any such entity] associated with positions or holdings arising out of” such activities; or (2) purchases or sales of ABS made pursuant to and consistent with commitments of any such entity (or any affiliate or subsidiary thereof) to provide liquidity for such ABS, or bona fide market-making in such ABS.\textsuperscript{465} The SEC is directed to issue rules implementing § 27B no later than 270 days after the date of enactment of the Dodd-Frank Act.\textsuperscript{466}

The legislative history of section 621 indicates that Congress intended to address “blatant conflicts of interest” in which an underwriter or sponsor creates an ABS that is “designed to fail” and then profits by betting against it, by means of short sales or otherwise.\textsuperscript{467} The legislative history further provides that changes in market conditions “may lead an underwriter to wish to sell the securities it holds. That is also not likely to pose a conflict.”\textsuperscript{468} Although the legislative history indicates a narrow focus, the language of section 621 appears significantly broader. Unless the rules implementing section 621 effectuate this more narrow focus, the section could be read to preclude ordinary course business transactions, such as asset-servicing activities by an affiliate or subsidiary of an entity covered by the section pursuant to the transaction documents; the origination or acquisition of second liens on the real properties securing the ABS; and loans or other extensions of credit by such entities to ABS sponsors, issuers, servicers, or credit enhancers to provide funds for operations.\textsuperscript{469}

\textsuperscript{464} Id. (to be codified at 15 U.S.C. § 77z-2a(a)).
\textsuperscript{465} Id., 124 Stat. at 1632 (to be codified at 15 U.S.C. § 77z-2a(c)). Section 27B(d) expressly provides that the subsection does not limit the application of new § 15G of the Exchange Act relating to credit risk retention required for Exchange Act-ABS transactions. Id. (to be codified at 15 U.S.C. § 77z-2a(d)).
\textsuperscript{466} Id. § 621(b), 124 Stat. at 1632 (to be codified at 15 U.S.C. § 77z-2a note).
\textsuperscript{468} 156 CONG. REC. S5901 (daily ed. July 15, 2010).
\textsuperscript{469} See Letter from Jeffrey W. Rubin, Chair, Comm. on Fed. Regulation of Sec., Am. Bar Ass’n Section of Bus. Law & Vicki O. Tucker, Chair, Comm. on Securitization & Structured Fin., Am. Bar Ass’n Section of Bus. Law, to U.S. Sec. & Exch. Comm’n 4–5 (Oct. 29, 2010) (¨Request for Public Comments on SEC Regulatory Initiatives Under the Dodd-Frank Act, Title VI—Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions, Section 621 Conflicts of Interest¨), available at http://www.sec.gov/comments/dt-title-vi/conflicts-of-interest/conflicts-of-interest-8.pdf (requesting that the final rules clarify that such ordinary course business transactions would not be affected by the rules).
h. Rescission of Rule 436(g)

Although not considered to be part of the “securitization reforms,” section 939G of the Dodd-Frank Act had an immediate impact on ABS transactions. Section 939G provides that “Rule 436(g), promulgated by the Securities and Exchange Commission under the Securities Act of 1933, shall have no force or effect.”470 Rule 436(g) had expressly exempted credit ratings provided by NRSROs from being considered a part of the registration statement prepared or certified by a person within the meaning of §§ 7 and 11 of the Securities Act,471 thereby effectively shielding NRSROs from liability as experts under § 11 for material misstatements or omissions in the registration statement with respect to credit ratings. With the rescission of Rule 436(g), an issuer that discloses a credit rating assigned by an NRSRO or other credit rating agency in connection with a registered offering would be required to file the consent of the rating agency as an exhibit to the registration statement and the rating agency would be subject to potential liability under § 11 of the Securities Act.

In a 2009 concept release requesting comment on the possible rescission of Rule 436(g),472 the SEC noted that NRSROs long have argued that they should not be considered experts for purposes of §§ 7 and 11 of the Securities Act, and, consequently, if Rule 436(g) were revoked, NRSROs might be unwilling to give their consents and take on expert liability under § 11.473 Not surprisingly then, the rescission of Rule 436(g) raised immediate concern for issuers of publicly registered ABS inasmuch as Regulation AB requires such issuers to disclose in their prospectuses information about the credit ratings issued on the ABS if obtaining such credit ratings is a condition to the issuance of the ABS.474 Because most issuances of ABS are conditioned upon receipt of required credit ratings, those credit ratings and the identity of the credit rating agency or agencies must be disclosed for publicly registered ABS, and, with the rescission of Rule 436(g),

471. 17 C.F.R. § 220.436(g) (2010).
Under § 7 of the Securities Act, if a party “is named as having prepared or certified any part of the registration statement, or is named as having prepared or certified a report or valuation for use in connection with a registration statement, the written consent of such person shall be filed with the registration statement.” 15 U.S.C. § 77g(a) (2006).
Section 11 imposes liability on parties who are involved in the preparation of registration statements filed under the Securities Act, which liability extends to persons who prepare or certify any part of the registration statement or who are named as having prepared or certified a report or valuation for use in connection with the registration statement. 15 U.S.C. § 77k (2006).
473. See id. at 53118. At the same time it issued the concept release, the SEC also proposed to amend its rules to require disclosure of information regarding credit ratings used by registrants, including certain investment companies, in connection with a registered offering of securities. Credit Ratings Disclosure, Securities Act Release No. 33-9070, 74 Fed. Reg. 53086 (proposed Oct. 15, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249 & 274).
consents to such disclosure had to be obtained from such credit rating agency or agencies.

Following the enactment of the Dodd-Frank Act, citing its inability to comply with Regulation AB because applicable NRSROs had indicated that they would not be willing to provide their consent to the inclusion of their names and ratings in registration statements or prospectuses until they had time to assess the implications of such consents, Ford Motor Credit Company LLC sought no-action relief from the SEC regarding the enforcement of Regulation AB’s disclosure requirement if such consents were not filed. In a July 22, 2010, no-action letter, the SEC indicated that, “[i]n order to facilitate a transition for asset-backed issuers,” it would not recommend enforcement action if an ABS issuer omits the ratings required by Regulation AB from a prospectus or registration statement in connection with ABS offerings prior to January 24, 2011. The SEC subsequently extended the no-action letter indefinitely to “allow adequate time to complete the regulatory actions required by the Dodd-Frank Act” and “facilitate [the Commission’s] consideration of whether and, if so, how those final regulatory actions should affect the Commission’s disclosure requirements regarding credit ratings for asset-backed securities offerings, while permitting registered asset-backed securities offerings to continue without interruption.” In doing so, the SEC noted that since the date of the earlier no-action letter, NRSROs had not changed their position of refusing to provide consents to the inclusion of their names and ratings in registration statements until after they had assessed the implication of such consents.

II. NON-DODD-FRANK ACTIONS TAKEN BY THE SEC

A. AMENDMENTS TO REGULATION SHO

In February 2010, the SEC adopted an alternative uptick rule as part of its continuing efforts to increase regulatory oversight over short selling. The alterna-
tive uptick rule, adopted in the form of an amendment to Rule 201 of Regulation SHO, requires that trading centers “establish, maintain, and enforce written policies and procedures reasonably designed to . . . prevent the execution or display of a short sale order of a covered security” if a “circuit breaker” is triggered with respect to the security. The circuit breaker of a covered security is triggered if the security’s price decreases by 10 percent or more from the prior day’s closing price. Once a circuit breaker is triggered with respect to a security, execution of a displayed short sale order of the security is permitted only if (i) its price is above the current national best bid or (ii) it is marked as “short exempt” and the circuit breaker remains in effect with respect to the stock for the remainder of the day and for the following day. The alternative uptick rule generally applies to equity securities listed on a national securities exchange, whether traded on an exchange or on the OTC market. Under the rule, trading centers are required to monitor the effectiveness of their policies and promptly take action to remedy deficiencies. According to the SEC, the adoption of the alternative uptick rule implemented through a circuit breaker rather than the other proposals struck the appropriate balance between the SEC’s goal of preventing potential short sale abuse and the need to limit impediments to the normal operations of the market.

Exchange Act Release 34-54891, 71 Fed. Reg. 75068 (proposed Dec. 13, 2006) (to be codified at 17 C.F.R. pts. 240 & 242). However, as noted by the SEC and by the researchers performing the studies, there was not a severe market-wide decline during the period in which the pilot program was conducted and, thus, the studies did not include an evaluation of the performance of the uptick rule, or the lack thereof, in such a market environment. See id. at 75073–75. Many believe that the elimination of the uptick rule facilitated the short selling that, at least in part, played a role in the financial crisis of 2008 and 2009.

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481. Id. § 242.201.

482. Id. § 242.201(b)(1)(i). In an April 2009 request for comments on proposed short sale price restrictions and “circuit breaker” restrictions, the SEC proposed two approaches to restrictions on short selling: one approach would apply on a market-wide and permanent basis, the “uptick rule,” and the other approach would apply only to a particular security during severe market declines in that security, or “circuit breakers.” Amendments to Regulation SHO, Exchange Act Release No. 34-58748, 74 Fed. Reg. 18042, 18043 (proposed Apr. 20, 2009) (to be codified at 17 C.F.R. pt. 242) [hereinafter April 2009 Amendments to Regulation SHO]. The SEC requested comments on two different proposals relating to market-wide and permanent restrictions, or uptick rules, and two proposals relating to circuit breakers. Id. The two proposed uptick rules included the “proposed modified uptick rule,” which was based on the current national best bid of a security, and the “proposed uptick rule,” which was based on the last sale price of a security. Id. The SEC also requested comments on the “alternative uptick rule,” which would permit short selling only at an increment above the current national best bid, unless an applicable exception were applicable, although the SEC was not making a proposal with respect to the alternative uptick rule. Amendments to Regulation SHO, Exchange Act Release No. 34-60509, 74 Fed. Reg. 42033, 42033 (proposed Aug. 20, 2009) (to be codified at 17 C.F.R. pt. 242). In August 2009, the SEC requested additional comments on the alternative uptick rule. Id. The SEC collected over 4,000 comment letters and in May 2009 held a public roundtable to discuss, among other things, short selling issues. Id. at 42033–34.


484. Id. at 18050. The term “covered security” under the rule is defined by reference to Regulation NMS, 17 C.F.R. §§ 242.600–612 (2010). Generally, “covered securities” include “any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan.” Id. § 242.600(b)(46).


The amendments to Regulation SHO also include an amendment to Rule 200(g).\textsuperscript{487} As amended, Rule 200(g) provides that a broker or dealer must mark all sell orders of any equity security as “long,” “short,” or “short exempt.”\textsuperscript{488} A broker may only mark a security as “short exempt” if the provisions of new Rule 201(c) and (d) are met.\textsuperscript{489} Rule 201(c) provides that once it is determined that the circuit breaker has been tripped with respect to any given security and the market has been notified of this occurrence as required under Rule 201(b)(3) (the “notification requirement”),\textsuperscript{490} a broker or dealer may mark a short sale order of the security as “short exempt” if it identifies the order as being above the current national best bid at the time the order is submitted.\textsuperscript{491} Notwithstanding the foregoing, the broker or dealer that so identifies a short sale “must establish, maintain, and enforce written policies and procedures reasonably designed to prevent incorrect identification of orders” under Regulation SHO.\textsuperscript{492} The broker or dealer must also regularly monitor the effectiveness of those policies and procedures and take prompt action to remedy any deficiencies.\textsuperscript{493} In addition, Rule 201(d)\textsuperscript{494} provides that, following a determination that the circuit breaker has been triggered with respect to any security and compliance with the notification requirement in connection therewith, a broker or dealer may mark a short sale order of the security “short exempt” if the broker or dealer has a reasonable basis to believe that:

- “The short sale order of a covered security is by a person that is deemed to own the security pursuant to [Rule 200 of Regulation SHO], provided that the person intends to deliver the security as soon as all restrictions on delivery have been removed.”\textsuperscript{495}

- “The short sale order of a covered security is by a market maker to offset customer odd-lot orders or to liquidate an odd-lot position that changes such broker’s or dealer’s position by no more than a unit of trading.”\textsuperscript{496}

- “The short sale order of a covered security is for a good faith account of a person who then owns another security by virtue of which he is, or presently will be, entitled to acquire an equivalent number of securities of the same class as the securities sold; provided such sale, or the purchase which such sale offsets, is effected for the bona fide purpose of profiting from a current difference between the price of the security sold and the security owned and that such right of acquisition was originally attached

\textsuperscript{487} Id. at 11323 (to be codified at 17 C.F.R. § 242.200(g)).
\textsuperscript{488} Id.
\textsuperscript{489} Id. (to be codified at 17 C.F.R. § 242.200(g)(2)).
\textsuperscript{490} Id. at 11323–24 (to be codified at 17 C.F.R. § 242.201(b)(3)).
\textsuperscript{491} Id. at 11324 (to be codified at 17 C.F.R. § 242.201(c)).
\textsuperscript{492} Id. (to be codified at 17 C.F.R. § 242.201(c)(1)).
\textsuperscript{493} Id. (to be codified at 17 C.F.R. § 242.201(c)(2)).
\textsuperscript{494} Id. (to be codified at 17 C.F.R. § 242.201(d)).
\textsuperscript{495} Id. (to be codified at 17 C.F.R. § 242.201(d)(1)).
\textsuperscript{496} Id. (to be codified at 17 C.F.R. § 242.201(d)(2)).
to or represented by another security or was issued to all the holders of any such securities of the issuer." 497

- “The short sale order of a covered security is for a good faith account and submitted to profit from a current price difference between a security on a foreign securities market and a security on a securities market subject to the jurisdiction of the United States, provided that the short seller has an offer to buy on a foreign market that allows the seller to immediately cover the short sale at the time it was made.” 498

- The short sale order of the security is (1) “by an underwriter or member of a syndicate or group participating in the distribution of a security in connection with an over-allotment of securities” or (2) “for purposes of a lay-off sale by an underwriter or member of a syndicate or group in connection with a distribution of securities through a rights or standby underwriting commitment.” 499

- “The short sale order of a covered security is by a broker or dealer effecting the execution of a customer purchase or the execution of a customer ‘long’ sale on a riskless principal basis.” 500

- “The short sale order is for the sale of a covered security at the volume weighted average price (VWAP) that meets” the criteria set forth in the new Rule 201(d)(7). 501

The amendments to Rule 201 and Rule 200(g) became effective on May 10, 2010. 502 However, in November 2010, the SEC, after working with market participants to resolve certain operational issues relating to the implementation of the amended rule, elected to extend the compliance date of Rule 201 and Rule 200(g) from November 10, 2010, to February 28, 2011. 503 The SEC found that the exchanges needed additional time to adopt procedures to comply with amended Rule 201

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497. Id. (to be codified at 17 C.F.R. § 242.201(d)(3)).
498. Id. (to be codified at 17 C.F.R. § 242.201(d)(4)). For purposes of the exception, “a depository receipt of a security shall be deemed to be the same security as the security represented by such receipt.” Id.
499. Id. (to be codified at 17 C.F.R. § 242.201(d)(5)).
500. Id. (to be codified at 17 C.F.R. § 242.201(d)(6)). A broker or dealer taking advantage of this exception must have written policies and procedures in place to assure that, at a minimum: (i) The customer order was received prior to the offsetting transaction; (ii) The offsetting transaction is allocated to a riskless principal or customer account within 60 seconds of execution; and (iii) The broker or dealer has supervisory systems in place to produce records that enable the broker or dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders on which the broker or dealer relies pursuant to this exception.

501. Id. (to be codified at 17 C.F.R. § 242.201(d)(7)).
502. Id. at 11232.
and that other industry participants may benefit from extra time for programming and testing for compliance with the rule.\textsuperscript{504}

\section*{B. SEC Proxy Access Rules}

In August 2010, the SEC adopted amendments to its proxy rules to permit shareholders to nominate directors in a company’s proxy materials—commonly referred to as “proxy access.”\textsuperscript{505} The vote on the amendments was three-two, with Commissioners Casey and Paredes dissenting because of numerous concerns, including that the proxy access rules encroach on state corporate law and interfere with private ordering by companies and their shareholders.\textsuperscript{506}

The SEC previously proposed amendments to the federal proxy rules regarding proxy access in 2003\textsuperscript{507} and 2007.\textsuperscript{508} The rules that were adopted are based on those proposed on June 10, 2009.\textsuperscript{509} More recently, as discussed above, the Dodd-Frank Act amended § 14(a) of the Exchange Act\textsuperscript{510} to authorize, but not require, the SEC to issue rules regarding the inclusion of shareholder nominees in a company’s proxy materials.\textsuperscript{511}

\subsection*{1. Overview of the Final Proxy Access Rules}

There are two components to the proxy access rules approved by the SEC: (1) establishing a federal proxy access right pursuant to Rule 14a-11\textsuperscript{512} and related amendments, and (2) amending Rule 14a-8 to permit shareholder proposals that would establish additional, more flexible proxy access procedures.\textsuperscript{513}

\begin{footnotesize}
\begin{itemize}
\item[504.] Id. at 68703.
\item[511.] Dodd-Frank Act, supra note 1, § 971, 124 Stat. at 1915 (to be codified at 15 U.S.C. § 78n(a)).
\item[513.] Id. at 56782 (to be codified at 17 C.F.R. § 240.14a-8).
\end{itemize}
\end{footnotesize}
a. Federal Proxy Access Right Created by Rule 14a-11

Rule 14a-11 creates a federal law process for a shareholder or group of shareholders to nominate one or more directors and have those nominees included in a company’s proxy materials if certain requirements are satisfied. Rule 14a-11 will not apply where applicable state or foreign law or a company’s governing documents (e.g., charter, bylaws, certificate of designations, etc.) prohibit the company’s shareholders from nominating directors.

(i) Companies Subject to Proxy Access

Rule 14a-11 will apply to companies (including investment companies and controlled companies) subject to the Exchange Act proxy rules other than companies subject to such rules solely because they have debt securities registered under § 12 of the Exchange Act. In addition, Rule 14a-11 will apply to companies that voluntarily register a class of securities under § 12(g). Rule 14a-11 will not apply to foreign private issuers.

Unlike previously proposed proxy access rules, companies will be subject to Rule 14a-11 regardless of any “triggers” that may demonstrate an objective need for proxy access.

Companies cannot “opt out” of being subject to Rule 14a-11: the proxy access right will apply regardless of whether a company has a provision in its governing documents providing for or prohibiting the inclusion of shareholder nominees in its proxy materials. The only exception to Rule 14a-11’s applicability is if state or foreign law or a company’s governing documents prohibit shareholders from nominating directors.

(ii) Ownership Requirement

To be eligible to use the Rule 14a-11 process, shareholders must own at least 3 percent of the total voting power of the company’s securities entitled to vote on the election of directors at the annual meeting. The rules contain detailed instructions on how to calculate ownership.

Shareholders may aggregate their securities with other shareholders in order to meet the 3 percent threshold. However, only shares over which the share-
holder has investment and voting control will be counted toward the 3 percent threshold—borrowed shares will be excluded. 526 Securities that have been loaned to a third party by a nominating shareholder may be counted toward the ownership threshold if the nominating shareholder has the right to recall the securities and will recall the loaned securities upon notification that the shareholder’s nominee will be included in the company’s proxy materials. 527

Shareholders must have held their shares for at least three years, 528 must provide a statement that they intend to continue to own at least the required amount of securities through the date of the meeting at which directors are elected, 529 and must disclose their intent regarding continued ownership of the securities after the election. 530

Shareholders who hold the securities for the purpose of changing control of the company or to gain a number of seats on the board of directors that exceeds the maximum number of nominees a company could be required to include under Rule 14a-11 are not eligible to nominate directors under Rule 14a-11. 531

(iii) Other Eligibility Requirements

The director nominee’s candidacy and, if elected, service on the board must not violate federal, state, or foreign law, or the rules of a national securities exchange, if applicable, 532 and the nominee must satisfy the objective independence standards of the applicable national securities exchange. 533

Additionally, neither the nominee nor the nominating shareholder (including any member of the nominating shareholder group) may have any direct or indirect agreement with the company regarding the nomination. 534 Notably, Rule 14a-11 does not restrict the ability of shareholders to nominate directors with whom they have a relationship.

(iv) Notice Requirements

If a shareholder seeks to nominate one or more director candidates, the nominating shareholder must file a new Schedule 14N with the SEC and provide a copy to the company, no later than 120 days before the anniversary of the mailing date of the company’s definitive proxy statement in the previous year. 535 Schedule 14N, 536 which will be publicly available when filed, requires any nominating shareholders to make certain disclosures, including reporting:

526. Id.
527. Id.
528. Id. (to be codified at 17 C.F.R. § 240.14a-11(b)(2)).
529. Id. at 56784 (to be codified at 17 C.F.R. § 240.14a-11(b)(3)).
530. Id. (to be codified at 17 C.F.R. § 240.14a-11(b)(4)).
531. Id. (to be codified at 17 C.F.R. § 240.14a-11(b)(6)).
532. Id. (to be codified at 17 C.F.R. § 240.14a-11(b)(8)).
533. Id. (to be codified at 17 C.F.R. § 240.14a-11(b)(9)). Note that this Review does not address proxy access rules applicable to investment companies.
534. Id. (to be codified at 17 C.F.R. § 240.14a-11(b)(7)).
535. Id. at 56784–85 (to be codified at 17 C.F.R. § 240.14a-11(b)(10)).
536. Id. at 56789–92 (to be codified at 17 C.F.R. § 240.14n-101).
• the name and address of the nominating shareholder or each member of the nominating shareholder group;\textsuperscript{537}

• the amount and percentage of the company’s shares held and entitled to vote in the director election and related ownership information;\textsuperscript{538}

• that the shares used to satisfy the ownership threshold have been held continuously for at least three years;\textsuperscript{539}

• that the nominating shareholder or each member of the nominating shareholder group intends to hold its shares through the date of the meeting;\textsuperscript{540}

• the intent of the nominating shareholder or each member of the nominating shareholder group with respect to continued ownership after the election;\textsuperscript{541}

• any relationship between the nominating shareholder or group, the nominee or nominees, and the company;\textsuperscript{542}

• biographical information about the nominating shareholder or each member of the nominating shareholder group and the nominee or nominees;\textsuperscript{543}

• a statement that, to the best of the nominating shareholder’s or group’s knowledge, the nominee meets the objective criteria for “independence” under applicable stock exchange rules, and a statement of whether, to the best of the nominating shareholder’s or group’s knowledge, the nominee meets the director qualifications, if any, set forth in the company’s governing documents;\textsuperscript{544}

• disclosure of any legal proceeding that the nominating shareholder or member of the nominating shareholder group has been involved in during the past ten years;\textsuperscript{545}

• a representation that the nominee’s candidacy and, if elected, service would not violate controlling state, federal, or foreign law, or rules of a national securities exchange or national securities association, and otherwise would satisfy the eligibility requirements of Rule 14a-11;\textsuperscript{546}

• a statement in support of the nominee or nominees not exceeding 500 words per nominee, if the nominating shareholder or group elects to include such a statement in the company’s proxy statement,\textsuperscript{547} and

\begin{footnotesize}
\textsuperscript{537} Id. at 56790 (Items 1 \& 2).
\textsuperscript{538} Id. (Item 3).
\textsuperscript{539} Id. (Item 4(a)).
\textsuperscript{540} Id. (Item 4(b)).
\textsuperscript{541} Id.
\textsuperscript{542} Id. at 56791 (Item 5(g)).
\textsuperscript{543} Id. at 56790 (Item 5(b) \& (c)).
\textsuperscript{544} Id. at 56791 (Item 5(e) \& (f)).
\textsuperscript{545} Id. (Item 5(d)).
\textsuperscript{546} Id. (Item 8).
\textsuperscript{547} Id. (Item 5(h)(i)).
\end{footnotesize}
a certification by the nominating shareholder or group that the nomination is not intended either to result in a change in control of the company or to gain more than the maximum number of board seats permitted under Rule 14a-11.548

(v) Number of Directors

Shareholders may include in a company’s proxy materials the greater of one director nominee or a number of director nominees that equals up to 25 percent of the company’s board, which number may be rounded down.549 If the number of nominees submitted exceeds the authorized number of permissible nominees under Rule 14a-11, then priority is given to the nominees from the nominating shareholder or shareholder group holding the greatest percentage of securities eligible to vote in the election of directors.550 If a company agrees to nominate a candidate who is proposed by a shareholder under Rule 14a-11, the candidate will count against the 25 percent limit.551 For companies with classified boards, this limit is calculated based on the total number of directors on the board even though only one-third of the directors may be up for election at the meeting.552

(vi) Deadlines Under Rule 14a-11

Shareholders seeking to submit a director nominee under Rule 14a-11 and the companies subject to Rule 14a-11 must follow the following timeline, which is similar to the timeline for shareholder proposals submitted under Rule 14a-8:

• Shareholders must file Schedule 14N with the SEC and provide a copy to the company no earlier than 150 days and no later than 120 days before the anniversary of the mailing of the company’s proxy statement in the previous year.553

• If a company determines to include the shareholder nominee in its proxy materials, it must notify the nominating shareholder or group no later than thirty days before the company files its definitive proxy statement with the SEC.554

• If the company seeks to exclude the shareholder nominee from its proxy materials, the company must provide notice to the shareholder or group no later than fourteen days after the applicable deadline for transmitting a Schedule 14N for such annual meeting.555

548. Id. (Item 8).
549. Id. at 56785 (to be codified at 17 C.F.R. § 240.14a-11(d)(1)).
550. Id. at 56786 (to be codified at 17 C.F.R. § 240.14a-11(e)(1)).
551. Id. at 56785 (to be codified at 17 C.F.R. § 240.14a-11(d)(4)).
552. Id. (to be codified at 17 C.F.R. § 240.14a-11(d)(2)).
553. Id. at 56784–85 (to be codified at 17 C.F.R. § 240.14a-11(b)(10)).
554. Id. at 56786 (to be codified at 17 C.F.R. § 240.14a-11(g)(1)).
555. Id. at 56786–87 (to be codified at 17 C.F.R. § 240.14a-11(g)(2)).
• The nominating shareholder or group then will have fourteen days after receipt of the notice by the company to respond and correct any eligibility or procedural deficiencies identified in the notice.556

• If the company continues to believe that it has a basis for not including the nominee in its proxy materials, the company must provide notice of the basis for its exclusion to the SEC no less than eighty days before it files its definitive proxy statement with the SEC.557 The company also may request that the SEC staff issue a no-action letter concurring that the company may exclude the director nominee or the statement in support of such nominee.558

(vii) Liability

The nominating shareholder or group will be liable for any statement on Schedule 14N or any other related communication that is false or misleading with respect to any material fact, or that omits to state any material fact necessary to make any statement not false or misleading, regardless of whether that information is ultimately included in the company’s proxy statement.559 Companies will not be liable for information provided by the nominating shareholder or group under Rule 14a-11 that the company includes in its proxy statement,560 except to the extent that the company subsequently specifically incorporates the information by reference or “otherwise adopt[s] the information as its own.”561

(viii) Amendments to Related SEC Rules

The SEC also amended the following related rules:

• Nominating shareholder groups may report their aggregate ownership on Schedule 13G, rather than Schedule 13D, if the group was formed solely for the purpose of nominating director(s) pursuant to Rule 14a-11.562 In providing this exception, the SEC noted that the more burdensome Schedule 13D disclosure requirements could deter some shareholders from forming such nominating groups.563

• The exception, however, is unavailable to nominating shareholders or groups that engage in activities beyond nominating directors, or soliciting proxies for their director nominees or against a company’s nominees in accordance with Rule 14a-11.564

556. Id. at 56787 (to be codified at 17 C.F.R. § 240.14a-11(g)(2)(ii)).
557. Id. (to be codified at 17 C.F.R. § 240.14a-11(g)(3)).
558. Id.
559. Id. at 56782 (to be codified at 17 C.F.R. § 240.14a-9(c)).
560. Id. at 56676, 56773, 56786 (to be codified at 17 C.F.R. § 240.14a-11(f)).
561. Id. at 56740.
562. Id. at 56780 (to be codified at 17 C.F.R. § 240.13d-1).
563. Id. at 56751–52.
564. Id. at 56736–37.
Nominating shareholders or groups submitting a nomination pursuant to a company’s governing documents or applicable state or foreign law provisions will not be eligible for the exception to reporting on Schedule 13D.\textsuperscript{565}

The SEC did not exempt nominating shareholders and groups from the applicability of § 16.\textsuperscript{566} The SEC noted that groups could form in order to nominate directors without crossing the 10 percent threshold that triggers § 16 reporting and short swing profit recovery provisions.\textsuperscript{567} Shareholder groups with greater than 10 percent beneficial ownership will continue to be analyzed under § 16 in the same way as groups formed for any other purpose.\textsuperscript{568} Likewise, nominating shareholders and groups are not exempted from the operation of the Securities Act standards for affiliates.\textsuperscript{569}

Written and oral communications made pursuant to Rule 14a-11, which would be deemed solicitations under the SEC proxy rules, will be exempt from certain disclosure, filing, and other requirements of those rules,\textsuperscript{570} so long as the shareholder is not holding the company’s securities with the purpose or effect of changing control of the company.\textsuperscript{571}

\textit{b. Amendment to Rule 14a-8(i)(8) on Proxy Access Shareholder Proposals}

Rule 14a-8(i)(8) currently permits companies to exclude proxy access shareholder proposals.\textsuperscript{572} Pursuant to the amendment to Rule 14a-8(i)(8), companies will not be able to exclude a proxy access shareholder proposal under Rule 14a-8(i)(8) solely because it relates to proxy access,\textsuperscript{573} but can exclude a proxy access shareholder proposal if it conflicts with state law\textsuperscript{574} or Rule 14a-11.\textsuperscript{575} A shareholder proposal could expand proxy access to a broader group of shareholders or create alternative proxy access rights, but could not have the effect of preventing a shareholder or group that satisfies the requirements of Rule 14a-11 from having its nominee included in a company’s proxy materials.\textsuperscript{576} For example, a shareholder proposal could not simply propose higher ownership thresholds than those found in Rule 14a-11. In the context of any alternative access mechanism established under Rule 14a-8(i)(8), the amended rules also change a number of

\begin{itemize}
  \item \textsuperscript{565} Id.
  \item \textsuperscript{566} Id. at 56676, 56737; see Exchange Act § 16, 15 U.S.C.A. § 78p (West 2009 & Supp. 2011).
  \item \textsuperscript{567} 2010 Proxy Access Amendments, \textit{supra} note 505, 75 Fed. Reg. at 56737.
  \item \textsuperscript{568} Id.
  \item \textsuperscript{569} Id. at 56737–38.
  \item \textsuperscript{570} Id. at 56676, 56726–27.
  \item \textsuperscript{571} See id. at 56699–700.
  \item \textsuperscript{572} 17 C.F.R. § 240.14a-8(i)(8) (2010).
  \item \textsuperscript{573} 2010 Proxy Access Amendments, \textit{supra} note 505, 75 Fed. Reg. at 56782 (to be codified at 17 C.F.R. § 240.14a-8(i)(8)).
  \item \textsuperscript{574} 17 C.F.R. § 240.14a-8(i)(1) (2010).
  \item \textsuperscript{575} Id. § 240.14a-8(i)(3).
  \item \textsuperscript{576} See id.
\end{itemize}
other proxy rules in a manner that is generally consistent with Rule 14a-11 and new Schedule 14N.

The current eligibility provisions of Rule 14a-8 remain unchanged, requiring that a shareholder proponent have continuously held at least $2,000 in market value (or 1 percent, whichever is less) of the company’s securities entitled to be voted on the proposal at the meeting, for a period of at least one year prior to submitting the proposal.577

2. Effective Date

These proxy access rules were to become effective sixty days after publication in the Federal Register, or on November 15, 2010.578 However, the effective date of Rule 14a-11—but not the amendments to Rule 14a-8(i)(8)—for smaller reporting companies is three years from the rule’s effective date.579

The rules were published in the Federal Register on September 16, 2010.580 However, as discussed below, the effective date of Rule 14a-11 and the amendments to Rule 14a-8 have been stayed in light of pending litigation.

3. Litigation

On September 29, 2010, Business Roundtable and the U.S. Chamber of Commerce filed a petition with the U.S. Court of Appeals for the District of Columbia Circuit seeking review of Rule 14a-11 and related amendments.581 On the same day, they filed a motion with the SEC seeking a stay of the effective date of the rule.582

On October 4, 2010, the SEC issued an order granting a stay of the effectiveness of its proxy access rule, Rule 14a-11, and related rule amendments.583 The stay also applies to the amendments to the SEC’s shareholder proposal rule, Rule 14a-8, which was adopted contemporaneously with Rule 14a-11, as the SEC found that there was a potential for confusion if the Rule 14a-8 amendments were to become effective while Rule 14a-11 was stayed.584 The effectiveness of related rule amendments adopted in connection with Rule 14a-11 (e.g., amendments to Form 8-K and Rule 14a-5) likewise are stayed.585

577. Id. § 240.14a-8(b).
579. Id.
580. Id.
583. Id. at *2; see also Facilitating Shareholder Director Nominations, Securities Act Release No. 33-9151, 75 Fed. Reg. 64641 (Oct. 20, 2010).
584. Order Granting Stay, supra note 582, at *1.
585. See id.
a. Summary of Petitioners’ Arguments

The petitioners have challenged the rules on the grounds that they are arbitrary and capricious in violation of the Administrative Procedure Act, that the SEC failed to assess adequately the rules’ effects on efficiency, competition, and capital formation as required by the Exchange Act and the Investment Company Act, and that the rules infringe First Amendment rights under the U.S. Constitution. In seeking a stay from the SEC, the petitioners argued that the SEC erred in appraising the costs the rules would pose, that the SEC failed to estimate properly the frequency with which proxy access will be used, that the adopting release is arbitrary and capricious in its treatment of state law, that the rules fail to serve their stated goal of empowering shareholders, and that the SEC erred by covering investment companies under the rules. In the stay, the SEC stated it was not addressing the merits of the petitioners’ challenge.

b. Litigation Schedule

On October 8, 2010, the SEC and the petitioners jointly filed a proposed briefing schedule for the case before the Court of Appeals. In the filing, the SEC confirmed that it does not expect proxy access to be available for the 2011 proxy season, and instead seeks a court ruling by the summer of 2011, so that if the rules are upheld, they may be used in the 2012 proxy season. The motion stated that the stay “necessarily means that the [SEC’s] rule changes will not be available for use by shareholders during the 2010–2011 proxy season.”

In their joint motion, the parties proposed to the court that the case be briefed in November through February, with the petitioners’ brief due on November 30, 2010, and the SEC’s brief due on January 19, 2011. Oral argument is expected in March or April under this schedule, with a decision by the summer. The schedule has been approved by the court.

C. Proposed Rule on Short-Term Borrowings Disclosure

On September 17, 2010, the SEC issued a proposed rulemaking release that would require in-depth disclosure about short-term borrowings (“Short-Term Borrowings Release”). The Short-Term Borrowings Release was issued in re-

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587. Id.
588. Order Granting Stay, supra note 582, at *1–2.
590. Id. at 4.
591. Id.
592. Id. at 5; see Opening Brief of Petitioners, Bus. Roundtable v. SEC, No. 10-1305 (D.C. Cir. Nov. 30, 2010).
spose to the SEC’s belief that “leverage and liquidity continue to be significant areas of focus for investors,” particularly in light of the recent financial crisis.595 The SEC noted the emergence of certain short-term financing techniques, such as commercial paper, repurchase transactions, and securitizations, that are subject to risks when market liquidity is limited and that create complex accounting and disclosure issues.596 In addition, the SEC noted concern about the lack of transparency of intra-period variations of short-term borrowings that are not reflected in end-of-period financial statements.597 To address these concerns, the Short-Term Borrowings Release contains proposed amendments to the “Management’s Discussion and Analysis of Financial Condition and Results of Operations” (colloquially known as “MD&A”) disclosure rules to require a new short-term borrowings table and narrative qualitative disclosures about short-term borrowings.598

1. Definition of Short-Term Borrowings

The proposed rules are centered around the definition of “short-term borrowings.” As proposed, the term “short-term borrowings” would mean amounts payable for short-term obligations that are

- Federal funds purchased and securities sold under agreements to repurchase;
- Commercial paper;
- Borrowings from banks;
- Borrowings from factors or other financial institutions; and
- Any other short-term borrowings reflected on the registrant’s balance sheet.599

The Short-Term Borrowings Release noted that the proposed definition is derived from the accounting concept of short-term obligations, which are generally those obligations that are scheduled to mature within one year after the date of the balance sheet, and are typically stated separately on the balance sheet.600

2. Proposed Tabular Disclosure of Short-Term Borrowings

The Short-Term Borrowings Release proposed to require all registrants to add tabular disclosures in MD&A.601 Currently, bank holding companies are subject to a similar disclosure requirement in what is referred to as “Industry Guide 3.”602 The Short-Term Borrowings Release would codify the Industry Guide 3 provisions for disclosure of short-term borrowings to become applicable to all companies

595. Id. at 59867.
596. Id. at 59867–68.
597. Id.
598. Id. at 59868.
599. Id. at 59870, 59888 (to be codified at 17 C.F.R. § 229.303(a)(6)(iii)).
600. See id. at 59870 n.38.
601. Id. at 59869.
that provide MD&A disclosure, not only to bank holding companies.\footnote{603} The proposed table of short-term borrowings would require disclosure of:

- The amount in each specified category of short-term borrowings at the end of the reporting period and the weighted average interest rate on those borrowings;
- The average amount in each specified category of short-term borrowings for the reporting period and the weighted average interest rate on those borrowings;
- For registrants meeting the proposed definition of “financial company,”\footnote{604} the maximum daily amount of each specified category of short-term borrowings during the reporting period; and
- For all other registrants, the maximum month-end amount of each specified category of short-term borrowings during the reporting period.\footnote{605}

In reporting the average amounts of short-term borrowings and the weighted average interest rates, the Short-Term Borrowing Release provides an accommodation for companies that do not qualify as financial companies.\footnote{606} Financial companies must calculate the average amounts for the reporting period based on the daily amounts of short-term borrowings outstanding at the end of each day.\footnote{607} In contrast, non-financial companies are not required to calculate average outstanding amounts on a daily average basis, but the averaging period may not exceed one month and the non-financial company would be required to disclose the basis it used for calculating the average amounts reported in the table.\footnote{608}

The Short-Term Borrowings Release does not create specific categories of short-term borrowings to be included in the table. Rather, the proposed rules provide each registrant with flexibility to present each of the categories that is relevant to the types of short-term financing activities it conducts.\footnote{609} In addition, the pro-

\footnote{603} Short-Term Borrowings Disclosure, supra note 594, 75 Fed. Reg. at 59869.
\footnote{604} Under the proposed rules, a “financial company” is defined as a registrant that “is engaged to a significant extent in the business of lending, deposit-taking, insurance underwriting or providing investment advice, or is a broker or dealer.” Id. at 59871, 59888 (to be codified at 17 C.F.R. § 229.303(a)(6)(iv)). This definition includes “an entity that is, or is the holding company of, a bank, a savings association, an insurance company, a broker, a dealer, a business development company . . . , an investment adviser, a futures commission merchant, a commodity trading advisor, a commodity pool operator, or a mortgage real estate investment trust.” Id.
\footnote{605} Id. at 59869, 59888 (to be codified at 17 C.F.R. § 229.303(a)(6)(i)).
\footnote{606} Id. at 59871.
\footnote{607} Id.
\footnote{608} Id. Under the proposed rules, a company that is engaged in both financial and non-financial businesses would be able to provide separate short-term borrowings disclosures for the financial and non-financial businesses in accordance with the applicable disclosure requirements for each business. Id.
\footnote{609} Id. at 59870. The proposed rules would allow foreign private issuers that do not prepare financial statements in accordance with U.S. GAAP to provide “categories that correspond to the classifications used for such types of short-term borrowings” under the home-country GAAP used, “so long as the disclosure is provided at a level of detail that satisfies the objective of the [proposed] disclosure requirement.” Id.
posed rules do not provide a quantitative threshold at which registrants can disaggregate amounts into separate categories of short-term borrowings to be reported in the table.\footnote{610} Accordingly, under the proposed rules, the table would not allow registrants to aggregate categories of short-term borrowings, even where a particular category includes a relatively small amount.\footnote{611} Moreover, the proposed rules would require a registrant to disaggregate a category of short-term borrowings further by currency or by interest rate to the extent such disaggregation is necessary to promote understanding or to prevent aggregated amounts from being misleading.\footnote{612}

3. Proposed Narrative Disclosure of Short-Term Borrowings

The Short-Term Borrowings Release proposes to require registrants to provide narrative disclosures in order to place the short-term borrowings table into context.\footnote{613} The proposed narrative disclosures include the following:

- A general description of the short-term borrowings arrangements included in each category (including any key metrics or other factors that could reduce or impair the registrant’s ability to borrow under the arrangements and whether there are any collateral posting arrangements) and the business purpose of those arrangements;
- The importance to the registrant of its short-term borrowings arrangements to its liquidity, capital resources, market-risk support, credit-risk support or other benefits;
- The reasons for the maximum amount for the reporting period, including any non-recurring transactions or events, use of proceeds or other information that provides context for the maximum amount; and
- The reasons for any material differences between average short-term borrowings for the reporting period and period-end short-term borrowings.\footnote{614}

The Short-Term Borrowings Release noted that the proposed narrative disclosure is not intended to be duplicative of the registrant’s other disclosures about liquidity and capital resources.\footnote{615}

4. Proposed Reporting Periods

The proposed rules would be applicable to annual and quarterly reports, as well as registration statements.\footnote{616}
• “For annual reports, information would be presented for the three most recent fiscal years and for the fourth quarter.”

• For registration statements, registrants “would be required to include short-term borrowings disclosure for the three most recent full fiscal year periods and interim information for any subsequent interim periods.”

• “For quarterly reports, information would be presented for the relevant quarter, without a requirement for comparative data.”

Unlike traditional MD&A requirements, registrants would be required to include the full presentation of quantitative and qualitative information in each quarterly report or for each interim period included in a registration statement. This is in contrast to other MD&A disclosures that require the full disclosure on an annual basis, with a discussion of material changes during interim periods. In addition, the requirement to include the proposed disclosure for the fourth quarter in a registrant’s annual report is also a departure from past practices. Finally, the SEC declined to extend the safe harbor for forward-looking statements contained in MD&A to the proposed disclosures.

5. Transition Period

To ease the transition for registrants that are not subject to Industry Guide 3, the SEC is proposing to phase in the short-term borrowings disclosures as follows:

• In the initial year, “companies would be required to include short-term borrowings information for the most recent fiscal year” and could “omit information for the two preceding fiscal years”; 624

• In the second year, “companies would be required to include the two most recent fiscal years” and could “omit the third preceding fiscal year”; 625 and

• In the third year, and thereafter, “companies would be required to include disclosure for each of the three most recent fiscal years.”

Since bank holding companies already must comply with Industry Guide 3, those companies would be required to provide the proposed disclosures for the three most recent fiscal years.

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617. Id.
618. Id.
619. Id. While no prior-period comparison is required for quarterly reports, the proposed rules would require the registrant to include narrative disclosure of any material changes from prior periods. Id.
620. Id.
621. Id.
622. Id.
623. Id. at 59875; see 17 C.F.R. § 229.303(c) (2010).
625. Id.
626. Id.
627. Id.
D. SEC Guidance on Presentations of Liquidity and Capital Resources Disclosures in MD&A

1. SEC Guidance Regarding Liquidity and Capital Resources Disclosures in MD&A

On September 17, 2010, the SEC issued an interpretive release to provide guidance to public companies to improve disclosure of liquidity and capital resources in MD&A in order to facilitate a greater investor understanding of a company’s liquidity and funding risks (“Liquidity Release”). 628 The Liquidity Release was a companion release to a proposed rulemaking that would require more in-depth disclosure about short-term borrowings, discussed above. 629 The SEC noted in the Liquidity Release that the existing MD&A disclosure requirements are broad enough to require the disclosure discussed in the release. 630 In particular, the Liquidity Release discusses MD&A disclosure regarding three topics: (i) liquidity, (ii) leverage ratios, and (iii) the contractual obligations table. 631

a. Liquidity Disclosure

The SEC noted the recent expansion of the types of funding methods and cash management tools used by companies. 632 The Liquidity Release cautioned that, as “financing activities . . . become more diverse and complex, it is increasingly important that the [MD&A] discussion of liquidity and capital” resources promotes an understanding of a registrant’s funding and liquidity risk. 633 In that regard, the Liquidity Release reiterates the MD&A requirement in Item 303(a)(1) of Regulation S-K 634 to discuss "known trends or any known demands, commitments, events or uncertainties that will result in, or that are reasonably likely to result in, the registrant’s liquidity increasing or decreasing in any material way." 635 The Liquidity Release noted that, in preparing the liquidity and capital resources section of MD&A, companies should consider whether the following matters constitute "trends, demands, commitments, events or uncertainties" that would require disclosure:

- “difficulties accessing the debt markets”, 636
- “reliance on commercial paper or other short-term financing arrangements”. 637

631. Id.
632. Id. at 59894.
633. Id.
636. Id.
637. Id.
The Liquidity Release also addresses situations where a registrant’s financial statements as of the end of a period may not adequately convey intra-period financing activities or the impact of known trends, demands, commitments, events, or uncertainties with respect to those activities. The SEC stated that, if intra-period borrowing activities are materially different from the period-end amounts that are reported in the registrant’s financial statements, then the current MD&A rules discussed above would require disclosure about intra-period variations.

In the Liquidity Release, the SEC clarified how registrants should approach recent advancements in short-term financing techniques, such as “repurchase transactions,” which are accounted for as a sale of assets (despite the registrant’s continuing involvement in the sold assets) and, therefore, do not appear as liabilities on the registrant’s period-end balance sheet. Despite the fact that such financing arrangements may not be specifically addressed in the MD&A rules for off-balance sheet arrangements or the Table of Contractual Obligations, the more flexible, principles-based MD&A liquidity disclosure rules discussed above are broad enough to require disclosure of these arrangements. The Liquidity Release states that, when evaluating possible MD&A disclosure of “repurchase transaction[s], securities lending transaction[s], or any other transaction[s] involving the transfer of financial assets with an obligation to repurchase financial assets, the registrant should consider whether the transaction is reasonably likely to result in the use of a material amount of cash or other liquid assets.” Finally, the Liquidity Release indicates that registrants should use their judgment to determine where in MD&A the disclosure about these short-term financing arrangements should be located (e.g., Off-Balance Sheet Arrangements, Liquidity and Capital Resources, Table of Contractual Obligations), based upon the type of arrangement, the obligations involved, and the potential exposures to the registrant.

638. Id.
639. Id. at 59895.
640. Id.
641. Id.
642. Id.
643. Id.
644. Id.
646. Id. § 229.303(a)(5).
648. Id.
649. Id.
b. Cash Management and Risk Management Policies

The Liquidity Release discusses disclosure considerations regarding a company’s cash management and risk management policies in order to provide additional context for the liquidity and capital resources exposures identified in MD&A. The SEC noted that “[b]anks, in particular, should consider discussing their policies and practices in meeting applicable banking agency guidance . . . , or any policies and practices that differ from applicable agency guidance.” For all companies, the Liquidity Release states that if a company relies upon a “portfolio of cash and other investments that is a material source of liquidity,” then it should consider discussing the “nature and composition if [its] portfolio, including a description of the assets held and any related market risk, settlement risk or other risk exposure,” including limitations or constraints on access to those assets.

c. Leverage Ratio Disclosure

The Liquidity Release provides guidance on MD&A disclosures of capital or leverage ratios that is intended to aid investors in more clearly understanding the presentation of such ratios. The SEC addressed ratios that are either not required by a regulation, or that are modified from the ratio that is prescribed by a regulation.

In addition, registrants are advised to consider whether or not a ratio presented is a financial or non-financial measure. If the measure is a non-financial measure, such as an industry or value metric, then the Liquidity Release refers readers to the guidance on such measures set forth in a 2003 interpretive release on MD&A. The 2003 MD&A Release stated that, “[w]here a company discloses [non-financial measures], and there is no commonly accepted method of calculating a particular non-financial metric, it should provide an explanation of its calculation to promote comparability across companies within the industry.” If a ratio is a financial measure, then the Liquidity Release reminds registrants of the SEC requirements for the presentation of non-GAAP financial measures in SEC filings. Registrants are to determine whether the ratio being presented is a

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650. Id.
651. Id.
652. Id.
653. Id. at 59895–96.
654. Id.
655. Id.
non-GAAP financial measure, and, if so, it must comply with the requirements set forth in Item 10(e) of Regulation S-K and related SEC staff guidance. The Liquidity Release cautioned that any ratio or measure included in an SEC filing, whether a non-GAAP financial measure or not, “should be accompanied by a clear explanation of the calculation methodology.” The disclosure should also include a clear explanation of the treatment of any variables in the ratio that are “unusual, infrequent or non-recurring, or that are otherwise adjusted.” Similar to the SEC disclosure requirements for non-GAAP financial measures designed to eliminate investor confusion, the Liquidity Release noted that, if the ratio presented differs from other ratios commonly used in the registrant’s industry, then the registrant should consider including disclosure about those differences and whether a presentation of the commonly used ratios (without adjustments) would be necessary. Also, the Liquidity Release states that registrants should consider disclosing an explanation of why the ratio is useful to understanding their financial condition. Finally, where a ratio is presented in connection with disclosure about debt instruments and related covenants, the Liquidity Release refers companies to the SEC’s past guidance in the 2003 MD&A release.

**d. Guidance on Table of Contractual Obligations**

The MD&A disclosure requirement to provide tabular disclosure of contractual obligations was initially adopted in early 2003. The tabular disclosure required by Item 303(a)(5) of Regulation S-K was intended to provide investors with a “meaningful snapshot of cash requirements arising from contractual payment obligations.” The disclosure requirements were designed to be flexible to enable a registrant to reflect company-specific information in a way that is suitable to its business. In the Liquidity Release, the SEC noted that since the adoption of the contractual obligations table, there have been divergent practices among registrants for including or excluding certain items in the table, and the manner of presentation of certain items. For example, the SEC noted divergent practices in the disclosure of “interest payments, repurchase agreements, tax liabilities, synthetic leases, and obligations that arise under off-balance sheet arrangements,” in

660. 17 C.F.R. § 229.10(e) (2010).
662. Id. at 59896.
663. Id.
664. Id.
665. Id.
666. Id. at 59896 & n.15; see 2003 MD&A Release, supra note 656, 68 Fed. Reg. at 75064.
670. Id.
671. Id.
addition to purchase obligations. 672 The Liquidity Release indicated that registrants have the flexibility to make judgments about how to resolve uncertainties over whether and how to report items in the Table of Contractual Obligations. 673 Any decisions made by registrants should be consistent with the purpose of the Table of Contractual Obligations to “improve transparency of . . . short-term and long-term liquidity and capital resources needs and to provide context for investors to assess the relative role of off-balance sheet arrangements.” 674 In addition, the Liquidity Release suggests that registrants include footnotes to the contractual obligations table, or additional narrative disclosures, where necessary for an understanding of the timing and amounts of contractual payment obligations reported in the table. 675

E. SEC GUIDANCE REGARDING DISCLOSURE RELATED TO CLIMATE CHANGE

1. Background

On February 2, 2010, the SEC issued an interpretive release to provide guidance to public companies regarding the SEC’s existing disclosure requirements on climate change matters (“Climate Change Release”). 676 At the SEC’s open meeting for the Climate Change Release, 677 Chairman Mary Schapiro noted that the interpretive guidance contained in the Climate Change Release does not create new legal requirements or modify existing legal requirements. 678 Rather, the Climate Change Release was “intended to provide clarity and enhance consistency” regarding disclosure related to climate change. 679 Furthermore, Chairman Schapiro reiterated that the SEC is not taking a position on the environmental debate regarding climate change. 680

2. Recent Regulatory, Legislative, and Other Developments Regarding Climate Change

The Climate Change Release discusses recent regulatory and legislative developments regarding climate change, 681 and then it addresses how those develop-
ments should be analyzed within the context of the SEC’s existing disclosure regulations.\textsuperscript{682} In particular, the Climate Change Release discusses the following climate change developments:

- Proposed legislation designed to reduce greenhouse gas emissions, including “cap and trade” legislation;\textsuperscript{683}
- Regulatory actions taken by the Environmental Protection Agency to require reporting of greenhouse gas emissions and possible direct regulation under the Clean Air Act;\textsuperscript{684}
- International initiatives, such as the Kyoto Protocol, the European Union Emissions Trading System, and the United Nations Climate Conference in Copenhagen;\textsuperscript{685} and
- The National Association of Insurance Commissioners’ uniform standard for mandatory disclosure by insurance companies to state regulators of financial risks due to climate change and actions taken to mitigate them.\textsuperscript{686}

In addition to regulatory and legislative developments, the Climate Change Release notes that there may be business and market impacts related to climate change.\textsuperscript{687} For example, the SEC notes that climate change matters could have a significant effect on operating and financial decisions, including:

- Capital expenditures to reduce greenhouse gas emissions;\textsuperscript{688}
- Expenses related to purchasing allowances under “cap and trade” systems;\textsuperscript{689}
- Changes to prices for goods and services due to the effects of climate change;\textsuperscript{690} and
- Opportunities created by new trading markets for emission credits under “cap and trade” programs.\textsuperscript{691}

Finally, the Climate Change Release notes that “there may be significant physical effects of climate change that have the potential to have a material effect on a registrant’s business and operations.”\textsuperscript{692}

3. Sources of Climate Change-Related Disclosures

The Climate Change Release observes the increasing calls for climate-related disclosures by institutional investors, corporate governance groups, and state
prosecutors and it discusses disclosure initiatives outside of the SEC rules that result in the publication of information about greenhouse gas emissions and climate change risks.\textsuperscript{693} The SEC received several rulemaking petitions for interpretive guidance regarding climate change disclosures.\textsuperscript{694} The SEC discussed the settlements between the New York Attorney General’s Office and heavy greenhouse gas emitters Xcel Energy, Dynegy Inc., and AES Corporation.\textsuperscript{695} That settlement agreement required those companies to disclose a significant amount of information about their greenhouse gas emissions and climate change risks in their Exchange Act annual reports.\textsuperscript{696} In addition, the Climate Change Release discusses the voluntary disclosure initiatives and other regulatory requirements regarding climate change disclosure, such as the Climate Registry, the Carbon Disclosure Project, and the Global Reporting Initiative.\textsuperscript{697} The Climate Change Release cautions registrants to be aware of information that they are reporting outside of their SEC filings that may also be required to be reported in SEC filings pursuant to existing SEC disclosure requirements.\textsuperscript{698}

4. Overview of Rules Requiring Disclosure of Climate Change Issues

The Climate Change Release provides a description of the pertinent non-financial statement SEC disclosure rules that may require disclosure related to climate change:\textsuperscript{699}

- Item 101 of Regulation S-K\textsuperscript{700} requires a registrant to describe its business, and Item 101(c)(1)(xii) expressly requires disclosure regarding certain costs of complying with environmental laws.\textsuperscript{701}
- Item 103 of Regulation S-K\textsuperscript{702} generally requires a registrant to describe briefly any material pending legal proceedings, other than ordinary routine litigation incidental to its business, and Instruction 5 to Item 103 specifically requires disclosure regarding certain “administrative or judicial proceeding[s] . . . arising under any Federal, State or local” environmental laws, even if such proceeding would have otherwise been considered “ordinary routine litigation incidental to its business.”\textsuperscript{703}

\textsuperscript{693} Id. at 6291–92.
\textsuperscript{694} See id. at 6291 n.20.
\textsuperscript{695} Id. at 6291–92.
\textsuperscript{696} Id. at 6292.
\textsuperscript{697} Id.
\textsuperscript{698} Id.
\textsuperscript{699} Id. at 6293.
\textsuperscript{700} 17 C.F.R. § 229.101 (2010).
\textsuperscript{701} Climate Change Release, supra note 676, 75 Fed. Reg. at 6293.
\textsuperscript{702} 17 C.F.R. § 229.103 (2010).
\textsuperscript{703} Climate Change Release, supra note 676, 75 Fed. Reg. at 6293–94.
• Item 503(c) of Regulation S-K\textsuperscript{704} requires a registrant to provide “under the heading ‘Risk Factors[,]’ a discussion of the most significant factors that make an investment in the registrant speculative or risky.”\textsuperscript{705}

• Item 303 of Regulation S-K,\textsuperscript{706} which is known as “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” or “MD&A,” requires disclosure of known trends, events, demands, commitments, and uncertainties that are reasonably likely to have a material effect on the registrant’s financial condition or results of operations.\textsuperscript{707} The Climate Change Release includes a significant discussion on MD&A disclosure, which is discussed in more detail below.

The Climate Change Release also notes that the disclosure obligations of foreign private issuers generally parallel the disclosure requirements for domestic issuers discussed above, although in some cases they are not as prescriptive as the provisions applicable to domestic issuers.\textsuperscript{708}

5. Management’s Discussion and Analysis Disclosure of Climate Change Matters

The Climate Change Release notes that the MD&A disclosure requirements are flexible enough to allow disclosures to keep pace with the evolving nature of business trends without the need to amend continuously the text of the rule.\textsuperscript{709} The Climate Change Release reminds registrants that identifying and evaluating known trends, events, demands, commitments, and uncertainties for possible disclosure in MD&A involves the following:

• Consideration of financial, operational and other information known to the registrant;
• Identification, based on this information, of known trends and uncertainties; and
• Assessment of whether these trends and uncertainties will have, or are reasonably likely to have, a material impact on the registrant’s liquidity, capital resources or results of operations.\textsuperscript{710}

The SEC notes that the particular time horizon for each registrant to consider in assessing the impact of a known trend, event, or uncertainty that is reasonably likely to occur will depend on a registrant’s particular circumstances and the particular trend, event, or uncertainty under consideration.\textsuperscript{711} In addition,
in light of technological and communications advances, the Climate Change Release indicates that registrants should be considering a greater universe of financial and non-financial information about trends, events, or uncertainties, even if such information is not ultimately included in the MD&A disclosure. The Climate Change Release adds that a registrant’s disclosure controls and procedures should be sufficient to capture and process this greater universe of information.

The Climate Change Release notes the importance of a registrant’s materiality determinations in MD&A disclosure, and it reiterates the 1989 MD&A framework for preparing MD&A disclosure. Under that framework, once management identifies a known trend, demand, commitment, event, or uncertainty, it must assess whether the known trend, demand, commitment, event, or uncertainty is likely to come to fruition. If management determines that the known trend, demand, commitment, event, or uncertainty is not reasonably likely to occur, then no disclosure is required. If management cannot determine that the known trend, demand, commitment, event, or uncertainty is not reasonably likely to occur, then “it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant’s financial condition or results of operations is not reasonably likely to occur.”

In addition, the Climate Change Release states “[r]egistrants should address, when material, the difficulties involved in assessing the effect of the amount and timing of uncertain events, and provide an indication of the time periods in which resolution of the uncertainties is anticipated.” Finally, the SEC cautions that registrants must also disclose any other information in MD&A that is necessary to an understanding of their financial condition, changes in financial condition, and results of operations.

6. Potential Triggers for Disclosure About Climate Change Matters

In the Climate Change Release, the SEC provides the following examples of areas where climate change may trigger disclosure requirements under the rules discussed above:

712. Id. at 6294–95.
713. See id. at 6295.
714. Id. at 6294–95.
717. Id.
718. Id.
719. Id.
720. Id.
• Impact of Legislation and Regulation: When assessing potential disclosure obligations, a company should consider whether the impact of certain existing laws and regulations regarding climate change is material.\textsuperscript{721} In certain circumstances, a company should also evaluate the potential impact of pending legislation and regulation.\textsuperscript{722}

• Impact of International Accords: A company should consider, and disclose when material, the risks or effects on its business of international accords and treaties relating to climate change.\textsuperscript{723}

• Indirect Consequences of Regulation or Business Trends: “Legal, technological, political and scientific developments regarding climate change may create new opportunities or risks for [companies].”\textsuperscript{724} For instance, a company may face “[d]ecreased demand for goods that produce significant greenhouse gas emissions” or “[i]ncreased demand for goods that result in lower emissions than competing products.”\textsuperscript{725} As such, a company should consider, for disclosure purposes, the actual or potential indirect consequences it may face due to climate change-related regulatory or business trends.\textsuperscript{726}

• Physical Impacts of Climate Change: Companies should also evaluate for disclosure purposes the actual and potential material impacts of environmental matters on their businesses.\textsuperscript{727}

7. Conclusion

The Climate Change Release notes that the SEC will monitor companies’ disclosures on climate change matters as part of its ongoing disclosure review program.\textsuperscript{728} The SEC indicates that it will consider its experience with the disclosure review program, together with any advice or recommendations of the SEC’s recently formed Investor Advisory Committee, to “determine whether further guidance or rulemaking relating to climate change disclosure is necessary or appropriate in the public interest or for the protection of investors.”\textsuperscript{729}

F. Amendments to Rule 10b-18

On January 25, 2010, the SEC proposed amendments to Rule 10b-18 under the Exchange Act,\textsuperscript{730} which provides an issuer and certain others with a non-
exclusive “safe harbor” from liability for manipulation “when they repurchase the issuer’s common stock in the market in accordance with [Rule 10b-18’s] manner, timing, price, and volume conditions.” The proposed amendments are intended to clarify and modernize the safe harbor provisions in light of market developments since Rule 10b-18’s adoption in 1982.

The SEC proposed the following revisions to Rule 10b-18:

1. Expand the Timing Condition

The proposal seeks to expand the current prohibition against effecting Rule 10b-18 purchases as the opening purchase reported in the regular way consolidated system to preclude Rule 10b-18 purchases as the opening purchase in the principal market for the security and in the market where the purchase is effected.

2. Relax the Price Condition for Certain VWAP Transactions

Rule 10b-18 limits an issuer to bidding for, or buying, its security at a purchase price that is no higher than the highest independent bid or last independent transaction price, whichever is higher, quoted or reported in the consolidated system at the time the purchase is effected. Many issuers have proposed being able to purchase securities based on the VWAP. The SEC disagrees with this proposal:

In order to provide issuers with additional flexibility to conduct repurchase programs using VWAP, the SEC proposes to except purchases effected on a VWAP basis from Rule 10b-18’s price condition if the following criteria are met:

- The purchase must otherwise comply with Rule 10b-18 timing and pricing conditions.
- The security is an “actively traded security,” as defined in Regulation M.

733. 17 C.F.R. § 240.10b-18(b)(2)(i).
734. 2010 Amendment to Rule 10b-18, supra note 730, 75 Fed. Reg. at 4715.
735. 17 C.F.R. § 240.10b-18(b)(3).
736. 2010 Amendment to Rule 10b-18, supra note 730, 75 Fed. Reg. at 4717.
737. Id.
738. Id. at 4728 (to be codified at 17 C.F.R. § 240.10b-18(a)(14)).
739. Id. (to be codified at 17 C.F.R. § 240.10b-18(a)(14)(i); see Regulation M, 17 C.F.R. § 242.101(c)(1) (2010).
• “The purchase is entered into or matched before the opening of the regular trading session[.]”

• “The execution price of the VWAP purchase is determined based on all regular way trades effected in accordance with [specified] conditions . . . that are reported in the consolidated system during the primary trading session for the security[.]”

• “The purchase does not exceed 10% of the security’s relevant average daily trading volume[.]”

• “The purchase is not effected for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security[.]”

• The VWAP is calculated in accordance with the provisions of the rule.

• “The purchase is reported using a special VWAP trade modifier.”

3. Limit the Disqualification Provision in Fast Moving Markets

The SEC acknowledges that the speed at which current markets move, citing “flickering quotes” specifically, has made it “increasingly difficult for an issuer to ensure that every purchase of its common stock during the day meets the rule’s current price condition.” Failure of any one of the four conditions of Rule 10b-18 with respect to any sale will disqualify all purchases during that day from the benefit of the safe harbor. The SEC proposes to “amend Preliminary Note 1 to Rule 10b-18 and paragraph (d) of the rule to limit the rule’s disqualification provision in instances where an issuer’s repurchase order is entered in accordance with the rule’s four conditions but is, immediately thereafter, executed outside of the price condition solely due to flickering quotes. In these instances, only the noncompliant purchase, rather than all of the issuer’s other Rule 10b-18 purchases for that day, would be disqualified from the safe harbor.”

740. 2010 Amendment to Rule 10b-18, supra note 730, 75 Fed. Reg. at 4728 (to be codified at 17 C.F.R. § 240.10b-18(a)(14)(ii)).
741. Id. (to be codified at 17 C.F.R. § 240.10b-18(a)(14)(iii)).
742. Id. (to be codified at 17 C.F.R. § 240.10b-18(a)(14)(iv)).
743. Id. (to be codified at 17 C.F.R. § 240.10b-18(a)(14)(v)).
744. Id. (to be codified at 17 C.F.R. § 240.10b-18(a)(14)(vi)).
745. Id. (to be codified at 17 C.F.R. § 240.10b-18(a)(14)(vii)).
746. Id. at 4720. “Flickering quotes’ occur when there are rapid and repeated changes in the current national best bid during the period between identification of the current national best bid and the execution or display of the Rule 10b-18 bid or purchase. In many active NMS stocks, the price of a trading center’s best displayed quotations can change multiple times in a single second.” Id. at 4720 n.74.
747. Id. at 4720.
748. See Preliminary Note 1 to Rule 10b-18, 17 C.F.R. § 240.10b-18 (2010).
749. 2010 Amendment to Rule 10b-18, supra note 730, 75 Fed. Reg. at 4720 (footnote omitted).
4. Modify the “Merger Exclusion” Provision for SPACs

The SEC proposes to amend the provision that extends the time in which the safe harbor is unavailable in connection with an acquisition by a special purpose acquisition company (“SPAC”) until the earlier of the completion of such transaction or the completion of the votes by the target and SPAC shareholders (not just the target’s shareholders as currently contemplated by the rule).\textsuperscript{750} SPACs were not significant when the rule was modified in 2003 to address the concern that issuers in contemplation of a shareholder vote upon a merger or acquisition may seek to repurchase shares in order to influence the vote.\textsuperscript{751} The proposal outlines the SEC’s concerns about the “heightened incentive” of a SPAC issuer to seek to purchase its shares prior to the vote of its shareholders on a merger or acquisition.\textsuperscript{752} SPAC issuers will still be able to effect limited repurchases in accordance with the rule, which reflects the SEC’s belief that limited repurchases cannot have a significant effect on the contemplated merger or other transaction.\textsuperscript{753}

In addition, the SEC proposes a number of updates to definitions and references to reflect the current provisions of Rule 10b-18.\textsuperscript{754}

G. REG AB AMENDMENTS

On April 7, 2010, the SEC issued a lengthy release (the “Reg AB Amendments Proposing Release”)\textsuperscript{755} proposing substantial modifications to the regulations affecting asset-backed securities.\textsuperscript{756}

Among the most notable of the changes that would be brought about by the proposed rules are the following:

- The elimination of the “investment grade securities” condition for shelf registration of asset-backed securities,\textsuperscript{757} and the replacement of that condition with four eligibility criteria, including, significantly, a risk-retention requirement that the sponsor or an affiliate retain a 5 percent interest in each class of offered asset-backed securities.\textsuperscript{758}
- In connection with registered public offerings of asset-backed securities, the implementation of enhanced disclosure requirements\textsuperscript{759} entailing, in

\textsuperscript{750} Id. at 4721.
\textsuperscript{751} Id.
\textsuperscript{752} Id.
\textsuperscript{753} Id.
\textsuperscript{754} Id. at 4715.
\textsuperscript{756} This Review uses the term “Item 1101 asset-backed securities” (or, unless the context requires otherwise, simply “asset-backed securities”) to refer to securities defined as asset-backed securities in Item 1101(c) of Regulation AB under the Securities Act. See 17 C.F.R. § 229.1101(c) (2010). The term “ABS,” as used in this Review, is intended to denote the broader meaning of “asset-backed securities” as that term is commonly used by securitization practitioners.
\textsuperscript{758} Id.
\textsuperscript{759} Id. at 23354.
most cases, specific, standardized data points with respect to the securitized assets.\footnote{Id. at 23358.}

- The requirement that, in registered public offerings of asset-backed securities, issuers develop and file with the SEC a “waterfall computer program” designed to enable investors to input investment assumptions and asset data in order to forecast cash flows on the offered securities.\footnote{Id. at 23378.}

- The imposition of “speed bumps” in the shelf registration offering process through the requirement that a preliminary prospectus be delivered at least five business days before the first sale of offered securities.\footnote{Id. at 23335.}

- With respect to a broad class of ABS referred to as “structured finance products” (which would include securities such as collateralized debt obligations, asset-backed commercial paper, and certain synthetic ABS), the conditioning of the use of the private sale and resale safe harbors under the Securities Act on an issuer making a covenant and representation to supply investors, on request, with disclosure that would otherwise typically be required only in registered public offerings of asset-backed securities.\footnote{Id. at 23395–97.}

The SEC is undoubtedly preoccupied with rulemaking efforts required by the enactment of the Dodd-Frank Act and, therefore, not surprisingly, has not yet issued final rules in connection with the matters covered by the Reg AB Amendments Proposing Release. A number of issues addressed by the Reg AB Amendments Proposing Release—in particular, risk retention—were the subject of the Dodd-Frank Act, which, to the extent they relate to securitization, are discussed above. It remains to be seen whether, and to what extent, final rules to be issued by the SEC in connection with the Reg AB Amendments Proposing Release will harmonize with the rules called for by the Dodd-Frank Act.

This Review will describe the more significant proposals set forth in the Reg AB Amendments Proposing Release.

2. Proposed Forms SF-1 and SF-3

The SEC is proposing to adopt new forms that would be used for the registration and sale of securities meeting the definition of an “asset-backed security,”\footnote{17 C.F.R. § 229.1101(c) (2010).} as defined in Item 1101(c) of Regulation AB.\footnote{Reg AB Amendments Proposing Release, supra note 366, 75 Fed. Reg. at 23337, 23441–48 (to be codified at 17 C.F.R. §§ 239.44 & 239.45).} Proposed Forms SF-1 and SF-3 would replace Forms S-1 and S-3, respectively, for the registration of Item 1101 asset-backed securities offerings.\footnote{Id. at 23337.} Any such offerings qualifying for shelf registration would be registered on Form SF-3 (and on no other registration state-
ment form but Form SF-3\textsuperscript{767}), and non-shelf offerings would be registered on Form SF-1.\textsuperscript{768} Form S-1 would still be available for the registration of offerings of ABS other than Item 1101 asset-backed securities.

3. Proposed Form SF-3 Shelf Registration Requirements

a. Form SF-3 Eligibility Criteria

Currently, in order for an issuer to be eligible to register an offering of Item 1101 asset-backed securities by means of a shelf registration statement on Form S-3, the securities must satisfy certain conditions, one of which is that the securities must be "investment grade securities," i.e., at the time of their sale, at least one NRSRO must have rated them in one of its four highest rating categories.\textsuperscript{769} The SEC proposes, concurrently with the adoption of Form SF-3, to eliminate the investment-grade security condition for shelf registration of asset-backed securities and replace it with four new eligibility criteria (the "SF-3 Transaction Requirements")\textsuperscript{770}:

(i) Risk Retention

The sponsor or one of its affiliates would be required to retain a "net economic interest" in any offered securities by means of one of the two following methods:

- "Retention of a minimum of five percent of the nominal amount of each of the tranches sold or transferred to investors [often referred to as a ‘vertical slice’ of the issued securities], net of hedge positions directly related to the securities or exposures taken by such sponsor or affiliate."\textsuperscript{771}

- "In the case of revolving asset master trusts [as in credit card securitizations], retention of the originator’s interest of a minimum of five percent of the nominal amount of the securitized exposures, net of hedge positions directly related to the securities or exposures taken by such sponsor or affiliate, provided that the originator’s interest and securities held by investors are collectively backed by the same pool of receivables, and payments of the originator’s interest are not less than five percent of payments of the securities held by investors collectively."\textsuperscript{772}

\textsuperscript{767} "Mortgage-related securities," as that term is defined in § 3(a)(41) of the Exchange Act, 15 U.S.C. § 78c(a)(41) (2006), are currently eligible for shelf registration regardless of form eligibility and can therefore be registered on a delayed basis on Form S-1 if not eligible for shelf registration on Form S-3. Under the SEC’s proposal, offerings of mortgage-related securities would be eligible for shelf registration only if, like other asset-backed securities, they meet the proposed Form SF-3 shelf registration eligibility criteria. See Reg AB Amendments Proposing Release, supra note 366, 75 Fed. Reg. at 23338.

\textsuperscript{768} Reg AB Amendments Proposing Release, supra note 366, 75 Fed. Reg. at 23337.

\textsuperscript{769} See General Instructions to Form S-3, 17 C.F.R. § 239.13 (2010); see also Reg AB Amendments Proposing Release, supra note 366, 75 Fed. Reg. at 23348.


\textsuperscript{771} Id. at 23339, 23444 (to be codified at 17 C.F.R. § 239.45(b)(1)(i)).

\textsuperscript{772} Id.
The “net economic interest” would be measured at the time of issuance of the securities with respect to the first method and at origination of the assets backing the securities with respect to the second method and, in each case, would need to be maintained as long as non-affiliates of the depositor held any of the securities of the issuer that were sold in the offering.\footnote{773} Hedge positions not directly related to the securities or exposures taken by the sponsor or affiliate—“hedges related to overall market movements, such as movements of market interest rates, currency exchange rates, or of the overall value of a particular broad category of asset-backed securities”—would not be required to be netted.\footnote{774} The prospectus filed as part of the registration statement would be required to provide disclosure relating to the retained interest.\footnote{775}

The SEC’s proposed risk-retention requirement has come under criticism for a number of reasons, not the least of which is its relative inflexibility, compared with the range of options available to deal with risk retention pursuant to §15G of the Exchange Act, as enacted by the Dodd-Frank Act.\footnote{776}

\begin{itemize}
\item \textbf{(ii) Third-Party Opinion Provision in Transaction Agreement}

The pooling and servicing agreement (or other securitization transaction agreement) filed with the SEC would be required to contain a provision obligating any party that had made representations and warranties relating to the pool assets (the “obligated party”) to furnish to the trustee, at least quarterly, an opinion or certificate delivered by an unaffiliated third party relating to any asset that the trustee asserted was in breach of a representation or warranty and that the obligated party declined to repurchase or replace on the basis of an assertion that the representation or warranty was not violated.\footnote{777} The purpose of the third-party opinion or certificate would be to support the obligated party’s assertion.\footnote{778} The Reg AB Amendments Proposing Release states that this shelf-eligibility criterion is “designed to help ensure that representations and warranties about assets provide meaningful protection to investors, . . . [and hence the criterion] should encourage sponsors to include higher quality assets in the asset pool.”\footnote{779}

\item \textbf{(iii) Certification of the Depositor’s CEO}

The issuer would have to file a certification (in a prescribed form that the issuer would not be permitted to vary) signed by the chief executive officer of the depositor with respect to each takedown of securities off the Form SF-3 registration statement.\footnote{780} The CEO would have to certify that he or she had reviewed the

\begin{footnotes}
\item[773] Id.
\item[774] Id. at 23340.
\item[775] Id. at 23340–41.
\item[777] Reg AB Amendments Proposing Release, supra note 366, 75 Fed. Reg. at 23344, 23444 (to be codified at 17 C.F.R. § 239.45(b)(1)(ii)).
\item[778] See id. at 23344.
\item[779] Id.
\item[780] Id. at 23345, 23444 (to be codified at 17 C.F.R. § 239.45(b)(1)(iii)).
\end{footnotes}
prospectus and applicable documents and that, to his or her knowledge, the securitized assets backing the securities had “characteristics that provide[d] a reasonable basis to believe that they would produce, taking into account internal credit enhancements, cash flows at times and in amounts necessary to service payments on the securities as described in the prospectus.”

The Reg AB Amendments Proposing Release states that this criterion is being proposed as a certification rather than as a disclosure requirement because of the SEC’s belief that requiring an individual to make the certification would cause the officer to review the disclosure and the securitization more carefully and to participate more extensively in the securitization’s oversight.

(iv) Undertaking to File Ongoing Reports

The issuer would be required to provide an undertaking to file reports that would be mandated by § 15(d) of the Exchange Act and the rules thereunder if the registrant were subject to those reporting requirements. The filing requirement would remain in effect as long as any person not affiliated with the depositor held any securities of the issuer that were sold in registered transactions (and irrespective of whether the issuer’s duty to file ongoing reports under the Exchange Act had been suspended under § 15(d) of the Exchange Act). The prospectus filed as part of the Form SF-3 registration statement would have to disclose that the issuer had made the undertaking.

b. Form SF-3 Registrant Requirements

The SEC has proposed, as additional eligibility conditions to registering asset-backed securities on Form SF-3, the following three registrant requirements (“SF-3 Registrant Requirements”), which would relate to compliance with the proposed SF-3 Transaction Requirements discussed above:

First, to the extent that, with respect to the depositor (or an issuing entity previously established by the depositor or one of its affiliates), the sponsor of the asset-backed securities transaction being registered was required, pursuant to the SF-3 Transaction Requirements relating to risk retention, to retain risk with respect to a previous asset-backed securities offering involving the same asset class, that sponsor would have to be holding that required risk at the time the registration statement was filed.

Second, “to the extent the depositor or any issuing entity previously established, directly or indirectly, by the depositor or any affiliate of the depositor was at any time during the twelve calendar months and any portion of a month immediately preceding the filing of the registration statement required to comply

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781. Id. at 23345.
782. Id.
783. Id. at 23346–47, 23444 (to be codified at 17 C.F.R. § 239.45(b)(1)(iv)).
784. Id.
785. Id.
786. Id. at 23348.
787. Id. at 23348, 23444 (to be codified at 17 C.F.R. § 239.45(a)(1)).
with the other transaction requirements of Form SF-3 [the ‘look-back period’], with respect to a previous offering of securities involving the same asset class,” the depositor and each such issuing entity would be required (i) to have filed, on a timely basis, all transaction agreements and certifications required by the SF-3 Transaction Requirements and (ii) to have “filed all the reports that they had undertaken to file during the previous twelve months (or such shorter period during which the depositor or issuing entity had undertaken to file reports) as would be required under [§] 15(d) of the Exchange Act” if the depositor and issuing entities had been subject to those reporting requirements.\textsuperscript{788}

Third, the Form SF-3 registration statement would have to contain disclosure stating that the registrant had complied with the SF-3 Registrant Requirements described in the two preceding paragraphs.\textsuperscript{789}

c. Preliminary Prospectus in Takedown Off Form SF-3 Registration Statement

The SEC has proposed the adoption of Rule 430D, which would replace current Rule 430B to the extent that Rule 430B provides the framework for shelf offerings of asset-backed securities.\textsuperscript{790} Rule 430D would allow the form of prospectus filed as part of a Form SF-3 registration statement to omit “information that is unknown or not reasonably available to the issuer”—i.e., offering-specific information—provided that the issuer subsequently filed with the SEC a preliminary prospectus (“424(h) prospectus”) containing substantially all of the omitted information (except for “information with respect to the offering price, underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds or other matters dependent upon the offering price”) at least five business days before the first sale of securities in the offering in accordance with Rule 424(h).\textsuperscript{791} If the 424(h) prospectus were used more than five business days before the first sale, it would have to be filed by the second business day after first use.\textsuperscript{792}

Any material change in the information provided in the 424(h) prospectus, other than price, would need to be reflected in a new 424(h) prospectus and would trigger an additional period of five business days before the offered securities could be sold.\textsuperscript{793}

The 424(h) prospectus would be deemed part of and included in the registration statement as of the date the prospectus was filed with the SEC or, if used earlier than the date of filing, the date it was first used after effectiveness.\textsuperscript{794} The final prospectus filed with the SEC would be deemed to be part of and included in the registration statement on the earlier of the date it was first used or the date

\textsuperscript{788} Id. (to be codified at 17 C.F.R. § 239.45(a)(2)).
\textsuperscript{789} Id. (to be codified at 17 C.F.R. § 239.45(a)(3)).
\textsuperscript{790} Id. at 23336.
\textsuperscript{791} Id. at 23336, 23437 (to be codified at 17 C.F.R. § 230.430D(a)(1)).
\textsuperscript{792} Id. at 23335.
\textsuperscript{793} Id. at 23335, 23437 (to be codified at 17 C.F.R. § 230.430D(a)(2)).
\textsuperscript{794} Id.
and time of the first contract of sale of securities in the offering. For purposes of liability under § 11 of the Securities Act of the issuer and any underwriter at that time, the date on which the final prospectus was deemed to be part of and included in the registration statement would be deemed to be a new effective date of the registration statement relating to the securities offered by the prospectus.

Proposed Rule 430D and an instruction to proposed Form SF-3 would require a single, integrated form of prospectus for each offering. The form of prospectus historically used in shelf offerings of asset-backed securities has consisted of a “base” prospectus, filed as part of the registration statement, and an offering-specific prospectus supplement. Under the SEC’s proposed rules, the base-and-supplement format would no longer be permitted.

d. 48-hour Preliminary Prospectus Delivery Requirement

“Except for securities issued under master trust structures, shelf-eligible ABS issuers generally are not reporting issuers at the time of issuance. . . . [W]ith respect to an issue of securities where the issuer has not been previously required to file reports pursuant to §§ 13(a) and 15(d) of the Exchange Act, unless the issuer has been exempted from the requirement to file reports . . . pursuant to § 12(h) of the Exchange Act,” Rule 15c2-8(b) under the Exchange Act provides that at least forty-eight hours before sending a confirmation of sale to any person who is expected to receive such a confirmation, a broker or dealer is required to deliver to that person a copy of the related preliminary prospectus. The rule currently does not apply to offerings of asset-backed securities eligible for registration on Form S-3. The SEC is proposing to eliminate the exception so that Rule 15c2-8(b)’s forty-eight-hour preliminary prospectus delivery requirement would apply to all issuances of Item 1101 asset-backed securities, regardless of whether the related issuers were previously subject to the Exchange Act reporting requirement. Given that Rule 430D already requires that, in a shelf offering, a 424(h) prospectus be delivered at least five business days before the first sale of securities, Rule 15c2-8(b) would not seem to pose much of an impediment to the offering process.

e. “Pay-as-You-Go” Registration Fees for Form SF-3

The SEC proposes to amend Rule 456 under the Securities Act to allow, but not require, asset-backed issuers eligible to use Form SF-3 to pay filing fees as

795. Id.
796. Id.
797. Id. at 23353.
798. Id. at 23351–52.
799. Id. at 23352–53.
800. Id. at 23350.
801. Id.
802. Id. at 23350–51, 23450 (to be codified at 17 C.F.R. § 240.15c2-8(b)).
803. See supra note 791 and accompanying text.
securities are taken down and offered off a shelf registration statement.\(^{804}\) (Currently, only “well-known seasoned issuers” have that option in connection with automatic shelf registration statements.\(^{805}\)) Under the proposal, payment of the registration statement filing fee could be deferred until the filing of a Rule 424(h) prospectus.\(^{806}\)

\hspace{1cm} f. Additional SF-3 Registration Statement Requirements

Any sponsor with a shelf registration statement that includes multiple base prospectuses—each for a different asset class, and each with its own depositor—would no longer be able to include multiple depositors under the proposed rules, which would require each depositor to file a separate SF-3 registration statement corresponding to a single asset class.\(^{807}\) Similarly, issuers could add new structural or credit-enhancement features only by post-effective amendment and not by filing a Rule 424(b) prospectus.\(^{808}\)

\hspace{1cm} 4. Enhanced Disclosure Requirements

\hspace{1.5cm} a. Asset-Level Data and Grouped Account Data

With certain exceptions, the SEC is proposing to require specific asset-level information, in a standardized format, in the offering materials and post-offering periodic reports with respect to each asset in the pool of assets underlying an issuance of Item 1101 asset-backed securities.\(^{809}\)

Proposed Schedule L (Item 1111A) of Regulation AB would enumerate all of the asset-level data points required to be provided for each asset underlying asset-backed securities in connection with the offering of asset-backed securities.\(^{810}\) Item 1111(h)(1) of Regulation AB would require this information to be provided as of a date (to be referred to in Item 1111(h) as the “measurement date”) that is designated by the registrant and is as “recent [as] practicable,” at the time of filing the Rule 424(h) prospectus (in the case of a takedown off a shelf registration) or the prospectus filed with a Form S-1 registration statement.\(^{811}\) In order for investors to “receive a data file with final pool information at the time of the offering, . . . an updated Schedule L, as of the cut-off date for the securitization, [would] be provided with the final prospectus under Rule 424(b).”\(^{812}\) To facilitate investors’ use of asset data files, the data would be filed on EDGAR in Extensible Markup Language

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\(^{804}\) Id. at 23353–54, 23438–39 (to be codified at 17 C.F.R. § 230.456(c)(1)).


\(^{806}\) Reg AB Amendments Proposing Release, supra note 366, 75 Fed. Reg. at 23354, 23439 (to be codified at 17 C.F.R. § 230.456(c)(1)).

\(^{807}\) Id. at 23353.

\(^{808}\) Id.

\(^{809}\) Id. at 23355.

\(^{810}\) Id. at 23356, 23422–28 (to be codified at 17 C.F.R. § 229.1111A).

\(^{811}\) Id. at 23356, 23422 (to be codified at 17 C.F.R. § 229.1111(h)).

\(^{812}\) Id.

\(^{813}\) Id. at 23356.
Updates to the Schedule L information (including in the case of post-closing additions to the asset pool) would be required under revised Item 6.05 of Form 8-K. In each of the foregoing cases, the Schedule L data would be filed as an exhibit to Form 8-K, pursuant to proposed Item 6.06.

The SEC’s apparent intent in proposing a data point disclosure requirement is to indicate the quality of the obligor or the asset origination process, thereby enabling investors to perform better prepayment analysis or credit analysis and facilitating informed investment decisions.

In general, every issuer would be required to provide the twenty-eight data points listed under “Item 1. General” of Schedule L, including information such as origination date, original loan amount, asset maturity date, amortization term, and interest rate. The “Item 1. General” data points entail basic characteristics of assets that the SEC has stated it feels would be useful to investors in asset-backed securities across all asset classes.

Class-specific data points would also be required for ten specified asset classes: residential mortgage loans, commercial mortgage loans, auto loans, auto leases, equipment loans, equipment leases, student loans, floorplan financings, corporate debt, and resecuritizations. The number and character of data points would vary with each asset class, ranging from five data points for equipment loans to 137 for residential mortgage loans.

Credit cards and charge cards (collectively, for purposes of the Reg AB Amendments Proposing Release and this Review, “credit cards”) would be excluded from the asset-level data requirement because of the sheer volume of data associated with credit card securitizations. However, the issuers of asset-backed securities backed by credit cards would be required to provide grouped account data created by compressing the underlying asset-level data into combinations of standardized distributional groups using asset-level characteristics and providing specified data about the groups. The proposal for grouped account data would be in addition to the disclosure currently required with respect to the composition and characteristics of the asset pool as a whole.

Proposed Item 1111(i) and Schedule CC (new Item 1111B) of Regulation AB would describe the standardized distributional groups and the information that would be provided for each group. As in the case of Schedule L data, issuers in

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814. Id. at 23356, 23422 (to be codified at 17 C.F.R. § 229.1111(h)(3)).
815. Id. at 23356.
816. Id. at 23355.
817. Id. at 23358.
818. Id.
819. Id. at 23357.
820. Id. at 23365.
821. Id. at 23361.
822. Id. at 23360.
823. Id. at 23372, 23422 (to be codified at 17 C.F.R. § 229.1111(i)).
824. Id.
825. Id. at 23372, 23422, 23428 (to be codified at 17 C.F.R. §§ 229.1111(i), 229.1111B).
credit card securitizations would be required to provide Schedule CC data as of a recent “measurement date” at the time of filing a Rule 424(h) prospectus and at the time of filing the final prospectus under Rule 424(b). 826 “Likewise, if issuers are required to report changes to the pool under Item 6.05 of Form 8-K, updated Schedule CC data would be required.” 827 Additionally, because the composition of the asset pool underlying a credit card securitization varies over time, the SEC has proposed that an updated Schedule CC be filed with each periodic report on Form 10-D. 828

b. Asset-Level Ongoing Reporting Requirements

In addition to requiring asset-level information at the time of an offering of asset-backed securities, the SEC is “proposing to require [standardized] asset-level performance information . . . [to be] filed on EDGAR in periodic reports required under §§ 13 and 15(d) of the Exchange Act, including those required pursuant to the new undertaking to continue reporting, as described above. The proposed asset-level performance data in periodic reports would differ from [asset-level] information that would be required at the time of the offering” by focusing, for example, “on whether an obligor is making payments as scheduled, the efforts by the servicer to collect amounts past due, and the losses that may pass on to the investors.” 829

Proposed Item 1121(d) and Schedule L-D (new Item 1121A) disclosure would be required at the time each periodic distribution report on Form 10-D was required to be filed. 830 “Periodic reports on Form 10-D are required to be filed within 15 days after each required distribution date on the asset-backed securities.” 831 The disclosure of assets “added to the pool during the reporting period, either through prefunding periods, revolving periods or substitution, . . . would be required under proposed revisions to Item 6.05 on Form 8-K. Similarly, the Schedule L data contained in proposed Item 1111A would need to be provided.” 832

The same asset classes would be required for Schedule L-D as for Schedule L. 833 As with the proposed asset-level information at the time of the offering, most issuers would be required to provide the forty-six data points listed under “Item 1. General” of Schedule L-D. 834 Data points would be required, to the extent applicable, for the same asset classes for which asset-level information is required under Schedule L. 835 The number and character of these data points would vary with each asset class, ranging up to 151 data points for residential mortgage loans. 836

826. Id.
827. Id. at 23372.
828. Id.
829. Id.
830. Id. at 23367–68, 23430–35 (to be codified at 17 C.F.R. §§ 229.1121(d), 229.1121A).
831. Id.
832. Id. at 23368.
833. Id.
834. Id.
835. Id.
836. Id.
For the same reasons relating to proposed asset-level data at the time of the offering, the SEC is proposing to exclude asset-backed securities backed by credit cards from the requirement to provide ongoing asset-level data in periodic reports and to require grouped account data instead. Because the composition of the asset pool underlying a credit card securitization varies over time, an updated Schedule CC would be required to accompany the filing of each periodic report on Form 10-D.

Under the SEC’s proposal, stranded cost securitizations would be excluded from both the Schedule L and Schedule L-D asset-level data requirements because of the nature of the underlying assets.

c. Waterfall Computer Program

The SEC is proposing to require that most asset-backed securities issuers create and file a computer program that gives effect to the priority-of-payment, or “waterfall,” provisions in the relevant transaction agreements of each securitization. The program would be required to enable its users to “programmatically input” (i) the Schedule L, L-D, and CC XML data files described above and (ii) “the user’s own assumptions regarding the future performance and cash flows from the pool assets [underlying the asset-backed securities], including but not limited to assumptions about future interest rates, default rates, prepayment speeds, [and] loss-given-default rates.” Issuers would be required to file, as part of the waterfall computer program, “a sample expected output for each ABS tranche based on sample inputs provided by the issuer.” The sample inputs and outputs would be intended to confirm that the program was functioning and would not serve to make any representations about the actual expected performance of the securitization. The computer program would be filed on EDGAR in the form of downloadable source code in Python, an open source interpreted programming language. The filing would be made as an exhibit to Form 8-K in accordance with new Item 6.07. The Form 8-K would then also be incorporated by reference into the registration statement.

The Reg AB Amendments Proposing Release contemplates that an investor would download the source code for the waterfall computer program and run it on the investor’s own computer. The program would yield, as output, “resulting
cash flows associated with the asset-backed securities, including the amount and timing of principal and interest payments payable or distributable to a holder of each class of securities and each other person or account entitled to payments or distributions in connection with the [asset-backed securities] securities." 849  The Reg AB Amendments Proposing Release states that by facilitating analysis of an investment in the asset-backed securities and enhancing the investor’s ability to monitor the asset-backed securities’s ongoing performance by periodically updating its investment analysis to reflect updated asset performance, the waterfall computer program requirement would enable market participants to conduct their own evaluations of asset-backed securities and therefore be less dependent on the analysis of third parties such as credit rating agencies. 850

Issuers would be required to provide the waterfall computer program at the time of filing the Rule 424(h) prospectus, in the case of a takedown off a shelf registration statement, and, in any event, at the time of filing the final prospectus under Rule 424(b) as of the date of the filing. 851

Registrants with respect to credit card master trusts would be required to report changes to the waterfall computer program on Form 8-K and to file an update to the program as an exhibit. 852  They would also be required to provide, concurrently, updated Schedule CC grouped account data, in order to enable investors to “evaluate the effect of the change in the flow of funds using the updated underlying pool information.” 853

d.  Pool-Level Information

Item 1111 of Regulation AB outlines certain aspects of the pool assets that should be covered by the prospectus disclosure. 854  The SEC proposes to amend Item 1111 as follows:

- To specify that disclosure on the underwriting of assets that deviate from the criteria disclosed in the prospectus would have to “be accompanied by specific data on the amount and characteristics of those assets that did not meet the disclosed standards. To the extent that disclosure was provided regarding compensating or other factors, if any, that were used to determine that the assets should be included in the pool, despite not having met the disclosed underwriting standards, the issuer would be required to specify the factors that were used and provide data on the amount of assets in the pool that are represented as meeting those [compensating or other] factors” and the amount of assets not meeting such factors. 855
• To require disclosure of the steps undertaken by an originator “to verify the information used in the solicitation, credit-granting or underwriting of the pool assets.”

• To require disclosure as to whether any representations and warranties related to fraud in the origination of the assets had been made and, if so, a description of those representations and warranties.

\[856.\] Id. at 23377, 23422 (to be codified at 17 C.F.R. § 229.1111(a)(5)).

\[857.\] Id. (to be codified at 17 C.F.R. § 229.1111(e)).

\[858.\] Id. at 23384.

\[859.\] Id. at 23385, 23421 (to be codified at 17 C.F.R. § 229.1105).

\[860.\] Id. (to be codified at 17 C.F.R. § 229.1105(a)(3)(iv)).

\[861.\] Id. (to be codified at 17 C.F.R. § 220.1105(c)).

\[862.\] Id. (to be codified at Instruction to Item 1105(a)(3)(ii), 17 C.F.R. § 229.1105(a)(3)(ii)).

\[863.\] Id.

instead of by filing the information with the prospectus on EDGAR.  

Under the proposed amendment of Rule 312 of Regulation S-T, all static pool information would have to be filed on EDGAR, but issuers would be permitted to make the filings, as official filings, in Portable Document Format (PDF).


f. Additional Disclosures with Respect to Transaction Parties

(i) Identification of Originators

Under Regulation AB, an issuer is currently required to disclose the identity of originators (unless the sponsor or its affiliates are originators) only if the originator has originated, or expects to originate, 10 percent or more of the pool assets.

The SEC proposes to amend Item 1110(a) of Regulation AB to require disclosure of the identification of each originator if the cumulative amount of assets originated by parties other than the sponsor or its affiliates is equal to or greater than 10 percent of the total pool assets.

(ii) Information on Asset Repurchases

For any sponsor or 20 percent originator (as defined below) that was required to repurchase or replace a pool asset for breach of a representation and warranty under the securitization transaction agreements (an “obligated party”), proposed amendments to Items 1104 and 1110 of Regulation AB would require disclosure of the following information, on a pool-by-pool basis:

- The amount, if material, of publicly securitized assets originated or sold by the sponsor or a 20 percent originator that were the subject of a repurchase or replacement demand made in the prior three years, pursuant to the transaction agreements, for breach of the representation and warranties concerning the pool assets.

- Of the amount in the preceding bullet point, the percentage not then repurchased or replaced by the sponsor or 20 percent originator (as applicable).

Of those assets not then repurchased or replaced, the issuer would be required to disclose whether an opinion of a third party not affiliated with the sponsor or 20 percent originator (as applicable) had been furnished to the trustee confirming that the assets did not violate the representations and warranties. A “20% originator” is an originator that has originated, or is expected to originate, 20 percent or more of the assets.
(iii) Financial Information Regarding Party Obligated to Repurchase Assets

The proposed amendments to Items 1104 and 1110, referred to above, would also require disclosure, with respect to an obligated party, of the financial condition of the sponsor or 20 percent originator (as applicable) to the extent that there was a material risk that the financial condition could: (i) have a material impact on the sponsor’s or 20 percent originator’s ability to comply with the transaction agreement provisions relating to the obligation to repurchase those assets; (ii) with respect to the financial condition of the sponsor, otherwise materially impact the pool; or (iii) with respect to the financial condition of a 20 percent originator, have a material impact on the origination of the 20 percent originator’s assets. 874

(iv) Economic Interest in the Transaction

The SEC is proposing to revise Items 1104, 1108, and 1110 of Regulation AB to require disclosure of any interest retained by the sponsor, any servicer, or any 20 percent originator, including the amount and nature of the interest. 875 This disclosure requirement applies to both shelf and non-shelf offerings. 876 However, if the offering was registered on Form SF-1, the proposed rules would require the issuer to disclose clearly that the sponsor was not required by law to retain any interest in the securities and would be permitted to sell, at any time, any interest initially retained. 877

g. Proposed Revisions to the Definition of “Asset-Backed Security”

Currently, only ABS that are Item 1101 asset-backed securities are eligible for shelf registration on Form S-3. 878 An “asset-backed security” under Item 1101(c) of Regulation AB is a security that, subject to satisfying certain other requirements, is “primarily serviced by the cash flows of a discrete pool of receivables or other financial assets.” 879 From the time Regulation AB was adopted, the “discrete pool” requirement has been subject to certain exceptions, which the SEC is proposing to limit in three distinct circumstances, as follows:

- Master trusts not supported by assets that arise out of revolving accounts would no longer qualify for the exception to the “discrete pool” requirement. 880

- Securitizations that contemplate a revolving period where cash flows from the pool assets may be used to acquire additional pool assets would still

874. Id. at 23382, 23421 (to be codified at 17 C.F.R. §§ 229.1104(f), 229.1110(b)).
875. Id. at 23383, 23420–21 (to be codified at 17 C.F.R. §§ 229.1104, 229.1108 & 229.1110).
876. Id. at 23383.
877. Id.
878. See General Instructions to Form S-3, 17 C.F.R. § 239.13 (2010); 17 C.F.R. § 229.1100 (2010).
879. 17 C.F.R. § 229.1101(c) (2010).
qualify for the exception (if the unamended conditions to the exception are otherwise satisfied) so long as, for securities backed by receivables or other financial assets that do not arise under revolving accounts, the revolving period does not extend for more than one year from the date of issuance of the securities.\footnote{Id. at 23389–90.} (The only change is that the exception currently permits a three-year revolving period.)

- The amount of prefunding permitted by the exception is currently limited to 50 percent of the proceeds of the related securities offering or, in the case of master trusts, 50 percent of the aggregate principal balance of the total asset pool whose cash flows support the asset-backed securities.\footnote{Id. at 23390.} Under the proposed rules, the pre-funding amount ceilings would be lowered to 10 percent.\footnote{Id.}

5. Exchange Act Reporting Proposals

a. Form 8-K

(i) Changes in Material Pool Characteristics

Item 6.05 of Form 8-K currently provides, with respect to an offering of asset-backed securities registered on Form S-3, that “if any material pool characteristic of the actual asset pool at the time of issuance of the securities differs by 5 percent or more (other than as a result of the amortization of the pool assets converting to cash in accordance with their terms) from the description of the asset pool in the prospectus filed for the offering pursuant to Securities Act Rule 424, the issuer must provide certain disclosure regarding the actual asset pool.”\footnote{Id. at 23392.} Under the proposed rules (and with respect to Form SF-3), the percentage would be lowered to 1 percent.\footnote{Id.} As proposed to be revised, Item 6.05 of Form 8-K would also require “a description of the changes that were made to the asset pool, including the number of assets substituted or added to the asset pool.”\footnote{Id.} The Reg AB Amendments Proposing Release notes that except for assets acquired through pre-funding, the pool assets should be as described in the prospectus and that significant changes in pool asset composition, although described in compliance with the requirements of Form 8-K, may not have been adequately conveyed at the time of sale for the purpose of Securities Act Rule 159.\footnote{Id. at 23393.}

(ii) Change in Sponsor’s Interest in the Securities

The SEC is proposing to add a new Item 6.09 to Form 8-K to require the filing of a Form 8-K report to describe any material change in the sponsor’s interest in the related securities.\footnote{Id. at 23392–93.}
b. Ongoing Reporting of Information on Asset Repurchases

The SEC is proposing a new reporting requirement that is similar to the proposed disclosure requirement described under “Information on Asset Repurchases” above, except that it would apply to all originators, not just 20 percent originators. For any sponsor or originator that was required to repurchase or replace a pool asset for breach of a representation and warranty under the securitization transaction agreements (an “obligated party”), the proposed amendment to Item 1121 of Regulation AB would require disclosure of the following information in the distribution report on Form 10-D:

- The amount, if material, of publicly securitized assets originated or sold by the sponsor or originator that were the subject of a repurchase or replacement demand made pursuant to the transaction agreements, in the period covered by the report, for breach of the representations and warranties concerning the pool assets.
- Of the amount in the preceding bullet point, the percentage not then repurchased or replaced by the sponsor or originator (as applicable).

Of those assets not then repurchased or replaced, the issuer would be required to disclose whether an opinion of a third party not affiliated with the sponsor or 20 percent originator (as applicable) had been furnished to the trustee confirming that the assets did not violate the representations and warranties. A “20% originator” is an originator that has originated, or is expected to originate, 20 percent or more of the assets.

c. Servicer’s Assessment of Compliance with Servicing Criteria

The Form 10-K report of an asset-backed securities issuer is required by Item 1122 of Regulation AB to contain, among other things, an assessment of compliance with servicing criteria by each party participating in the servicing function. The servicer’s assessment is filed as an exhibit to the report, and the body of the Form 10-K report must also contain disclosure regarding material instances of non-compliance with servicing criteria.

The servicer’s assessment is required to be made at the servicing platform level, rather than with respect to individual transactions, and a particular servicer may provide servicing for several unaffiliated issuers. Consequently, the servicer’s assessment is expected to be made with respect to all asset-backed securities trans-
actions that involve that servicer and that are backed by assets of the type backing the asset-backed securities covered by the Form 10-K report. 897

Because a servicer’s assessment relating to several issuers backed by the same type of assets will be filed as an exhibit to each issuer’s Form 10-K, it may not be evident whether any material instance of non-compliance with the servicing criteria set forth in Item 1122 relates to the asset-backed securities that are the subject of the Form 10-K report. 898 The SEC has therefore proposed requiring that, “along with disclosure of material instances of noncompliance with servicing criteria, the body of the [10-K] report also disclose whether identified instance[s] of noncompliance[, if any,] involved the servicing of the assets backing the asset-backed securities covered in the particular Form 10-K report.” 899 The proposed rules would also require that the body of the 10-K report discuss any steps taken to remedy any such material instances of non-compliance previously identified by an asserting party for its platform-level activities. 900 “This disclosure would be required whether or not the instance of noncompliance involved the servicing of assets backing the securities covered in the particular Form 10-K.” 901

6. Privately Issued ABS

The SEC is proposing major revisions to the Securities Act safe harbors for exempt offerings and resales of ABS. 902 First, the enhanced disclosure requirements discussed above with respect to public offerings of asset-backed securities registered on Form SF-1 or Form SF-3 would effectively be extended to securitization sales or resales, as applicable, made in reliance on Rule 144A, on Rule 144, 903 or on Rule 506 of Regulation D 904. Second, the new safe harbor provisions would apply to “structured finance products,” a term that would not be limited to “asset-backed securities” within the meaning of Item 1101 of Regulation AB but would apparently encompass virtually all asset classes considered to be “asset-backed securities” in the broader sense of that term as commonly used in securitization parlance. 905

The revisions to the safe harbors would apply to “structured finance products,” a term that would be broadly defined to include (i) synthetic ABS and (ii) “fixed-income or other securit[ies] collateralized by any pool of self-liquidating financial assets, such as loans, leases, mortgages, and secured or unsecured receivables that entitle[] [their] holders to receive payments that depend on the cash flow from

897. See id.
898. Id.
899. Id. at 23391, 23435 (to be codified at 17 C.F.R. § 229.1122(c)).
900. Id.
901. Id. at 23391.
902. Id. at 23393.
903. The proposed revisions to Rule 144 would apply only if (i) the seller relying on that rule was an affiliate of the issuer and (ii) the issuer was not subject to the reporting requirements of section 13 or § 15(d) of the Exchange Act. Id. at 23396.
904. Id. at 23393.
905. Id. at 23395.
the [underlying] assets,” including securities such as collateralized mortgage obligations, collateralized bond obligations, collateralized debt obligations, “asset-backed securities” within the meaning of Item 1101 of Regulation AB, and other securities that at the time of an offering are commonly known as asset-backed securities or structured finance products.\footnote{906. \textit{Id.} The Reg AB Amendments Proposing Release notes the SEC’s view that asset-backed commercial paper is also covered in this definition. \textit{Id.}}

The requirements of the safe harbors, as proposed to be revised, vary slightly, but in general they would require underlying securitization transaction agreements to grant purchasers and security holders (and, in the case of Rule 144 and Rule 144A, prospective purchasers designated by a security holder) “the right to obtain from the issuer promptly, upon request of the purchaser or holder,” (i) “information as would be required if the offering were registered on Form S-1 or Form SF-1 under the Securities Act” and (ii) in the case of Rule 144 and Rule 144A, “any ongoing information regarding the securities that would be required by § 15(d) of the Exchange Act if the issuer were required to file reports under that section.”\footnote{907. \textit{Id.} at 23395–96.} Additionally, issuers would be required to represent that they would provide, upon request of the purchaser or holder, information described in the preceding sentence.\footnote{908. \textit{Id.} at 23396.} The SEC has not sought to apply these requirements to pure private placements under § 4(2) or to so-called “(4-1½)” transactions.\footnote{909. \textit{Id.}}

The Reg AB Amendments Proposing Release notes that the specific disclosure that issuers would be required to provide would vary depending on the type of security offered.\footnote{910. \textit{Id.} “For an offering of structured finance products where the securities meet the Regulation AB [Item 1101(c)] definition of an asset-backed security, the disclosure requirements of Form SF-1 would apply.”\footnote{911. \textit{Id.} For offerings of structured finance products . . . [other than Item 1101(c) asset-backed securities], the requirements of Form S-1 would apply.” in which case “the issuer would be required to provide information required under Regulation AB regarding the assets and parties as well as additional information required under Regulation S-K.”\footnote{912. \textit{Id.} In any event, it is not beyond doubt that the asset-level data disclosure requirements and waterfall computer program requirement would not apply to structured finance products offered pursuant to these safe harbors.\footnote{913. \textit{Id.} If an issuer of structured finance products represented and covenanted to provide that information, and failed to provide it, Rule 192 would effectively deem that failure to provide it as a failure to comply with Rule 192.”} The SEC has proposed the adoption of Rule 192, which would require an issuer of privately issued structured finance products to provide, upon the investors’ request, information called for by the proposed revisions to the safe harbors.\footnote{914. \textit{Id.} at 23396, 23436 (to be codified at 17 C.F.R. § 230.192).}
to be "a fraud or deceit upon the purchaser." The Reg AB Amendments Proposing Release notes that if, in accordance with the proposed safe harbor revisions, the transaction agreements contained the applicable representation and covenant but the issuer failed to provide security holders or prospective purchasers, upon their request, some of the promised information, that failure would not, in and of itself, constitute a failure of the safe harbor conditions. However, investors would have recourse against the issuer under the transaction agreements, and the SEC could bring an action for violation of Rule 192.

The SEC is also proposing to require that a notice be filed with the SEC in Rule 506 sales of structured finance products and in the initial placement of structured finance products in Rule 144A transactions. Form D, which is currently the official form of notice of an offering of securities made without registration under the Securities Act in reliance on an exemption provided by Regulation D, would be amended to add an entry for structured finance products and related information (e.g., names of sponsor, principal originators, and, if applicable, servicer or collateral manager). The SEC has proposed a corresponding form of notice filing—Form 144A-SF—for initial placements of structured finance products pursuant to Rule 144A. In general, Form D currently must be filed, and Form 144A-SF would be required to be filed, not more than fifteen calendar days after the first sale of securities in the offering.

If an issuer failed to file Form D (in the case of a sale of structured finance products under Rule 506) or Form 144A-SF (in the case of a sale of structured finance products under Rule 144A), then Rule 506 and Rule 144A, as applicable, would be unavailable for subsequent sales or resales of newly issued structured finance products of the issuer (or, with respect to Form 144A-SF, affiliates of the issuer), at least, in the case of Form 144A-SF, until the notice was filed with the SEC.

7. Transition Periods

In the Reg AB Amendments Proposing Release, the SEC does not recommend an implementation or compliance date for its proposals, but it expresses its belief that compliance dates should not extend past a year after adoption of the new rules. It also states its expectation that the new rules—and it expressly mentions the proposed asset-level information requirements and the proposed changes with respect to privately issued ABS—would apply to securities that are issued after the implementation date.
Accounting Developments 2010

Distributions to Shareholders with Components of Stock and Cash

In January 2010, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2010-01, which focuses on distributions made to shareholders that contain both stock and cash components. ASU No. 2010-01 provides guidance as to how an entity should classify the stock portion of a distribution to its shareholders when such a distribution provides that a shareholder may elect to receive a certain portion of that distribution in either cash or shares.

In ASU No. 2010-01, the FASB concluded that these distributions are to be considered a share issuance. The FASB indicated that it was issuing ASU No. 2010-01 to reduce diversity in practice, noting that a discrepancy existed whereby some entities classified the stock portion of such a distribution as a new share issuance, reflected in earnings per share prospectively, while other entities treated “the stock portion of [such a] distribution as a stock dividend by retroactively restating shares outstanding and [earnings per share] for all periods presented.”

After noting that ASU No. 2010-01 would reduce the existing diversity in practice, the FASB cautioned that the amendments contained in ASU No. 2010-01 may result in differences in both accounting and reporting between United States generally accepted accounting principles (“U.S. GAAP”) and International Financial Reporting Standards. ASU No. 2010-01 is effective for both interim and annual financial periods ending after December 15, 2009, although it should be applied on a retrospective basis.

Decreases in Ownership of a Subsidiary

In January 2010, the FASB issued ASU No. 2010-02, which addresses accounting and reporting guidance for non-controlling interests and changes in

2. Id. at 1.
3. Id.
4. Id.
5. Id.
6. Id. at 2.
7. Id.
ownership interests of a subsidiary. ASU No. 2010-02 notes that change in ownership provisions in FASB Accounting Standards Codification Subtopic 810-10, Consolidation—Overall Subtopic (“Subtopic 810-10”) may provide conflicting guidance with respect to the treatment of gain or loss upon the derecognition of a subsidiary, relative to other U.S. GAAP.

In ASU No. 2010-02, the FASB amended Subtopic 810-10 to make clear that the guidance contained in Subtopic 810-10 applies to a decrease in ownership of: (i) “A subsidiary or group of assets that is a business or nonprofit activity”; (ii) “A subsidiary that is a business or nonprofit activity that is transferred to an equity method investee or joint venture”; or (iii) “An exchange of a group of assets that constitutes a business or nonprofit activity for a non-controlling interest in an entity.” Other activity, such as sales of subsidiaries in real estate or conveyances of oil and gas mineral rights, should not be treated as prescribed by Subtopic 810-10.

In addition to clarifying that the guidance in Subtopic 810-10 should not be applied to certain changes in ownership interests of a subsidiary, ASU No. 2010-02 also clarified, and increased, the disclosure a reporting entity should provide with respect to events, such as a deconsolidation of a subsidiary, or a derecognition of a group of assets, that do fall within the scope of Subtopic 810-10’s guidance. Additional disclosure includes (i) valuation techniques used by an entity to value “any retained investment in the former subsidiary or group of assets,” (ii) “[t]he nature of continuing involvement with the subsidiary or entity acquiring” the deconsolidated or derecognized assets, and (iii) the relationship, if any, between the entity deconsolidating or derecognizing such a subsidiary or assets and the entity acquiring such a subsidiary or assets.

ASU No. 2010-02 provides that the amendments contained become effective upon the adoption of an entity of the concepts embodied in Subtopic 810-10; for entities that have already adopted these concepts, the amendments in ASU No. 2010-02 are effective during the first interim or annual reporting period ending on or after December 15, 2009, and should be applied retrospectively.

**Improving Disclosures About Fair Value Measurements**

In January 2010, the FASB issued ASU No. 2010-06, which revises the guidelines for disclosures regarding fair value measurements by an entity. ASU
No. 2010-06 amends FASB Accounting Standards Codification Subtopic 820-10, Fair Value Measurements and Disclosures—Overall Subtopic (“Subtopic 820-10”) with respect to existing disclosure requirements, and it also introduces additional disclosure requirements. In ASU No. 2010-06, the FASB noted that an entity must appropriately determine the classes in which it places its assets and liabilities and provide disclosure regarding the fair value measurement for each class of assets and liabilities an entity determines exists. For fair value measurements in Level 2 and Level 3, the FASB clarified that an entity needs to disclose the valuation methods used for both recurring and nonrecurring measurements.

ASU No. 2010-06 revises Subtopic 820-10 to require reporting entities to disclose accurately “significant” transfers in and out of Level 1 and 2 assets; for Level 3 fair value measurements, the FASB advised that reporting entities should present “separate information about purchases, sales, issuances, and settlements” (that is, on a gross basis rather than as one net number). Level 3 assets are those for which significant unobservable inputs factor into the measurement of fair value.

The FASB indicated it was issuing the amendments contained in ASU No. 2010-06 due to comments it received from the users of financial statements, and that requiring an entity to provide a “greater level of disaggregated information” to the users of financial statements “would be useful.”

**SUBSEQUENT EVENTS: RECOGNITION AND DISCLOSURE REQUIREMENTS**

In February 2010, the FASB issued ASU No. 2010-09 which aims to clarify what some constituents believed was a conflict between FASB Accounting Standards Codification Topic 855, Subsequent Events (“Topic 855”) and guidance issued by the U.S. Securities and Exchange Commission (“SEC”). In ASU No. 2010-09, the FASB addresses the particular date through which certain entities should evaluate subsequent events. ASU No. 2010-09 amends Topic 855 to clarify that entities that make filings with the SEC evaluate subsequent events through the date that the financial statements are issued. Entities that do not make filings with the SEC, on the other hand, should evaluate subsequent events through the date the financial statements are available to be issued. Non-SEC

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17. Id. at 1.
18. Id.
19. Id. at 1–2.
20. Id. at 1.
21. See id.
22. Id. at 2.
24. Id. at 1.
25. Id.
26. Id.
filers, however, must disclose the particular date through which subsequent events have been evaluated.27

ASU No. 2010-09 amended Topic 855 to remove the definition of “public entity,” while adding the term “SEC filer.”28 An “SEC filer” is “[a]n entity that is required to file or furnish its financial statements with either of the following: (a) The Securities and Exchange Commission [or] (b) With respect to an entity subject to Section 12(i) of the Exchange Act . . . , the appropriate agency under that Section.”29 Additionally, ASU No. 2010-09 amended Topic 855 to note that “[f]inancial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included” within the definition of an “SEC filer.”30 Such an entity would only be required to evaluate subsequent events within the date financial statements are available to be issued.

As amended by ASU No. 2010-09, Topic 855 no longer requires an SEC filer to disclose a date in both issued and revised financial statements.31 For an entity that is not an SEC filer, but that revises its financial statements, the FASB noted that such an entity would have to disclose information about the date(s) through which subsequent events were evaluated for both the issued and revised financial statements.32 Generally, the amendments issued by the FASB in ASU No. 2010-09 became effective immediately upon release of the final update.33

**INVESTMENT FUNDS: CONSOLIDATION**

In February 2010, the FASB issued ASU No. 2010-10, which deferred the consolidation requirements of Topic 810 applicable to reporting entities for their interests in certain entities, including investment companies.34 ASU No. 2010-10 amended Subtopic 810-10 to carve out certain entities from subject to the application of the content contained in FASB Statement No. 167.35 Statement 167 contains guidance on financial reporting by “variable interest entities.”36 Through ASU No. 2010-10, the FASB indicated that the transition and effective date information related to Statement 167 shall not be applied to an entity (i) “that has all of the attributes of an investment company” as defined in FASB Accounting Stan-

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27. *Id.* at 2.
28. *Id.* at 1–2.
29. *Id.* at 4.
30. *Id.*
31. *Id.* at 2. Financial statements may be revised due to a need to correct an error in the issued financial statements or to apply retrospectively U.S. GAAP. *Id.*
32. *Id.*
33. *Id.*
36. *Id.* at i.
dards Codification Topic 946, Financial Services—Investment Companies (“Topic 946”) or (ii) “for which it is industry practice to apply measurement principles for financial reporting that are consistent with those in Topic 946.”

The amendments to Subtopic 810-10 contained in ASU No. 2010-10 note that entities that “may meet” the criteria in the paragraph above include “a mutual fund, a hedge fund, a mortgage real estate investment fund, a private equity fund, and a venture capital fund.” Additionally, the FASB also noted that “[t]he amendments may also affect reporting entities with interests in entities that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.”

Deferral is not available for entities that are securitization entities, asset-backed financing entities, or entities that were formerly considered qualifying special purpose entities. Additionally, deferral is not permitted for a reporting entity “that [has] an explicit or implicit obligation to fund losses of the entity that could potentially be significant to the entity.” In ASU No. 2010-10, the FASB stated that, in making such a determination, consideration should be given to the “legal structure of the reporting entity’s interest, the purpose and design of the entity, and any guarantees provided by the reporting entity’s related parties.” The FASB additionally noted that it would not provide guidance that could establish any “‘bright lines’ that would be used in practice as the sole factor for determining whether that obligation could potentially be significant to the entity,” but that, “if a reporting entity’s exposure to the obligations of an investment fund, such as partnership, is limited based on the legal structure of its interest, the entity may qualify for the deferral.”

The FASB indicated that the amendments in ASU No. 2010-10 “do not defer the disclosure requirements in the Statement 167 amendments to Topic 810” and that “both public and nonpublic companies are required to provide the disclosures included in Topic 810, as amended by Statement 167, for all variable interest entities in which they hold a variable interest.” Early application is not permitted, and the amendments contained in ASU No. 2010-10 are effective “as of the beginning of a reporting entity’s first annual period that begins after
November 15, 2009, and for interim periods within that first annual reporting period.\textsuperscript{45}

**Modification of Loans Contained in Pools**

In April 2010, the FASB issued ASU No. 2010-18,\textsuperscript{46} which addresses the accounting treatment associated with the increasingly common practice of loan modification and, specifically, the considerations associated when those loans form part of a pool of loans accounted for as a single asset.\textsuperscript{47} ASU No. 2010-18 amends portions of FASB Accounting Standards Codification Subtopic 310-30, Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality (“Subtopic 310-30”). The FASB noted that Subtopic 310-30 prescribes the circumstances under which an acquisition of loans with “evidence of credit deterioration” may be “accounted for in the aggregate as a pool.”\textsuperscript{48} Through ASU No. 2010-18, the FASB indicated that the critical determination in this regard is whether the acquired assets have “common risk characteristics.”\textsuperscript{49}

The FASB indicated that, when loans are accounted for as a pool, certain calculations, such as the purchase discount and the impairment analysis, are to be applied to the pool as a whole and not to individual loans.\textsuperscript{50} One of the effects of ASU No. 2010-18’s amendments to Subtopic 310-30 is to provide that “modifications of loans that are accounted for within a pool . . . do not result in the removal of those loans from the pool even if the modification of those loans would otherwise be considered a troubled debt restructuring.”\textsuperscript{51}

The FASB noted that ASU No. 2010-18 does not require any additional disclosures from a reporting entity, but made clear that it is considering credit loss disclosures and may in the future require additional disclosure for modifications of loans accounted for within pools.\textsuperscript{52} ASU No. 2010-18 should help conform the accounting treatment that reporting entities apply to the modifications of loans accounted for within pools, according to the FASB, and its amendments are effective for modifications of loans accounted for within pools occurring in the first interim or annual period ending on or after July 15, 2010.\textsuperscript{53} The FASB also is allowing a reporting entity, upon initial adoption of the guidance in ASU No. 2010-18, to “terminate accounting for loans as a pool” on a “pool-by-pool” basis, which will not “preclude an entity from applying pool accounting to subsequent acquisitions of loans with credit deterioration.”\textsuperscript{54}

\textsuperscript{45} Id. at 3.
\textsuperscript{47} Id. at 1.
\textsuperscript{48} Id.
\textsuperscript{49} Id.
\textsuperscript{50} Id.
\textsuperscript{51} Id. at 2.
\textsuperscript{52} Id.
\textsuperscript{53} Id.
\textsuperscript{54} Id. at 2–3.
CREDIT QUALITY OF FINANCING RECEIVABLES

In July 2010, the FASB issued ASU No. 2010-20,\textsuperscript{55} which requires reporting entities to provide additional disclosures regarding (i) their portfolios of financing receivables, (ii) how those portfolios are evaluated with respect to credit loss allowances, (iii) changes in credit loss allowances, and (iv) reasons for any changes in credit loss allowances.\textsuperscript{56} A “financing receivable” is a financing arrangement that “represents a contractual right to receive money” on demand, or on fixed or determinable dates, and “is recognized as an asset in an entity’s statement of financial position.”\textsuperscript{57} According to the FASB, these disclosures should be provided on a disaggregated basis, for which two levels exist: (i) “portfolio segment” and (ii) “class of financing receivables.”\textsuperscript{58} A portfolio segment is “the level at which an entity develops and documents a systematic method for determining its allowance for credit losses,” while a “class[] of financing receivables generally [is] a disaggregation of [a] portfolio segment.”\textsuperscript{59}

ASU No. 2010-10 requires the provision of additional disclosure by a reporting entity of the following information regarding financing receivables, broken down by class of financing receivables: “credit quality indicators . . . at the end of the reporting period,” “aging of past due financing receivables at the end of the reporting period,” “the nature and extent of troubled debt restructurings that occurred during the period . . . and their effect on the allowance for credit losses,” and “the nature and extent of financing receivables modified as troubled debt restructurings within the previous 12 months that defaulted during the reporting period and their effect on the allowance for credit losses.”\textsuperscript{60} ASU No. 2010-20 also requires disclosure by a reporting entity of “[s]ignificant purchases and sales of financing receivables during the reporting period,” at the portfolio segment level of disaggregation.\textsuperscript{61}

The FASB indicated that, for public entities, the amendments contained in ASU No. 2010-20 that require disclosures at the end of a reporting period will be “effective for interim and annual reporting periods ending on or after December 15, 2010,” while ASU No. 2010-20’s disclosure requirements concerning activity occurring “during a reporting period shall be effective for interim and annual reporting periods beginning on or after December 15, 2010.”\textsuperscript{62} For nonpublic entities, the amendments in ASU No. 2010-20 will be effective for annual reporting periods ending on or after December 15, 2011.\textsuperscript{63} The FASB also indicated that, while

\begin{thebibliography}{9}
\bibitem{55} Fin. Accounting Standards Bd., Accounting Standards Update No. 2010-20, Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses (July 2010).
\bibitem{56} \textit{Id.} at 1–2.
\bibitem{57} \textit{Id.} at 5–6.
\bibitem{58} \textit{Id.} at 2.
\bibitem{59} \textit{Id.}
\bibitem{60} \textit{Id.}
\bibitem{61} \textit{Id.}
\bibitem{62} \textit{Id.}
\bibitem{63} \textit{Id.}
\end{thebibliography}
the “amendments [in ASU No. 2010-20] encourage, but do not require, comparative disclosures for earlier reporting periods that ended before initial adoption,” such comparative disclosures must be provided for periods ending subsequent to initial adoption.64

**Effect on Practice**

The accounting pronouncements issued by the FASB in 2010 reflect ever-increasing scrutiny on the preparation and disclosure of information in financial statements. The FASB appears focused on increasing transparency for financial statement users and promoting the reduction of discrepancies or inconsistencies in accounting practice as utilized by reporting entities. Attorneys who work with clients in preparing financial statements should take into account these updates and alert their clients to important changes in accepted accounting practices.

Particularly, clients should be made aware that the FASB has increased the disclosure required by reporting entities with respect to their valuation methods used for both recurring and nonrecurring measurements of assets. Additionally, clients should be informed that the FASB has provided guidance on the treatment of certain credit-related matters, including modifications to loans contained within pools and financing receivables. Attorneys with clients who are considered investment companies should be aware that the FASB has issued guidance deferring the application of certain accounting treatments related to consolidation that, if implemented, could have a material impact on those clients.

Finally, clients preparing financial statements should be made aware that, as in recent years, the FASB has also taken steps to increase the amount of financial information that companies are required to disclose for both interim and annual periods.

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64. *Id.*
Caselaw Developments 2010

OVERVIEW

U.S. Supreme Court interprets two-year portion of Rule 10b-5 statute of limitations, addresses the extraterritorial reach of Rule 10b-5, limits “honest services” wire and mail fraud, considers standards applicable to claims that fees paid to mutual fund advisors violate § 36(b) of the Investment Company Act, and addresses the constitutionality of the statute creating the Public Company Accounting Oversight Board (“PCAOB”). The U.S. Supreme Court decided five cases with securities law implications in 2010. The Court held, first, that inquiry notice triggers the portion of the Rule 10b-5 statute of limitations that bars actions brought more than two years after discovery of the facts constituting the violation, that a plaintiff has inquiry notice when the facts would lead a reasonably diligent investor to investigate further, that a plaintiff thereafter has two years in which to bring the suit whether or not the plaintiff conducts an investigation, and that notice of the facts constituting the fraud include notice of facts that the defendants acted with scienter. The Court ruled, second, that Rule 10b-5 provides a private plaintiff with a cause of action only if the security that the plaintiff purchased is listed on an exchange in the United States or the purchase or sale on which the plaintiff bases the claim occurred in this country. Addressing the mail and wire fraud statutes that often underlie government prosecutions of alleged securities malefactors, the Court held, third, that those statutes are not implicated by a defendant’s breach of fiduciary duty to his or her employer except in those instances in which the defendant took a bribe or kickback. The Court ruled, fourth, that a court analyzing a claim—under § 36(b) of the Investment Company Act—should apply the substantive standard that the fees that a mutual fund adviser receives violate the adviser’s fiduciary duty if the fees are so disproportionately large that they bear no reasonable relationship to services rendered and could not have resulted from arm’s length bargaining, but also ruled that, in reviewing fees under this standard, courts should generally defer to the judgment of the fund’s board of directors, with the extent of that deference depending on such factors as the expertise of the board, how conscientiously the

1. The caselaw developments section covers cases decided through the end of November 2010. Where this portion of the annual review expresses opinions, those opinions are those of the author of the caselaw developments, William O. Fisher, and not necessarily the opinions of other authors contributing to the annual review or of members of the subcommittee producing the review or of the American Bar Association.
2. See infra notes 57–98 and accompanying text.
3. See infra notes 99–112 and accompanying text.
4. See infra notes 113–36 and accompanying text.
board reviewed the fees before approving them, and whether the manager withheld important information.\(^5\) In reviewing the law that created the PCAOB, the Court found, fifth, that the law was unconstitutional to the extent that it limited the SEC’s power to remove PCAOB members only “for good cause shown” but held that, with the excision of that one provision (which the Court separated and struck down), the statute passed constitutional muster.\(^6\)

While this large number of U.S. Supreme Court cases necessarily leads the parade, the courts of appeals also authored last year important and interesting securities opinions. The courts rendered these decisions in criminal and civil government enforcement actions, as well as private lawsuits. The subjects ranged from criminal aiding and abetting, to § 5 registration violations, to attorney liability for offering documents, to the statutory protections for forward-looking statements. The appellate courts addressed elements as diverse as loss causation, the definition of scienter, the duty to disclose, materiality, and even whether memberships in a hunting preserve were “investment contracts” within the meaning of the federal securities laws. Here is a brief overview.

Criminal cases. The Tenth Circuit held that one defendant could not be convicted for causing false statements made by a second defendant when the first defendant did not know that the second defendant was making false statements and that the first defendant could not be convicted for aiding and abetting the second defendant in making false statements when the second defendant did not know that her statements were untrue.\(^7\) The Sixth Circuit held that the government can satisfy the knowing and substantial assistance element of aiding and abetting a securities crime by proving that a defendant signed officer’s certificates that were true of themselves, while the defendant knew that the crime was ongoing and that the securities involved could not be issued without the certificates.\(^8\) The Second Circuit held that, while the government can prove knowledge of a fact sufficient for a § 32(a) conviction by showing that the defendant consciously avoided learning the fact, such a showing requires proof both that the defendant was actually aware of a high probability of the fact’s existence and that the defendant did not actually believe that the fact did not exist.\(^9\) That court reaffirmed that proof of willfulness under § 32(a) does not require evidence that the defendant understood that his or her conduct violated the law but does require evidence that he or she understood that the conduct was wrong.\(^10\) The Sixth Circuit held that particular circumstances in the case before it showed that a defendant investment advisor owed fiduciary duties under the Investment Advisers Act to an investor in a fund—and that the violation of those duties could support a criminal conviction—where the investor was the defendant’s client for other investments.

\(^5\) See infra notes 137–59 and accompanying text.
\(^6\) See infra notes 160–72 and accompanying text.
\(^7\) See infra notes 181–99 and accompanying text, particularly at notes 185–89.
\(^8\) See infra notes 204–11 and accompanying text.
\(^9\) See infra notes 212–21 and accompanying text, particularly at notes 215–16.
\(^10\) See infra notes 212–21 and accompanying text, particularly at notes 217–21.
had invested in the fund as part of a single strategy in which the defendant was involved, and was the only investor in the fund.\textsuperscript{11} Courts of appeals affirmed long sentences—over 300 years for one defendant and thirty years for a second (Tenth Circuit);\textsuperscript{12} and 262 months, even after extensive cooperation (Seventh Circuit).\textsuperscript{13}

\textit{SEC enforcement actions.} The Ninth Circuit affirmed a §5 violation in a multi-step transaction by which one company controlled by an individual sold to a second company also controlled by that individual, which had transferred its interest in the stock to another individual and an entity, who then sold on to the public.\textsuperscript{14} In the same case, the court held that the controlling individual could be ordered to disgorge proceeds from the sale even though he did not personally receive the money.\textsuperscript{15}

\textit{Indemnification and Directors and Officers (“D&O”) insurance.} The Tenth Circuit held that a bylaw indemnification provision was not an illusory promise even though it permitted the company to stop defense payments upon the company's own decision that its financial resources should be devoted to other uses—with the court qualifying its holding that this provision was enforceable with the caveat that the company would have to make such a decision in good faith.\textsuperscript{16} The Fifth Circuit ruled that a D&O exclusion, operating when a determination had been made “in fact” that an insured had engaged in money laundering (as defined in the policy to include use or possession of a benefit obtained from criminal conduct), could not be triggered by the carrier's unilateral decision that the insured had engaged in such conduct but could be triggered by a decision in a coverage action.\textsuperscript{17}

\textit{Definition and proof of scienter.} The Ninth Circuit held that scienter is subjective but can be proved in some cases by objective recklessness, such as the failure by a broker to confirm statements of a third party before passing the substance of those statements on to the broker's customers.\textsuperscript{18}

\textit{Primary liability under Rule 10b-5.} The First Circuit, in an en banc opinion, rejected the government's contention that a securities professional makes the statements in a prospectus—for Rule 10b-5 purposes—by using the prospectus to sell securities.\textsuperscript{19} The Second Circuit held that attorneys were not primary Rule 10b-5 violators either by reason of drafting offering documents or by reason of negotiating and documenting transactions that produced deceptive financial statements.\textsuperscript{20} The Fifth Circuit held that attorneys were not primary Rule 10b-5 violators sim-

\textsuperscript{11}. See infra notes 222–33 and accompanying text.
\textsuperscript{12}. See infra notes 181–99 and accompanying text, particularly at notes 190–99.
\textsuperscript{13}. See infra notes 200–03 and accompanying text.
\textsuperscript{14}. See infra notes 234–68 and accompanying text, particularly at notes 243–63.
\textsuperscript{15}. See infra notes 234–68 and accompanying text, particularly at notes 264–68.
\textsuperscript{16}. See infra notes 271–90 and accompanying text.
\textsuperscript{17}. See infra notes 291–305 and accompanying text.
\textsuperscript{18}. See infra notes 306–22 and accompanying text.
\textsuperscript{19}. See infra notes 328–65 and accompanying text.
\textsuperscript{20}. See infra notes 366–87 and accompanying text.
ply because they worked behind the scenes to create tax shelter investments—without attribution of the work or statements to the attorneys or identification of the attorneys to the plaintiff purchasers.21

Loss causation. The Fifth Circuit appeared to hold that, in order to prove that a prediction was false, a plaintiff must prove that the prediction was intentionally misleading (i.e., subjectively false) and that, therefore, to show loss causation, that plaintiff must prove a decline in the price of the relevant security after disclosure that the prediction was intentionally misleading.22 The Ninth Circuit held that the Exchange Act’s requirement for proof of loss causation in private lawsuits applied in an action alleging false statements in a proxy statement, even though the plaintiff contended that it was seeking equitable relief only in the form of a rescissory recovery.23 The Second Circuit held that loss causation is analyzed when the omitted or truthful facts are first disclosed, not when later cascading developments related to those facts occur—such as the resignation of a director and financial press and analyst reaction to that resignation.24

Falsity. The Fifth Circuit held that statements saying that no mortgages in a pool were delinquent were not false—even though some were in fact delinquent—where the prospectus for the securities sold by the trust holding the pool also stated that the seller of the mortgages would buy back delinquent mortgages or substitute ones that were current.25

Duty to disclose. The Second Circuit ruled that prospectuses for mutual funds did not need to disclose a conflict of interest plaguing analysts at companies affiliated with the mutual fund issuer.26 The Eleventh Circuit found no duty, on the part of a debenture purchaser, to disclose to the seller’s shareholders.27 Disagreeing with the Fifth Circuit, the Third Circuit held that one executive has no duty to disclose simply because he or she is present when a second executive makes a misleading statement.28

Reliance. The Third Circuit rejected use of the fraud-created-the-market theory to show reliance.29

Materiality. The Second Circuit held that savings that organizers of a mutual fund reaped by subcontracting transfer services, but that were kept by a company affiliated with the organizers instead of being passed on to the mutual fund shareholders, were material to those shareholders.30 Government proof that a company’s stock price declined after a press release did not, the Third Circuit found,

21. See infra notes 388–96 and accompanying text.
22. See infra notes 401–24 and accompanying text.
23. See infra notes 425–39 and accompanying text.
25. See infra notes 460–73 and accompanying text.
26. See infra notes 478–504 and accompanying text.
27. See infra notes 505–16 and accompanying text.
28. See infra notes 517–31 and accompanying text.
29. See infra notes 532–49 and accompanying text.
30. See infra notes 552–72 and accompanying text.
prove materiality of the truth the release revealed about the alleged fraud where the release contained negative information that was not related to the alleged fraud and the government’s expert had not disaggregated the stock price decline to show what part, if any, the disclosure of the truth played in the stock loss.  

Control person liability. The Eighth Circuit held, again, that culpable participation in the alleged wrongdoing is not necessary for control person liability under the federal securities laws but nevertheless held that a parent company was not a control person liable for the violations of a registered representative at a subsidiary.

Insider trading. The Fifth Circuit found allegations sufficient to avoid dismissal of a government enforcement action based on the misappropriation theory where a large shareholder learned of a PIPE offering in a private conversation with the issuer’s CEO and then sold his stock in the issuer.

Class certification. The Seventh Circuit broke with recent decisions in other circuits, holding that a plaintiff need prove neither loss causation nor materiality in order to obtain certification of a plaintiff class under Federal Rule of Civil Procedure 23(b)(3).

Private Securities Litigation Reform Act (“PSLRA”) pleading. Courts held that complaints failed to allege adequately defendants’ scienter in cases arising in a wide variety of circumstances: alleged omission of a merger partner’s attempt to renegotiate a deal price (Second Circuit); alleged misrepresentations and omissions in a Dear Doctor letter sent out by medical device manufacturer (Eighth Circuit); an allegedly misleading clean auditor opinion on financials, followed by a large write-off due to uncollectible accounts (Sixth Circuit); and financial statements and proxy disclosures related to backdated options (Eleventh Circuit).

Forward-looking statements. The Third Circuit held that statements about a ratio including a component comprised of future cost were forward-looking statements protected by cautionary language saying that future profitability depended on the issuer’s ability to forecast the future cost. Both the Ninth and Eleventh Circuits ruled that meaningful cautionary language will protect a forward-looking statement in a private lawsuit even though the plaintiff can plead that the issuer made the statement with actual knowledge that it was false or misleading. The Second Circuit employed a *Tellabs* analysis to conclude that the plaintiffs failed to allege adequately that the defendants—when saying that a company expected

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32. *See infra* notes 584–601 and accompanying text.
33. *See infra* notes 602–20 and accompanying text.
34. *See infra* notes 621–35 and accompanying text.
35. *See infra* notes 645–56 and accompanying text.
36. *See infra* notes 657–86 and accompanying text.
37. *See infra* notes 687–709 and accompanying text.
38. *See infra* notes 710–16 and accompanying text.
40. *See infra* notes 736–43 and accompanying text.
future losses on a high-yield debt portfolio for the last three quarters of a year would be substantially below the losses on that portfolio in the first quarter—had “actual knowledge” that their statements were false or misleading. The Second Circuit ruled that statements about risk management are forward-looking if they expressly or implicitly predict future losses but not if the statements report risk management steps that an issuer has taken to date.

SEC rulemaking. The D.C. Circuit held that the SEC collected insufficient evidence to support its conclusion that NYSE Arca’s depth-of-book pricing would be constrained by competition.

Securities Litigation Uniform Standards Act (“SLUSA”). The Sixth Circuit strictly construed the SLUSA exclusion for claims brought by states, their political subdivisions, and state pension plans, requiring that the plaintiffs in such a case all be named and that each named entity or pension plan have authorized participation in the suit. The Second Circuit held that alleged misrepresentations about the sufficiency of investments to support retirement could be “in connection with” those investments even if the actual investments were made months after the misrepresentations.

Sarbanes-Oxley clawback. The Second Circuit followed the Ninth Circuit in holding that only the SEC can sue for the § 304 clawback, holding as well that a settlement in a private lawsuit cannot cut off the clawback claim or provide for indemnification of clawback payments owed under § 304.

Additional cases. The Ninth Circuit ruled that § 13(a) of the Investment Company Act does not create a private cause of action. The Second Circuit found that an integration clause could cut off a Rule 10b-5 claim by a sophisticated investor based on alleged representations outside the deal document containing that clause. The Seventh Circuit refused to disaggregate variable life insurance policies into component parts to determine whether to apply the exclusion for securities claims in the Class Action Fairness Act. The Second Circuit ruled that memberships in a hunting preserve were not “investment contracts” within the meaning of the securities laws, while the Fifth Circuit held that interests in single-member limited liability companies can be “investment contracts.”

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41. See infra notes 744–70 and accompanying text.
42. See infra notes 771–83 and accompanying text.
43. See infra notes 784–97 and accompanying text.
44. See infra notes 801–14 and accompanying text.
45. See infra notes 815–26 and accompanying text.
46. See infra notes 827–49 and accompanying text.
47. See infra notes 855–62 and accompanying text.
48. See infra notes 863–65 and accompanying text.
49. See infra notes 866–75 and accompanying text.
50. See infra notes 876–78 and accompanying text.
51. See infra notes 879–83 and accompanying text.
U.S. Supreme Court

Last year, the Court interpreted the statute of limitation governing private actions under Rule 10b-5; restricted the extraterritorial reach of private Rule 10b-5 actions; limited the application of the wire and mail fraud statutes in cases where the government charges deprivations of “honest services”; held that investment advisers violate their fiduciary duty when they take fees so disproportionately large that the fees bear no reasonable relationship to services rendered and could not have been the product of arm’s length bargaining, but also held that courts evaluating claims that investment adviser fees violate § 36(b) of the Investment Company Act should generally defer to the decisions of mutual fund boards of directors but in a graduated manner depending on examination of the facts surrounding those decisions, and found the law establishing the PCAOB constitutional after separating out and striking down one part of that law.

Inquiry notice suffices to trigger two-year portion of statute of limitations for private Rule 10b-5 actions but must include notice that defendants acted with scienter. In 2010, the U.S. Supreme Court interpreted the statute of limitations that governs private actions under § 10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) and Rule 10b-5. That statute provides that the plaintiff must bring the action “not later than the earlier of (1) 2 years after the discovery of the facts constituting the violation or (2) 5 years after such violation.” In Merck & Co. v. Reynolds, the Supreme Court addressed the first half of this limitation, providing three important holdings.

First, the Court held that the “word ‘discovery’ refers not only to a plaintiff’s actual discovery of certain facts, but also to the facts that a reasonably diligent plaintiff would have discovered.” The Court reached this conclusion on the grounds that “discovery” carries this meaning generally in limitations jurisprudence and that, when Congress passed the current statute of limitations for Rule 10b-5

52. See infra notes 57–98 and accompanying text.
53. See infra notes 99–112 and accompanying text.
54. See infra notes 113–36 and accompanying text.
55. See infra notes 137–59 and accompanying text.
56. See infra notes 160–72 and accompanying text.
58. Id. §§ 78a–78mm.
60. 28 U.S.C. § 1658(b) (2006). This statute applies to private actions “that involve[] a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws.” Id. It applies to private actions under Exchange Act § 10(b) because that section forbids, in the purchase or sale of any security, “any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe.” 15 U.S.C.A. § 78j(b) (West 2009 & Supp. 2011).
61. 130 S. Ct. 1784 (2010).
62. Id. at 1793.
63. Id. at 1794 (“[T]reatise writers now describe ‘the discovery rule’ as allowing a claim ‘to accrue when the litigant first knows or with due diligence should know’ facts that will form the basis for an action.” (quoting 2 CALVIN W. CORMAN, LIMITATION OF ACTIONS § 11.1.1, at 134 (1991 & Supp. 1993) (emphasis added))).
actions in 2002, the courts of appeals had interpreted “discovery” in the predecessor statute to include the time at which a reasonably diligent plaintiff would have found the facts comprising the violation.\textsuperscript{64} Summarizing this first holding, the Court wrote that “‘discovery’ as used in this statute encompasses not only those facts the plaintiff actually knew, but also those facts a reasonably diligent plaintiff would have known.”\textsuperscript{65}

Second, the Court held that, because scienter is an essential element of a Rule 10b-5 claim, it is one of the “facts” that must be discovered in order for the two-year period in the first part of the statute to begin to run.\textsuperscript{66} That is, before the statutory period starts, the plaintiff must have actually discovered facts sufficient to plead scienter or the court must conclude that a reasonably diligent plaintiff would have discovered those facts.\textsuperscript{67} The Court went on to reject Merck’s position

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\item \textsuperscript{64} In \textit{Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson}, 501 U.S. 350, 364 n.9 (1991), the Court adopted § 9(e) of the Exchange Act, 15 U.S.C. § 78i(e), as the statute of limitations for Rule 10b-5 claims brought by private litigants. That statute provides that an action must be brought “within one year after the discovery of the facts constituting the violation and within three years after such violation.” 15 U.S.C.A. § 78i(e) (West 2009 & Supp. 2011). The Court in \textit{Lampf} held that “[l]itigation instituted pursuant to § 10(b) and Rule 10b-5 therefore must be commenced within one year after the discovery of the facts constituting the violation and within three years after such violation.” 501 U.S. at 364. In \textit{Merck}, the Court observed that “[s]ubsequently, every Court of Appeals to decide the matter held that ‘discovery of the facts constituting the violation’ occurs not only once a plaintiff actually discovers the facts, but also when a hypothetical reasonably diligent plaintiff would have discovered them.” 130 S. Ct. at 1795 (citations omitted). The Court assumed that, when Congress enacted 28 U.S.C. § 1658(b) as the new statute of limitations, it was aware of that judicial history and used “discovery” in accordance with that awareness.

Justice Scalia (joined by Justice Thomas) concurred in the judgment. \textit{Merck}, 130 S. Ct. at 1800–03 (Scalia, J., concurring). But Justice Scalia pointed out that the statute of limitations, 15 U.S.C. § 77m, for private actions under §§ 11 and 12, 15 U.S.C. §§ 77k, 77l, of the Securities Act of 1933 explicitly states that an action must be brought “within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence.” Id. at 1800 (emphasis added). Since the new statute for Rule 10b-5 did not include the italicized words, Justice Scalia concluded that the new statute did not include the meaning that those words conveyed. Id. at 1801 (“[T]he meaning of ‘discovery’ in the broader context of limitations provisions is overcome by its meaning in the more specific context of the federal securities laws.”). Justice Scalia also quarreled with the majority’s conclusion that post-\textit{Lampf} courts of appeals’ opinions had consistently interpreted the pre-2002 statute of limitations to start when a plaintiff had not, but should have, discovered the triggering facts. Id. at 1799 (Stevens, J., concurring).

Justice Stevens concurred in the majority judgment but noted that, since in this case “there is no difference between the time when the plaintiffs actually discovered the factual basis for their claim and the time when reasonably diligent plaintiffs should have discovered those facts,” he “would reserve decision” on the Scalia argument that the current statute requires actual discovery of the facts. Id. at 1799 (Stevens, J., concurring).

65. \textit{Merck}, 130 S. Ct. at 1796 (majority opinion).

66. Id.

67. Id. In this regard, the Court noted the special pleading rule specifying that a private plaintiff in a Rule 10b-5 case must, in the complaint, “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” Id. (quoting 15 U.S.C. § 78u-4(b)(2) (emphasis added)). The Court provided the following analysis:

As a result [of this special pleading requirement], unless a § 10(b) plaintiff can set forth facts in the complaint showing that it is “at least as likely as” not that the defendant acted with the relevant knowledge or intent, the claim will fail. See \textit{Tellabs, Inc. v. Makor Issues & Rights, Ltd.}, 551 U.S. 308, 328 [(2007)]. It would therefore frustrate the very purpose of the discovery rule
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that discovery of “facts that tend to show a materially false or misleading statement (or material omission) are *ordinarily* sufficient to show scienter as well.”68 Instead, the facts discovered must support the “context specific” required “state of mind” and may therefore in a particular case have to include more than that the defendant spoke or wrote a falsehood.69

Third, the Court held that the two-year portion of the statute does not necessarily begin at “the point where the facts would lead a reasonably diligent plaintiff to investigate further,”70 even when the plaintiff fails after that point to conduct any investigation.71 Instead, the Court stayed with the simple rule that, regardless of whether a particular plaintiff has conducted an investigation and regardless of the timing or extent of such an investigation, “the limitations period in § 1658(b) (1) begins to run once the plaintiff did discover or a reasonably diligent plaintiff would have ‘discover[ed . . . ] the facts constituting the violation’—whichever comes first.”72

Applying these holdings to the case before it, the Court affirmed the Third Circuit’s decision that reversed a district court order dismissing a case against Merck on the basis that the two-year portion of the statute of limitations had run.73 Merck had marketed a pain suppressant called Vioxx after the Federal Food and Drug Administration (“FDA”) approved it.74 A subsequent study showed a higher

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68. *Id.* (emphasis added).

69. *Id.* at 1796–97. The Court did, however, acknowledge that, in some instances, facts showing falsity would also support scienter:

We recognize that certain statements are such that, to show them false is normally to show scienter as well. It is unlikely, for example, that someone would falsely say “I am not married” without being aware of the fact that his statement is false. Where § 10(b) is at issue, however, the relation of factual falsity and state of mind is more context specific. An incorrect prediction about a firm’s future earnings, by itself, does not automatically tell us whether the speaker deliberately lied or just made an innocent (and therefore nonactionable) error. Hence, the statute may require “discovery” of scienter-related facts beyond the facts that show a statement (or omission) to be materially false or misleading.

70. *Id.* at 1797.

71. *Id.* at 1797–98.

72. *Id.* at 1798 (quoting 28 U.S.C. § 1658(b)(1)) (ellipses added). The Court added that:

In determining the time at which “discovery” of those “facts” occurred, terms such as “inquiry notice” and “storm warnings” may be useful to the extent that they identify a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating. But the limitations period does not begin to run until the plaintiff thereafter discovers or a reasonably diligent plaintiff would have discovered “the facts constituting the violation,” including scienter—irrespective of whether the actual plaintiff undertook a reasonably diligent investigation.

73. *Id.* at 1792–93, 1799.

74. *Id.* at 1790.
incidence of heart attacks among patients using Vioxx than among those using an alternative drug, naproxen. The plaintiffs purchased Merck stock from May 21, 1999, through October 29, 2004, a period during which they alleged Merck, with scienter, made false statements about Vioxx’s harmful cardiac effects.

Merck’s public statements explained the higher heart attack rate among Vioxx users, compared to naproxen users, as due to a decrease in heart attacks caused by naproxen rather than an increase in heart attacks caused by Vioxx, an interpretation of study results known as “the naproxen hypothesis.” In May 2001, Vioxx users filed a products-liability lawsuit against Merck. In September 2001, the FDA sent Merck a publicly released letter requiring Merck to include in Vioxx marketing a statement that the increased incidence of heart attack associated with taking Vioxx could be due to negative cardiac effects from Vioxx rather than positive cardiac effects from taking naproxen as an alternative; the agency ordered Merck to send this information to healthcare providers. The FDA said that Merck’s Vioxx “marketing was ‘false, lacking in fair balance, or otherwise misleading’” because it presented the naproxen hypothesis “without adequately acknowledging another reasonable explanation,” namely that Vioxx caused heart attacks. The FDA said the Merck had “‘minimized . . . potentially serious cardiovascular findings.’” Merck’s stock price dropped by more than 6.6 percent in the several days following this FDA action.

Throughout this time, Merck statements had reaffirmed Vioxx’s safety and, even after the FDA letter, the president of Merck Research Laboratories said only that there were “‘two possible interpretations’: ‘‘Naproxen lowers the heart attack rate, or Vioxx raises it.’” More products-liability lawsuits followed the FDA epistle. Securities analysts noted, after all of these events, “that the FDA had not denied that the naproxen hypothesis remained an unproven but possible explanation.”

All of this occurred before November 6, 2001—more than two years before the plaintiffs filed this lawsuit on November 6, 2003. The Court held that none

75. Id.
77. Merck, 130 S. Ct. at 1791.
78. Id.
79. Id.
80. Id.
81. Id. at 1799 (quoting FDA letter).
82. Id. at 1791.
83. Id. at 1792 (quoting Merck president).
84. Id.
85. Id.
86. Id. at 1790.
87. In re Merck & Co. Sec., Derivative & “ERISA” Litig., 483 F. Supp. 2d 407, 410 (D.N.J. 2007) (Merck district court opinion). Of course, much happened after November 6, 2001, with the Wall Street Journal publishing an article in October 2003 reporting that another study showed that Vioxx users suffered 37 percent more heart attacks than patients taking another pain suppressant or those taking no painkiller at all. Merck, 130 S. Ct. at 1792. In September 2004, Merck took Vioxx off the market, saying that a new study showed “an increased risk of confirmed cardiovascular events beginning
of the events showed that the plaintiffs had actually discovered or that a reasonably diligent plaintiff should have discovered that Merck made statements about Vioxx safety with scienter. 88 The FDA letter expressly acknowledged that the naproxen hypothesis was a “possible explanation” for the higher incidence of heart attacks among Vioxx users in the study, and the FDA did not say that Merck knowingly made false statements by advancing that hypothesis. 89 While the pleadings in the product-liability lawsuits included allegations “that Merck had ‘omitted, suppressed, or concealed material facts concerning the dangers and risks associated with Vioxx’ and ‘purposefully downplayed and/or understated the serious nature of the risks associated with Vioxx,’” 90 such general charges failed to “reveal ‘facts’ indicating scienter”—critical because the statute of limitations requires, in order to start the two-year limitations period, that the plaintiff discover “the facts constituting the violation.” 91

Significance and analysis. Since the defendant’s state of mind may be the most difficult yet most critical of all matters in a securities case on which to find “facts”—particularly given the discovery stay at the outset of a private Rule 10b-5 case and the requirement that a plaintiff “state with particularity [in the complaint] facts giving rise to a strong inference” of scienter—Merck’s holding that the two-year portion of the statute of limitations does not begin to run until a plaintiff has, or a reasonable plaintiff would have, discovered such facts benefits plaintiffs. Indeed, by linking the “facts” needed to start the statutory period to the facts that plaintiffs must plead in a private securities fraud suit, the opinion may permit plaintiffs’ counsel to avoid the choice between naming a secondary defendant too early in an investigation—and thereby risking dismissal (and possibly even sanctions) for failure to plead scienter under the strict rules that apply to that element—or waiting until an investigation discloses good evidence of scienter—and thereby risking possible dismissal on statute of limitations grounds. 94

On the other hand, the Merck opinion contains a very odd passage that the Court is “saying nothing about other facts necessary to support a private § 10(b) action,” and then refers to the Solicitor General’s brief that “suggest[ed] that facts concerning a plaintiff’s reliance, loss, and loss causation are not among those that constitute ‘the violation’ and therefore need not be ‘discover[ed]’ for a claim to

89. Id. at 1799 (quoting FDA letter).
90. Id. (some internal quotation marks omitted).
91. Id.
94. See Levitt v. Bear Stearns & Co., 340 F.3d 94, 103 (2d Cir. 2003) (“It makes little sense from a policy perspective to require specific factual allegations—on pain of dismissal in cases of this sort—and then to punish the pleader for waiting until appropriate factual information can be gathered by dismissing the complaint as time barred.”).
accrue.” This passage raises the possibility that a plaintiff could run past the two-year limit, even though the plaintiff had not discovered, and with reasonable diligence could not have discovered, “facts” sufficient to plead those other elements. This would be a bizarre outcome. The point of Merck is that, since scienter is “an important and necessary element of a § 10(b) violation,” facts respecting that element are among those that must be discovered (actually or by notice) in order that the plaintiff have discovered the “facts constituting the violation.” The Court has previously held that reliance, loss, and loss causation are also necessary elements of a private Rule 10b-5 case, and that loss causation must be pled with at least some factual detail. It is hard to see how the Merck logic would not extend to a requirement that a plaintiff have actually discovered the “facts” as to all elements of a Rule 10b-5 claim, or could have done so by reasonable inquiry, before the sands of the two years begins to run through the hourglass. Deliberately confusing this issue may frustrate plaintiffs and seems poor Supreme Court work.

Finally, the Court’s insistence that allegations from other lawsuits count toward limitations notice of scienter only if those allegations include “facts” rather than conclusory statements illustrates the slippery nature of limitations analysis even after Merck. Suppose that a plaintiff in a products-liability case alleges, without any detail, that a drug manufacturer deliberately concealed statistically significant adverse side effects. Such a general allegation might well not provide the “facts” constituting scienter and therefore not start the two years under 28 U.S.C. § 1658(b) for a private Rule 10b-5 securities lawsuit based on concealment of the side effects. But such an allegation could still be relevant to when a diligent plaintiff would have started to look for such facts. In short, while Merck encourages a sharp focus on a single date—when the plaintiff acquired actual knowledge of the “facts constituting the violation,” or reasonably could have come by those facts—much of the murky pre-Merck law may remain relevant.

Private Rule 10b-5 actions limited to those that either involve a security listed on a domestic exchange or a purchase or sale in the United States. Last year, the Court in Morrison v. National Australia Bank Ltd. significantly limited the extent to which private plaintiffs can sue in U.S. courts to recover under Rule 10b-5 for losses in securities transactions that involve actions overseas. The plaintiffs, who were all Australians, had purchased stock in an Australian bank, buying only on foreign stock exchanges. They alleged that the bank had made false statements about write-downs of assets owned by a subsidiary that was headquartered in Florida.

95. Merck, 130 S. Ct. at 1796 (quoting Solicitor General’s brief) (last alteration in original).
96. Id.
98. For example, some courts divide the analysis into two steps—when should “storm warnings” have alerted plaintiffs to the need to investigate for possible fraud and how soon thereafter would reasonable investigation have uncovered enough to plead fraud. See Young v. Lepone, 305 F.3d 1, 8 (1st Cir. 2002), cited in Merck, 130 S. Ct. at 1798; see also supra note 72.
100. Id. at 2875–76.
and that conducted a mortgage servicing business. The district court in Manhattan dismissed the case for lack of subject-matter jurisdiction, and the Second Circuit affirmed, applying its long-standing “conduct” and “effects” tests to determine that the federal courts in this country could not properly hear this case involving foreign purchasers who had purchased stock in a foreign company on a foreign exchange. The court of appeals rested its holding on its conclusion that “[t]he acts performed in the United States did not ‘compris[e] the heart of the alleged fraud.’ ”

In affirming, the Supreme Court first held that the issue was not one of subject-matter jurisdiction because the federal courts had such jurisdiction “to adjudicate the question whether § 10(b) applies to National’s conduct.” Second, the Court held that § 10(b) applies “only” to “transactions in securities listed on domestic exchanges, and domestic transactions in other securities.” The Court reached this second ruling by reasoning that federal statutes presumptively “‘apply only within the territorial jurisdiction of the United States’” and that nothing in § 10(b) disturbs that presumption. The majority rejected the Second Circuit

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101. Id.
102. Id. at 2876. As the court of appeals explained:

[In determining the extraterritorial reach of Section 10(b) we look to whether the harm was perpetrated here or abroad and whether it affected domestic markets and investors. This binary inquiry calls for the application of the “conduct test” and the “effects test.” We ask: (1) whether the wrongful conduct occurred in the United States, and (2) whether the wrongful conduct had a substantial effect in the United States or upon United States citizens. Where appropriate, the two parts of the test are applied together because “an admixture or combination of the two often gives a better picture of whether there is sufficient United States involvement to justify the exercise of jurisdiction by an American court.” In this case, however, Appellants rely solely on the conduct component of the test.]


103. Id., 130 S. Ct. at 2876 (quoting Morrison, 547 F.3d at 167, 175–76) (second alteration in original).
104. Id. at 2877.
105. Id. at 2884. The opinion restates the holding in equivalent language elsewhere. Id. at 2886 (referring to “[t]he transactional test we have adopted—whether the purchase or sale is made in the United States, or involves a security listed on a domestic exchange”); id. at 2888 (“Section 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.”).
106. Id. at 2877 (quoting EEOC v. Arabian Am. Oil Co., 499 U.S. 244, 248 (1991)).
107. Id. at 2881–83. Section 10(b) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumental-ity of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe . . . .

Id. at 2881–82 (quoting 15 U.S.C. § 78j(b)). While the related Rule 10b-5 refers to the “purchase or sale of any security,” 17 C.F.R. § 240.10b-5 (2010) (emphasis added), that rule “‘does not extend beyond conduct encompassed by § 10(b)’s prohibition.’” Morrison, 130 S. Ct. at 2881 (quoting United States v. O’Hagan, 521 U.S. 642, 651 (1997)). The general reference in § 10(b) to “interstate
“conduct” and “effects” test, and “the proliferation of vaguely related variations” on that test adopted by other courts of appeals, in part because those tests constituted “judicial-speculation-made-law-divining [of] what Congress would have wanted if it had thought of the situation before the court.” The Justices also declined to adopt the test advanced by the Solicitor General—that § 10(b) applies “when the [securities] fraud involves significant conduct in the United States that is material to the fraud’s success.”

Significance and analysis. Morrison provides a straightforward test that brushes aside the imprecise and somewhat confusing extraterritorial protocols that preceded the Court’s intervention. The test that the Court prescribes still permits American citizens, or for that matter citizens of other countries, access to U.S. courts for Rule 10b-5 cases based on transactions through U.S. exchanges in securities issued by or based on securities issued by companies domiciled overseas. For example, a German citizen could bring a Rule 10b-5 claim in U.S. courts based on the purchase of American Depository Receipts sold on the New York Stock Exchange but based on stock issued by a German company. The decision, however, leaves open the questions raised in trying to reach a sensible result in such an action if other purchasers of securities issued by the same company sue for fraud in a court outside the United States or settle outside the U.S. case.

Note, as well, that the Dodd-Frank Wall Street Reform and Consumer Protection Act requires that the SEC conduct a study—to be completed within eighteen months of the July 21, 2010, passage of that law—to determine, essentially,
whether a test like that of the Second Circuit should govern the reach of private actions under Rule 10b-5.\footnote{112}

Deprivation of employee’s honest services can constitute mail or wire fraud only if the employee took a bribe or received a kickback. The government sometimes prosecutes securities fraud under the mail and wire fraud statutes or includes a mail or wire fraud count in a case charged otherwise under the criminal provisions of the securities laws.\footnote{113} Among other things, the mail and wire fraud statutes criminalize “any scheme or artifice to defraud.”\footnote{114} In 1987, the Court held that the prohibition against “schemes . . . to defraud” in those laws extended only to schemes that damaged “property rights.”\footnote{115} As so construed, the mail and wire fraud statutes did not punish a scheme to deprive an employer of the honest services of an employee.\footnote{116} Congress reacted the following year by passing a law now codified at 18 U.S.C. § 1346, which defines the “schemes” prohibited by the mail and wire fraud statutes to “include[]” those designed “to deprive another of the intangible right of honest services.”\footnote{117}

In \textit{Skilling v. United States},\footnote{118} the Court interpreted this “honest services” provision in a narrow way. Mr. Skilling—who had been the CEO of Enron for part of

\begin{itemize}
  \item \footnote{112} See Pub. L. No. 111-203, § 929Y(a), 124 Stat. 1376, 1871 (2010). This section states that: The Securities and Exchange Commission of the United States shall solicit public comment and thereafter conduct a study to determine the extent to which private rights of action under the antifraud provisions of the Securities and Exchange Act of 1934 (15 U.S.C. § 78u-4) should be extended to cover—
    \begin{enumerate}
      \item conduct within the United States that constitutes a significant step in the furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; and
      \item conduct occurring outside the United States that has a foreseeable substantial effect within the United States.
    \end{enumerate}

\textit{Id.}

\footnote{113} \textit{Louis Loss \& Joel Seligman, Fundamentals of Securities Regulation} 1422–23 (5th ed. 2004).

\footnote{114} The mail fraud statute reads, in pertinent part:

Whoever, having devised or intending to devise \textit{any scheme or artifice to defraud}, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises . . . , for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service . . . shall be fined under this title or imprisoned not more than 20 years, or both.

18 U.S.C. § 1341 (2006) (emphasis added). The wire fraud statute is similar:

Whoever, having devised or intending to devise \textit{any scheme or artifice to defraud}, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio . . . any writings . . . for the purpose of executing such scheme or artifice, shall be fined under this title or imprisoned not more than 20 years, or both.


\footnote{116} \textit{Id.} at 359–60.


\footnote{118} 130 S. Ct. 2896 (2010).
2001—was convicted on, among other things, a count charging conspiracy “to commit . . . wire fraud to deprive Enron and its shareholders of the honest services owed by its employees.” The wire fraud “scheme” consisted of “[d]eceiving[] the investing public, including Enron's shareholders, . . . about the true performance of Enron's businesses by: (a) manipulating Enron's publicly reported financial results; and (b) making public statements and representations about Enron's financial performance and results that were false and misleading.”

In vacating the Fifth Circuit's ruling that affirmed Skilling's conviction on the conspiracy count, a majority of Supreme Court Justices viewed their task as construing the “honest services” statute—if possible—so as to avoid finding it unconstitutionally vague. To discharge that task, the Court reviewed the pre-1987 cases developing the “honest services” concept in the wire and mail fraud settings, found that “bribery and kickback schemes” formed the “core category” of that concept, concluded that by the 1988 statute “Congress intended § 1346 to reach at least bribes and kickbacks,” and then construed the statute so that it “criminalizes only” that “bribe-and-kickback core.”

119. Id. at 2907.

120. The Fifth Circuit opinion makes this clear. United States v. Skilling, 554 F.3d 529, 542 (5th Cir. 2009). According to the indictment, the conspiracy included three objects: “(1) securities fraud, (2) wire fraud to deprive Enron and its shareholders of money and property, and (3) wire fraud to deprive Enron and its shareholders of the honest services owed by its employees.” Id. Since the Court concluded that one of the objects was not illegal, the Court remanded for the Fifth Circuit to determine whether conviction on the conspiracy charge should be reversed or whether the presence of the honest services fraud in it was harmless error. Skilling, 130 S. Ct. at 2934–35.

121. Skilling, 130 S. Ct. at 2908 (quoting the indictment) (ellipses in original).

122. Id. at 2935. The Court also considered Skilling's argument that he was denied a fair trial by publicity, community prejudice, the district court's refusal to change venue, and actual prejudice among jurors. Id. at 2907. The majority opinion rejected that argument. Id. at 2912–25. Justice Sotomayor, joined by Justices Stevens and Breyer, dissented on the fair trial issue. Id. at 2942–63 (Sotomayor, J., concurring in part and dissenting in part). Among many points, the dissent attacks the popular judicial practice of declining to excuse a juror for cause after an exchange in which the juror clearly states bias but—after repeated suggestive questions by the judge—concedes generally that he or she can reach a fair result:

[T]he court declined to dismiss for cause any prospective juror who ultimately gave a clear assurance of impartiality, no matter how much equivocation preceded it. Juror 29, for instance, wrote on her questionnaire that Skilling was “not an honest man.” During questioning, she acknowledged having previously thought the defendants were guilty; and she disclosed that she lost $50,000–$60,000 in her 401(k) as a result of Enron's collapse. But she ultimately agreed that she would be able to presume innocence. Noting that she “blame[d] Enron for the loss of her money” and appeared to have “unshakeable bias,” Skilling's counsel challenged her for cause. The court, however, declined to remove her, stating that “she answered candidly she's going to have an open mind now” and “agree[ing]” with the Government's assertion that “we have to take her at her word.” As this Court has made plain, jurors' assurances of impartiality simply are not entitled to this sort of talismanic significance.

123. Id. at 2959 (citations omitted).

124. Id. at 2928 (majority opinion).

125. Id. at 2928–31.

126. Id. at 2931.
The majority specifically rejected the government’s position, which would have extended § 1346 to include “‘undisclosed self-dealing by a public official or private employee—i.e., the taking of official action by the employee that furthers his own undisclosed financial interests while purporting to act in the interests of those to whom he owes a fiduciary duty.’”128 Here, because the government never alleged that “Skilling solicited or accepted side payments from a third party in exchange for making . . . misrepresentations” about Enron’s financial condition or results, the Court found his conviction on the conspiracy count encompassing the honest services fraud scheme “flawed.”129 Acceptance of lucre from a third party was key because the conviction could not stand on the prosecution’s theory that Skilling had “‘profited from the fraudulent scheme . . . through the receipt of salary and bonuses, . . . and through the sale of approximately $200 million in Enron stock, which netted him $89 million.’”130

After holding unequivocally “that honest-services fraud does not encompass conduct more wide-ranging than the paradigmatic cases of bribes and kickbacks”131 and that “no other misconduct falls within § 1346’s province,”132 the majority found that, so limited, § 1346 was not unconstitutionally vague.133

Significance and analysis. Given that the most common individual benefits from securities fraud—proceeds from insider trading and incentive payments for reported financial metrics—cannot support honest services fraud under Skilling, the statute’s application in the securities context is quite narrow. An executive who received payment for providing material nonpublic information to a hedge fund manager would presumably commit such fraud.134 Since tipping requires a personal gain by the tipper,135 tipping would also constitute such fraud, at least

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128. Id. at 2932 (quoting government argument).
129. Id. at 2934.
130. Id. (quoting government brief) (ellipses in original).
131. Id. at 2933.
132. Id.
133. Id. at 2933–34. The majority reaffirmed that an honest services prosecution can be based on action in the “private . . . sector.” Id. at 2934 n.45. The opinion says that § 1346’s prohibition on bribes and kickbacks draws content not only from the pre-McNally case law, but also from federal statutes proscribing—and defining—similar crimes. See, e.g., 18 U.S.C. §§ 201(b), 666(a)(2); 41 U.S.C. § 52(2) (“The term ‘kickback’ means any money, fee, commission, credit, gift, gratuity, thing of value, or compensation of any kind which is provided, directly or indirectly, to [enumerated persons] for the purpose of improperly obtaining or rewarding favorable treatment in connection with [enumerated circumstances].”).
134. Such an act would also violate Reg FD. See 17 C.F.R. § 243.100 (2010).
135. See Dirks v. SEC, 463 U.S. 646, 662 (1983) (“[T]he test is whether the insider will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders.”).
where the tipper received (or perhaps just expected to receive) a tangible benefit from his or her actions.136

While an investment adviser violates its fiduciary duty by taking fees that are so disproportionately large that they bear no reasonable relationship to the services rendered and could not have been the product of arm’s length bargaining, courts should generally apply a standard that defers to the judgment of the investment company’s board of directors; the degree of that deference, however, depends on the procedures that the board follows and other matters such as whether the adviser withheld pertinent information from the board. Last year, the Supreme Court interpreted § 36(b) of the Investment Company Act, which provides in pertinent part that “the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company.”137 The law provides that shareholders in an investment company, directors, and the SEC have the right to sue an investment adviser who violates this standard. In Jones v. Harris Associates L.P., the Court recognized that the fiduciary standard applies to investment adviser companies that organize and run mutual funds—and therefore, as a practical matter, may not bargain in a competitive market with the boards of those funds over the compensation paid to the advisers.138 The Court held that, “to face liability under § 36(b), an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s length bargaining.”139

Aside from this legal standard, five aspects of the Harris Associates opinion deserve emphasis. First, the Court vacated a Seventh Circuit decision holding that, so long as the adviser made full disclosure and otherwise dealt fairly with the mutual fund board, no plaintiff could attack the adviser’s compensation.140 The Court rejected the Seventh Circuit view that § 36(b) imposes no substantive limit on compensation.141

Second, noting the statutory requirement that “the plaintiff shall have the burden of proving a breach of fiduciary duty” in a § 36(b) case,142 Harris Associates held that, generally, the Gartenberg v. Merrill Lynch Asset Management, Inc. opin-

136. Dirks suggests that even the psychological satisfaction of gifting inside information to a friend or relative would suffice for the personal benefit necessary to underlie a tipping violation. Id. at 664.
139. Id. at 1426.
140. Id. at 1424, 1431 (discussing Jones v. Harris Associates L.P., 527 F.3d 627 (7th Cir. 2008) (Harris Assocs. Seventh Circuit Opinion)).
141. Id. at 1424 (holding that “[a] fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation” and that “the amount of an adviser’s compensation would be relevant [in a § 36(b) action] only if the compensation were ‘so unusual’ as to give rise to an inference ‘that deceit must have occurred, or that the persons responsible for decision have abdicated’” (quoting Harris Assocs., 527 F.3d at 632)).
ion provides the analytical framework for such a plaintiff’s claim. Third, since the statute provides that a decision by a mutual fund board on the fund advisor’s compensation “shall be given such consideration by the court as is deemed appropriate under all the circumstances,” federal judges should extend “a measure of deference” to such a board judgment, with the degree of deference “depending on the circumstances.” The relevant circumstances include the expertise of board members, how well they informed themselves before making the compensation decision, and how conscientiously they acted. The Justices later commented that both “procedure and substance” play a role in a court review of fees, with something of an adjustable scale so that a district court will rightly take a “more rigorous look at the outcome” if “the [mutual fund] board’s process was deficient or the adviser withheld important information.”

Fourth, the Court declined to endorse, at least categorically, the notion that a plaintiff can prove a fiduciary violation by an investment adviser if the adviser charges mutual fund fees in excess of fees that the adviser charges to independent clients, such as pension funds. Conceding only that “courts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require,” the Court expressly warned against “inapt comparisons” in light of higher turnover in mutual funds, the consequent need for redemption liquidity, and the greater marketing and regulatory compliance costs that mutual fund administration entails. Harris Associates similarly counsels against too-heavy reliance “on comparisons with fees charged to mutual funds by other advisers,” as those fees “may not be the product of negotiations conducted at arm’s length.”

Fifth and finally, the Court noted “that the standard for fiduciary breach under § 36(b) does not call for judicial second-guessing of informed board decisions.” Even “[p]otential conflicts [of interests] . . . . . do not suggest that a court may supplant the judgment of disinterested directors apprised of all relevant information, without additional evidence that the fee exceeds the arm’s-length

143. 694 F.2d 923 (2d Cir. 1982).
144. Harris Assocs., 130 S. Ct. at 1427 (endorsing “the Gartenberg approach” as “fully incorporat[ing]” the appropriate “understanding of the fiduciary duty”); id. at 1430 (“By focusing almost entirely on the element of disclosure, the Seventh Circuit panel erred.”). In a concurrence, Justice Thomas, however, cautioned, “Whatever else might be said about today’s decision, it does not countenance the free-ranging judicial ‘fairness’ review of fees that Gartenberg could be read to authorize.” Id. at 1431 (Thomas, J., concurring).
146. Harris Assocs., 130 S. Ct. at 1428 (majority opinion).
147. Id. (citing Gartenberg, 694 F.2d at 930). It is hard to know what the Court means—beyond the consideration of relevant information—by careful and conscientious action. Perhaps this refers to such matters as the amount of time that mutual fund board members devoted to reviewing the information.
148. Id. at 1429–30.
149. Id. at 1428–29.
150. Id.
151. Id. at 1429.
152. Id. at 1430.
range.” The standard “does not require courts to engage in a precise calculation of fees representative of arm’s-length bargaining,” and “courts are not well suited to make such precise calculations.”

Significance and analysis. Harris Associates does away with the free-market approach that Judge Easterbrook adopted in the decision that the Court reversed. But the two-part standard that Harris Associates substitutes is hard to apply as a direct result of the Court’s accompanying admonitions. The first part of the alternative test is that there is “no reasonable relationship [of the fees] to the services rendered.” Yet, the Court expressly discourages one test, which would seem to help in determining reasonableness—“comparisons with fees charged to mutual funds by other advisers.” The second part of the Court’s test is whether the fee “could not have been the product of arm’s length bargaining.” But since the adviser—or an affiliate—organizes a fund, it is (as the Court concedes) hard to see how any of the fees would constitute arm’s-length bargains.

Statute establishing the Public Company Accounting Oversight Board (“PCAOB”) constitutional after excising portion of the law that limited the SEC’s power to remove board members only “for good cause shown.” In Free Enterprise Fund v. Public Company Accounting Oversight Board, the Supreme Court considered whether the provisions of the Sarbanes-Oxley Act (“SOX”) creating the PCAOB violate the U.S. Constitution. The majority concluded that, as written, those provisions deprive the President of the constitutionally mandated ability to “take Care that the Laws be faithfully executed.” SOX states that the SEC, which appoints members of the PCAOB, can only remove a member “for good cause shown.” All parties conceded that the President can only remove SEC Commissioners for “inefficiency, neglect of duty, or malfeasance in office.” The majority reasoned that a President therefore could not simply remove a PCAOB member who the

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153. Id. (quoting Burks v. Lasker, 441 U.S. 471, 481 (1979)).
154. Id.
155. Judge Easterbrook had put it thus:

Today thousands of mutual funds compete. . . . Mutual funds rarely fire their investment advisers, but investors can and do “fire” advisers cheaply and easily by moving their money elsewhere. Investors do this not when the advisers’ fees are “too high” in the abstract, but when they are excessive in relation to the results—and what is “excessive” depends on the results available from other investment vehicles, rather than any absolute level of compensation.

156. Harris Assocs., 130 S. Ct. at 1426.
157. Id. at 1428–29.
158. Id. at 1426.
159. Id. at 1422.
160. 130 S. Ct. 3138 (2010).
162. Free Enter Fund, 130 S. Ct. at 3147 (quoting U.S. Const. art. II, § 3).
165. Free Enter Fund, 130 S. Ct. at 3148 (quoting Humphrey’s Ex’r v. United States, 295 U.S. 602, 620 (1935)).
President “determine[d] . . . [to be] neglecting his duties or discharging them improperly.”166 “That judgment is instead committed to another officer, who may or may not agree with the President’s determination, and whom the President cannot remove simply because that officer disagrees with him.”167 This double “for cause” insulation of PCAOB members from presidential removal “contravenes the President’s ‘constitutional obligation to ensure the faithful execution of the laws.’”168 Despite this constitutional defect, the majority did not strike down the SOX sections creating the PCAOB in their entirety but opted instead to excise the “unconstitutional tenure provisions” so that PCAOB members are “removable by the [SEC] at will.”169 This leaves the SEC “fully responsible for the [PCAOB’s] actions, which are no less subject than the [SEC’s] own functions to Presidential oversight.”170

Significance and analysis. The majority’s opinion changes little in the securities world.171 The PCAOB will continue to promulgate auditing standards, inspect accounting firms auditing public companies, publish inspection reports to the extent provided in the statute and PCAOB rules, and bring disciplinary actions against audit firms and individual auditors. The circumstance that the PCAOB members are now subject to at-will removal by the SEC should make those mem-

166. Id. at 3147.
167. Id.
168. Id. (quoting Morrison v. Olson, 487 U.S. 654, 693 (1988)).
169. Id. at 3161.
170. Id. With the statute clipped in this way, the majority quickly disposed of the Fund’s argument that appointment of PCAOB members by the SEC violated the Appointments Clause, “which requires ‘Officers of the United States’ to be appointed by the President with the Senate’s advice and consent.” Id. at 3149 (quoting U.S. CONST. art. II, § 2, cl. 2). Absent the “for good cause shown” removal restriction, the SEC can dismiss PCAOB members at will. Since those members can be removed at will, they are “inferior Officers” within the meaning of the Appointments Clause who can, if legislation so provides, be appointed by “Heads of Departments.” Id. at 3162. The SEC is a “Department” within the meaning of that Clause because the SEC “is a free-standing component of the Executive Branch, not subordinate to or contained within any other such component.” Id. at 3163. The SEC Commissioners, collectively, are the “Head” of that “Department” because the SEC’s “powers . . . are generally vested in the Commissioners jointly,” and a “multimember body” can be a “Head.” Id. Accordingly, the Constitution did not require that the President, as opposed to the SEC, appoint the members of the PCAOB. Id. at 3164.

Justice Breyer, joined by three other Justices, dissented on the grounds that (i) all conceded that a one-level “for cause” limitation on presidential removal power was justified and there was no analyti-
cally sound reason to object to a two-level limitation if the Constitution permits one, id. at 3170–71 (Breyer, J., dissenting), and (ii) even without removal power, the SEC has under SOX such vast power to control the PCAOB, id. at 3172–73, that “if the President's control over the [SEC] is sufficient, and the [SEC’s] control over the [PCAOB] is virtually absolute, [then] the President's control over the [PCAOB] should prove sufficient as well,” id. at 3173.

The dissent further argued that many officers within the government were two “for cause” levels removed from presidential dismissal and that the majority’s opinion threw the status of those officers into doubt. Id. at 3179–82. Finally, sowing a little doubt itself, the dissent questioned whether the President’s power to remove SEC Commissioners really is limited by some “for cause” standard. Id. at 3182–84.

171. I put aside here the dissent’s prediction of chaos in those federal offices that the dissent argued are now subject to the kind of double “for-cause” removal that the majority condemned. See id. at 3184–3218 (appendices listing the supposedly threatened positions).
bers no more disinclined to thwart the SEC's will than before this ruling, given the extensive control the SEC already had over PCAOB actions. 172

**Courts of Appeals**

**Criminal Cases:** Ponzi scheme principal not liable, on substantive counts, for false statements of agent where government failed to prove that principal knew of or caused the agent’s false statements; 300-plus year sentence, and 262-month sentence after extensive cooperation, both affirmed; signing true statements of corporate status can constitute substantial assistance for aiding and abetting a securities fraud; appreciation of wrongfulness sufficient for willfulness under Exchange Act § 32(a) and conscious avoidance of facts sufficient for knowledge under that section; where defendant was the investment adviser to an investor that, as part of a single investment strategy, became the only investor in a hedge fund that the defendant ran, the investor was the defendant’s “client” for purposes of applying the antifraud provision in the Investment Advisers Act to the defendant’s wrongdoing in managing the hedge fund

The year 2010 produced six noteworthy court of appeals opinions in criminal cases involving securities violations, five of which this section summarizes. 173 The Tenth Circuit held that the government (i) had not proved substantive crimes against one defendant based on false statements made by a second defendant,

172. Here is a summary, provided by the dissent:

- No Accounting Board rule takes effect unless and until the Commission approves it, § 7217(b)(2);
- The Commission may “abrogate[e], delete[e] or add[d] to” any rule or any portion of a rule promulgated by the Accounting Board whenever, in the Commission’s view, doing so “further[s] the purposes” of the securities and accounting-oversight laws, § 7217(b)(5);
- The Commission may review any sanction the Board imposes and “enhance, modify, cancel, reduce, or require the remission of” that sanction if it finds the Board’s action not “appropriate,” §§ 7215(e), 7217(c)(3);
- The Commission may promulgate rules restricting or directing the Accounting Board’s conduct of all inspections and investigations, §§ 7211(c)(3), 7214(h), 7215(b)(1)–(4);
- The Commission may itself initiate any investigation or promulgate any rule within the Accounting Board’s purview, § 7202, and may also remove any Accounting Board member who has unreasonably “failed to enforce compliance with” the relevant “rule[s], or any professional standard,” § 7217(d)(3)(C) (emphasis added);
- The Commission may at any time “relieve the Board of any responsibility to enforce compliance with any provision” of the Act, the rules, or professional standards if, in the Commission’s view, doing so is in “the public interest,” § 7217(d)(1) (emphasis added).

... Moreover, the Commission has general supervisory powers over the Accounting Board itself. It controls the Board’s budget, §§ 7219(b), (d)(1); it can assign to the Board any “duties or functions” that it “determines are necessary or appropriate,” § 7211(c)(5); it has full “oversight and enforcement authority over the Board,” § 7217(a), including the authority to inspect the Board’s activities whenever it believes it “appropriate” to do so, § 7217(d)(2) (emphasis added). And it can censure the Board or its members, as well as remove the members from office, if the members, for example, fail to enforce the Act, violate any provisions of the Act, or abuse the authority granted to them under the Act, § 7217(d)(3).

Id. at 3172–73 (alterations in original).

173. In addition to the cases summarized in this section, see U.S. v. Schiff, 602 F.3d 152 (3d Cir. 2010), summarized at infra notes 517–31 and 573–83 and accompanying text.
when the first defendant did not know that the second defendant was making false statements and had not caused her to do so, and (ii) had not proved that the first defendant aided and abetted the second defendant in making statements that—unknown to the second defendant—were untrue. In the same case, the Tenth Circuit affirmed a sentence of more than 300 years. The Seventh Circuit affirmed a sentence of 262 months for the “mastermind” of a securities fraud, even though the defendant provided extensive cooperation to the government. The Sixth Circuit held that a defendant could aid and abet a securities fraud by signing completely truthful officer certificates where the certificates were necessary to issue the securities and the defendant knew of the fraud in the securities sale. The Second Circuit reaffirmed its position that the government can prove that a defendant had “knowledge” of a fact for purposes of a prosecution under § 32(a) of the Exchange Act by proving that the defendant consciously avoided learning the fact, but only if the defendant (i) was aware of a high probability that the fact existed, and (ii) did not actually believe that the fact did not exist. In that same case, the court of appeals again held that a defendant acts “willfully” for purposes of § 32(a) if the defendant knows that his or her conduct is wrongful, regardless of whether the defendant also knows that the conduct violates the law. The Sixth Circuit held that, under the particular circumstances presented, an adviser to a hedge fund owed fiduciary duties—under § 206 of the Investment Advisers Act—to the sole investor in that fund.

Criminal liability, on substantive counts, for false statements of agents; length of sentences. The government charged the two defendants in United States v. Lewis with operating a Ponzi scheme. The fraud deprived victims of some $40 million. The jury convicted each defendant of multiple counts of mail fraud, wire fraud, and securities fraud—as well as convicting each of conspiracy.

The Tenth Circuit opinion focused on issues raised by Norman Schmidt, and two of those issues merit discussion here. First, Schmidt contended that the government presented insufficient evidence to support his conviction on three counts of wire fraud and one count of securities fraud. Rebecca Taylor, “an agent” of one of the companies used in the scheme, made the false statements supporting each of these counts. The court held that, since Taylor did not know that her statements were false, she “did not . . . act with [the requisite] criminal intent” to

174. See infra notes 181–203 and accompanying text, particularly at notes 185–89.
175. See infra notes 181–203 and accompanying text, particularly at notes 190–99.
176. See infra notes 200–03 and accompanying text.
177. See infra notes 204–11 and accompanying text.
178. See infra notes 212–21 and accompanying text, particularly at notes 215–16.
179. See infra notes 212–21 and accompanying text, particularly at notes 217–21.
180. See infra notes 222–33 and accompanying text.
181. 594 F.3d 1270, 1272 (10th Cir. 2010).
182. Id. at 1273.
183. Id.
184. Id.
185. Id. at 1274.
186. Id.
violate these statutes, and since she therefore did not violate the statutes, Lewis
could not have aided and abetted her violation. 187  Nor could the government sup-
port the counts on the basis that Lewis “caused” Taylor to make the false represen-
tations 188  because the government could point to no evidence “that Schmidt knew
that Taylor was making false statements to investors, much less that he caused her
to make such statements.” 189

Second, Schmidt claimed that his sentence (originally 330 years but down to
310 years after reversal of the four counts discussed above) 190  was both procedur-
ally and substantively unreasonable. 191  As to procedure, Schmidt conceded that
“a proper calculation under the guidelines leads to an advisory sentence of life
imprisonment.” 192  The Tenth Circuit held that, in light of that circumstance and
the circumstance that “[n]one of the offenses of which Schmidt was convicted
carries a life sentence,” the district court acted in an “eminently reasonable” way
by “imposing the maximum sentence for each crime of which Schmidt was convi-
ceted and making the sentences consecutive,” thereby “[imposing] a sentence
functionally equivalent to life imprisonment.” 193  The court also rejected Schmidt’s
contention that the trial court failed to consider adequately his argument that
his sentence was out of line with those imposed on similar offenders. 194  While
Schmidt had presented the lower court with a list of twenty-eight offenders who
had committed financial crimes but received lighter sentences, that list did not
show that those offenders were similar to Schmidt or that their crimes were com-
parable to his. 195  As to substance, Schmidt’s sentence was “presumed reasonable”
because it was “within the properly calculated guidelines range.” 196  Schmidt failed
to show, by reference to the factors in the sentencing statute, that the appellate

187. Id. (“Because Taylor did not herself act with criminal intent, Schmidt could not be liable as
one who aided and abetted Taylor.”).
188. See 18 U.S.C. § 2(b) (2006) (“Whoever willfully causes an act to be done which if directly
performed by him or another would be an offense against the United States, is punishable as a
principal.”).
189. Lewis, 594 F.3d at 1275.
190. Id. at 1273, 1275.
191. Id.
192. Id. at 1275.
193. Id.
194. The federal sentencing statute requires a court to consider whether its sentence “would create
an ‘unwarranted . . . disparit[y] among defendants with similar records who have been found guilty of
similar conduct.’ ” Id. at 1276 (quoting 18 U.S.C. § 3553(a)(6)) (alteration in original).
195. Id. (“Schmidt failed to provide information about the comparison-defendants’ offense levels
or criminal histories, not to mention information about the specifics of their offenses, such as the
number of victims, whether the victims were particularly vulnerable, or the defendant’s role in the
criminal scheme.”).
196. Id. at 1277.
court should disturb this presumption. 197 The Tenth Circuit went on to quote the district court’s findings that Schmidt had defrauded particularly vulnerable victims—the old and disabled—in many cases out of their life savings. 198

Significance and analysis. The Lewis decision provides further proof that financial fraud sentences can run to biblical lengths. The approval of a 300-year sentence, apparently imposed simply to insure that Schmidt never see the light of day, incurred no censure on appeal. The second defendant in the case had no success in challenging his thirty-year sentence. 199 Where the loss calculated under the sentencing guidelines is large and the government can charge the defendant with multiple counts (thereby facilitating the use of consecutive sentences to reach a large guideline-recommended total), a convicted defendant can expect a stunning prison term.

Even cooperating with the government may not avoid a long stay in a penitentiary. In United States v. Favara, 200 the architect of a fraudulent scheme who pled guilty to multiple counts of wire and securities fraud received 262 months, 201 even though the district court characterized his “cooperation with the government . . . [as] ‘substantial’ and ‘extensive.’ ” 202 The Seventh Circuit, in affirming this sentence, held that “[t]he mere fact” of his cooperation “did not bind the court to impose a lenient sentence” in light of this defendant’s criminal past, his role as “mastermind” here, the extensive planning that he devoted to the fraud, and “his failure to repatriate” “the proceeds of the scheme” “from an off-shore bank account.” 203

197. Id. (citing 18 U.S.C. § 3553(a), which sets out the factors).
198. Id. at 1277–78.
199. Id. at 1273, 1287–91.
200. 615 F.3d 824 (7th Cir. 2010).
201. Id. at 826, 829.
202. Id. at 829.
203. Id.
Aiding and abetting securities fraud by actions legal in themselves. The federal government can bring a criminal action not only against those who commit securities fraud but also against those who aid and abet such fraud.\(^{204}\) To prove that a defendant aided and abetted a securities crime, the government must show that (i) “some other party has committed a securities law violation,” (ii) “the accused party had general awareness that his role was part of an overall activity that [was] improper,” and (iii) the defendant “knowingly and substantially assisted the violation.”\(^{205}\) In *United States v. Faulkenberry*,\(^{206}\) the Sixth Circuit addressed the third element. The defendant was the Director of Seuritizations for an issuer that sold bonds on the promise that the investors’ money would be used to purchase accounts receivable meeting certain criteria.\(^{207}\) In fact, the issuer “routinely advanced funds to healthcare providers without obtaining any receivables, much less eligible ones, in return.”\(^{208}\)

In affirming Mr. Faulkenberry’s conviction for aiding and abetting a securities fraud in the sale of four bond issues,\(^{209}\) the Sixth Circuit found sufficient evidence to support the third element of the offense in the proof that Faulkenberry had signed “incumbency certificates,” which “essentially state[d] that the entities issuing the bonds were corporations ‘duly organized and validly existing under the laws of the State of Ohio,’ that the officers who signed the bonds had the positions the bonds represented them to have, and that the officers’ signatures were genuine.”\(^{210}\) While “[n]o one contend[ed] that the certificates themselves were fraudulent” and while there was no proof that Faulkenberry had himself spoken or written any false statement relating to the bonds, the evidence was sufficient to support a jury finding that he “knew that his role in signing the certificates was part of an overall fraudulent scheme” and—particularly important to the third aiding and abetting element—knew that his signature constituted “substantial assistance” because “the bonds could not have been issued . . . absent the signed certificates.”\(^{211}\)

Significance and analysis. The Faulkenberry decision suggests that attorneys speaking at compliance programs for corporate clients would do well to tell attendees that they might be criminally prosecuted for aiding and abetting a securities fraud even if they do not themselves write or speak a falsehood. The decision also suggests that a corporate attorney might be liable for aiding and abetting a fraud if he or she provides opinions for securities offerings while knowing that the issuer is selling the securities by fraud—even if nothing in the opinion is false or misleading or deceptive in any way.

\(^{207}\) 493 F.2d 1304, 1316 (6th Cir. 1974).
\(^{205}\) 614 F.3d 573, 583 (6th Cir. 2010) (quoting SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974)).
\(^{206}\) Id.
\(^{208}\) 493 F.2d 1304, 1316 (6th Cir. 1974).
\(^{209}\) Id. at 583–84, 591.
\(^{210}\) Id. at 583.
\(^{211}\) Id. at 583–84.
Knowingly and willfully in the Exchange Act section defining a crime. The defendant’s mental state is often key to a criminal case. A criminal violation of the Exchange Act requires either that the defendant “willfully” violate the act or a rule adopted pursuant to the act or “willfully and knowingly make[, or cause[] to be made,” a false and material “statement in any application, report, or document required to be filed under” the act or related rule.\(^{212}\) In vacating the conviction of an executive for conspiracy and substantive securities fraud in connection with his company’s improper recognition—in financial statements—of promotional allowances from suppliers, the Second Circuit in \textit{United States v. Kaiser} addressed the meanings of both “knowingly” and “willfully” as used in the Exchange Act criminal provision.\(^{213}\) The district court had charged the jury that the government could prove that the defendant knew facts relating to the allowances by showing that the defendant had consciously avoided learning the facts.\(^{214}\) While acknowledging that conscious avoidance can be legally equivalent to knowing a fact, the Second Circuit held the trial court’s instruction failed to include the requirement that the government prove both that (i) the defendant was “‘aware of a high probability’” that the fact exists, and (ii) the defendant did not “‘actually believe[] that it does not exist.’”\(^{215}\) The error violated the defendant’s substantial rights and so was fatal to the conviction because the evidence showed that the defendant was “directly involved in relatively few contracts” providing the allowances and because the government’s witnesses’ credibility was open to question.\(^{216}\)

On the other hand, the Second Circuit found no error in the trial court’s charge on willfulness, rejecting the defendant’s argument that willfulness required that he be aware that he was breaking the law.\(^{217}\) The court held that willfulness “do[es] not require a showing that a defendant had awareness of the general unlawfulness of his conduct, but rather, that he had an awareness of the general wrongfulness of his conduct.”\(^{218}\) Although the district court did not employ this phraseology in its charge, it did state that the jury “had to find that [the defendant] knew the statements [in the issuer’s filings] were ‘false and fraudulent’ and that he made those

\(^{213}\) 609 F.3d 556, 559–63 (2d Cir. 2010).
\(^{214}\) Here was the trial court’s instruction:

In determining whether the defendant acted knowingly, you may consider whether the defendant deliberately closed his eyes to what otherwise would have been obvious. To put it in very concise terms, there are times that a person can consciously avoid looking at facts that are available and that, in the law, is the equivalent of knowledge; in other words, you can’t just hide yourself from knowing something, deliberately hide and then escape responsibility for that. And so we have the concept in the law of conscious avoidance.

And if there was conscious avoidance, that is deliberate failure to learn information, then that is the equivalent of actual knowledge, because somebody can’t escape criminal responsibility by deliberately shutting his eyes to something which would have told him the facts.

\(^{215}\) Id. at 564 (quoting district court).
\(^{216}\) Id. at 555–56 (quoting United States v. Schultz, 333 F.3d 393, 413 (2d Cir. 2003)).
\(^{217}\) Id. at 567.
\(^{218}\) Id. at 567–70.
statements ‘with intent to create a deception,’ and the government had to prove ‘the contrary of the idea of mistake or good faith.’”

Significance and analysis. As did the Ninth Circuit in 2009, the Second Circuit decision in 2010 confirms that individuals can criminally violate the securities laws even when they do not know that their conduct transgresses a law. A willful violation requires only that the individual realize that what he or she is doing is wrong. This is a low threshold in a securities fraud case where the proof is likely to involve showing that the defendant knew that he or she was committing a fraud. Everyone knows that fraud is wrong.

On the other hand, proof of knowledge of the fraud by showing that a defendant consciously avoided learning of the fraud seems a bit harder under the Kaiser standard because it requires the defendant be both aware of a “high probability” of a fact and not actually believe that the fact does not exist. In practice, however, attendance at meetings where accounting shenanigans were discussed together with signing securities filings without reading them and throwing budget reports in the trash without reading them can suffice to show conscious avoidance that the securities filings contained false numbers—without direct proof that the defendant knew that the accounting maneuvers were actually translated into materially false figures included in the filings. Accordingly, in practice, the conscious avoidance doctrine substantially improves prosecutors’ chances to convict executives in accounting fraud cases, helping particularly where the executives claim ignorance of how the final numbers in company reports are prepared.

Investor in hedge fund as “client” of hedge fund adviser. In United States v. Lay, the Sixth Circuit affirmed an investment adviser’s conviction for criminal violation of § 206 in the Investment Advisers Act (“IAA”), a section that largely tracks Rule 10b-5 but focuses on fraud committed against a “client” or “prospective client.”

219. Id. at 569–70 (quoting district court). Here was the full charge:

In order to convict the defendant, you must find that he knew that false statements were being made, false information was being incorporated into the earnings results and the accounts receivable results, that he knew that the promotional allowance figures were being inflated, and that he did this with intent to cause a deception, a falsification. Now this means that he cannot be convicted of mistake, he cannot be convicted if he in good faith thought that these results were correct, even though they turned out not to be correct. And the government must prove the contrary of the idea of mistake or good faith belief. The government must prove, as set forth here, that he knew of the false and fraudulent inflation of the promotional allowance figures, he knew of the false and fraudulent inflation of earnings as a result and accounts receivable as a result and that he did that with intent to create a deception.

Id. at 567–68 (quoting district court).

220. United States v. Reyes, 577 F.3d 1069, 1079 (9th Cir. 2009).

221. See United States v. Ebbers, 458 F.3d 110, 124–25 (2d Cir. 2006).

222. 612 F.3d 440, 442–43, 449 (6th Cir. 2010). IAA § 206 provides:

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumental-
ity of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
Lay was an investment adviser to the Ohio Bureau of Workers' Compensation (the "Bureau"), for whom he managed a bond fund called the Long Fund. Lay also organized a hedge fund called the Active Duration Fund—in which the Bureau was the only investor—and Lay was the investment adviser to the Active Duration Fund. The Bureau invested in the Active Duration Fund "to 'provide Lay with flexibility and investment management alternatives for half of the [Long Fund] monies in order to reduce the overall risk to the [Bureau] monies under Lay's control.'" The agreement between the Bureau and the Active Duration Fund "set a non-binding 150% leveraging guideline," and the government charged that Lay violated IAA § 206 because he "consistently leveraged Active Duration Fund assets far over 150%." On appeal, Lay argued that, as the investment adviser to the Active Duration Fund, he owed a fiduciary duty to that fund but not to the Bureau, which was simply an investor in the fund. The Sixth Circuit reasoned, however, that the fiduciary duty that Lay owed to the Bureau as a result of being the Bureau's investment adviser for the Long Fund "continued through the existence of the Active Duration Fund and encompassed the Bureau's Active Duration Fund investment." This was so, the court of appeals concluded, because (i) the Bureau's investment in the Active Duration Fund was part of "a single investment strategy and therefore part of the Bureau's single relationship with Lay," (ii) the Long Fund reports from Lay's company listed the interest in the Active Duration Fund as "'other assets,'" (iii) the Bureau was the only investor in the Active Duration Fund, and (iv) the Bureau's representative met personally with Lay to discuss that fund.

Significance and analysis. In Goldstein v. SEC, the U.S. Court of Appeals for the District of Columbia Circuit carefully differentiated between a hedge fund, which

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

223. Lay, 612 F.3d at 442.  
224. Id. at 442, 445.  
226. Id. at 442–43.  
227. Id. at 445–46.  
228. Id. at 446.  
229. Id. (quoting Long Fund reports). As to the first point,

[The Bureau's Chief Financial Officer] testified . . . [that] the Bureau invested in the Active Duration Fund to diversify existing investments, achieve positive returns regardless of market conditions, and increase returns above those the Bureau could achieve with the Long Fund alone.

Id. The appellate opinion does a poor job connecting the dots between the relationship it finds and the statute that Lay violated. The district court reasoned that the various relationships showed that the Bureau was Lay's "client" for purposes of IAA § 206(1) and (2) and that his fiduciary duty to the Bureau as client activated the prohibition in § 206(4). Lay, 566 F. Supp. 2d at 668–71.
is the client of its investment adviser and to which that adviser owes fiduciary duties, and the investors in the hedge fund, who are not the clients of the fund's adviser and to whom the adviser does not owe fiduciary duties under IAA § 206.230 In Lay, the Sixth Circuit distinguished Goldstein on the basis of the four facts set out above. On the one hand, the Lay reading of § 206 avoids a mechanical application that absolves an adviser of fiduciary duties where the economic reality suggests that the investor in the fund is really the adviser's client, not just the fund itself. As Goldstein recognized, however, there are situations in which an adviser to a hedge fund faces inevitable conflicts in advising the fund, on the one hand, and investors in the fund, on the other.231 It is therefore important that advisers know whether they owe fiduciary duties to just the fund or to the fund and its investor(s). Unless closely cabined, exceptions to the mechanical, bright-line rule can grow through case-by-case creep until they introduce excessive uncertainty. Moreover, any uncertainty that the Lay opinion creates for the work of investment advisers was arguably created for nothing. The government charged Lay with mail and wire fraud as well as with investment adviser fraud, and the jury convicted him of counts under both statutes.232 The trial court sentenced Lay to sixty months on the IAA count and 144 months for each mail and wire fraud count, with the sentences running concurrently.233 So the investment adviser conviction added nothing in the end, except possibly confusion in other cases. The Department of Justice ("DOJ") should consider such unintended consequences of multiple statute indictments when it charges cases.

SEC Enforcement Actions: chain of transactions was not exempted from registration because the issuer's CEO controlled the company to which the issuer transferred the shares that were then sold on to the public; Ninth Circuit suggests that a defendant may be jointly and severally liable for disgorgement even when the defendant did not personally receive the proceeds of the wrongdoing

As is true of several other recent § 5234 cases,235 SEC v. Platforms Wireless International Corp.236 involved a chain of transactions found to violate the requirement that sales of securities either be covered by a registration statement or meet the

231. See id. The court in Goldstein stated:

If the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest. Consider an investment adviser to a hedge fund that is about to go bankrupt. His advice to the fund will likely include any and all measures to remain solvent. His advice to an investor in the fund, however, would likely be to sell.

Id. This quotation suggests that the key fact in Lay was that the Active Duration Fund had but one investor—the Bureau—and so what was good for the fund was good for the investor and what was bad for the fund was bad for the investor. But the Sixth Circuit did not limit its ruling to one-investor funds, instead relying on the multi-fact analysis set out above. See text accompanying supra note 229.

232. Lay, 612 F.3d at 442, 445.
233. Id. at 450 (Kethledge, J., concurring in part and dissenting in part).
236. 617 F.3d 1072 (9th Cir. 2010).
criteria for an exemption from registration. William Martin had owned a sole proprietorship, Intermedia Video Marketing Company ("Intermedia"), through which he performed consulting services for Platforms Wireless International Corporation ("Platforms Wireless") between 1998 and January 2000. By that work, Intermedia earned 17.45 million shares of Platforms Wireless stock. In January 2000, Martin transferred his interest in Intermedia to his former spouse in a divorce settlement, and, in March of that year, Martin became the CEO of Platforms Wireless. In September 2000 and February 2001, Platforms Wireless issued to Intermedia the 17.45 million shares of Platforms Wireless stock that Intermedia had earned between 1998 and 2000. At the time that Platforms Wireless issued that stock, Intermedia transferred its interest in the securities to an individual and an entity who, when they received the stock, promptly sold it on to the public. They sold the stock "with the understanding that the money would pay for Platforms' operating expenses and other obligations, including certain employee salaries," and "at least some of the money was thus spent.

Affirming summary judgment against Platforms Wireless and Martin in an SEC enforcement action for violating § 5, the Ninth Circuit began with the basic principal that § 5 "make[s] it unlawful to offer or sell a security in interstate commerce if a registration statement has not been filed as to that security, unless the transaction qualifies for an exemption from registration." Since "the chain of transactions leading to the sale to the public of 17.45 million unregistered Platforms securities was a prima facie violation of § 5," the defendants could only escape liability if they carried the burden of proving that the sale qualified for an exemption from registration. The defendants argued that the exemption in § 4(1) of the Securities Act applied. That exemption covers "transactions by any person other than an issuer, underwriter, or dealer." The defendants argued that the sales to the public—after transfer of the shares from Platforms Wireless to Intermedia—and that neither Intermedia nor its transferees were issuers, underwriters, or dealers.

The decisive issue was whether Intermedia was an "underwriter." The defendants relied on Rule 144(k) which, as written at the time of the transactions...
here, provided that a nonaffiliate of a company was not an underwriter in a sale if that nonaffiliate had held the stock for at least two years before the sale.\textsuperscript{251} But the Ninth Circuit agreed with the trial court that no genuine issue of triable fact existed as to whether Intermedia was an “affiliate” of Platforms Wireless when the stock was transferred.\textsuperscript{252} Two companies are “affiliates” if they are under common control,\textsuperscript{253} and “control . . . means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.”\textsuperscript{254} Here, Martin controlled Platforms Wireless at the time it issued the shares to Intermedia because Martin was Platform Wireless’s CEO.\textsuperscript{255} And he controlled Intermedia at that time because he remained an officer there (claiming to be its president and CEO), was expressly authorized to transfer securities that Intermedia owned (by an October 2000 “Certificate of Corporate Authorization to Transfer”), and “never disputed that the specific transactions at issue in this case were orchestrated under his direction.”\textsuperscript{256} Since Intermedia and Platforms Wireless were “affiliates,” the Rule 144(k) safe harbor against underwriter status did not apply.\textsuperscript{257}

\textsuperscript{251}. See Appellant and Cross-Appellee William C. Martin’s Opening Brief at 8, 19–22, SEC v. Platforms Wireless Int’l Corp., 617 F.3d 1072 (9th Cir. 2010) (Nos. 07-56542, 09-55039), 2009 WL 6042995 (a lawyer had “opined that because Intermedia had earned the shares for consulting services it performed in 1997 and 1998, Intermedia had beneficially owned the transferred shares for more than two years, and therefore had met a two-year ‘holding period’ for resale provided in the registration exemption set forth in Rule 144”); 17 C.F.R. § 230.144(k) (2001).

\textsuperscript{252}. Platforms Wireless, 617 F.3d at 1087–90.

\textsuperscript{253}. Id. at 1087 (quoting 17 C.F.R. § 230.144(a)(1) (2001)).

\textsuperscript{254}. Id. (quoting 17 C.F.R. § 230.405 (2001)).

\textsuperscript{255}. Id.

\textsuperscript{256}. Id. at 1087–88. The court rejected arguments that Martin’s transfer of Intermedia’s ownership to his former wife, or the letter that an attorney wrote opining that Intermedia and Platforms Wireless were not affiliates, raised a question on the affiliation question that prohibited summary judgment:

The defendants argue that the transfer of ownership of Intermedia from Martin to his former wife raises a genuine factual issue of control. We disagree. Ownership is one means of control, but it is not the only means, and multiple persons can exercise control simultaneously. Martin’s position as a top-ranking officer of Intermedia with the explicit power to direct the specific share transfers at issue establishes control resting on Martin’s title and role in the company. That conclusion is not contradicted by the mere fact of an ownership transfer.

The defendants next contend that attorney Brown’s opinion letters stating that Intermedia was not an affiliate of Platforms also raise a genuine issue of fact on control. We reject this argument. Brown’s letters, offering only legal opinions, and premised on the information provided by defendants, do not bear on the issue of Intermedia’s affiliate status.

\textsuperscript{257}. Id. at 1088 (footnote omitted).

Ordinarly, failure to qualify for the Rule 144 safe harbor does not automatically prevent a transaction from qualifying for the broader Section 4(1) exemption. In this case however, Intermedia’s affiliate status precludes any eligibility for the exemption. See SEC v. Cavanagh, 445 F.3d 105, 111 n.12 (2d Cir. 2006) (observing that affiliates of an issuer are ordinarily “outside the coverage of Section 4(1)”). Because Intermedia was an “affiliate” of Platforms at the time the transactions took place, by definition it necessarily also qualified as an “issuer” for the limited purpose of defining underwriters under Section 2(a)(11). See 15 U.S.C. § 77b(a)(11) (“As used in this paragraph...
The court also rejected the defense argument that the exemption from registration in Securities Act § 4(2)—for sales “not involving any public offering”—applied because the issuance of the shares by Platforms Wireless was exempted by Rule 506. Rule 506 only protects an offering if the issuer has “exercise[d] reasonable care to assure that the purchasers of the securities are not underwriters,” with the rule laying out specific steps that (nonexclusively) demonstrate such “reasonable care.” Platforms Wireless had not taken any of the specific steps laid out in Rule 502. And the court rejected the defense argument that obtaining an attorney’s opinion that Intermedia was not a Platforms Wireless “affiliate” constituted “reasonable care” to assure that Intermedia was not an underwriter because the attorney had simply “relied on” the assumption that Intermedia was not an affiliate . . . , a fact ‘which [Platforms] ha[d] furnished to [the attorney] and represented to be true and correct.’” Not surprisingly, the court of appeals held that “the defendants were not entitled to rely on a conclusion of law that they themselves provided.”

In addition to affrming summary judgment for the government on the § 5 violation, the Ninth Circuit affirmed a disgorgement judgment in the amount of the gross proceeds from the sale of the 17.45 million Platforms Wireless shares. The district court entered that judgment jointly and severally against Martin and Platforms Wireless, and the court of appeals rejected those defendants’ argument that, for each of them, liability “should have been limited to the amount of proceeds that they personally received from the unlawful sales.” Instead, the Ninth Circuit held that both were liable for all because “Martin had control over when and by whom the securities would be sold and hence how the proceeds would be used” and Platforms Wireless had a “close relationship” with Martin and “collaborated in the [§] 5 violations.” While Martin contended that he should not

the term ‘issuer’ shall include . . . any person under direct or indirect common control with the issuer.). Having acquired the securities from an “issuer” with an aim to distribute those securities to the public, [the two transferees from Intermedia] are rendered underwriters, making the transaction ineligible for the Section 4(1) exemption.

Id. at 1090.

258. Id. at 1090 (quoting 15 U.S.C. § 77d(2)).
259. The court of appeals discusses Regulation D only in the context of the § 4(2) exemption, id. at 1090–91. While Regulation D encompasses offerings under Rules 504, 505, and 506, 17 C.F.R. §§ 230.501–508 (2010), a Rule 504 and a Rule 505 offering are exempt under Securities Act § 3(b).

260. Platforms Wireless, 617 F.3d at 1091 (quoting 17 C.F.R. § 230.502(a)).

261. Id.

262. Id. (quoting the attorney’s opinion) (alterations in original).

263. Id.

264. Id. at 1096–99.

265. Id. at 1097–98.

266. Id. at 1098. The court quoted here from SEC v. First Pacific Bancorp, 142 F.3d 1186, 1191 (9th Cir. 1998), which held: “[W]here two or more individuals or entities collaborate or have a close relationship in engaging in the violations of the securities laws, they have been held jointly and severally liable for the disgorgement of illegally obtained proceeds.” Id.
be liable for the disgorgement because he had not put the proceeds from the sales in his own pocket, the court wrote that it had “never held that a personal financial benefit is a prerequisite for joint and several liability” and that, in any event, Martin had benefited from the sales because he had put his own money into Platforms Wireless and proceeds from the sale went into that company, “defraying further investment of his own money, and protecting his substantial personal financial interest in the company.”

Significance and analysis. The Platforms Wireless decision contains few surprises. The court looked at the reality of control—Martin’s top officership at both Intermedia and Platforms Wireless—rather than simply the different ownership of the two companies. The attorney opinion that the defendants obtained before the transactions availed them naught because they provided the attorney with an assumption that the attorney did not check, that drove the attorney’s analysis, and that the courts found, beyond any genuine question, to be wrong. The suggestion that a joint and several disgorgement award may be entered against a defendant who did not derive any personal benefit from the proceeds that a securities law violation generates is a suggestion only. The court went on to find at least some economic benefit to the disgorging defendant from the violation.

Indemnification and Insurance: corporation may condition indemnification on company’s determination that the company “has the financial ability to make the payment, and [that] the financial resources of the corporation should be devoted to this use rather than some other use by the corporation”; Director and Officer Liability Insurance Policy exclusion upon “in fact” determination that insureds engaged in money laundering required court determination, which could be made in coverage action preceding trial of litigation in which the policy was funding defense costs.

Courts of appeals in 2010 rendered two significant decisions on important protections for officers and directors. In the first, the Tenth Circuit found that a

267. Id. In one other holding of note, the Ninth Circuit endorsed use of the tax-underpayment interest rate as the prejudgment rate on the disgorgement on the ground that the interest rate should deprive the wrongdoers of an interest-free loan during the time that they held the proceeds of their wrong and that the tax-underpayment rate—set at a fixed margin above the T-bill rate—accomplishes that purpose. Id. at 1099–1100.

268. In one other SEC enforcement case last year, the Eleventh Circuit addressed remedies in a case in which the defendants had violated the registration requirement of § 5 of the Securities Act and the anti-misstatement/omission prohibitions in § 17(a)(2) and 17(a)(3) of that act. SEC v. Merch. Capital, LLC, 397 F. App’x 593, 595 n.1 (11th Cir. 2010) (citing 15 U.S.C. §§ 77e, 77q(a)(2) & (3)). Finding no clear error in the district court’s determination that the defendants had withheld information by negligence, the appellate court held that the lower court had not abused its discretion in denying a permanent injunction and imposing civil penalties of only $50,000 on the entity defendant and $6,000 and $2,000 respectively on the two individual defendants. Id. at 595; see Brief of the Securities and Exchange Commission, Appellant at 7–8, SEC v. Merch. Capital, LLC, 397 F. App’x 593 (11th Cir. 2010) (No. 09-14890) (“The only remedies the district court imposed were civil penalties in token amounts—$50,000 on Merchant Capital, $6,000 on Wyer and $2,000 on Beasley—for both their registration violations and their negligence-based fraud violations.”). The Eleventh Circuit, however, reversed the trial court’s decision against entering an order for disgorgement, saying: “Disgorgement is not dependent on scienter, but is tied instead to the idea of unjust enrichment: the broad idea is that persons not profit from breaking the securities laws.” Merch. Capital, 397 F. App’x at 595.
corporation's indemnification bylaw did not constitute an illusory promise where it conditioned indemnification on, among other things, the corporation's conclusion that "the financial resources of the corporation should be devoted to this use rather than some other use." In the second, the Fifth Circuit held that, where a director and officer liability insurance policy excluded coverage if it was "determined . . . in fact" that the insured had engaged in "money laundering," as specially defined in the policy to include the possession or use of benefits from the commission of a crime, the insurance company could not simply determine itself that the insured had engaged in money laundering (and that the exclusion therefore applied), but the carrier could obtain such a determination in a coverage action pending before the insureds faced a criminal trial.

Bylaw conditioning indemnification on company's decision that money spent to indemnify should not be used for other corporate purposes does not make an illusory promise. Corporation statutes typically permit companies wide latitude in indemnifying officers and permit the indemnification to include advancement of expenses to officers who are being pursued in government or private cases for actions the officers took at the company. In *Flood v. ClearOne Communications, Inc.*, the Tenth Circuit considered whether a condition that a company placed on indemnification rendered the promise to indemnify illusory.

The ClearOne bylaws conditioned indemnification not only on an officer having satisfied a standard of conduct in taking the actions challenged by the government or private parties but also "on a conclusion that the expenses are reasonable, the corporation has the financial ability to make the payment, and the financial resources of the corporation should be devoted to this use rather than some other use by the corporation." The separation agreement between ClearOne and its CEO—who had come under SEC and DOJ scrutiny—provided that she would be indemnified, and that the company would "continue to pay for [her] reasonable defense costs" "subject to the . . . limitations" in the bylaws.

After about a year of paying the now-former CEO's legal bills, ClearOne first reduced its payments to half the ex-executive's bills, then quit paying altogether.

269. See infra notes 271–90 and accompanying text.
270. See infra notes 291–305 and accompanying text.
272. 618 F.3d 1110 (10th Cir. 2010).
273. The bylaws provided that:

The individual shall demonstrate that:

1. his or her conduct was in good faith; and
2. he or she reasonably believed that his or her conduct was in, or not opposed to, the corporation's best interests; and
3. in the case of any criminal proceeding, he or she had no reasonable cause to believe his or her conduct was unlawful.

Id. at 1112–13 (quoting the bylaws).
274. Id. at 1112 (quoting the bylaws) (emphasis added).
275. Id.
276. Id. at 1113.
ClearOne stopped paying because it had “‘been unable to determine the reason- 
ableness of [the former CEO's attorney] fees and expenses’” and because “‘the best 
interests of the Company’ necessitated that the funds [the former CEO] sought instead be 
put to use for other corporate purposes.’” The company argued that it reached the 
latter conclusion “in part because the company was at the time ‘plagued by a lack 
of liquidity resulting from various economic factors.’”

The former CEO sued ClearOne in federal court to force advancement of fees 
and expenses, and the district court entered a preliminary injunction requiring 
the company to pay 60 percent of fees and expenses at least through the CEO's 
criminal trial and place the remaining 40 percent in a court escrow account. The 
district court ruled in the executive's favor because it concluded that she was 
likely to win on her claim for indemnification. The lower court reasoned that 
the executive would win because conditioning indemnification on the company's 
determination that there was no better corporate use for the money spent on 
indemnification payments rendered the promise to indemnify illusory. The dis-
trict court then found that, with that offending condition excised, the former CEO 
was likely to show that she was owed the fees and expenses she sought.

In vacating the preliminary injunction, the Tenth Circuit held, first, that the 
district court's enforcement of indemnification after excising the condition effect-
ively created an unconditional indemnification and thereby wrongly “impose[d] 
on the parties a new deal to which they[] never assented.” Instead, if the condi-
tion made the promise to indemnify illusory, then the promise was not enforceable 
at all. Second, and more important however, the court of appeals held that the condition ClearOne set did not make the promise illusory. Applying Utah con-
tract law, the Tenth Circuit reached this conclusion because the company could 
invoke the condition only “in good faith” and only “in a ‘reasonable’ manner,” 
which would require that the “process” by which the company concluded that 
the money could be better used other than to pay indemnification display honest 
and reasonable consideration of its financial options. Reasoning that a com-
pany will not always “conclude that its resources are better spent on things other 
than defending its executives against criminal charges,” the court suggested that

277. Id. (quoting the appendix on appeal) (emphasis added).
278. Id. (quoting the ClearOne brief).
279. Id. at 1114. The former CEO eventually was convicted of conspiracy to falsify her company's 
books, willfully making false statements in periodic reports, and making false statements to ClearOne's 
auditors. Id. She appealed the criminal conviction and that appeal was pending at the time the Tenth 
Circuit wrote the opinion summarized here. Id.
280. Id. at 1118.
281. Id.
282. Id.
283. Id. at 1126.
284. Id. at 1119.
285. Id.
286. Id. at 1119–23.
287. Id. at 1120.
288. Id. at 1123.
corporations have “powerful incentives” to “avoid the stigma (and possible liability) associated with having top company officers convicted of crimes” and that “pull[ing]” indemnification “for insufficiently compelling reasons” would “likely . . . make [the company] less competitive in attracting talented applicants in the future.” The court of appeals sent the case back to the district court, without expressing any opinion as to whether the “company is right or wrong,” with the lower court implicitly tasked to find whether ClearOne acted in good faith in ending the indemnification payments.

Significance and analysis. Although the Tenth Circuit may be right in speculating that a company will not cavalierly cease indemnification payments to a former executive, the urge to end the payments can be quite compelling when the officer is fully out of the executive suite and when the developing facts in various investigations turn against the old officer. A company may have sent the officer packing precisely in order to “clean house” and may wish to show the public—and government authorities—a complete break with the former executive. A “good faith” process requirement that a company with a condition on indemnification similar to that at ClearOne carefully consider whether money that would go to paying defense fees and costs for a former officer might better be spent elsewhere imposes little restraint on the desire to end the payments. Thus, regardless of whether a ClearOne-like condition on indemnification renders an indemnification promise illusory in a legal sense, such a condition poses an enormous threat to an executive who could face defense fees and costs in possibly ruinous amounts should his or her service at a company prompt a government investigation and enforcement action, possibly with accompanying private lawsuits. An attorney counseling an executive considering an employment opportunity should review indemnification provisions in bylaws and an employment contract with ClearOne in mind and warn a client of these risks whenever the attorney finds a condition that permits a potential employer to suspend or decline indemnification if the company concludes that the money it could pay for defense fees and costs would benefit the company more if devoted to other business purposes. If a company does have such a condition on bylaw indemnification, an attorney representing an executive who is negotiating an exit agreement in the face of possible government and private lawsuits should bargain for a contractual indemnification in the exit agreement that is not dependent on the bylaws and that does not include any such condition.

Decision in coverage action on whether insured “in fact” engaged in conduct triggering D&O liability policy exclusion. While indemnification provisions in bylaws and employment or separation agreements provide one form of protection to directors and officers sued for securities violations, D&O liability insurance provides pro-
tection in another form. The year 2010 produced a Fifth Circuit decision interpreting such an insurance policy, *Pendergest-Holt v. Certain Underwriters at Lloyd’s of London*. The plaintiffs, officers at companies allegedly perpetrating a Ponzi scheme, sued an insurance company that had written a D&O liability policy. The SEC and the DOJ were pursuing the executives in civil and criminal proceedings. The insurer had funded defense costs until one of the executives pled guilty and implicated the others in statements connected with his plea. The insurer relied on a policy exclusion that permitted the carrier to cease funding defense costs when “it is determined” that an “‘alleged act or alleged acts’” of “money laundering” “‘did in fact occur.’” The policy contained its own definition of “money laundering,” which the court characterized as “the use or possession of Criminal Property,” a phrase that the policy defined to include any “benefit obtained from or as a result of or in connection with criminal conduct.”

The trial court entered a preliminary injunction requiring the insurer to continue paying defense costs “until a trial on the merits” in the coverage action or until “such other time as this Court orders.” On appeal of that injunction, the Fifth Circuit rendered four principal rulings. First, the court of appeals held that the insurer could not itself make the “in fact” determination that an act of money laundering had occurred because the policy did not explicitly reserve to the carrier the right to make that determination and that determination therefore “require[d] a judicial decisionmaker.” Second, the Fifth Circuit ruled that the coverage question—whether a “money laundering” act had “in fact” occurred—was “to be made . . . not in the criminal or SEC actions . . . but in a parallel and independent proceeding”—here the case before the court, in which the preliminary injunction had been entered. Third, the court held that the parties could introduce “extrinsic evidence” in the coverage action—that is, more than the pleadings in the SEC and DOJ actions, and the policy itself. Finally, the Fifth Circuit determined that the policy obligated the insurer to continue to advance costs until a “merits decision is reached” in the coverage action and that, in the event the decision was against coverage, that decision would be “subject

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291. *600 F.3d 562* (5th Cir. 2010).
292. *Id.* at 565, 568.
293. *Id.* at 565. At the time the appellate court decided the case, the lower courts had stayed the SEC’s civil action so that the criminal prosecution could proceed and had scheduled jury selection in that criminal case for January 2011. *Id.* at 566.
294. *Id.* at 565–66, 567–68.
295. *Id.* at 567 (quoting the policy) (emphasis omitted).
296. *Id.* (quoting the policy).
297. *Id.* at 568 (quoting the district court).
298. *Id.* at 570–72 (with quotation at 572). The court applied Texas insurance law. *Id.* at 569.
299. *Id.* at 573. In reaching this conclusion, the court contrasted the “in fact” determination language from the money laundering exclusion with the language of the fraud exclusion, which precluded coverage only in the event of a “‘final adjudication’” that the insurance claim resulted from “‘any dishonest, fraudulent or criminal act or omission.’” *Id.* at 566–67, 572–73 (quoting policy exclusions). Such a “final adjudication” could come only in the underlying substantive action. *Id.* at 572 & n.28.
300. *Id.* at 574.
to reconsideration” if the executives obtained a “favorable verdict” in the government actions.  

Significance and analysis. The Pendergest-Holt case gives with one hand and takes with the other. Since the policy did not expressly provide the insurer the right to determine unilaterally whether the insureds had “in fact” committed an act of money laundering and since the insureds provided a reasonable interpretation of the policy that required a court to make the determination, the ambiguity was—in accordance with black letter insurance law—construed in favor of the insured.  

The carrier could not itself determine that the exclusion applied and then cut off funding. On the other hand, the Fifth Circuit enthusiastically expressed the view that the carrier was entitled to a decision in the coverage dispute before the executives’ impending criminal trial. This left the executives with the unpalatable prospect of possibly devoting time and attention to the coverage case when they needed to prepare for the proceeding that could send them to prison. And it left them with the real possibility that, because they were exercising their Fifth Amendment right in the coverage action, they would lose that case to the carrier and head into the criminal trial without the financial strength for their defense that the policy would have provided.

It may be difficult to conjure sympathy for executives when they are arraigned in the dock. But when examining D&O policies on behalf of executives and directors, lawyers would do well to seek those as to which all exclusions based on misconduct come into play only upon a “final adjudication” in some underlying action.

Definition and Proof of Scienter: while this element is subjective, objective unreasonableness can constitute circumstantial proof of recklessness; scienter can consist

301. Id. at 576. Similarly, the executives’ obligation to repay defense costs if they engaged in “money laundering” within the meaning of the policy would be “triggered only by the coverage determination after any reconsideration.” Id. With this final holding, the court of appeals left the trial court’s preliminary injunction—requiring continued defense funding—in place, subject to the outcome of the coverage case, with that outcome subject to reconsideration should the executives beat the government. Id. However, the Fifth Circuit did direct that the coverage case be moved from the district court judge who was trying the criminal case to another judge. Id. at 575.

302. Id. at 569.

303. As the court put it:

The underwriters are entitled to a decision in a separate coverage action, for their bargain sought to mitigate the risk of advancing substantial fees on behalf of policyholders should it be found that the insureds did in fact commit Money Laundering as defined in the policy. By the bargain, they are not compelled to remain aboard an aircraft that has lost its wings.

304. Id. at 568.

305. Here the carrier could not pull the defense funding based on the fraud/dishonesty exclusion precisely because that exclusion depended on a “final adjudication.” Id. at 566–67. See supra note 299. The policy seems a bit unfair. The definition of Money Laundering was so broad, see text accompanying supra note 296, that it would largely overlap with the acts embraced by the fraud/dishonesty exclusion. When the government alleged fraud, the carrier could use the Money Laundering exclusion to cut off defense funding through a coverage action before the underlying action(s) ended even when the carrier could not use the fraud/dishonesty exclusion to do so because that exclusion had to rest on a final adjudication in the underlying action(s). But the opinion did not address this issue.
of making representations without knowing whether they are true or not and without investigating to determine their truth.

In *Gebhart v. SEC*, the Ninth Circuit opined on the nature and proof of recklessness sufficient to supply scienter under § 10(b) of the Exchange Act and Rule 10b-5. The court denied a petition of two brokers who were disciplined by the National Association of Securities Dealers (“NASD”) and who had unsuccessfully asked the SEC to overturn that discipline. The brokers had sold notes to their customers while representing that the investments were protected by deeds of trust on mobile home parks—trust deeds that would ensure that “in the worst case scenario their clients would be part owners of the mobile home parks and would be able to recover their investments.” The two petitioning brokers made these statements on the basis of representations to them by a third broker, who had described the business of the issuer and the nature of the protections that note holders would enjoy—particularly that the notes were secured by the deeds and that the mobile home properties were only modestly leveraged. In fact, none of the deeds was ever recorded, and the properties were “overencumbered.”

The SEC decision upheld a NASD finding that the two brokers had violated § 10(b) of the Exchange Act, Rule 10b-5, and related NASD Rule 2120. By this petition, the two brokers challenged the SEC conclusion that they had acted with scienter. The Ninth Circuit held that a defendant has scienter if he or she either intends to deceive or is “reckless as to the truth or falsity of [his or her] statements.” Even when scienter consists of recklessness, it remains “a subjective inquiry” turning on “the defendant’s actual state of mind.” But, when the scienter consists of recklessness, a trier of fact may consider whether “the objective unreasonableness of the defendant’s conduct . . . raise[s] an inference of scienter” even though “the ultimate question is whether the defendant . . . was consciously reckless as to . . . truth or falsity.”

In this case, substantial evidence supported the SEC finding that the two brokers were reckless because the two brokers “conducted no meaningful independent investigation to confirm the truth” of the statements by the third broker.
that the two then passed on to their customers.\footnote{317} In that regard, the SEC had emphasized that the two brokers knew that the deeds of trust supposedly securing the notes were second deeds, and the two brokers failed to determine (i) why their clients were depending on second deeds, (ii) who held the first deeds, and (iii) the amounts of the first deeds—all key to whether the second deeds adequately secured the notes.\footnote{318} While the circumstance that the two brokers had themselves bought some of the notes weighed against scienter, the objective unreasonableness of the failure to verify facts was enough to sustain the SEC decision.\footnote{319}

**Significance and analysis.** Clearly a broker who makes a material representation without any idea whether it is true or false is reckless under the standard that Gebhart lays out. The difficulty lies in the two brokers’ reliance on the third broker, who one of the two knew before either started selling the notes and who the two apparently believed to be more experienced than they.\footnote{320} In light of these facts, and the fact that the two put their own money into the notes, it is hard to see how they consciously disregarded the truth or falsity of their statements to clients. The case leaves unanswered whether it would ever be acceptable for one broker to rely on the word of another—or, for that matter, for any other Rule 10b-5 defendant

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\footnote{317. Id. at 1044.}
\footnote{318. Id. at 1043.}

The two brokers argued that they had performed an adequate investigation because (i) they believed that a reputable brokerage had approved the note; (ii) they informed another brokerage’s compliance officer about the program and never received any objection from that compliance officer; (iii) they believed that third-party banks would ensure that the deeds were recorded; (iv) the issuer paid on the notes for a number of years; and (v) they visited two of the mobile home parks that provided the security.\footnote{Id. at 1044 n.12. But, the first point rested on unchecked assurances from the third broker. The visits to the parks did nothing to investigate whether the deeds were recorded or the properties were subject to first deeds that might eat up so much equity that the note holders would be unprotected or under-protected by the second deeds, and the SEC did not find the brokers’ asserted reliance on the banks credible. Id.} In a later case last year, the Ninth Circuit affirmed summary judgment against a company and its chairman/CEO for violating Rule 10b-5 by issuing a press release. SEC v. Platforms Wireless Int’l Corp., 617 F.3d 1072, 1081, 1092–96 (9th Cir. 2010). The court held that “the press release leaves the unmistakable impression that the [company’s planned product] exists,”\footnote{Id. at 1095, when the company “did not have an operating prototype,” id. Acknowledging that “the ultimate question is whether the defendant knew his or her statements were false, or was consciously reckless as to their truth or falsity,” id. at 1093 (quoting Gebhart, 595 F.3d at 1042), the Ninth Circuit wrote: “Evidence showing that the defendants did not appreciate the gravity of the risk of misleading others is relevant to such a determination,” id. at 1093–94. The court held that “a defendant ordinarily will not be able to defeat summary judgment by the mere denial of subjective knowledge of the risk that a statement could be misleading.” Id. at 1094. In Platforms Wireless, Martin knew that Platforms had not produced a complete, field-tested ARC System, [but] . . . he authorized the materially misleading press release suggesting that Platforms had in fact done so. Because no reasonable juror could conclude that Martin was not conscious of the risk that the press release would be misinterpreted, we conclude that Martin was deliberately reckless in issuing this press release. Id. at 1095.}

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\footnote{320. One of the petitioners met the third broker while working with him at Mutual of New York. Gebhart, 595 F.3d at 1037. The other petitioner testified that “we always looked at [the third] as . . . more experienced.” Id. at 1038.}
to rely on the word of someone else—when making statements to investors. The case also leaves unanswered what effort to corroborate would have been enough. While the SEC characterized the two brokers as having made “no effort” to verify the claims of the third, they did at least visit a couple of the properties on which the deeds were written, which would constitute verification that the properties existed. 321 What more was needed—a visit to a county recorder’s office to check on at least one first deed, or a check at that office to find a few first deeds? The root problem with the decision is that Rule 10b-5 recklessness must be more than aggravated negligence, and reliance on a trusted source without adequate checking seems like negligence. 322

Primary Liability Under Rule 10b-5(b): underwriter who distributes prospectus does not thereby “make” the statements in the prospectus; attorney is not a primary violator where he or she negotiates and documents transactions producing deceptive financial statements and drafts offering documents containing misleading statements as to which the attorney has scienter; attorneys are not primary violators where they design a tax shelter security sold by others, the offering documents do not specifically identify the attorneys, and the purchasers do not otherwise learn the names of the attorneys before buying

The Supreme Court has held that the private right of action under Rule 10b-5 does not reach those who aid and abet such a violation, with the result that investors can only sue primary violators under the rule. 323 Last year produced a new crop of cases addressing whether defendants who played particular roles in securities transactions were primary violators and therefore could be properly named as defendants. The First Circuit held that a president and a managing director of a distributor and underwriter for a family of mutual funds were not primary Rule 10b-5 violators with regard to misrepresentations in prospectuses for the funds either (i) on the theory that they “used” the prospectuses to sell shares in the funds, or (ii) on the theory that they implicitly represented that the prospectuses were true. 324 The Second Circuit held that attorneys did not commit primary violations of Rule 10b-5 either by drafting offering documents containing misrepresentations or by negotiating and documenting transactions that produced deceptive financial information included in offering materials. 325

321. See supra note 318; Gebhart, 595 F.3d at 1043 (“The SEC found that the Gebharts ‘made no effort to investigate . . .’ ”).
322. Tellingly, the Ninth Circuit quotes its own definition of recklessness in Gebhart but leaves out the critical passage that emphatically distinguishes recklessness sufficient for Rule 10b-5 from negligence of any sort. Here are the court’s words, with the omitted language in brackets:

[R]eckless conduct may be defined as [a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but] an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Gebhart, 595 F.3d at 1041-42 (quoting Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc)).
324. See infra notes 328–65 and accompanying text.
325. See infra notes 366–87 and accompanying text.
In both that case and a second case—in which the Fifth Circuit held that attorneys did not commit primary violations by designing tax shelters\footnote{See infra notes 388–96 and accompanying text.}—the courts held that the key to attorney liability lies in whether misrepresentations are specifically attributed to attorneys before investors buy or whether the attorneys are specifically identified, before plaintiffs purchase, as having committed an allegedly deceptive act.\footnote{See infra notes 366–96 and accompanying text, particularly at notes 375 and 391.}

Who makes a statement for purposes of Rule 10b-5(b). In 2010, the First Circuit issued an en banc opinion in \textit{SEC v. Tambone}.\footnote{SEC v. Tambone, 550 F.3d 106 (1st Cir. 2008).} The court addressed one issue decided in an earlier panel opinion\footnote{Tambone, 597 F.3d at 442.}: whether “a securities professional” commits a primary violation of Rule 10b-5(b)

\begin{itemize}
\item either by (i) using statements to sell securities, regardless of whether those statements were crafted entirely by others, or (ii) directing the offering and sale of securities on behalf of an underwriter, thus making an implied statement that he [or she] has a reasonable basis to believe that the key representations in the relevant prospectus are truthful and complete.\footnote{Tambone, 597 F.3d at 442.}
\end{itemize}

The First Circuit answered “‘no.’”\footnote{Id. at 439.}

The SEC sued the co-president and a managing director of a company acting as a distributor and underwriter for a family of mutual funds.\footnote{Id. at 439.} A parent company owned both this distributor and a company that acted as the investment advisor to the funds.\footnote{Id.} The Commission alleged that the two defendants knew that fund prospectuses stated that the funds discouraged or prohibited market timing and knew that the statements were false because the defendants had personally “entered into, approved, and/or knowingly permitted arrangements allowing certain preferred customers to engage in market timing forays in at least sixteen different [family] Funds.”\footnote{Id. at 439–40.} The Commission charged that the defendants “used” the prospectuses in their efforts to sell the mutual funds “by allowing the prospectuses to be disseminated and referring clients to them for information.”\footnote{Id. at 440.}

The SEC however did not, by the time the court of appeals considered the question en banc, contend that the defendants “made” the statements by their involvement in the preparation of the prospectuses,\footnote{Id. at 441.} which were the “[d]irect responsibility” of the investment advisor that was affiliated with the distributor/underwriter for which the defendants worked.\footnote{Id. at 439.}

Section 10(b) of the Exchange Act makes it “unlawful . . . [t]o use or employ . . . any manipulative or deceptive device or contrivance in contravention of such
rules . . . as the [SEC] may prescribe.” 338 The SEC issued Rule 10b-5(b) under this section. 339 Rule 10b-5, in turn, makes it “unlawful” for “any person, directly or indirectly” to take any of three actions—set out in subparts (a), (b), and (c). 340 Subpart (b) prohibits “mak[ing] any untrue statement of a material fact or . . . omit[ting] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.” 341

The court of appeals first looked to the ordinary meaning of the word “make,” and found it to mean to “‘create [or] cause’” or to “‘compose,’” 342 which the defendants had not done by simply distributing the prospectuses. 343 The court went on to parse the wording of Rule 10b-5, noting that subpart (a) makes it unlawful “‘to employ’” a “device, scheme, or artifice to defraud.” 344 Subpart (b) on the other hand is limited to a prohibition against “mak[ing]” the identified statements and “making”—presumably in contrast to “employing”—does not reach to simply “using” such statements. 345 The First Circuit noted that a precise reading of Rule 10b-5(b) is important to private securities lawsuits. 346 While the SEC can bring an enforcement action against a defendant who merely aids and abets a violation of Rule 10b-5, 347 a private plaintiff cannot do so but is instead limited to suing primary violators of the rule. 348 The SEC’s argument—“‘reading make’ to include the use of a false statement by one other than the maker”—would “blur the line between primary and secondary violations in [a] manner [that] would be unfaithful” to the private lawsuit limitation 349 by “imput[ing] statements to persons who may not have had any role in their creation, composition, or preparation.” 350

Finally, the First Circuit rejected the SEC argument that “securities professionals impliedly ‘make’ a representation to investors that the statements in a prospectus are truthful and complete.” 351 That position “would . . . impose primary liability under Rule 10b-5(b) on these . . . professionals whenever they fail to disclose

339. Tambone, 597 F.3d at 442.
341. Id. § 240.10b-5(b).
342. Tambone, 597 F.3d at 443 (quoting WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY 1363 (2002); BLACK’S LAW DICTIONARY 1041 (9th ed. 2009)) (alteration in original).
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344. Id. (quoting 17 C.F.R. § 240.10b-5(a)).
345. Id. at 443–44.
346. Id. at 445. 347. Id. at 445–46 (citing 15 U.S.C. § 78t(e)).
348. Id. (citing Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994)). The First Circuit acknowledged that, after Central Bank, different courts of appeals formulated two different tests to determine whether a defendant in a private securities lawsuit is sufficiently related to a statement so as to be a primary violator if the statement is false and the defendant knows that, but commented that “the use and dissemination of prospectuses created by others” does not satisfy either of those tests. Id. at 447. Instead, those “tests focus, albeit to different degrees, on the actual role that a defendant played in creating, composing, or causing the existence of an untrue statement of material fact.” Id.
349. Id. at 446.
350. Id. at 447.
351. Id.
material information not included in a prospectus, regardless of who prepared the prospectus.”

Such a “free-standing and unconditional duty to disclose” would “strike in the teeth of Supreme Court precedent,” which imposes a duty to disclose only in the context of a “fiduciary relationship.”

Significance and analysis. The First Circuit reinstated the panel decision to the extent that it reversed the district court’s dismissal of claims that the defendants violated § 17(a) of the Securities Act and aided and abetted violations by the investment advisor affiliate of Rule 10b-5 and § 206 of the Investment Advisers Act. Section 17(a)(2)—unlike Rule 10b-5(b)—prohibits “obtain[ing] money . . . by means of any untrue statement of a material fact” in the sale of securities and thereby, the First Circuit held, “may fairly be read to cover the ‘use’” of such a statement for that purpose. And, as a concurring opinion pointed out, “the conduct charged [to the defendants] is already covered by an aiding and abetting remedy available to the SEC.” But there is no private right of action under § 17(a), and private litigants cannot sue a defendant for aiding and abetting a Rule 10b-5 violation.

352. Id. at 447–48.

353. Id. at 448. Two judges dissented, arguing that the portion of the majority opinion dwelling on who made the challenged statement in the prospectuses was irrelevant to the SEC argument that underwriters, because of the special position they occupy in distributing securities, make implied statements that prospectuses are true. Id. at 453–64 (Lipez, J., dissenting).

354. Id. at 450 (majority opinion).


356. Id. § 80b-6.

357. Tambone, 597 F.3d at 444. The breadth of this § 17(a)(2) interpretation may be seen in an opinion authored by the Sixth Circuit last year. That court affirmed the securities law criminal conviction of a principal in a corporation that issued bonds. United States v. Ayers, 386 F. App’x 558 (6th Cir. 2010). Ayers was an owner of the corporation issuing the bonds, and the Vice Chairman and Chief Operating Officer. See United States v. Poulsen, 568 F. Supp. 2d 885, 891 (S.D. Ohio 2008) (district court decision).

The jury convicted Ayers of, among other things, a willful violation of § 17(a)(2). Ayers, 386 F. App’x at 562 (citing 15 U.S.C. §§ 77q(a)(2), 77x). Section 17(a)(2) makes it unlawful “to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.” 15 U.S.C.A. § 77q(a)(2) (West 2009 & Supp. 2011). The Sixth Circuit quoted the Tambone decision discussed in the text for the proposition that “the expansive language” of § 77q(a)(2). . . “cover[s] the “use” of an untrue statement of material fact (regardless of who created or composed the statement).” Ayers, 386 F. App’x at 562 (quoting Tambone, 597 F.3d at 444).

In Ayers, the false statements appeared in private placement memoranda prepared to sell the bonds. Id. The Sixth Circuit held that the language in those memoranda was “attributable” to the defendant under § 17(a)(2) because “as a principal [of the issuer], Ayers was responsible for deciding whether and when to issue new bonds,” and “as a member of the Board of Directors, Ayers signed Resolutions authorizing each of the six charged issuances.” Id. The Sixth Circuit held that the evidence showed Ayers had actual knowledge that the critical statements in the private placement memoranda were false. Id. at 562–64.

Although the Sixth Circuit affirmed Ayers’s securities law conviction and conviction for conspiracy to commit securities and wire fraud, it reversed his conviction for conspiracy to launder money. Id. at 564–66.

358. Tambone, 597 F.3d at 452 (Boudin, J., concurring).

359. 4 THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION § 12.22, at 463–64 & nn.25–26 (6th ed. 2009) (“Although some authority remains for the recognition of the section 17(a) remedy, the majority of the more recent decisions favors the denial of an implied right of action under section 17(a).” (collecting cases)).
violation. Moreover, if the private Rule 10b-5 plaintiff seeks to expand the list of defendants—in a case in which a false statement caused the private loss—by resort to subparts (a) and (c) of the rule, the plaintiff is limited by Stoneridge Investment Partners, LLC v. Scientific–Atlanta, Inc. Stoneridge effectively requires that a defendant who did not “make” a statement in such a case have committed another deceptive act on which the plaintiff relied and that was sufficiently “proximate” to the plaintiff’s harm—e.g., by rendering the loss-causing statement “inevitable.”

So the defendants’ actions in Tambone were quite enough to land them in all kinds of trouble with the government. Ultimately, as the First Circuit suggested, the real impact of this decision will appear in private securities lawsuits.

Much of this elaborate effort to cabin private securities lawsuits derives from judicial distrust of private class actions under Rule 10b-5 to remedy securities violations. But it leads to odd results. The Tambone majority concedes that the definition of who “makes” a statement under Rule 10b-5(b) can differ in private lawsuits from the definition in government enforcement actions. All of this demands that courts exercise constant vigilance in such enforcement actions lest they write an unguarded sentence that is appropriate to SEC cases but that might inadvertently cause mischief in a private case. In the end it may be the SEC’s responsibility to avoid leading the court into an unintended error in this regard.

**Attorney liability in private Rule 10b-5 lawsuits.** Last year produced two decisions addressing attorneys’ primary liability under Rule 10b-5. In the first, Pacific Investment Management Co. v. Mayer Brown LLP, the Second Circuit affirmed dismissal of an attorney and his firm. The plaintiffs alleged that Refco Inc. (“Refco”) hid loans to it from an entity controlled by Refco’s CEO by end-of-quarter transactions in which Refco loaned money to third parties, who in turn loaned money to the entity controlled by the CEO, which in turn paid off the loans from Refco. In

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360. See supra note 348 and accompanying text.
361. Those portions of the rule read:

It shall be unlawful for any person, directly or indirectly . . . ,

(a) To employ any device, scheme, or artifice to defraud,

. . . ,

or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

363. Id. at 158–59, 161.
365. Id. at 447 n.9 (majority opinion) (noting that the Second Circuit test, in a private Rule 10b-5 case, requires that an actor both make the offending statement and that it be publicly attributed to that actor at the time of dissemination—with the latter requirement resting on the private plaintiff’s need to prove reliance, an element that the SEC need not prove); see also SEC v. Wolfson, 539 F.3d 1249, 1259–60 (10th Cir. 2008).
366. 603 F.3d 144 (2d Cir. 2010).
367. Id. at 148, 161.
368. Id. at 149.
this way, the affiliated entity had no loans from Refco at the quarter’s conclusion that would have to be reported as related-party transactions.\textsuperscript{369} After the quarter ended, the parties reversed the chain of transactions, thus reinstating the obligation running from the related-party entity to Refco.\textsuperscript{370}

The plaintiffs alleged that the individual attorney defendant’s involvement, and his firm’s involvement, “included negotiating the terms of the loans, drafting and revising the documents relating to the loans, transmitting the documents to the participants, and retaining custody of and distributing the executed copies of the documents.”\textsuperscript{371} The plaintiffs also alleged that the attorney and his firm “participated in the creation of . . . false statements contained in” an offering memorandum for a private offering by Refco, a registration statement for a bond offering by Refco, and a registration statement for Refco’s initial public stock offering (“IPO”).\textsuperscript{372} As part of this work, the individual attorney defendant, together with another lawyer from his firm, “personally drafted the Management Discussion & Analysis (‘MD & A’) portion of the [private] Offering Memorandum, which, according to plaintiffs, discussed Refco’s business and financial condition in a way that defendants knew to be false.”\textsuperscript{373} in light of the debt owed to Refco by the entity controlled by the Refco CEO.\textsuperscript{374} While the private offering memorandum and the IPO registration statement “note[d] that Mayer Brown represented Refco in connection with those transactions,” the registration statement for the bond offering did “not mention Mayer Brown” at all, and “[n]one of the documents specifically attribute[d] any of the information contained therein to Mayer Brown or [the partner there whom the plaintiffs named as an individual defendant].”\textsuperscript{375}

Turning first to the attorneys’ involvement in drafting the several offering documents, the Second Circuit reaffirmed its rule that “secondary actors” such as these lawyers “can be liable in a private action under Rule 10b-5 for only those statements that are explicitly attributed to them.”\textsuperscript{376} The Second Circuit acknowledged

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{369} Id.
\item \textsuperscript{370} Id.
\item \textsuperscript{371} Id.
\item \textsuperscript{372} Id.
\item \textsuperscript{373} Id. at 149–50.
\item \textsuperscript{374} The district court’s decision makes this clear. \textit{In re Refco, Inc. Sec. Litig.}, 609 F. Supp. 2d 304, 308–09 (S.D.N.Y. 2009) (“The portions of the memorandum drafted by the Mayer Brown Defendants included the Management’s Discussion & Analysis (‘MD & A’) and Risk Factors portions, which discussed Refco’s business and financial condition in a way that, given Mayer Brown’s involvement in the round-trip loan transactions and knowledge of the [related-party] receivables, the Mayer Brown Defendants knew to be false.”).
\item \textsuperscript{375} \textit{Pac. Inv. Mgmt.}, 603 F.3d at 150.
\item \textsuperscript{376} Id. at 155.
\item The court noted that, when the defendant is an issuer insider, the Second Circuit precedent is unclear, with \textit{In re Scholastic Corp. Securities Litigation}, 252 F.3d 63, 75–76 (2d Cir. 2001) stating that a corporate officer—who was “involved in the drafting, producing, reviewing and/or disseminating of the false and misleading statements issued by” his or her company—could be individually liable for those statements. \textit{Pac. Inv. Mgmt.}, 603 F.3d at 154. The court of appeals opinion did not attempt to reconcile \textit{Scholastic} with its holding here. \textit{Id.} at 158 n.6. The concurring opinion—noting both the intra-circuit uncertainty created by \textit{Scholastic} and the divergence among the circuits on an attribution requirement for liability by secondary actors—suggested that the U.S. Supreme Court address this issue. \textit{Id.} at 161–62 (Parker, J., concurring).
\end{itemize}
\end{footnotesize}
that the Ninth Circuit employs a different standard—under which such an actor can be primarily liable for a false statement if that actor (with scienter) plays a "‘significant role in drafting and editing’" the statement—377—and noted that the SEC had urged in an amicus brief that the Second Circuit should "adopt a ‘creator standard’ and hold that a defendant can be liable for creating a false statement that investors rely on, regardless of whether that statement is attributed to the defendant at the time of dissemination."378 But the Second Circuit chose to retain its attribution rule both because (i) it is more consistent with the reliance element of a private Rule 10b-5 action,379 and (ii) the attribution rule provides a "bright-line" test, as opposed to the fuzzy boundaries of the "creator standard" that would extend "to secondary actors who ‘supplied the writer with false or misleading information’ or ‘‘caused’ a false or misleading statement to be made,’" and might even reach to a person who "‘merely gave advice to another person regarding what was required to be disclosed and then that person made an independent choice to follow the advice.’"380 Applying the attribution rule here, the Second Circuit held that the attorney and his firm could not be liable on the offering documents because the challenged statements in those documents were never attributed to the lawyer defendants.381

Turning second to the attorneys’ role in negotiating and documenting the round-trip transactions that hid the related-party loans, the court of appeals noted that the plaintiffs premised lawyer liability here not on the theory that counsel had made false statements—and thereby violated Rule 10b-5(b)—but on the theory that counsel had engaged in a "scheme . . . to defraud" and thereby violated Rule 10b-5(a), or engaged in an "act, practice, or course of business which operate[d] . . . as a fraud," and thereby violated Rule 10b-5(c).383 The court of appeals read the U.S. Supreme Court as holding in Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.384 that "the mere fact that the ultimate result of a secondary actor’s deceptive course of conduct is communicated to the public through a company’s financial statements is insufficient to show reliance on the secondary actor’s own deceptive conduct."385 The attorney defendants had done no more than participate in transactions that created false financial documents, and their

377. Id. at 153 (majority opinion) (quoting Wright v. Ernst & Young LLP, 152 F.3d 169, 174–75 (2d Cir. 1998) (internal quotation omitted)).
378. Id. at 151.
379. Id. at 156 (“Where statements are publicly attributed to a well-known national law or accounting firm, buyers and sellers of securities (and the market generally) are more likely to credit the accuracy of those statements. Because of the firm’s imprimatur, individuals may be comforted by the supposedly impartial assessment and, accordingly, be induced to purchase a particular security. Without explicit attribution to the firm, however, reliance on that firm’s participation can only be shown through ‘an indirect chain . . . too remote for liability.’” (quoting Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 159 (2008) (ellipses in original))).
380. Id. at 156–57 (quoting SEC brief).
381. Id. at 158.
382. See supra notes 340–42 and accompanying text.
383. See supra note 361.
385. Pac. Inv. Mgmt., 603 F.3d at 159.
conduct did not “‘make it necessary or inevitable for Refco to record the transactions as it did.’” 386 Therefore, the attorneys were not liable to the investors, in a private Rule 10b-5 action, for their work on the transactions. 387

The Fifth Circuit reached a similar conclusion in Affco Investments 2001, L.L.C. v. Proskauer Rose, L.L.P. 388 The plaintiffs invested in tax shelters marketed by KPMG on representations that the accounting firm would “provide independent opinions from ‘several major national law firms’ that had analyzed and approved the tax strategy.” 389 The plaintiffs ultimately received a letter from Sidley Austin Brown & Wood, 390 but did not allege that “they had knowledge of Proskauer’s role prior to their actual investment.” The tax shelter losses were disallowed, and the plaintiffs paid back taxes, interest, and penalties. 391 The plaintiffs sued Proskauer on, among other claims, a Rule 10b-5 count 392 alleging that Proskauer was involved in the creation of the tax shelters by “work[ing] with KPMG and other defendants behind the scenes to prepare, in advance, model opinions supporting the validity of the tax scheme.” 393 The court held that, since the plaintiffs did “not allege that they knew of Proskauer’s role . . . when they were making their investment decisions” because no statements were attributed to Proskauer during that time, the plaintiffs failed to plead reliance. 394

Significance and analysis. The determined distinction between a Rule 10b-5(b) theory and a Rule 10b-5(a) and (c) theory seems strained. Could a plaintiff argue that, by participating in the writing of misleading disclosure prose with knowledge that it would mislead, an attorney—instead of making a false statement under 10b-5(b)—engaged in a “scheme . . . to defraud” or an “act, practice, or course of business which operate[d] . . . as a fraud” under 10b-5(a) or (c)? If so, then the Stoneridge analysis—which seems to turn on how proximate the defendant’s deceptive act (here writing the misleading words) was to the public statement on which investors relied (by reading those words, or transacting at a price that had changed in reaction to those words) 395—might impose liability on an attorney-drafter because of the close relationship between that attorney’s action and the

386. Id. at 160 (quoting In re Refco, Inc. Sec. Litig., 609 F. Supp. 2d 304, 316 (S.D.N.Y. 2009)).
387. Id.
388. 625 F.3d 185 (5th Cir. 2010).
389. Id. at 188.
390. Id. at 195.
391. Id. at 187.
392. Id. at 189.
393. Id. at 188. In addition, after having invested, the plaintiffs received tax opinions from Proskauer to the effect that, despite certain notices issued by the Internal Revenue Service, “the ‘losses’ generated through the tax scheme were . . . likely allowable.” Id. But that later involvement by the firm could not support a Rule 10b-5 claim for fraud by Proskauer in the purchase of the investments. Id. at 195 n.7.
394. Id. at 195.
395. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 158–59 (2008) (posing that the Eighth Circuit had in that case reasoned that “any deceptive statement or act respondents made was not actionable because it did not have the requisite proximate relation to the investors’ harm,” then saying, “[t]hat conclusion is consistent with our own determination that respondents’ acts or statements were not relied upon by the investors and that, as a result, liability cannot be imposed upon respondents”).
publication of the misleading statement. While the attorney’s action would not in such a case have made the publication “necessary or inevitable” because the client could have changed the words that the attorney wrote, the attorney would not have been “remote” from the wrongful statement, and perhaps therefore a primary violator under Rule 10b-5. 396

**Loss Causation:** the “truth” that must be revealed to show the falsity of a prediction includes more than that the prediction was incorrect; Exchange Act requires economic loss in proxy misrepresentation case, even when a private plaintiff in a direct action seeks equitable relief, and dilution without more is not economic loss; when facts regarding an alleged fraud appear at one time and, at a later time, a director and the financial press and investors react to those facts, a court properly evaluates loss causation at the time the facts appeared rather than at the time of the later reaction.

The Fifth Circuit held last year that a stock decline following revelation that a company failed to make a projection did not show loss causation unless the disclosure also showed that the projection was misleading when made, thereby linking loss causation and the peculiar rules governing whether a forecast is false. 397 The Ninth Circuit ruled that the statute requiring that plaintiffs prove loss causation in private Exchange Act cases applies in actions based on proxy statement claims, even when the plaintiff styles its monetary relief as equitable. 398 That court went on to hold that dilution does not by itself constitute economic loss. 399 The Second Circuit held that loss causation is determined when an omitted fact (or the truth behind a misrepresentation) is first revealed to the market and not by the disclosure of later events that are linked to the fact—such as a director resignation or analysis in the financial press or in analyst reports. 400

Loss causation where the alleged false statement is an estimate. In Dura Pharmaceuticals, Inc. v. Broudo, the Supreme Court held that private plaintiffs could prove loss causation in a Rule 10b-5 action by showing that the security they purchased lost value after, and as a result of, revelations disclosing the truth behind falsehoods that the defendants wrote or spoke or the truth that the defendants wrongfully withheld. 401 The Fifth Circuit applied that principle to a case involving an allegedly false prediction in Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co. 402

Among other things, the plaintiff contended that Halliburton had misrepresented its potential liability in asbestos litigation. 403 Halliburton’s exposure derived

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396. *Id.* at 160 (stating that the “inquiry [is] whether [defendants’] acts were immediate or remote to the injury”).
397. *See infra* notes 401–24 and accompanying text.
400. *See infra* notes 440–59 and accompanying text.
401. 544 U.S. 336, 344 (2005) (noting the “common-law roots of the securities fraud action” and that “the Restatement of Torts, in setting forth the judicial consensus, says that a person who ’misrep-resents the financial condition of a corporation in order to sell its stock’ becomes liable to a relying purchaser ‘for the loss’ the purchaser sustains ‘when the facts . . . become generally known’ and ‘as a result’ share value ‘depreciate[s].’ § 548A, Comment b, at 107.” (ellipses in original)).
402. 597 F.3d 330 (5th Cir. 2010).
403. *Id.* at 339.
from its merger with another company.\textsuperscript{404} After that merger, Halliburton reported in May 2001 that it had reserved about $30 million for asbestos liability.\textsuperscript{405} In late June of that same year, Halliburton reported that it was increasing that reserve by $50 to $60 million, then reported, in October and December, judgments in asbestos cases for which Halliburton was responsible.\textsuperscript{406} The plaintiff contended that Halliburton had violated Rule 10b-5 by stating that the reserve was adequate.\textsuperscript{407}

When the plaintiff moved for class certification, it argued that it could prove reliance by showing a fraud on the market and thereby satisfy the requirement that common issues of law and fact predominated, which is a prerequisite for class certification under Rule 23(b)(3).\textsuperscript{408} After the district court denied that motion, the Fifth Circuit affirmed\textsuperscript{409} in an opinion noting that this circuit requires a plaintiff seeking class certification based on fraud-on-the-market reliance to establish loss causation—on the certification motion—by a preponderance of the evidence.\textsuperscript{410}

As to the asbestos liability reserve, the plaintiff had shown that Halliburton’s stock price declined after the June 2001 announcement that the company was increasing the reserve and after the October and December disclosures of jury verdicts that Halliburton would have to pay.\textsuperscript{411} But the court of appeals held that the press release in June did “not correct a specific prior alleged misstatement.”\textsuperscript{412} The Fifth Circuit reasoned that “[j]ust as merely lowering earnings estimates does not reveal that a defendant previously misrepresented those estimates, merely raising the asbestos reserves does not show that those prior reserve estimates were intentionally misleading.”\textsuperscript{413} The court went on to say that “a company is allowed to be proven wrong in its estimates,” and that there was “no indication from the June 28, 2001 press release that Halliburton’s prior asbestos reserve estimates were misleading or deceptive.”\textsuperscript{414} The court rejected the plaintiff’s position that the June announcement “corrected prior allegedly false estimates . . . merely because

\begin{itemize}
\item 404. Id.
\item 405. Id.
\item 406. Id.
\item 407. Id.
\item 408. Id. at 334 (suggesting that the plaintiff relied on the fraud-on-the-market theory); FED. R. CIV. P. 23(b) (requiring the court to “find[] that the questions of law or fact common to class members predominate over any questions affecting only individual members”); Basic Inc. v. Levinson, 485 U.S. 224, 228–30 (1988) (noting the importance of presuming reliance to Rule 23(b)(3) class certification).
\item 409. Archdiocese, 597 F.3d at 334, 344.
\item 410. Id. at 335.
\item 411. Id. at 339. Curiously, the Fifth Circuit states at one point that a plaintiff may demonstrate a fraud-on-the-market at the class certification stage by showing either “an increase in stock price immediately following the release of positive [false] information, or by showing negative movement in the stock price after release of the alleged ‘truth’ of the earlier falsehood.” Id. at 335. In this case, the plaintiff chose the second path. Id. But the first path seems foreclosed by the Supreme Court’s reasoning in the \textit{Dura} case, where the Court expressly rejected the notion that a plaintiff could show loss causation by proving that he or she or it had purchased at a price that was inflated by a falsehood, rather than by proving that disclosure of the truth knocked the price down. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345 (2005).
\item 412. Archdiocese, 597 F.3d at 339–40.
\item 413. Id. at 340.
\item 414. Id.
\end{itemize}
As to the announcements of judgments for which Halliburton was responsible, those disclosures failed to show that previous company statements were false because Halliburton had warned repeatedly of “the uncertainties of litigation and the possibility that a series of adverse court rulings could materially impact the expected resolution of asbestos claims.”

Significance and analysis. The Fifth Circuit stated that, in order to prove loss causation, the plaintiff needed “to demonstrate the joiner between an earlier false or deceptive statement, for which the defendant was responsible, and a subsequent corrective disclosure that reveals the truth of the matter, and that the subsequent loss could not otherwise be explained by some additional factors revealed then to the market.” The plaintiff’s fatal failing was its failure to show that the revelations to which it pointed actually revealed “the truth” about “an earlier false or deceptive statement.”

To the extent that the court suggests that, in order to show an estimate false, a plaintiff must show that it was “intentionally misleading,” the opinion at first blush seems to confuse falsity with scienter. But there is substantial authority for the view that, in order to be “false,” an opinion or prediction must be both subjectively false (in the sense that the speaker or writer did not believe in the opinion or prediction when he or she or it announced it) and objectively false (in the sense that the opinion or prediction implied objective facts that were not true).

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415. Id.
416. Id. The court also held that the plaintiff failed to demonstrate loss causation as to two other alleged misrepresentations. First, the plaintiff contended that Halliburton had made false statements about benefits from a merger with Dresser Industries. Id. at 341. The plaintiff attempted to show loss causation as to that part of its case by pointing to a decline in Halliburton’s stock price after an October 4, 1999, Halliburton announcement that it was selling two assets acquired in the Dresser deal and after two analysts lowered their estimates of Halliburton’s future earnings. Id. But both the October 1999 announcement and the analysts’ reports contained multiple pieces of bad news, and the plaintiff never showed that it was the Dresser-related news that caused the stock price decline that followed. Id. at 341–42. As the court put it in its general discussion of loss causation, the plaintiff’s burden is to show that the correction of the alleged fraud “and not any other unrelated negative statement . . . caused the stock price decline.” Id. at 337.

Second, the plaintiff charged that Halliburton falsely included, in its reported revenue, cost overruns on fixed price contracts—overruns for which customers had not agreed to pay. Id. at 341, 342. The plaintiff argued that price declines after an October 24, 2000, press release and a December 21, 2000, announcement demonstrated loss causation in this part of the case. Id. at 342. But the October 2000 press release did “not mention fixed price contracts, unapproved claims, or the method for recognition of revenue from such claims.” Id. Instead, that release “attribute[d] a large drop in . . . revenue to a decline in customer spending.” Id. at 343. The October 2000 release therefore did not correct the alleged falsehood and, accordingly, could not be a “corrective disclosure that reveals the truth of the matter” that was followed by a “subsequent loss.” Id. at 336. The December 2000 announcement contained “clearly non-culpable negative information” including the company’s discouraging comments on “a consolidating customer base, difficult relationships with certain customers . . . and a fiercely competitive environment.” Id. at 343. The plaintiff’s expert apparently failed to show that any portion of a stock price decline following that announcement could be attributed to exposing the truth of any alleged Halliburton misstatement. Id.

417. Id. at 336.
418. Id. at 340.
419. The court expressly likens the reserves estimate to an “earnings estimate.” Id.
420. See Rubke v. Capitol Bancorp Ltd., 551 F.3d 1156, 1162 (9th Cir. 2009).
If that is correct, then indeed, a "corrective" statement showing an opinion or prediction—such as a litigation reserve—to be false must show that it was subjectively false, i.e., that the defendant did not believe it or, as the Fifth Circuit put it, that the opinion, prediction, or estimate was "intentionally misleading."\textsuperscript{421} Although this seems to inject scienter into falsity, as the First Circuit observed in 2005, when dealing with opinions the "subjective aspect of the falsity requirement and the scienter requirement essentially merge."\textsuperscript{422}

The interaction between loss causation and the requirement that a speaker disbelieve\textsuperscript{423} an opinion or prediction is tricky. On the one hand, there will be few instances in which a defendant makes a "corrective" statement acknowledging that it disbelieved an opinion or prediction when the defendant provided that opinion or prediction. So requiring a plaintiff to prove such a corrective statement for loss causation—or requiring a plaintiff to otherwise show by a preponderance of the evidence that the market knew of the subjective falsity before dropping the price of a security—might virtually prohibit private Rule 10b-5 actions on opinions and predictions. On the other hand, the technical statement of loss causation—that a disclosure show that the defendant's statement was "false," with that disclosure causing a price decline—seems to demand just that.

An alternative analysis focusing on what caused a stock price to drop might find loss causation if a disclosure revealed either subjective or objective falsity of an estimate or projection. Under this approach, if the disclosure that an estimate was objectively false causes the stock price to fall, then that decline would be sufficient for loss causation. If, on the other hand, the stock only drops after disclosure that the author did not believe the estimate to be correct at the time the author provided the estimate, then that disclosure would suffice for loss causation. As an example, suppose that a CEO predicts earnings of $1.00/share in the third quarter and that the company later announces that the company anticipates earnings of only $.50/share. Suppose that the company also states that its backlog of orders did not, at the time of the $1.00 estimate, justify that high a projection—even though the top executives at the company thought the estimate a good one. If the share price drops on this disclosure of objective falsity, then—under the alternative analysis suggested here—that drop would provide loss causation. Suppose, on the other hand, that the company's revised estimate is $.95/share and that, at the time of the revision, (i) the company states that its backlog at the time of the $1.00 projection did not support that prediction, and (ii) the price of the company's stock does not drop. Suppose that the company later releases the report of an internal investigation showing that the CEO predicted the $1.00/

\textsuperscript{421} Archdiocese, 597 F.3d at 340.
\textsuperscript{422} In re Credit Suisse First Bos. Corp., 431 F.3d 36, 48 (1st Cir. 2005).
\textsuperscript{423} It may be sufficient, for subjective falsity, that the speaker or writer was simply reckless with regard to the opinion or prediction. But see 15 U.S.C. § 78u-5(c)(1)(B) (2006) (requiring that, in order to recover in a private Rule 10b-5 case on a forward-looking statement, the plaintiff must prove that the defendant had "actual knowledge" that the statement was false or misleading when made).
share profit because the CEO wanted to sell her company stock and thought that the $1.00/share prediction would keep the stock price high during the period in which she planned to sell, even though she did not believe that the company would ever produce the $1.00/share profit. Suppose that it is only after this second revelation—of subjective falsity—that the stock price falls. Then that second revelation would have caused the drop and—under the alternative analysis suggested here—would be sufficient for loss causation.

The last part of the Fifth Circuit ruling on the asbestos issue is an odd one on class certification. The court says that there was no false statement about possible adverse court judgments because of Halliburton’s warnings that litigation was uncertain. But that analysis goes to whether there was a false statement at all, not to loss causation. While the issue of whether there was a false statement about possible lawsuit outcomes might be appropriately aired on a motion to dismiss or a motion for summary judgment, it seems a strange one to address at class certification. Perhaps there can be no “corrective” revelation for loss causation if there is no false statement. But bringing into loss causation whether a statement was false to begin with by such reasoning seems bootstrapping, particularly if the result is to litigate falsity on a class certification motion.

Loss causation and alleged false statements in proxies. The Exchange Act provides that, “[i]n any private action arising under this [Act], the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this [Act] caused the loss for which the plaintiff seeks to recover damages.” In New York City Employees’ Retirement System v. Jobs, the plaintiff filed a claim under § 14(a) of the Exchange Act and related SEC Rule 14a-9 alleging that Apple Computer Inc.’s 2005 proxy statement—which sought approval for committing shares to employee stock purchase and option plans—made false statements,}

424. Requiring that both subjective and objective falsity be shown—with a resulting price decline—might mean that plaintiffs could demonstrate such causation in only those rare cases in which a company simultaneously provides (i) a revised estimate, (ii) evidence of objective falsity, and (iii) evidence of subjective falsity. A disclosure both revising the estimate and supplying only evidence of objective falsity or only subjective falsity will likely drive the stock price down. The later disclosure of, respectively, the subjective or objective falsity of the original estimate—without a further revision—is unlikely to precipitate an additional decline.


426. 593 F.3d 1018 (9th Cir. 2010).

427. Id. at 1022. Section 14(a) lies at 15 U.S.C.A. § 78n(a) (West 2009 & Supp. 2011) and Rule 14a-9 at 17 C.F.R. § 240.14a-9 (2010). Section 14(a) prohibits proxy solicitations in violation of SEC rules, and Rule 14a-9 prohibits proxy statements that are “false or misleading with respect to any material fact, or which omit[] to state any material fact necessary in order to make the statements therein not false or misleading.”

428. The Ninth Circuit opinion is unclear. But the appellant’s brief on appeal is explicit. See Initial Brief for Plaintiff-Appellant, The New York City Employees’ Retirement System at 6 n.3, N.Y.C. Emps.’ Ret. Sys. v. Jobs, 593 F.3d 1018 (9th Cir. 2010) (No. 08-16488), 2008 WL 5070068 [hereinafter N.Y.C. Employees’ Appellate Brief] (“Specifically, the 2005 Proxy sought shareholder support to (a) increase the aggregate shares reserved under Apple’s Employee Stock Purchase Plan by 2 million up to a total of 70 million; and (b) increase the aggregate shares available for distribution under the Company’s 2003 Employee Stock Option Plan by 49 million.”).
all related to backdating of Apple options, the truth about which came to light only after the 2005 vote. Affirming the district court’s dismissal of this claim, the Ninth Circuit held that the plaintiff’s § 14(a) claim was a direct rather than a derivative claim as it asserted “that Apple shareholders were deprived of the right to a fully informed vote.” Accordingly, the plaintiff “had to allege loss causation” per the statute requiring loss causation in private Exchange Act lawsuits. Rejecting the plaintiff’s argument that that statute did not apply because the plaintiff sought equitable relief—“‘rescissory in nature’”—the Ninth Circuit held that the loss causation statute “does not differentiate between plaintiffs seeking legal and equitable remedies, and thus, without an allegation of economic loss, no remedy, equitable or otherwise, is available.” Moreover, the only economic loss that the plaintiff alleged was loss from dilution of its ownership interest through the issuance of the additional shares to Apple officers and employees. The court of appeals found this allegation insufficient as “economic loss does not necessarily accompany dilution” and “conclusory assertions of loss are insufficient.”

Significance and analysis. The statute seems clear. But it is important to remember that the requirement to prove loss causation arises only in a “private action,” so that it does not apply where the SEC seeks a remedy for a proxy violation.

429. The Ninth Circuit characterized the allegations in these words:

For the § 14(a) claim, NYCERS alleges three falsities in Apple’s 2005 proxy solicitation. First, the solicitation states that Apple’s compensation practices “align[ed]” the interests of employees and stockholders, because stock options would “have value only if the Company’s stock price increases.” NYCERS alleges falsity because backdated options can have value even if Apple’s stock price does not increase, thereby decoupling employee and shareholder interests. Second, the solicitation states that granted options “did not make up for the below market cash compensation paid to executive officers.” NYCERS alleges misrepresentation because backdating can surreptitiously increase compensation. Third, the solicitation states that in March 2003, Steve Jobs, Apple’s current Chairman and CEO, cancelled his outstanding options in exchange for ten million (split adjusted) shares of restricted stock. NYCERS alleges misrepresentation because some of the cancelled options were backdated, improperly providing Jobs with 630,000 extra shares valued at over $50 million.

N.Y.C. Emps.’ Ret. Sys., 593 F.3d at 1021.

430. N.Y.C. Employees’ Appellate Brief, supra note 428, at 5–6 (“[A]fter a series of public disclosures beginning in the summer of 2006, on December 29, 2006, Apple admitted that it had, on no fewer than 6,428 separate instances, improperly manipulated the grant dates in connection with stock options granted to employees over the previous decade.”).

431. N.Y.C. Emps.’ Ret. Sys., 593 F.3d at 1021, 1025. The court of appeals held, however, that the lower court had abused its discretion in denying the plaintiff an opportunity to reallege a claim, under § 10(b) of the Exchange Act and Rule 10b-5, that the plaintiff had omitted from its consolidated complaint. Id. at 1024–25. The Ninth Circuit reversed the order denying leave to reallege and remanded the case for further proceedings relating to that claim. Id. at 1025.

432. Id. at 1022–23.

433. Id. at 1023.

434. Id. at 1024. The complaint sought rescission of the vote authorizing the issuance of the shares and “compensatory damages for share dilution.” Id. at 1021.

435. Id. at 1024.

436. Id.

437. Id.

Troublingly, the Ninth Circuit suggests that the statute requires an allegation of economic loss and loss causation even if the plaintiff seeks only an injunction, which seems wrong.\footnote{439} Whether to test loss on revelation of information or later financial community reaction to the information. In 2010, the Second Circuit considered, in the loss causation context, the significance of reactions to disclosures that occur long after the disclosures themselves. The \textit{In re Omnicom Group, Inc. Securities Litigation}\footnote{440} plaintiff alleged accounting fraud related to an early 2001 transaction in which Omnicom transferred declining internet marketing and advertising businesses to Seneca, a company that Omnicom organized with a private equity firm.\footnote{441} At or close to the time of that deal, “[s]everal news articles . . . reported the Seneca transaction and suggested that it was an attempt to move the internet companies, whose value was deteriorating, off Omnicom’s books.”\footnote{442} Omnicom’s stock did not drop by a statistically significant amount in reaction to these stories.\footnote{443} In June 2002, the head of Omnicom’s audit committee resigned, and subsequent stories linked his departure to concerns about the Seneca deal.\footnote{444} Omnicom’s stock price dropped more than 25 percent in the two days after the most important of those stories, one in the \textit{Wall Street Journal}.\footnote{445} When investors brought a Rule 10b-5 action against Omnicom, the district court granted summary judgment for failure to raise a triable issue on loss causation.\footnote{446} In affirming,\footnote{447} the Second Circuit held that the plaintiff could not rely

\footnote{439} The statute refers to “the loss for which the plaintiff seeks to recover damages,” \textit{id.}, and so its application seems to depend on a plaintiff seeking damages. But the court states at one point that the statute “does not differentiate between plaintiffs seeking legal and equitable remedies, and thus, without an allegation of economic loss, no remedy, equitable or otherwise, is available.” \textit{N.Y.C. Emps.’ Ret. Sys.}, 593 F.3d at 1023 (emphasis added). Since the court made this comment in response to the plaintiff’s argument that it wanted a rescission remedy, the court may have intended to say simply that if a plaintiff seeks money—whether styling the monetary claim as legal or equitable—the plaintiff must prove loss causation.

\footnote{440} 597 F.3d 501 (2d Cir. 2010).
\footnote{441} \textit{id.} at 504.
\footnote{442} \textit{id.} at 505. Here are the samples that the court provided:

On May 7, 2001, \textit{Advertising Age} published an article stating that the Seneca transaction “was seen by some as a way for Omnicom to get struggling stocks off of its books.” InternetNews.com featured an article about the Seneca transaction on June 26, 2001, in which it stated that “[t]he merger comes out of a complicated effort by ad agency group Omnicom to lessen its losses in the interactive sector, by sharing its stakes in Agency.com and other I-shops with a private equity firm, Pegasus Partners.” Later, on September 17, 2001, an article in \textit{Fortune} stated that “[Omnicom’s CEO John] Wren is just cleaning up the mess from his last big foray into untapped market terrain: the Internet,” and that “Wren is now getting all the Net assets off Omnicom’s books by shoveling them into a private holding company called Seneca.” \textit{id.} at 505 n.1 (internal citations omitted) (alterations in original).

The court also commented that “observers expressed these views [that the Seneca transaction was a means of getting unprofitable internet businesses off Omnicom’s financial statements] well into 2002.” \textit{id.} at 505.

\footnote{443} \textit{id.}
\footnote{444} \textit{id.} at 505–07.
\footnote{445} \textit{id.} at 505–08.
\footnote{446} \textit{id.} at 509.
\footnote{447} \textit{id.} at 514.
on the June 2002 price decline for loss causation, because the facts regarding the Seneca transaction had been disclosed in 2001, digested by the market then, and incorporated—without significant effect—into the Omnicom stock price at that earlier time.\footnote{448}{Id. at 511.}

As the court saw it, the June 2002 stories did not “reveal some then-undisclosed fact with regard to the specific misrepresentations alleged in the complaint concerning the Seneca transaction.”\footnote{449}{Id.} Rather, the 2002 stories simply repeated earlier disclosures, and “[a] negative journalistic characterization of previously disclosed facts does not constitute a corrective disclosure” for loss causation analysis “of anything but the journalists’ opinions.”\footnote{450}{Id. at 512.} While the plaintiff pointed to the statements of two accounting professors quoted in the 2002 articles “to support a nexus between the fraud alleged and the June 2002 decline in [Omnicom] share price,” the Second Circuit held that “the conclusory suspicions of the accounting professors . . . added nothing to the public’s knowledge that the Seneca transaction was designed to remove losses from Omnicom’s books.”\footnote{451}{Id.} Although the plaintiff contended that the audit committee chair’s “resignation and the ensuing negative media attention were foreseeable risks of the fraudulent Seneca transaction and caused the temporary share price decline in June 2002,”\footnote{452}{Id. at 513.} the court rejected that theory of loss causation because it is generally the “facts underlying the fraud and resignation” that must cause the “compensable investor’s loss.”\footnote{453}{Id. at 514.}

Compensating investors for stock drops like the June 2002 price decline would “expose companies . . . to potentially expansive liabilities” depending on “distant, ambiguous, and perhaps idiosyncratic reactions by the press or even by directors” to “facts . . . known to the investing public” before the reactions, facts that “did not affect share price” when first revealed.\footnote{454}{Id.}

Significance and analysis. The Omnicom decision in the loss causation context resembles the Merck decision in 2005,\footnote{455}{In re Merck & Co. Sec. Litig., 432 F.3d 261 (3d Cir. 2005).} which found no materiality to the accounting treatment for prescription co-payments when the market did not react to the disclosure of the accounting treatment but did react after a \textit{Wall Street Journal} reporter estimated the magnitude of those payments.\footnote{456}{Id. at 268–71 (“Merck’s stock did not drop after the first disclosure, and that is generally when we measure the materiality of the disclosure,” id. at 269).} The theory behind these decisions posits that key participants in an efficient market not only read or hear new and unexpected information as soon as it appears but that those key market participants almost instantly analyze that information and incorporate it into new valuations which then, again almost immediately, generate buy/sell decisions and buy/sell recommendations. Plaintiffs frequently plead as much by alleging that a market is efficient and immediately incorporates all new and unexpected information into
price. Indeed, the _Omnicon_ plaintiff alleged that “the market for Omnicom’s securities promptly digested current information regarding Omnicom from all publicly available sources and reflected such information in Omnicom’s stock price.”

The reality, however, may be more complicated. The significance of information, to the market, can become apparent over time, and that process may involve the publication of analyst opinions and statements by present or former executives and directors. It is strange that, on summary judgment as in _Omnicon_ or on a motion to dismiss as in _Merck_, courts seem so eager to rely on efficient market theory that they refuse to entertain the possibility of a delay between disclosure of information and its analysis and conversion into price.

This phenomenon seems particularly odd in _Omnicon_ because the plaintiff pled that the significance of the information only became apparent when the head of the company’s audit committee resigned. Indeed, the opinion suggests that the court would have affirmed the summary judgment even if the audit chair, on resignation, had made some inflammatory remark to the effect that the Seneca transaction was an out-and-out deliberate fraud. Courts attribute different importance to the statements of different participants in the market—for example, attributing more importance to statements of insiders than those outside the company when evaluating a “truth-on-the-market” defense. Along the same lines, it is hard to see why a court would not at least entertain the possibility that the

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457. _Omnicon_, 597 F.3d at 510–11 (quoting complaint).

458. But this may be too strong. The Second Circuit did remark that the audit chair resigned in part because “he had been mistakenly informed that the Board had never approved [the Seneca deal].” _Id._ at 514. If the director’s departure had not been clouded by this misunderstanding, perhaps the court of appeals would have attributed more importance to it.

459. See _In re Seagate Tech. II Sec. Litig._, 802 F. Supp. 271, 275 (N.D. Cal. 1992). The court stated:

The Ninth Circuit has embraced [the] “truth on the market” defense suggested by the _Basic_ court. “[I]n a fraud on the market case, the defendant’s failure to disclose material information may be excused where that information has been made credibly available to the market by other sources.” _In re Apple Computer Securities Litigation_, 886 F.2d 1109, 1115 (9th Cir. 1989). . . .

The truth on the market defense has its limits. Scrutiny by the press or by analysts will not ordinarily excuse misleading statements or omissions, and corporations are not relieved of their duty to disclose material information where that information has received inadequate exposure from third party sources. This is because:

the investing public justifiably places heavy reliance on the statements and opinions of corporate insiders. In order to avoid Rule 10b-5 liability, any material information which insiders fail to disclose must be transmitted to the public with a degree of intensity and credibility sufficient to effectively counterbalance any misleading impression created by the insiders’ one-sided representations.

_Apple Computer_, 886 F.2d at 1116. With this language, the _Apple Computer_ court emphasized that even where information does seep into the market from third party sources, a confirming announcement from the company itself, or the absence thereof, may be “viewed by a reasonable investor as having significantly altered the ‘total mix’ of information made available.” _TSC Industries_, 426 U.S. at 449, 96 S. Ct. at 2132. The truth on the market defense can only be sustained where the corrective statements are shown to have “credibly entered the market.” _Apple Computer_, 886 F.2d at 1116, citing _Basic_, 485 U.S. at 249, 108 S. Ct. at 992 (emphasis added).

_Id._
market's reaction to corrective information might be delayed until a credible insider's comment on the information—or even implicit comment by a resignation linked to a questioned transaction—revealed its significance.

**Falsity:** statements that no mortgages in pool were delinquent were not false where prospectus also stated that seller of mortgages would repurchase or replace delinquent mortgages

*Lone Star Fund V (U.S.), L.P. v. Barclays Bank PLC*[^460] held that certain issuer representations in an offering, though false when considered by themselves, were not false for securities law purposes when considered in the context of other statements in the offering documents. Barclays bought more than 10,000 residential mortgages from NC Capital Corporation.[^461] Barclays then transferred pools of those mortgages to two trusts and underwrote securities offerings by those trusts,[^462] with those offerings made by documents that represented that the pools did not, with some exceptions, include delinquent mortgages.[^463] The plaintiffs, which had bought the securities issued by the trusts, later discovered that—at the time of purchase—290 mortgages held by one trust were delinquent and 848 mortgages held by the second trust were delinquent.[^464]

The plaintiffs sued “for material misrepresentations and fraud,” but the district court granted Barclay's motion to dismiss, and the Fifth Circuit affirmed.[^465] The court of appeals acknowledged that “[s]tanding alone, [the] ‘no delinquency’ provisions would support [the plaintiffs’] contentions.”[^466] However, the offering documents also included promises by Barclays to repurchase delinquent mortgages or replace them with fully performing ones.[^467] Considering both the no-delinquency representations and the “repurchase or substitute” promises, the Fifth Circuit held that:

[^460]: 594 F.3d 383 (5th Cir. 2010).
[^461]: Id. at 385.
[^462]: Id. at 386. The opinion lumps together Barclays Bank PLC and Barclays Capital, Inc., referring to them collectively as “Barclays.” *Id.* at 385. One or both of these entities bought the mortgages from NC Capital and pooled them into the trusts referred to in the text, although the opinion does not identify the roles that each Barclays entity played in that chain of transactions. *Id.* at 386. Barclays Capital, Inc. then underwrote the securities offerings by the trusts. *Id.*
[^463]: The prospectuses stated that Barclays would represent that:

As of the servicing transfer date, except with respect to the Delinquent mortgage loans described under “The Mortgage Loan Pool-General” in this prospectus supplement, no payment required under the mortgage loan is 30 days or more Delinquent nor has any payment under the mortgage loan been 30 days or more Delinquent at any time since the origination of the mortgage loan.

*Id.* at 388. Barclays also stated in a Representations and Warranties Agreement, to which the prospectuses referred, that:

(i) All payments required to be made up to the Closing Date for the Mortgage Loan under the terms of the Mortgage Note, other than payments not yet 30 days delinquent, have been made and credited, [and] (ii) no payment required under the Mortgage Loan has been 30 days or more delinquent at any time since the origination of the Mortgage Loan.[]
Read as a whole, the prospectuses and warranties provide that the mortgages *should be* non-delinquent, but if some mortgages were delinquent, then Barclays would either repurchase them or substitute performing mortgages into the trusts.468 Interpreted this way, “Barclays made no actionable misrepresentations.”469 In that regard, the court noted that the plaintiffs did not allege that Barclays failed to make good on its “repurchase or substitute” pledge.470

**Significance and analysis.** The Lone Star outcome seems sound, but the reasoning disappoints. The better way to the same result would reason that the representations of no delinquency were false but, because of the buyback or replace pledge, were not material falsehoods. Securities law judges the materiality of any falsehood in light of “the ‘total mix’ of information made available.”471 Using that concept, courts have developed the “bespeaks caution” doctrine and the “truth on the market” defense—both of which depend on the use of qualifiers or denials to find immaterial statements that, by themselves, are arguably false.472 The Fifth Circuit could have employed similar reasoning here, without stretching the ordinary meaning of the word “false.”473

**Duty to Disclose:** mutual fund had no duty to disclose, in registration statements and prospectuses used to sell its own shares, conflict of interest of analysts at related

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The obligations of Barclays to cure such breach or to substitute or purchase the applicable mortgage loan will constitute the sole remedies respecting a material breach of any such representation or warranty to the holders of the [Securities], the servicer, the trustee, the depositor and any of its affiliates.

*Id.* at 389 n.6 (alteration in original). The Representations and Warranties Agreements included these:

> It is understood and agreed that the obligation of [Barclays PLC] set forth in Section 3(a) to purchase or substitute for a New Century Mortgage Loan in breach of a representation or warranty contained in Section 2 constitutes the sole remedy of the Depositor or any other person or entity with respect to such breach.

*Id.* at 389 n.7 (alteration in original). The Fifth Circuit did not rely on the “sole remedy” language.

468. *Id.* at 389.

469. *Id.*

470. *Id.*


472. See SEC v. Merch. Capital, LLC, 483 F.3d 747, 767 (11th Cir. 2007) (“In this circuit we adhere to the bespeaks caution doctrine in assessing the materiality of forward-looking statements. ‘When an offering document’s projections are accompanied by meaningful cautionary statements and specific warnings of the risks involved, that language may be sufficient to render the alleged omissions or misrepresentations immaterial as a matter of law.’ ” (quoting Saltzberg v. TM Sterling/Austin Assocs., Ltd., 45 F.3d 399, 399 (11th Cir. 1995)) (footnote omitted)); Ganino v. Citizens Utils. Co., 228 F.3d 154, 167 (2d Cir. 2000) (Under the “truth-on-the-market” principle, “a misrepresentation is immaterial if the information is already known to the market because the misrepresentation cannot then defraud the market.”).

It is fundamental that a statement is not material simply because it is false. *Basic*, 485 U.S. at 238 (“It is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant.”).

473. The Supreme Court endorsed this approach in Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1097 (1991) (noting the distinction between “a merely misleading statement and one that is materially so. While a misleading statement will not always lose its deceptive edge simply by joinder with others that are true, the true statements may discredit the other one so obviously that the risk of real deception drops to nil.”).
broker-dealers; purchaser of asset owned by corporation had no duty to disclose facts to shareholders of that corporation; one executive had no duty to disclose during an analyst call when a second executive made a misstatement during that call and misstatements during such a call did not impose a duty to disclose in a subsequently filed Form 10-Q

The failure to disclose a material fact does not violate the securities laws, absent a duty to disclose. The courts of appeals published three opinions in 2010 addressing this duty. The Second Circuit held that mutual funds had no duty to disclose in registration statements and prospectuses that analysts at affiliated broker-dealers suffered from conflicts of interest. The Eleventh Circuit held that the purchaser of a bond from a corporate seller had no duty to disclose facts to the seller’s shareholders. The Third Circuit held that one executive did not have a duty to disclose simply because that executive was present when a second executive made misleading statements.

Duty to disclose conflict of interest at affiliated source of investment analysis. The plaintiffs suing in *In re Morgan Stanley Information Fund Securities Litigation* purchased shares in two mutual funds organized and marketed by Morgan Stanley entities, with Morgan Stanley Distributors underwriting the funds’ offerings and Morgan Stanley Investment Advisors Inc. being the funds’ principal investment manager. The plaintiffs sued under § 11 and § 12(a)(2) of the Securities Act, alleging that the registration statements and prospectuses for fund offerings failed to reveal that analysts at two broker-dealers—Morgan Stanley & Co. Inc. and Morgan Stanley DW Inc.—produced optimistically biased reports on companies from which those broker-dealers wanted investment banking business. The plaintiffs posited that the biased reports artificially increased the stock prices of those companies and that all of this created an undisclosed risk that “[i]nstead of investing in securities strictly on their merits . . . the Funds would disproportionately invest in and/or retain the securities of Morgan Stanley’s investment banking clients/potential clients, without regard to whether they were good

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474. Chiarella v. United States, 445 U.S. 222, 233 (1980) (“When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.”).
475. See infra notes 478–504 and accompanying text.
476. See infra notes 505–16 and accompanying text.
477. See infra notes 517–31 and accompanying text.
478. 592 F.3d 347, 353 (2d Cir. 2010).
480. Id. § 77l(a)(2).
481. Morgan Stanley Info. Fund, 592 F.3d at 354. The broker-dealers also “sold shares of the Funds to the public.” Id. at 353. The plaintiffs named the funds themselves and the underwriting Morgan Stanley entity as defendants on the § 11 claim, and the Second Circuit commented that all of them “appear to be permissible parties.” Id. at 359 n.6. The plaintiffs named the funds, the underwriting entity, the investment advisor entity, a related company to which the investment advisor entity subcontracted asset-management tasks, and the broker-dealers as defendants on the § 12(a)(2) claim, and the Second Circuit stated that it was “unclear . . . that each of these defendants satisfies the ‘statutory seller’ requirement,” limiting the permissible defendants under that statute. Id. The court found that it did not need to reach that issue “in light of [its] broader holding.” Id.
482. Id. at 354.
The plaintiffs sued all of the Morgan Stanley entities identified above, and the holding company, Morgan Stanley.\footnote{484. \textit{Morgan Stanley Info. Fund}, 592 F.3d at 352.} Affirming the district court’s dismissal of consolidated complaints,\footnote{485. \textit{Id.} at 351, 366.} the Second Circuit found the case to turn on whether the registration statements and prospectuses “omitted information that the defendants were required to disclose.”\footnote{486. \textit{Id.} at 360.} The court addressed two possible bases for a duty to disclose. First, the court considered “affirmative disclosure obligations” imposed by securities rules.\footnote{487. \textit{Id.} at 361.} The funds filed their offering documents on Form N-1A.\footnote{488. \textit{Id.} at 356.} The plaintiffs argued that two General Instructions on that form required disclosure of the conflicts of interest plaguing the analysts at the Morgan Stanley broker-dealers.\footnote{489. \textit{Id.}} In an amicus brief that the Second Circuit solicited,\footnote{490. \textit{Id.} at 357.} the SEC, however, expressed its view that the General Instructions “are ‘not an independent source of disclosure obligations’” but only supply “funds with general guidance as to the nature of the information they should provide in responding to specific disclosure items, and to the sorts of language, in terms of sophistication or technicality, that they should use in providing that information.”\footnote{491. \textit{Id.} (quoting SEC brief).} The court of appeals deferred to this agency interpretation and held “that the General Instructions to Form N-1A did not require defendants to disclose the allegedly omitted information.”\footnote{492. \textit{Id.} at 362.}

The plaintiffs also contended that the N-1 items mandating risk disclosures required the defendants to reveal the possibility that the funds would put money

\footnote{483. \textit{Id.} at 362 (quoting the plaintiffs’ response to an SEC amicus submission). Morgan Stanley entities had paid, or committed to spend, a total of $125 million to settle an SEC action against the broker-dealer entities based on alleged conflicts of interest that caused analysts at those firms to publish favorable research reports on companies as part of a strategy to win investment banking business from the companies. \textit{Id.} at 355. Many other investment banking houses settled similar claims in a Wall-Street-wide investigation that culminated in settlements for money, changes in practices, and ultimately new regulatory rules. \textit{See} William O. Fisher, \textit{Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?}, 54 \textit{Emory L.J.} 843, 944–50, 957–66 (2005).}

\footnote{484. \textit{Morgan Stanley Info. Fund}, 592 F.3d at 353.}

\footnote{485. \textit{Id.} at 351, 366.}

\footnote{486. \textit{Id.} at 360.}

\footnote{487. \textit{Id.} at 361.}

\footnote{488. \textit{Id.} at 356.}

\footnote{489. \textit{Id.} The plaintiffs relied on Item C(1)(b) of the General Instructions, which read:}

\begin{quote}

The prospectus disclosure requirements in Form N–1A are intended to elicit information for an average or typical investor who may not be sophisticated in legal or financial matters. The prospectus should help investors to evaluate the risks of an investment and to decide whether to invest in a Fund by providing a balanced disclosure of positive and negative factors. Disclosure in the prospectus should be designed to assist an investor in comparing and contrasting the Fund with other funds.

\textit{Id.} The plaintiffs also relied on Item C(2)(a), which read:

\begin{quote}

The purpose of the [Form N–1A] prospectus is to provide essential information about the Fund in a way that will help investors to make informed decisions about whether to purchase the Fund’s shares described in the prospectus.

\textit{Id.} (alteration in original).
\end{quote}
\end{quote}

\footnote{490. \textit{Id.} at 357.}

\footnote{491. \textit{Id.} (quoting SEC brief).}

\footnote{492. \textit{Id.} at 362.}
into poor investments as a result of relying on research from the Morgan Stanley broker-dealers, written by analysts whose views were colored by efforts to obtain investment banking business. The SEC, however, took the position that the risk a fund would rely on research tainted by conflicts of interest was a “‘generic risk,’” and that the affiliation of the Morgan Stanley broker-dealers with the other Morgan Stanley entities organizing and running the funds “‘appear[ed] to be irrelevant’ to the existence of such a risk.” The Second Circuit agreed, noting that Form N-1 “call[s] for the disclosure of only those risks ‘to which the Fund’s particular portfolio as a whole is expected to be subject’” and that the SEC had stated in a rule release that “this requirement [is designed] ‘to elicit risk disclosure specific to [the] fund.’” As to whether the asserted risk was ever realized, the district court had found “insufficient factual allegations to support an inference that the Funds’ managers pursued investment strategies that were designed to facilitate [the Morgan Stanley broker-dealers’] generation of investment banking revenue,” and the Second Circuit similarly found no allegations that the fund managers “uncritically follow[ed the Morgan Stanley broker-dealers’] potentially tainted recommendations.”

The court of appeals then turned to the second possible basis for a duty to disclose—that the offering documents needed to disclose the analyst conflict of interest at the Morgan Stanley broker-dealers in order to avoid misleading by other statements that those documents included. Here the plaintiffs contended that the statements about investment strategies and risks misled without the additional information about the analyst conflict. The Second Circuit rejected this contention on the basis that the funds’ statements on such subjects “did not trigger a generalized duty requiring defendants to disclose the entire corpus of their knowledge regarding [the Morgan Stanley broker-dealers].” As was true of the analysis finding no disclosure obligation based on a specific SEC mandate, this

493. Id.
494. Id. at 357 (quoting SEC brief).
495. Id. at 363 (first quotation from Form N-1A Item 9(c); second quotation from Registration Form Used by Open-End Management Investment Companies, Securities Act Release No. 33-7512, 63 Fed. Reg. 13916, 13928 n.111 (Mar. 23, 1998) (to be codified at 17 C.F.R. pts. 230, 232, 239, 240, 270 & 274) (emphasis added)). The court of appeals added: “Put differently, all investors, including the Funds’ managers, face the risk that the research they use to make their decisions may be biased or flawed, and that the prices they pay for securities may not accurately reflect the securities’ intrinsic value.” Id. at 363–64.
496. Id. at 362. In its amicus brief, the SEC stated that, if a fund’s investment objectives were to “‘enhanc[e] an affiliated entity’s investment banking business,’” the fund would have to disclose that objective. Id. (quoting SEC brief).
497. Id. at 364.
498. Id. at 365–66.
499. Id. at 365.
500. Id. at 366. The Second Circuit added:

Affiliated or not, the Funds were not [the broker-dealers’] keeper, and defendants were not obligated to suggest—in the Funds’ Offering Documents—that [those broker-dealers’] employees may have engaged in activities that might later be determined to run afoul of the securities laws. Id. at 365.
conclusion hinged largely on the plaintiffs’ failure to allege that the funds invested for the purpose of advancing investment banking business and that the risk that analyst reports were biased by pursuit of such business was a “commonly understood risk[] associated with securities research.”

Significance and analysis. The courts’ view that an issuer need not disclose all “generic” risks seems right. Otherwise, disclosure would expand limitlessly outward from an issuer’s operations, to cover virtually any risk that might affect performance. Moreover, the ruling is consistent with the SEC’s general risk disclosure requirement in Regulation S-K Item 503(c), which advises: “Do not present risks that could apply to any issuer or any offering.” But the Second Circuit’s use of the term “generic” raises two problems. First, the plaintiffs rested their case on analyst conflicts of interest at Morgan Stanley broker-dealers—conflicts generated by the broker-dealers’ efforts to win investment banking business. That seems pretty specific and only becomes “generic” after the court recharacterizes the issue as one of “biased or flawed” research generally. Second, it is confusing to introduce another term—“generic”—into a securities law lexicon already crowded with words that have been defined and then elaborated through judicial decisions and SEC pronouncements. Perhaps the court would have better rested its decision solely on the plaintiffs’ failure to allege that the analyst conflicts at the Morgan Stanley broker-dealers actually affected investment decisions at the funds. Or the court might have better analyzed the question as one going to materiality—concluding that general risks are so well known to the market that they are already part of the “total mix” of information.

Duty to disclose to opposing parties’ shareholders. Badger v. Southern Farm Bureau Life Insurance Co. presented an odd case in which shareholders of a corporation that sold a security contended that the purchaser of the security defrauded them. The selling company owned a debenture, and state law required that its shareholders approve the sale of the debenture because that instrument was a principal asset. The purchaser offered $3.3 million for the debenture based on a valuation prepared by an actuarial firm, with the purchaser’s attorney telling the attorney for the selling company that the valuation “reflected a ‘fair price.’” The selling company rejected the $3.3 million offer and eventually agreed to a sale for $4.4 million. The selling corporation then prepared and distributed a proxy statement, following receipt of which its shareholders approved the sale of the

501. Id. at 366.
502. 17 C.F.R. § 229.505(c) (2010).
503. Morgan Stanley Info. Fund, 592 F.3d at 363. Admittedly, at the time of the Morgan Stanley analyst conflicts, similar conflicts apparently plagued research at a multitude of firms. See supra note 483. Even so, the particular kind of conflict the plaintiffs alleged—created by such practices as compensating analysts on the basis of investment banking revenue to which the analysts contributed—may have been specific to the 1990s and the early 2000s and so not “generic” over time.
504. See supra note 471 and accompanying text.
505. 612 F.3d 1334 (11th Cir. 2010).
506. Id. at 1338.
507. Id. at 1337–38.
508. Id. at 1338.
Shareholders who had voted against the sale sued in this case, derivatively on behalf of the company that sold the debenture, alleging that the purchaser violated Rule 10b-5, and committed common law fraud, because the proxy statement sent to the seller's shareholders omitted facts showing that the selling company had special bargaining leverage over the buyer that could have increased the sale price.  

A jury returned a verdict in favor of the plaintiffs in the amount of $31.7 million in compensatory damages. The Eleventh Circuit reversed on the ground that a defendant can be liable for an omission under Rule 10b-5 and common law fraud only if the defendant had a duty to disclose the omitted fact. The court found that precedent “uniformly declined to find a duty to disclose running from one party in an arms-length securities transaction to the shareholders of the counterparty to the transaction, absent some fiduciary or other special relationship between them.” The seller's shareholders did not assert a fiduciary duty running from the purchasing company to the selling company, let alone such a duty running from the purchasing company to the selling company's shareholders. Moreover, the attorney for the selling company was fully aware of the facts that provided his client with the alleged leverage, so there was no fraud at the purchaser-seller level.

Duty of one participant in a presentation to disclose when another participant in the same presentation makes a misleading statement and duty to disclose in an Exchange Act filing following a misleading statement made in a presentation. A criminal case, U.S. v. Schiff, addressed critical duty to disclose issues, and disagreed with a rule that the Fifth Circuit announced in 2005. The government had indicted the Bristol-Myers Squibb (“Bristol”) CFO and the President of Bristol’s Worldwide Medicines Group (“President/WWMG”) contending, among other things, that they had made misleading statements in analyst calls to conceal Bristol practices that encouraged wholesalers to overstock Bristol drugs—thereby inflating short-term sales at the expense of long-term sales. When Bristol announced that inventories at wholesalers exceeded desirable levels, stated that the company

509. Id.
510. Id. The purchaser needed to buy the debenture from the selling corporation so that a third entity would consent to a change in a business venture in which the purchaser and the third company were engaged. Id. at 1337.
511. Id. at 1339.
512. Id. at 1347.
513. Id. at 1340–41.
514. Id. at 1343.
515. Id. at 1345. Along the way to this conclusion and relating directly to the charge that the buyer's attorney opined that the $3.3 million was “fair,” the Eleventh Circuit observed that it had found “no case suggesting that, in an arm’s-length transaction, the buyer's opinion of the value of the seller's asset, unaccompanied by a misstatement of fact on which the value is based, could constitute an affirmative statement which could be rendered misleading by an omission.” Id. at 1341–42.
516. The court held that the defendant could not be liable for failing to disclose facts to the selling corporation itself where the attorney for the seller knew those facts. Id. at 1346–47.
517. 602 F.3d 152 (3d Cir. 2010).
518. Id. at 156–57. Here are sample statements:
was therefore aggressively cutting shipments to wholesalers, disclosed that the President/WWMG was leaving the company, and released a full-year guidance projecting a 25 to 30 percent decline in annual earnings unrelated to wholesaler inventory adjustments, the price of Bristol stock dropped nearly 15 percent in a single day.\(^{519}\)

On appeal from a district court ruling precluding the government from using several arguments at trial, the Third Circuit held that the CFO had no duty to speak during conference calls in order to “rectify . . . material misstatements on analyst calls” made by the President/WWMG and related to wholesaler inventories.\(^{520}\) While the government relied on a general “fiduciary duty,”\(^{521}\) the court of appeals found only three bases for a duty to disclose—(i) a duty imposed on an insider who is trading in his or her company’s stock, (ii) a duty imposed by statute or rule, and (iii) a duty to add a material fact in order that a statement the speaker or writer makes does not mislead.\(^{522}\) The court rejected the government’s generalized “fiduciary duty” as an additional basis for a disclosure obligation because that basis lacked logical limitations; the duty it imposed was too vague.\(^{523}\)

\[\text{4/25/01 [CFO]—“We look at, very closely, the wholesaler stocking inventories . . . . [T]here are no unusual items that we see in the inventory levels.” (App. 73 (first quarter—[CFO] and [President/WWMG] on call));}\]

\[\text{7/25/01 [CFO]—“we don’t see anything unusual” in the “wholesaler inventories” (App. 73 (second quarter—[CFO] and [President/WWMG] on call));}\]

\[\text{[President/WWMG]—when asked whether there were inventory issues, he responded “no” (App. 500–02);}\]

\[\text{10/23/01 [CFO]—inventory was “up a couple of weeks” and expected “to be lower in the fourth quarter” (App. 74–75 (third quarter—[CFO] and [President/WWMG] on call)); and}\]

\[\text{12/13/01 [CFO]—“We don’t see any significant changes” in the prior call’s statements that “inventory levels are slightly higher” and “would be reduced by the end of the year” (App. 75 (outside of quarterly call cycle, [CFO] and [President/WWMG] on call)).}\]

\[]^{157}\ (ellipses and second alteration in original).\]

\[\text{519. Id. at 158–59.}\]

\[\text{520. Id. at 162–68.}\]

\[\text{521. Id. at 162.}\]

\[\text{522. Id. at 162–63.}\]

\[\text{523. The court expressed its concerns so:}\]

\[\text{[S]uch a generalized corporate fiduciary duty has few logical boundaries. What would the limiting principle be if we imposed this duty on corporations and its employees? The Government attempts to cabin this duty to an extent by characterizing it as only requiring “high corporate officers” to rectify misstatements. But what company employees qualify as high corporate officers? Certainly there is a grey area involving the corporate structures of individual companies. Apparently this would require a court to engage in a fact-intensive review on a case-by-case basis, but in the criminal context (and the potential exposure to civil liability) this uncertainty about who would qualify as a high corporate officer subject to this duty seems to undermine the requirement of fair notice.}\]

\[\text{Even more troubling is the question of how broadly this duty would apply. [The CFO] elaborates on this question in his brief:}\]

\[\text{[A] fiduciary presumably would owe shareholders a duty “to rectify” public misstatements of others whenever they are made (on a conference call or, say, in a written report or on the internet), whoever makes them (a fellow employee or, say, a securities analyst), and however the fiduciary learns about them (by hearing them on a joint call or, say, by reading them in a newspaper).}\]
course of reaching this result, the court disagreed with *Barrie v. Intervoice-Brite, Inc.* 524 that the Fifth Circuit decided in 2005 and that seemed to hold directly that a plaintiff stated a Rule 10b-5 claim against a first defendant by alleging that he or she remained silent when a second defendant spoke falsely in the presence of the first defendant. 525 The Third Circuit also appeared to limit the fiduciary obligation to disclose to the insider trading arena. 526

With the general fiduciary obligation to disclose out of the picture, the court quickly disposed of a second government argument—that the CFO’s duty to disclose rested on the third basis that the court articulated because the CFO had “‘actually made the omissions’ by not rectifying [the President/WWMGs] purported misstatements.” 527 The Third Circuit held that the CFO had made his own statements and the President/WWMG made his own statements, with neither “making” the other’s statements and therefore neither incurring, by the other’s statements, the obligation—imposed on the “maker” of a statement—to add material facts needed to avoid misleading. 528 The court similarly rejected the government’s contention “that the quarterly analyst calls and SEC 10-Q filings were tied together as essentially one event, such that the intentional misstatements on analyst calls created a duty of disclosure in the SEC filings under Rule 10b-5(b) to ‘make the statements in the prior analyst calls not misleading.’” 529 Here the appellate court agreed with the trial court, which had held that the duty to disclose material facts in order to avoid misleading by what the speaker says “‘arises when each statement [is] made.’” 530

([CFO] Br. at 53.) Moreover, for how long would this duty attach such that rectification would be required for an officer to absolve himself of this fiduciary liability? Would it be limited to the same day, a week, a month, or even one year? Would this duty potentially rope in all corporate officers based on a single misstatement by another individual, such that a case could be brought against all executives in a particular company under this theory?

These questions put into focus the vagueness of when such a duty would apply.

Id. at 164–65 (footnotes omitted) (second to last alteration in original).

524. 397 F.3d 249 (5th Cir.), modified on denial of reh’g, 409 F.3d 653, 656 (5th Cir. 2005) (“Where it is pled that one defendant knowingly uttered a false statement and the other defendant knowingly failed to correct it, . . . the fraud is sufficiently pleaded as to each defendant.”).

525. The Schiff panel characterized *Barrie* as ruling solely on a pleading matter rather than addressing “the actual viability of the legal theory.” Schiff, 602 F.3d at 163.

526. Id. at 165–66.

527. Id. at 168. Rule 10b-5 prohibits “omitting to state a material fact necessary in order to make the statements made . . . not misleading.” 17 C.F.R. § 240.10b-5 (2010).

528. Schiff, 602 F.3d at 168.

529. Id. (quoting U.S. v. Schiff, 538 F. Supp. 2d 818, 827 (D.N.J. 2008) (district court opinion)).

530. Id. at 169 (quoting district court). The Third Circuit also held that the facts did not implicate the “duty to update” because that duty arises only when “the initial statement concerns ‘fundamental[] change[s]’ in the nature of the company—such as a merger, liquidation, or takeover attempt—and when subsequent events produce an ‘extreme’ or ‘radical change’ in the continuing validity of that initial statement,” whereas here the statements about “ongoing sales volume of pharmaceutical products to wholesalers in its distribution chain . . . do not come close to fitting within the narrow range of this duty.” Id. at 170 (alterations in original). And the court of appeals found the duty to correct irrelevant as “[t]he key for this duty to exist is a triggering factual event after the statement is made” and the court could not “imagine what that event would be” here. Id. at 170–71.
Significance and analysis. The Third Circuit’s attempt to confine the duty to disclose to defined circumstances admirably seeks to inject certainty into this murky area of the law. But is the court’s triple test appropriately an exclusive one? For example, just two years ago, the Second Circuit found a duty to disclose in state law. Counsel should not count on the Third Circuit’s purportedly exhaustive listing as the sole sources of the duty to disclose.

Reliance: plaintiffs cannot employ the fraud-created-the-market theory to prove reliance in the Third Circuit

To win certification of a class under Federal Rule of Civil Procedure 23(b)(3), a plaintiff must show, among other things, that “questions of law or fact common to class members predominate over any questions affecting only individual members.” A securities law plaintiff suing under Rule 10b-5 cannot make that showing if each member of the class must prove reliance on the alleged fraud through evidence particular to that class member—e.g., that the class member read or heard the alleged fraudulent misrepresentation. To prove reliance in a manner that permits certification of a Rule 23(b)(3) class, plaintiffs frequently employ the fraud-on-the-market presumption—that all purchasers in an efficient market rely on a misrepresentation in the sense that they buy at a price that has adjusted to the false information. That presumption does not apply when pur-
chasers buy a security in a primary transaction—where similar securities by the same issuer are not traded in an efficient secondary market—because the price of that security in the primary market is set by the issuer and the underwriters, not by a market. 535

The Third Circuit considered, in *Malach v. BDO Seidman, LLP*, whether a related reliance presumption—that fraud created the market for the security—could be used to prove reliance, and hence support a 23(b)(3) class, in a case brought by debt purchasers under Rule 10b-5 based on alleged fraud in the primary market sale of the debt. 536 The court characterized the fraud-created-the-market theory as one “allow[ing] an investor to rely on the integrity of the market to the extent that the securities it offers to him for purchase are entitled to be in the market place.” 537 The courts recognizing this theory apply it where the security that the plaintiff bought would never have been marketed at all had the fraud not occurred. 538 In this case, the plaintiff alleged that the debt securities he bought would never have been sold had the defendant accounting firm not provided fraudulent audit opinions to the issuer. 539

The Third Circuit rejected the fraud-created-the-market theory and, accordingly, affirmed the district court’s denial of class certification because each member of the putative class would have had to prove reliance individually. 540 The court of appeals reasoned that presumptions are based on probability. 541 Here, the proposed presumption therefore rested on the supposed high probability that a security sale is free of fraud simply because the security is available for purchase. 542 Yet, the “entities involved in the issuance”—the promoter, the underwriter, the auditor, and legal counsel—“cannot be reasonably relied upon to prevent fraud” in part because they have “‘a significant self-interest in marketing the securities at a price greater than their true value.’” 543 Nor can a purchaser count on the SEC to prevent fraud because that agency “does not conduct ‘merit regulation.’” 544

Beyond the conclusion that the fraud-created-the-market presumption rests on a false assessment of reality, the Third Circuit found that adoption of the presump-

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535. See *In re Initial Pub. Offerings Sec. Litig.*, 471 F.3d 24, 42–43 (2d Cir. 2006) (fraud-on-the-market reliance presumption did not apply in initial public offering cases). See *In re Enron Corp. Sec. Derivative & ‘ERISA’ Litig.*, 529 F. Supp. 2d 644, 770 (S.D. Tex. 2006) (noting “criticism of the assumption that the fraud-on-the-market presumption should not be extended to the initial public offering/primary market context”; nevertheless declining to employ the presumption in a primary market for debt securities).

536. 617 F.3d 743 (3d Cir. 2010).

537. Id. at 747 (quoting Shores v. Sklar, 647 F.2d 462, 471 (5th Cir. 1981) (adopting the theory)).

538. Id. at 747–48.

539. Id. at 745.

540. Id. at 745, 756. The case came to the court of appeals under Federal Rule of Civil Procedure 23(f). Id. at 746.

541. Id. at 749.

542. Id.

543. Id. at 749–50 (quoting Ross v. Bank South, N.A., 885 F.2d 723, 740 (11th Cir. 1989) (Tjoflat, J., concurring)).

544. Id. at 750. Indeed, the plaintiff’s counsel conceded that the SEC would have permitted the sale of the debt in this case even if the auditor had not provided clean audit opinions. Id. at 751.
tion would constitute poor policy. Armed with the presumption, “[a]ny investor who purchases any security could point to the security's availability on the market to satisfy the reasonable reliance element of a § 10(b) claim.” 545 Easily satisfying that element would move Rule 10b-5 actions toward a form of insurance, which “is contrary to the goals of securities laws.” 546 Indeed, in order to preserve the presumption, investors might consciously avoid reading disclosures. 547 The too-easy presumption would also encourage frivolous Rule 10b-5 class actions that could persist through class certification and force settlements unwarranted by the facts. 548

Significance and analysis. The strongest argument against fraud-created-the-market is that its acceptance could eat up the reliance element. The argument that the presumption is insupportable because virtually all of the professionals involved in an offering have an economic interest in overpricing the securities is supported by citations to another judicial opinion and law review articles. 549 But that passage in Malack seems overheated, unnecessary, and lacking reliable support such as a study of a large and relevant sample.

Materiality: facts relating to mutual funds’ arrangement with affiliated company—by which the affiliate provided transfer agent services to the funds after contracting the work out to a third party for an amount far less than the funds paid the affiliate—were material because they showed a possible breach of fiduciary duty by self-dealing; for a market reaction to demonstrate materiality of a misstatement or omission, that reaction should be isolated to disclosures relating to that particular misstatement or omission.

The Second Circuit last year found material, to the shareholders of mutual funds, the fact that savings made by a company affiliated with the organizer and operator of the funds were not passed on to the fund shareholders. 550 The Third Circuit held that, when proving materiality by stock price decline after a disclosure that contains negative news revealing a fraud and other negative news as well, the government or private plaintiff must establish that the portion of the disclosure that reveals the fraud caused some part of the decline. 551

Facts relating to breach of fiduciary duty material. In Operating Local 649 Annuity Trust Fund v. Smith Barney Fund Management LLC, the plaintiffs purchased shares in mutual funds organized by the Smith Barney family of companies. 552 Smith Barney Asset Management LLC (“Smith Barney”), one of the investment advisers to the funds, had a contract with a transfer agent, First Data Investor Services Group.

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545. Id. at 752.
546. Id.
547. Id. at 753.
548. Id. at 754–55.
549. The quotations in the text accompanying supra note 543 read well enough at first. But doesn’t an auditor have its reputation at stake in an offering that refers to the auditor’s opinions, and doesn’t protection of that reputation argue against committing fraud? Isn’t that also true for legal counsel? Wouldn’t we really need some serious statistics before concluding that auditors and counsel have an economic stake in intentionally marketing securities for more than the securities are worth?
550. See infra notes 552–72 and accompanying text.
551. See infra notes 573–83 and accompanying text.
552. 595 F.3d 86, 89 (2d Cir. 2010).
A study by Deloitte & Touche Consulting recommended that Citigroup Asset Management (“CAM”), of which Smith Barney was a part, create a subsidiary to provide transfer agent services, using technology it could buy from First Data. Ultimately, CAM created a subsidiary, Citicorp Trust Banks (“CTB”), which entered into a contract with the funds to take over the transfer agent work that First Data had performed. CTB then subcontracted most of that work to First Data, at a rate substantially below the rate that First Data had charged to the funds. The plaintiffs alleged that CTB charged the funds much more than First Data charged CTB, with CAM ultimately receiving the difference. The plaintiffs sued CAM, Smith Barney, and another entity serving as an investment adviser to the funds, and individuals, alleging that the failure to disclose that a portion of the transfer agent savings had, as the Second Circuit summarized it, been “pocketed” by CAM. The plaintiffs brought the case, in part, under Rule 10b-5.

In vacating and remanding the district court’s dismissal of the Rule 10b-5 claim, the court of appeals rejected the district court’s conclusion that the facts showing where the transfer agent savings had gone were immaterial because only the total fees were important to investors. The Second Circuit found those facts material because, without them, “what the Fund investors could not divine from the disclosures [that were made] was that they were at the mercy of a faithless fiduciary.”

Continuing with its materiality analysis, but mixing it with what seems much like an analysis of the duty to disclose, the Second Circuit then observed that “the defendants had an obligation to negotiate the best possible arrangement for the
Funds” and “were obligated to disclose candidly to [fund] shareholders the material features of the arrangements they crafted.” In the court’s view, “[t]hese obligations required the defendants to make clear to [the boards of directors for the funds] and the Fund’s shareholders that CAM was assuming nearly the full benefit of the discounts generated by First Data.” Expanding on what might best be described as a duty to disclose analysis, the court pointed to SEC regulations requiring fund managers to provide fee information, separating management fees from “other fees.” In this case, the defendants had “categorized fees that it ultimately pocketed[—the transfer agent fees paid by the funds to CTB—] as ‘other fees’ rather than management fees,” which made the omission here material since, in light of the “importance the SEC attaches to the proper characterization of fees generally,” that characterization hid the fact—likely to be important to investors—that the reduction in transfer agent costs had generated “kickbacks” received by management affiliates.

Significance and analysis. The Second Circuit opinion makes for troubled reading. On quick review, it seems to say that if a fiduciary is violating a fiduciary duty, that violation is material and must be disclosed. The Supreme Court, in the Santa Fe case, unequivocally rejected the notion that a violation of fiduciary duty is, by itself, a violation of Rule 10b-5. There are therefore two questions in a case like Local 649 Annuity Trust Fund: (i) Did the defendants have a duty to disclose the omitted facts? and (ii) Were the omitted facts material? The Local 649 Annuity Trust Fund opinion comes close to saying that, if a fiduciary breaches his or her or its duty, the failure to disclose that breach is by itself a Rule 10b-5 violation. That is not the law. A breach of fiduciary duty states a claim under § 10(b).

The case also addressed two other issues worth noting. First, the court ruled that the plaintiff adequately pled loss causation on its Rule 10b-5 claim because “Local 649 has alleged that the defendants’ misrepresentations proximately resulted in the regular deduction of identifiable amounts that would not have been deducted had defendants conformed their conduct to what the law required.” This is a strange conclusion as it rests the loss on the concealed conduct—a breach of fiduciary duty that was not a Rule 10b-5 violation (see infra note 566 and accompanying text)—rather than on the concealment of that conduct, which could be a Rule 10b-5 violation. In addition, the court in this portion of the opinion found that the loss was caused by investors “maintain[ing]” their fund shares rather than buying or selling them. Local 649 Annuity Trust Fund, 595 F.3d at 96. But it is basic that a Rule 10b-5 claim must rest on a deception that results in the investor buying or selling, not holding, a security. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (“one asserting a claim for damages based on the violation of Rule 10b-5 must be either a purchaser or seller of securities,” id. at 749, specifically rejecting standing for those who “decided not to sell their shares because of . . . a failure to disclose unfavorable information,” id. at 737–38). The plaintiff brought, in addition to the Rule 10b-5 claim, a claim under § 36(b) of the Investment Company Act, Local 649 Annuity Trust Fund, 595 F.3d at 89, which creates a statutory cause of action for breach of fiduciary duty by an investment adviser to a mutual fund—a claim that can be brought “by a security holder of such [a fund] on behalf of such [fund],” 15 U.S.C. § 80a-35(b) (2006). The Second Circuit affirmed the district court’s dismissal of this claim on the ground that such a claim could be brought only in a derivative action, not a direct action by shareholders, as was done here. Local 649 Annuity Trust Fund, 595 F.3d at 96–99.

562. Id.
563. Id.
564. Id. at 94.
565. Id. at 95.
of the Exchange Act and the related rule “only if the conduct alleged can be fairly viewed as ‘manipulative or deceptive’ within the meaning of the statute.”

Among other things, Rule 10b-5 prohibits “omit[ting] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.” Determining that a defendant has a duty to disclose under this portion of the rule intertwines both of the questions set out above. There is only a duty to disclose the fact that will clarify the half-truth if the omitted fact is “material.” While not clear, the court in *Local 649 Annuity Trust Fund* apparently found the duty to disclose the “kickbacks” in the funds’ inclusion of the transfer agent charges in the “other fees”—i.e., not management fees—in the funds’ prospectuses. The theory, presumably, was that the “other fees” figure and the management fees figure were both wrong, as the “kickbacks” should have been subtracted from the “other fees” and included in the management fees. But simply adding the fees paid to CTB into the “management fees” would not have disclosed what the court saw as a breach of fiduciary duty. So perhaps the theory was that the separate disclosure of the fees to CTB, coupled with disclosure of the markup that CTB received over the amount that it paid to First Data, was necessary to avoid misleading by recording any amount as “management fees.” It would have been helpful if the Second Circuit had explicitly set out the basis of the disclosure duty it saw.

Without that explicit analysis, the disclosure duty that the case endorses by implication smacks of the very logic that the Supreme Court rejected in *Santa Fe*, which clearly holds that federal courts are not authorized—to entertain suits for a breach of fiduciary duties simply because shareholders sue based on that breach. Nevertheless, while the implied duty to disclose analysis in the Second Circuit opinion seems wrong, the court seems to get the materiality ruling right. Self-dealing breaches of fiduciary duty are frequently material for securities law purposes. And this may be so even if the breach has a small quantitative effect.

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567. *Id.* at 473–74; see also *Dirks v. SEC*, 463 U.S. 646, 654 (1983).


569. 17 C.F.R. § 240.10b-5 (2010).

570. *Local 649 Annuity Trust Fund*, 595 F.3d at 95.

571. Although decided in the proxy context, *Gaines v. Haughton*, 645 F.2d 761, 776–77 (9th Cir. 1981), overruled on other grounds by *In re McLinn*, 739 F.2d 1395, 1397 (9th Cir. 1984), drew “a sharp distinction . . . between allegations of director misconduct involving breach of trust or self-dealing[—]the nondisclosure of which is presumptively material[—]and allegations of simple breach of fiduciary duty/waste of corporate assets[—]the nondisclosure of which is never material for § 14(a) purposes.”

572. See *Staff Accounting Bulletin No. 99*, 64 Fed. Reg. 45150, 45152 (Aug. 19, 1999) (quantitatively small error in financials may be material if it “involves concealment of an unlawful transaction”). Obviously, there is still some quantitative sanity check. The CFO who takes pencils or pens home from the office for personal use cheats his employer and violates the fiduciary duty that he or she owes to the company. *Restatement (Third) of Agency* §§ 8.01, 8.05(1) (2006). But “concealing” that theft by failing to deduct the costs of the pencils or pens from corporate expenses would not create a material error in the company’s financial statements.
expressly poses (materiality), but puzzles and perhaps creates confusion by what it implies on a closely related question (duty to disclose).

Stock price reaction as evidence of materiality after the disclosure of multiple news items, only some of which relate to the alleged fraud. The Third Circuit reaffirmed in U.S. v. Schiff that stock price reaction can show materiality.\textsuperscript{573} In that case, however, the government had asked its expert witness to evaluate only whether a company announcement correcting misstatements and providing omitted facts affected stock price after controlling for “exogenous events beyond the company’s announcement (i.e., events outside the company’s control, such as market, industry, and economy-wide effects).”\textsuperscript{574} But the issuer had announced, in the statement on which the government relied to prove materiality, not only efforts to reduce inventories at wholesalers—which related to the fraud the government alleged—but also an estimated 25 to 30 percent reduction in earnings per share “[b]efore the impact of reductions in wholesaler inventories.”\textsuperscript{575} The stock price declined almost 15 percent on the day after the disclosure.\textsuperscript{576} The trial court held,\textsuperscript{577} and the court of appeals found no abuse of discretion with the holding,\textsuperscript{578} that the expert’s testimony should be excluded because, although the expert testified “that he could have statistically disaggregated [the] . . . simultaneously disclosed unrelated negative events . . . the Government did not ask him to do so.”\textsuperscript{579} Accordingly, the expert’s testimony would not illuminate whether “a company event unrelated to the wholesaler inventory issue, but simultaneously announced, triggered the stock drop.”\textsuperscript{580}

Significance and analysis. In the past, the Third Circuit has held that, if a security trades in an efficient market, the materiality of a misrepresentation or omission will be judged by the presence or absence of price movement on disclosure of the truth or the omitted fact.\textsuperscript{581} In Schiff, the court acknowledged that “other evidentiary methods” might suffice, including the testimony of “Wall Street analysts” who might state “that a pharmaceutical company’s sales and the level of wholesaler inventory are material to their investment decisions and forecasts.”\textsuperscript{582} The court added that “analyst and company reports discussing inventory levels are themselves probative of this issue.”\textsuperscript{583}

\textbf{Control Person Liability: Eighth Circuit reaffirms its rule that culpable participation in the underlying violation is unnecessary for control person liability under the Ex-
change Act but holds that a parent company was not a proper control person defendant in a case based on actions of its subsidiary’s registered representative.

Exchange Act § 20(a) provides that a person who controls an Exchange Act violator is jointly and severally liable with that violator unless the controlling person “acted in good faith and did not directly or indirectly induce the act or acts constituting the violation.”

The plaintiffs in Lustgraaf v. Behrens alleged that they invested in a Ponzi scheme run by a registered representative at a broker-dealer. They sued the broker-dealer and its parent company on the theory, among others, that the broker-dealer and parent were control persons liable for the Rule 10b-5 violation of the registered representative. Reviewing the district court dismissal of both defendants, the Eighth Circuit restated the elements of control person liability as (1) an underlying primary violation, (2) control actually exercised by the defendant over the general operations of the primary violator, and (3) power—though not necessarily exercised—by the defendant “to determine the specific acts or omissions upon which the underlying violation is predicated.” The court of appeals also reaffirmed that, in the Eighth Circuit, the plaintiff need not plead or prove that the control person culpably participated in the primary violation and declined to reconsider that position.

Applying these principles here, the court reversed the dismissal of the broker-dealer (Sunset Financial Services, Inc.), even though the complaint alleged that the primary violator (Behrens) committed his wrongdoing through a different brokerage (21st Century Financial Group, Inc.). The Eighth Circuit based this ruling on the rationale that “although Behrens’s fraud did not take place through Sunset, it is Sunset that effectively provided Behrens access to the markets, and Sunset that had the duty to monitor his activities.” The court of appeals, however, affirmed the dismissal of Sunset’s parent, Kansas City Life Insurance Company (“KCL”), on the grounds that while “the operative complaints allege that KCL wholly owned Sunset and thereby indirectly controlled Behrens,” they failed “to show that KCL actually exercised control over Behrens’s general operations.”

585. 619 F.3d 867 (8th Cir. 2010).
586. Id. at 871.
587. Id. at 871, 874.
588. Id. at 873 (quoting Farley v. Henson, 11 F.3d 827, 835 (8th Cir. 1993)).
589. Id. at 873–74. Of course, the control person defendant can still prevail on the “good faith” affirmative defense built into the statute.
590. Id. at 877 (citing cases from the Second, Third, and Fourth Circuits in which those courts required such culpable participation; also citing cases from the Fifth, Seventh, Eighth, Ninth, and Tenth Circuits in which those courts declined to require culpable participation).
591. Id. at 871, 877. The plaintiffs alleged that Behrens operated 21st Century “as a branch office of Sunset.” Id.
592. Id. at 876. The ruling has limited effect given the procedural posture of the case. See id. at 877 (distinguishing a case decided on summary judgment and couching its limited holding so: “we cannot say, taking the present allegations in the light most favorable to the Appellants, that the complaints demonstrate on their face that Behrens’s actions were so unrelated to his relationship with Sunset that we could find as a matter of law that Appellants have failed to state a claim”).
593. Id. at 878, 879.
Significance and analysis. The question of whether a plaintiff must, to allege a control person claim, plead wrongdoing by the control person defendant vitally affects the standard by which a district court evaluates a cause of action under § 20(a). If the plaintiff must plead that the control person defendant culpably participated in the wrongdoing, then the special pleading rule in the Exchange Act—requiring, in private cases for damages, that the plaintiff “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind”—applies to those allegations. But if the plaintiff need plead only that the control person exercised actual or potential control, that special rule does not apply.

While all of that suggests that it should be easy to state a control person claim in a circuit that does not require culpable participation, the Lustgraaf opinion proves that is not so when the claim is brought against a parent company. Even though applying the “notice-pleading standard,” the Eighth Circuit affirmed the district court’s denial of the plaintiffs’ motion to amend their complaint to add allegations that “(1) Sunset and KCL operated from the same location; (2) many of Sunset’s registered representatives were also agents of KCL; and (3) Sunset and KCL had shared directors and employees.” The court held that “the mere fact that the two entities shared the same office space is not an allegation of control,” and that a “crossover in agents and representatives” did not allege control of Behrens without a further allegation that the “overlapping agents exercised or even had the authority to control Behrens.” While “shared directors” were relevant, they were “not determinative.” Thus, at least in the Eighth Circuit, courts apparently will insist on particular and convincing facts to show that a parent corporation should remain as a control person defendant in a securities fraud case.

Insider Trading: Fifth Circuit finds allegations of duty not to trade sufficient to support pleading a misappropriation case but declines to address the legal effect of Rule 10b5-2(b)

In SEC v. Cuban, the Commission sued Mark Cuban for selling stock in Mamma.com (“Mamma”) after learning that the company was about to make a Private Investment in Public Equity (“PIPE”) offering. The SEC alleged that
Mamma's CEO called Cuban, obtained Cuban's agreement to keep the content of the call confidential, then told Cuban about the offering, which was not publicly disclosed at the time.\textsuperscript{603} Cuban expressed distress at the dilution to his holding that the PIPE offering would accomplish but concluded the call by saying, “Well, now I'm screwed. I can't sell.”\textsuperscript{604} The CEO later e-mailed Cuban contact information for an investment banker working on the offering, and Cuban called the banker.\textsuperscript{605} After learning in that call that the PIPE offering would sell at a discount to the market price for Mamma stock, Cuban instructed his broker to sell Cuban's entire stake in Mamma,\textsuperscript{606} which comprised 6.3 percent of the total outstanding Mamma common.\textsuperscript{607}

The SEC asserted that Cuban's sale violated § 17(a) of the Securities Act\textsuperscript{608} and Rule 10b-5.\textsuperscript{609} The Commission proceeded on the misappropriation theory, which required that the SEC plead and prove that Cuban traded on the nonpublic information in violation of a duty that he owed to the source of that information—Mamma.\textsuperscript{610} The SEC relied on its Rule 10b5-2(b)(1), which provides that violation of a “duty of trust or confidence” is sufficient to support an insider trading case brought on the misappropriation theory and that such a duty can be created by an “agree[ment] to maintain information in confidence.”\textsuperscript{611} Since the Supreme Court—when it endorsed the misappropriation theory—repeatedly referred to the duty that the misappropriator violates as a “fiduciary” duty,\textsuperscript{612} it is not clear that SEC Rule 10b5-2(b)(1), which rests the duty on any agreement of confidence, whether growing out of a fiduciary relationship or not, correctly defines the relationship that is sufficient to underlie a misappropriation case.\textsuperscript{613} The trial

\textsuperscript{603} Id. at 555.
\textsuperscript{604} Id. (quoting the complaint).
\textsuperscript{605} Id. at 556.
\textsuperscript{606} Id.
\textsuperscript{607} Id. at 555.
\textsuperscript{609} Cuban, 620 F.3d at 552.
\textsuperscript{610} Id. at 554–55.
\textsuperscript{611} 17 C.F.R. § 240.10b5-2(b)(1) (2010).

\textsuperscript{613} The SEC adopted Rule 10b5-2 in reaction to the Second Circuit's decision in United States v. Chestman, 947 F.2d 551, 570–71 (2d Cir. 1991), which reversed a criminal conviction obtained on the misappropriation theory because the relationship that the defendant abused was not shown to be a fiduciary one or its "functional equivalent." See SEC v. Yun, 327 F.3d 1263, 1273 n.23 (11th Cir. 2003) (history of the Commission rule). There is debate on the validity of the rule. Compare SEC v. Nothern, 598 F. Supp. 2d 167, 174 (D. Mass. 2009) (Rule 10b5-2 valid), with Tyler J. Bexley, Note, Reining in Maverick Traders: Rule 10b5-2 and Confidentiality Agreements, 88 Tex. L. Rev. 195 (2009) (arguing that the rule should be held invalid). The rule fits somewhat uneasily with the caselaw by which the misappropriation theory developed. See Donald C. Langevoort, Insider Trading: Regulation, Enforcement & Prevention § 6.7, at 6-30 (2011) (“One obvious question is whether the SEC's rule goes too far in concluding that an agreement to keep information confidential establishes a fiduciary-like relationship”); Donna M. Nagy, Insider Trading and the Gradual Demise of Fiduciary Principles, 94 Iowa L. Rev. 1315, 1361 (2009) (“The SEC's expansion of liability under the misappropriation theory is most apparent in connection with Rule 10b5-2(b)(1), which encompasses situations in which 'a person agrees to maintain information in confidence.' This category dispenses entirely with the relational elements of trust and loyalty essential to O'Hagan's reasoning. Thus, while Rule 10b5-1's second and third categories may substantially dilute fiduciary principles, the rule's first category simply dispenses with those principles altogether.” (internal citations omitted)).
court in the Cuban case dismissed the SEC’s complaint, ruling (as the Fifth Circuit summarized it) that “at most, the complaint alleged an agreement to keep the information confidential, but did not include an agreement not to trade.”

The Fifth Circuit vacated the lower court judgment, holding that the facts alleged in the complaint “provide more than a plausible basis to find that the understanding between the CEO and Cuban was that he was not to trade, that it was more than a simple confidentiality agreement.” But the court expressly declined to address “the force of Rule 10b5-2(b)(1).”

Significance and analysis. The SEC rule has always presented a linguistic puzzle for precisely the reason the district court raised. The rule states that a trader violates Rule 10b-5 by trading on information that he or she “agrees to maintain . . . in confidence.” Yet, it is perfectly possible, particularly when the trader buys or sells only a small percentage of outstanding shares and market volume, to maintain the confidentiality of information while nevertheless trading on it. The SEC could have written the rule to require that the agreement include a promise not to trade.

Courts should address head-on whether an agreement to keep information confidential—without an agreement not to trade—supports an insider trading case based on the misappropriation theory, as the text of the SEC rule suggests. While the uncertainty created by the current law may have some in terrorem deterrent effect on trading while in possession of material nonpublic information, the law is clear that simple possession of such information is not enough to impose a duty to forego purchases and sales.

Class Certification: Seventh Circuit disagrees with First, Second, and Eleventh Circuits and holds that a plaintiff need not show loss causation or materiality on a motion to certify a class under Rule 23(b)(3)

A district court may certify a class under Rule 23(b)(3) of the Federal Rules of Civil Procedure only if, among other things, “the court finds that the ques-

614. Cuban, 620 F.3d at 552.
615. Id. at 558.
616. Id. at 557. The court expanded so:

By contacting the [investment bank] to obtain the pricing information, Cuban was able to evaluate his potential losses or gains from his decision to either participate or refrain from participating in the PIPE offering. It is at least plausible that each of the parties understood, if only implicitly, that Mamma.com would only provide the terms and conditions of the offering to Cuban for the purpose of evaluating whether he would participate in the offering, and that Cuban could not use the information for his own personal benefit.

Id.
617. Id. at 558.
619. Confidentiality is impossible for a trader who owns 10 percent or more of a class of equity securities registered under the Exchange Act and who buys or sells those securities because, in that instance, the trader must file public reports disclosing the transactions. 15 U.S.C.A. § 78p(a) (West 2009 & Supp. 2011).
tions of law or fact common to class members predominate over any questions affecting only individual members.”\textsuperscript{621} To avoid individual questions of reliance from preventing such a certification, plaintiffs employ the fraud-on-the-market presumption that a misrepresentation affects the price at which all class members purchase a security in an efficient market and that all purchasers during the fraud thereby rely on the misrepresentation by buying at a price that has adjusted to take account of the falsely stated facts.\textsuperscript{622} The Fifth Circuit has held that, to win a class certification under Rule 23(b)(3) when using the fraud-on-the-market theory, a plaintiff must show loss causation—i.e., that the truth about the alleged misrepresentation came out and that the price of the security dropped as a result.\textsuperscript{623}

In 2010, the Seventh Circuit rejected that view in \textit{Schleicher v. Wendt}.\textsuperscript{624} The plaintiffs charged that Conseco made false positive statements in violation of Rule 10b-5 and sought certification of a class.\textsuperscript{625} On appeal from the order granting certification, the defendants argued that the district court should have determined “whether [the alleged] false statements materially affected the price” of Conseco stock.\textsuperscript{626} Of course, showing that misrepresentations caused loss—because the price of the stock declined after disclosure of the truth—would show such an effect.\textsuperscript{627} But the Seventh Circuit held that a plaintiff need not show such loss causation when seeking class certification because such a requirement would transgress the prohibition against making a plaintiff prove its substantive case in order to obtain certification.\textsuperscript{628} As the court put it, “Rule 23 allows certification of classes that are fated to lose as well as classes that are sure to win.”\textsuperscript{629} More specifically, the court wrote that “[i]t is possible to certify a class under Rule 23(b)(3) even though all statements turn out to have only trivial effects on stock prices. Certification is appropriate, but the class will lose on the merits.”\textsuperscript{630} In affirming the certification\textsuperscript{631} with this holding, the Seventh Circuit expressly disagreed with the Fifth Circuit.\textsuperscript{632} On similar reasoning, the Seventh Circuit held that a plaintiff seeking Rule 23(b)(3) certification in a securities fraud case need not show materiality at

\textsuperscript{621} FED. R. CIV. P. 23(b)(3).
\textsuperscript{622} See Basic Inc. v. Levinson, 485 U.S. 224, 228–30 (1988).
\textsuperscript{623} See Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 268–69 (5th Cir. 2005) (“loss causation is a fraud-on-the-market prerequisite”; “We hold hence that loss causation must be established at the class certification stage by a preponderance of all admissible evidence.”).
\textsuperscript{624} 618 F.3d 679 (7th Cir. 2010).
\textsuperscript{625} Id. at 681–83.
\textsuperscript{626} Id. at 685.
\textsuperscript{628} Schleicher, 618 F.3d at 686 (citing Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974)).
\textsuperscript{629} Id.
\textsuperscript{630} Id. at 685.
\textsuperscript{631} Id. at 688.
\textsuperscript{632} Id. at 685–87. The Seventh Circuit noted that it might be difficult to pin down when the truth leaked into the market during a class period and therefore difficult to tell when the truth affected price. Id. at 686–87. In the court’s view, that difficulty—although it would prove fatal at trial if the timing could not be pinned down then—should not preclude certification. Id. at 687.
the certification stage, thereby expressly disagreeing with the First and Second Circuits.  

**Significance and analysis.** The *Schleicher* decision is a marked departure from recent opinions endorsing or requiring elaborate merits inquiries on certification motions, complete with dueling experts. The Seventh Circuit still requires that the plaintiff show that the market for the security in a fraud-on-the-market case was efficient. But that is all. The Supreme Court might usefully take a case to resolve the split among circuits over the extent of the merits-related showing necessary to certify a securities fraud class action.

**PSLRA Pleading:** Pled facts failed to raise strong inference that target company failed, with scienter, to disclose to its shareholders that its merger partner was seeking to renegotiate price and that there was a high likelihood that the merger would not close; plaintiffs failed to allege scienter or falsity of “Dear Doctor” letter that the manufacturer of defibrillator leads sent out, prior to a voluntary recall, and that advises that the manufacturer had received reports of conductor fractures and was investigating those reports; complaint failed to allege auditor’s scienter in case focusing on audit client’s uncollectible accounts; allegations raised no strong inference that defendants knew of accounting improprieties related to backdated options

The Private Securities Litigation Reform Act of 1995 (“PSLRA”) requires that, when pleading a securities lawsuit under the Exchange Act, “the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.” The PSLRA also requires that, where a private Rule 10b-5 plaintiff seeks a monetary recovery, “the complaint shall, with respect to each act or omission alleged to violate [the Exchange Act], state with

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633. Id. at 687 (disagreeing with *In re Salomon Analyst Metromedia Litigation*, 544 F.3d 474, 479, 481 (2d Cir. 2008) and *In re PolyMedica Corp. Securities Litigation*, 432 F.3d 1, 8 n.11 (1st Cir. 2005)).

The Seventh Circuit included two other holdings of note. First, it held that the circumstance that Conseco’s price was generally falling during the class period was no impediment to the plaintiffs’ case, as the plaintiffs could claim—in a fraud-on-the-market case—that false positive statements or omissions of negative information slowed the decline in the price of the stock. Id. at 683–84 (“That Conseco’s stock was falling during the class period is irrelevant; fraud could have affected the speed of the fall.”). Second, the court of appeals held that the class could include short sellers. Id. at 684–85. The court reasoned that “[b]oth the long and the short are affected by news that influences the price they pay or receive.” Id. at 684. So the shorts could be in the class, even though “[i]t may turn out that [they] do not suffer compensable losses.” Id.

634. See, e.g., Fener v. Operating Eng’rs Constr. Indus. & Miscellaneous Pension Fund (Local 66), 579 F.3d 401 (5th Cir. 2009).

635. *Schleicher*, 618 F.3d at 682 (noting that Conseco’s stock traded on the New York Stock Exchange, that its market capitalization topped $2 billion, and that its stock was part of the Standard & Poor’s 500 Index—together facts that “comfortably qualify under Basic”; noting, as well, that an expert report concluded that Conseco’s stock traded in an efficient market); id. at 688 (“The district court assured itself that the market for Conseco’s stock was thick enough to transmit defendants’ statements to investors by way of the price. That finding supports use of the fraud-on-the-market doctrine as a replacement for individual reading and reliance on defendants’ statements.”).


particularity facts giving rise to a strong inference that the defendant acted with the required state of mind,”638 which is scienter in such a case.639 The Supreme Court has held that, to satisfy the latter standard, a court must consider allegations in a complaint, together with judicially noticeable material, and determine whether—taken together and examining both pejorative and benign inferences—the allegations and noticed material raise an inference of scienter that is “cogent and at least as compelling as any opposing inference of nonfraudulent intent.”640

As in every year since the PSLRA entered the statute books, the courts of appeals last year supplied several opinions addressing whether complaints in private Rule 10b-5 actions satisfied the requirement that the plaintiffs include allegations raising a strong inference that the defendants acted with scienter. The Second Circuit held that a plaintiff failed to allege sufficient facts to raise such an inference in an action in which the plaintiff charged a failure to disclose an attempt by a merger partner to renegotiate the deal price.641 The Eighth Circuit found a similar deficiency in an action based on alleged misrepresentations and omissions about problems with a medical device.642 The Sixth Circuit held that a complaint contained inadequate allegations to plead the scienter of an auditor in a case where the auditor had provided a clean opinion for financials and a large charge-off of uncollectible accounts occurred after the audit.643 And the Eleventh Circuit found scienter allegations insufficient in an options backdating case.644

Failure to disclose buyer attempt to renegotiate merger. In 2010, the Second Circuit applied the PSLRA pleading rules in First New York Securities LLC v. United Rentals Inc. to a Rule 10b-5 claim that United Rentals (“URI”) had failed to disclose (i) efforts by RAM Holdings, Inc. (“RAM”) to renegotiate a merger with URI, and (ii) the consequent high probability that the merger would not close.645 The district court had dismissed the complaint, brought by purchasers of URI stock during the period from August 30, 2001, through November 14, 2007.646 In affirming,647 the court of appeals focused on these facts: (1) When RAM first stated its desire to renegotiate the deal price in an August 29 meeting, the URI representatives responded by saying that RAM had no walkaway rights and that URI could specifically enforce the merger agreement.648 (2) A RAM letter two days later did not “clarify [RAM’s] position regarding its alleged threat to repudiate the agreement.”649 (3) There were
no other renegotiation discussions during the class period. RAM and URI “worked diligently [during the class period] to close the transaction by, inter alia, initiating tender offers for URI’s debt securities and conducting a ‘road show’ to place $2.5 billion in post-merger debt.”

The Second Circuit phrased the Rule 10b-5 case so: “URI’s failure to disclose certain information is not actionable unless it intended to defraud or mislead by withholding information that it knew it had a clear duty to disclose.” The alleged facts—taken together—did not raise a “cogent” inference of such an intent that was at least as compelling as a competing benign inference. To the contrary, the allegations convinced the court “that the more likely interpretation of the events surrounding the August 29th meeting between RAM and representatives of URI is that URI believed that the deal was going to close under the terms negotiated in the merger agreement.”

Significance and analysis. Virtually all merger agreements contain a material adverse event (“MAE”) clause. If the performance of the target company deteriorates between signing and closing or if larger economic events drastically affect the wisdom of the deal price, the buyer may suggest or state that it will refuse to close because an MAE has occurred, unless the price is renegotiated downward. The target board and management (advised by their counsel), however, may conclude that no MAE has occurred and that the buyer therefore has no legal right to scotch the deal. If, as happened in the United Rentals case, the buyer continues, after suggesting that it might walk, to take the steps needed to accomplish a closing—such as preparation of securities filings—then the target board and management may well conclude that the buyer’s talk about backing out of the deal was simply an “it can’t hurt to give it a try” effort to lower the price, an effort that once opposed will come to nothing. Under those circumstances, the target board and management will not want to make a public statement that will hurt the target’s share price by raising a false alarm concerning the vitality of the deal. The United Rentals decision provides some comfort that a target board and management in such a situation can refrain from sounding such an alarm without fear of being successfully sued for fraud.

650. Id.
651. Id.
652. Id.
653. Id.
654. Id.
655. Patricia A. Vlahakis, Takeover Law and Practice 2010, in 42ND ANNUAL INSTITUTE ON SECURITIES REGULATION 1129, 1214 (PLI Corporate Law and Practice, Course Handbook Series No. 1849, 2010); Diane Holt Frankle, Agreement and Plan of Merger by and Among Buyer Inc., as Buyer, Acquisition Corp., as the Merger Sub, Target, Inc., as the Company and Affiliate, as the Representative, in ACQUIRING OR SELLING THE PRIVATELY HELD COMPANY 2010, at 367, 482 (PLI Corporate Law and Practice, Course Handbook Series No. 1813, 2010).
656. When a buyer makes a premium offer for a publicly traded target, the target’s share price rises toward the offer price. But, absent the market believing that another bidder will appear to top the offer on the table, the target’s stock price will not reach the offer price because the market discounts for the possibility that the takeover will not occur. A public statement that the buyer is making noises about backing out will increase that discount, thereby lowering the target’s market price.
Disclosure of problems with medical device. The year 2009 produced two significant Rule 10b-5 decisions growing out of drug company disclosures. The year 2010 produced a Rule 10b-5 decision growing out of a medical device manufacturer’s disclosures—Detroit General Retirement System v. Medtronic, Inc. Medtronic produced a thin-filament defibrillator lead called Fidelis. After a doctor reported to Medtronic in February 2007 that some of the Fidelis leads had fractured and that the doctor, together with colleagues, planned to publish a study of Fidelis failures, Medtronic sent a March 21 “Dear Doctor” letter to physicians using the leads. The letter stated that “Medtronic has received reports from a limited number of implanting physicians indicating they have experienced higher than expected conductor fracture rates in their centers with Sprint Fidelis leads.” The letter went on to say that (i) “Medtronic is actively investigating these reports,” (ii) the company’s investigation to date “suggests that variables within the implant procedure may contribute significantly to these fractures,” (iii) a “System Longevity Study . . . indicated survival is 98.9% at two years,” (iv) a “return products analysis shows 99.86% chronic fracture-free survival at two years,” and (v) “[b]oth evaluation methods suggest performance is in line with other Medtronic leads and consistent with lead performance publicly reported by other manufacturers.” In mid-October 2007, Medtronic voluntarily suspended sales of the Fidelis leads, disclosing that its decision followed six months studying reports of product failure. In the days after this announcement, Medtronic’s stock fell about 11 percent.

The plaintiffs sued Medtronic in a Rule 10b-5 action, contending that—from the date of the Dear Doctor letter to the October announcement that Medtronic was pulling the product—the company failed to disclose material information about the lead failures and that various “promotional statements,” as well as “earnings reports and projections describing the Fidelis leads as successful and the demand for the product as strong were materially misleading.” Affirming a trial court dismissal of the case, the Eighth Circuit held first that the statements in the Dear Doctor letter were not misleading for want of additional disclosure.

658. 621 F.3d 800 (8th Cir. 2010).
659. Id. at 803.
660. Id.
661. Id. at 805.
662. Id. at 805–06.
663. Id. at 804.
664. Id.
665. The appellate opinion fails to include the class period, but the district court decision does. In re Medtronic Inc., Sec. Litig., 618 F. Supp. 2d 1016, 1021 (D. Minn. 2009).
666. Medtronic, 621 F.3d at 806.
667. Id. at 807–08.
668. Id. at 810.
669. Id. at 805–08.
“limited number” of physicians misled because at least six hospitals or clinics had ceased use of Fidelis leads, the court of appeals found no material error alleged because the plaintiffs failed to plead that the six had “informed Medtronic of a problem with the device at the time they discontinued use,” and failed to plead “how many Fidelis leads those clinics would ordinarily have ordered or whether those leads constituted a significant enough percentage of the Fidelis business market that referring to six clinics or hospitals as a ‘limited number’ would be materially misleading.” 670 Although the plaintiffs alleged that, when referring to the returned product analysis in the letter, Medtronic should have stated that such analyses were unreliable, the court of appeals found that the express identification of the analysis as based on returned product was enough. 671 The plaintiffs’ contention that Medtronic misled by failing to state in the letter that the numbers in the reports to it were not sufficient to draw statistically significant conclusions foundered on the fact that the letter “indicated an investigation was ongoing because, at that point, there was no data available with a large enough data set to be conclusive.” 672 Although the plaintiffs alleged that the letter falsely reassured investors by reference to “implant procedure” as a possible significant contributing factor to lead fracture and recitation of statistics indicating that the Fidelis failure rate was in line with that of other leads, the court found it fatal that the plaintiffs “failed to allege any facts proving the omitted information would have put investors on notice . . . that either doctor error was not a significant contributing factor in the device failures or the overall failure rate of the device was higher than that of other devices.” 673 The court rejected the argument that all the alleged misleading information was material because Medtronic’s stock price dropped after the October 15 product recall, as it was not the release of the information that caused the price to drop but the recall itself, which Medtronic initiated voluntarily and before the available data showed “a statistically significant difference in the failure numbers for the Fidelis leads compared to the [other, thicker lead that Medtronic produced].” 674

The plaintiffs’ allegations that Medtronic’s promotional materials for Fidelis, the company’s earnings reports, and its financial projections were materially misleading fell for failure to plead “facts sufficient to show there was a significant problem with the Fidelis leads at the time those statements were made.” 675 Indeed, more generally, the Eighth Circuit found fault with the complaint because it “fail[ed] to allege facts showing Medtronic possessed the [allegedly omitted] information

670. Id. at 807.
671. Id. The decision does not, but might have, referred to the general principle that a company making a disclosure of facts is not required to characterize those facts in a negative way. See, e.g., In re Stone & Webster, Inc., Sec. Litig., 253 F. Supp. 2d 102, 126 (D. Mass. 2003) (“[T]he securities laws do not impose on reporting companies an obligation to characterize their results—even if their results are very poor— in pejorative fashion.”).
672. Medtronic, 621 F.3d at 807.
673. Id.
674. Id. at 807–08.
675. Id. at 808.
at the time the supposedly inconsistent statements were made.” 676 The court also commented that the challenged statements in Medtronic’s promotional materials constituted puffing—being “so vague that an investor could not reasonably rely on them for any information related to the soundness of the investment”—and therefore could not support a securities fraud lawsuit. 677

In addition to finding that the complaint failed to allege adequately that Medtronic’s statements were false or misleading, the court of appeals found that the plaintiffs failed to plead scienter. 678 Central to the plaintiffs’ scienter allegations was the charge that, somewhere inside Medtronic, information showed that the Fidelis leads were defective and that therefore any reassuring statements about the product were fraudulent. 679 The Eighth Circuit found that the complaint failed to allege that any of the individual defendants were part of any “review or analysis” of such information that had been made “at the time [of] the alleged materially misleading statements” or that “any one individual or group of individuals had, or even had access to, all those pieces of information collectively at the time the allegedly misleading statements were made.” 680 Most importantly, the Eighth Circuit held that a company’s possession of raw data on lead failures did not render its statements in the Dear Doctor letter fraudulent because the company had not yet conducted its investigation prompted by that raw data. 681

**Significance and analysis.** It is useful to contrast the Medtronic facts with those in last year’s Ninth Circuit decision, *Siracusano v. Matrixx Initiatives, Inc.* where that court reversed a denial of a Rule 10b-5 claim. 682 The company in *Siracusano* aggressively defended its product when it came under attack for causing adverse side effects, even to the point of attacking a Dow Jones journalist who authored an

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676. Id. at 806.
677. Id. at 808.
678. Id. at 808–09.
679. Id. at 808 (“The complaint contains blanket assertions the appellees should or must have known of each of the allegedly significant facts after a review of market and other data related to Fidelis.”).
680. Id. The court characterized its holding here as rejecting the plaintiffs’ theory of “collective scienter,” but noted that this was “not a situation where the falsity was so obvious that anyone familiar with the business of the company would have known the statements to be false at the time they were made.” Id.
681. Here are the court’s words:

> [The plaintiffs] allege[] Medtronic had in its possession the data that indicated there was a problem with the Fidelis leads at the time it was still reassuring doctors that the leads were a viable product. That is true. However, mere possession of uncollected data does not indicate Medtronic was aware of the implications of that data. The complaint itself alleges Medtronic was reviewing the tracking data and does not allege the reports were conclusive any earlier than the date on which Medtronic took action with respect to the Fidelis leads. See Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc., 531 F.3d 190, 196 (2d Cir. 2008) (finding no inference of scienter where there was no allegation that raw data in possession of company had been collected into reports that would have contradicted the information released by the company during the class period).

Id. at 809.
682. 585 F.3d 1167 (9th Cir. 2009).
By contrast, the Eighth Circuit pointedly commented that the Dear Doctor letter made no “unequivocal statements about the safety of the device,” instead simply “disclosing a possible problem and an investigation into that problem.” This suggests that a restrained public response to a safety issue, published when the drug or device manufacturer has sufficient information to identify a possible problem, pays dividends in subsequent litigation.

Of greater importance, the Medtronic opinion expressly recognizes that, when evaluating scienter in drug and medical device cases, the manufacturer will almost always need some time to evaluate adverse data. That is, a company does not commit fraud by failing to constantly reveal adverse data that is trickling in from various doctors and hospitals. A responsible company will evaluate that data in a timely fashion and, after announcing that it is conducting an analysis of possible adverse effects, will make appropriate additional statements when that evaluation reaches a point that it will sufficiently support those further statements. A company does not commit fraud by failing to provide constant updates.

Auditor scienter respecting uncollectible accounts. Last year produced another victory for auditors in a securities fraud case, via Louisiana School Employees’ Retirement System v. Ernst & Young, LLP. The plaintiffs alleged that Ernst & Young (“EY”) violated Rule 10b-5 by providing an unqualified opinion on the financial statements of Accredo Health, Inc. (“Accredo”) for that company’s 2002 fiscal year. The court of appeals affirmed dismissal of this claim on the ground that the complaint failed to adequately plead EY’s scienter. The case centered on uncollectible accounts receivable at a business operation that Accredo had purchased from another company. Accredo had fired EY when the problems with the uncollectible accounts emerged, and the company had sued EY for malpractice.

The court of appeals reaffirmed that recklessness can suffice for scienter, but stated that “when the defendant is an outside auditor[,] . . . recklessness requires a mental state ‘so culpable that it approximate[s] an actual intent to aid in the fraud being perpetrated by the audited company.’” The auditor will only be liable on

683. Id. at 1172–74 (suggesting that the journalist’s source was an individual that the company was suing for defamation); id. at 1174 (denying any statistically significant relationship between the side effect and the ingredient in the drug that supposedly caused that effect).
684. Medtronic, 621 F.3d at 806.
687. 622 F.3d 471 (6th Cir. 2010).
688. Id. at 480.
689. Id. at 485, 486.
690. Id. at 475.
691. Id. at 476.
692. Id. at 479 (quoting PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 693 (6th Cir. 2004)) (second alteration in original).
a Rule 10b-5 claim if “the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful,” or “the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.” 693

Here, the plaintiffs alleged that EY, as the Sixth Circuit characterized the claim, “failed to follow the professional standards that govern the auditor’s testing of management’s accounting estimates, such as the allowance for doubtful accounts.” 694

With the “crux” of the claim 695 restated in this negligence language, the court of appeals easily found that the specific allegations failed to raise a strong inference of the extreme recklessness the court set as the minimum scienter state of mind. The plaintiffs alleged that EY used “stale” data to test Accredo’s allowance for uncollectible accounts. 696 But access to information showing the age of the data did not imply scienter. 697 The plaintiffs pointed to a memorandum that (i) said that the company selling the business operation to Accredo had “‘tweaked’” downward the percentages of uncollectible accounts, and (ii) stated that EY “‘has not seen the basis for doing so.’” 698 The Sixth Circuit held, however, that while a fact finder could infer from this memo that EY discovered accounting shenanigans, “the competing inference is that [EY] required [the selling company] to show why management” performed the tweaking, and “that the more compelling inference is that [EY] was resisting a lower reserve.” 699 The plaintiffs alleged that EY had audited the business that Accredo bought before that acquisition, had found accounts receivable problems in that prior audit, and should therefore have been on the lookout for similar problems when auditing those same business operations after Accredo bought them. 700 The court responded that the old accounts receivable problems did not “suggest[] that [EY] was on notice that the accounts receivable problems were in excess of the substantial allowance recorded in 2002.” 701

The plaintiffs charged that the size of the post-2002 audit write-off—$58.5 million—argued in favor of inferring the auditor’s scienter. 702 But the Sixth Circuit restated its rule that the size of an accounting error is not relevant to scienter because inferring scienter from the size of the mistake “would eviscerate the principle that accounting errors alone cannot support a finding of scienter.” 703

693. Id. (quoting PR Diamonds, 364 F.3d at 693–94).
694. Id. at 481.
695. Id.
696. Id.
697. Id. at 482.
698. Id. at 482–83.
699. Id.
700. Id. at 483.
701. Id. (emphasis added). The selling company had written off some $92 million in uncollectible accounts for the relevant operations in 2000. Id. at 475. Accredo had established—as buying the operations—a “substantial reserve for accounts receivable.” Id. at 477.
702. Id. at 475, 483–84.
703. Id. at 484. The court also found no scienter inference arising from the $1.1 million in fees that EY received for the Accredo audit:
would the Sixth Circuit infer fraud from Accredo’s malpractice lawsuit against EY or from a 2003 statement by an EY partner “that ‘there was a problem.’” Relying on these facts for scienter in 2002 would constitute, the court held, unacceptable “‘fraud by hindsight . . . where a plaintiff alleges that the fact that something turned out badly must mean [that the] defendant knew earlier that it would turn out badly.” Even when examining the plaintiffs’ allegations as a whole, instead of individually, the court of appeals held that they fell short of providing a strong inference of the egregious conduct indicating auditor scienter—“that [EY’s] work was ‘no audit at all.’”

Significance and analysis. While the court does not lean on it in the opinion, the plaintiffs’ problem stemmed in part from the nature of the accounting error. Accredo had established a reserve for doubtful accounts. Such a reserve is necessarily an estimate, and the auditor’s job in examining that estimate is to evaluate the reasonableness of the judgments that management made in preparing that estimate. Using the recklessness scienter standard that the Sixth Circuit employed—that “no reasonable accountant would have made the same decisions if confronted with the same facts”—it will be hard to find facts providing a strong inference that a judgment call, such as one addressing the reasonableness of an estimate, was fraudulent.

Even a specific account that was one of the auditor’s most lucrative would not imply scienter on the part of the auditor.

The complaint contains no allegations that Ernst & Young’s fees from Accredo were more significant than its fees from other clients or that Accredo’s business represented a significant portion of Ernst & Young’s revenue. Plaintiffs allege no facts to support an allegation that Ernst & Young’s motive to retain Accredo as a client was any different than its general desire to retain business.

Even. (internal citation omitted).

704. Id. at 484–85.
705. Id. (quoting Konkol v. Diebold, Inc., 590 F.3d 390, 403 (6th Cir. 2009)).
706. Id. at 485 (quoting PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 693 (6th Cir. 2004)).
707. Id. at 477.
708. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, AUDITING STANDARDS BD., CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, AU § 342.04 (2010).
709. In addition to those summarized in the text, one further case merits footnote attention. The Private Securities Litigation Reform Act of 1995 requires that a district court handle a private Exchange Act case conduct an analysis at the close of the case to determine whether the litigation was abusive. PSLRA § 101, 15 U.S.C. § 78u-4(c) (2006). The review is mandatory, and the court “shall include in the record specific findings regarding compliance by each party and each attorney representing any party with each requirement of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion.” Id. § 78u-4(c)(1). If the court finds that a complaint violated Rule 11(b), the court must impose sanctions, id. § 78u-4(c)(2), presumptively by “an award to the opposing party of the reasonable attorneys’ fees and other expenses incurred in the action,” id. § 78u-4(c)(3)(ii). In Thompson v. RelationServe Media, Inc., 610 F.3d 628, 636–39 (11th Cir. 2010), the court of appeals affirmed dismissal of a case and remanded on the cross appeal so that the trial court would make the required findings as to whether the plaintiffs’ complaints violated Rule 11. In doing so, the Eleventh Circuit held that while the PSLRA sanctions provisions left the “substantive analysis under Rule 11” unchanged, the statute “eliminate[s] a district court’s discretion on two fronts: (1) in choosing whether to conduct the Rule 11(b) inquiry and (2) in determining whether to impose sanctions following a finding of a Rule 11(b) violation.” Id. at 636, 637. One of the panel members dissented on the disposition of the cross appeal, arguing that the Rule 11 violations were clear and therefore the appellate court should have instructed the lower court to impose sanctions. Id. at 639–700 (Tjoflats, J., concurring in part and dissenting in part).
Improper accounting for backdated options. The year 2010 brought a Rule 10b-5 case based on backdated options that a company failed to expense properly. The plaintiffs in *Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.* sued a company that restated financial results for fiscal years 1996 through 2005 because Jabil had, during that time, awarded backdated options and failed to record expenses for those awards—thereby overstating earnings by an aggregate $54.3 million. The Eleventh Circuit affirmed a district court dismissal because the shareholders did “not plead any facts that indicate that any individual [defendant] knew about the accounting irregularities during the class period.” While the plaintiffs contended that “the $54.3 million accounting error was too large for Jabil to ignore without some fraudulent intent,” particularly since the restatement encompassed nearly 50 percent of company income in one year, the Eleventh Circuit held that “net income can vary so widely period to period [that] using it as a baseline for comparison provides the court no real standard on which to judge the significance of the accounting error” and that “[w]ithout an allegation that puts [the] amount [of the avoided expense] in context of total corporate business, . . . it is impossible for us to determine . . . whether any insider should have noticed the errors.” Although the plaintiffs also contended that a *Wall Street Journal* article should have alerted the company to backdating, the court found that that article had raised only the claim that options to the CEO were backdated and not a “suspicion that numerous stock options had been misdated and misaccounted.”

The complaint’s charge that the insiders sold stock during the alleged fraud did not raise a scienter inference because such sales “are only relevant to scienter

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710. 594 F.3d 783, 788–89 (11th Cir. 2010). Under the accounting rules during this period, a company did not need to record any expense for an option if the exercise price equaled the market price on the date of the award but did need to record an expense if the exercise price was below the market price on that date. Accordingly, if a company actually awarded a stock option on date 2, when the stock sold on the market at X, but backdated the award to date 1, when the stock sold on the market at X-A, the accounting rules required the company to take a charge in the year of the award. Fin. Accounting Standards Bd., Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (Oct. 1972) [hereinafter APB 25]; *Goodman*, 594 F.3d at 788.

711. *Goodman*, 594 F.3d at 791. The court noted that the SEC had conducted an investigation and that the company had conducted an internal investigation. *Id.* at 788. That internal investigation concluded that the company had violated APB 25 but “found no evidence that high-level employees had been issuing themselves backdated options.” *Id.* When it published its restatement, Jabil provided three explanations for the backdating:

1. changes to groups of people receiving grants, though the initial measurement date was not changed correspondingly;
2. new grants issued after initial grants had gone “underwater” but not properly accounted; and
3. improperly accounted stock option grants to a non-employee director for consulting services.

*Id.*

The court of appeals did agree that the plaintiffs had alleged falsity because they rested their case (i) on misstatement of figures in the initially published financials—which the company admitted were false by its own restatement—and (ii) on misstatements in proxy solicitations that the company was granting options with exercise prices equal to market prices on the dates of the grants. *Id.* at 788, 790.

712. *Id.* at 791.

713. *Id.* at 792.

714. *Id.*
when they are suspicious,” and are only suspicious if dramatically different from prior sales—which could not be determined here because the “shareholders failed to plead any information about any [defendant’s] trading history before the class period.”715

Significance and analysis. The Goodman decision shows, again, how difficult it is for shareholders to “cash in” through a Rule 10b-5 action on backdated options.716 But the Goodman reasoning seems strained. Surely earnings are a metric that investors watch quite closely. Just as surely, executives know this to be true. The idea that an action significantly affecting earnings would not catch executive attention, while an action significantly affecting revenue would, stretches reality. The better argument for dismissal on the basis that the plaintiffs failed to plead scienter might have been that the complaint failed to plead with specificity that the top executives at the company both (i) understood the accounting rule that applied to options, and (ii) knew that the company was failing to account properly for a large quantity of options under that rule.

Forward-Looking Statements: statements about a ratio, one component of which was future cost, were protected by the safe harbor statute, and statements that profitability depended on the issuer’s ability to forecast that cost and about the sensitivity of issuer results to increases in that cost were meaningful cautionary warnings that precluded a private lawsuit based on alleged misstatements about the ratio; meaningful cautionary language can cut off a suit on forward-looking statements even where a plaintiff alleges facts to show that defendants had actual knowledge that the statements were misleading when made; applying the Tellabs comparative analysis to the “actual knowledge” requirement for forward-looking statement liability, the most likely inference was that defendants did not intend to deceive when projecting losses on a high-yield debt portfolio

715. Id. at 793. While the shareholders argued that their scienter allegations were sufficient when considered as a whole even if insufficient individually, the court held: “The shareholders are correct to insist that the inference of scienter be aggregated from all of the complaint’s allegations, but we simply have no substantial allegations to aggregate.” Id.

The court also affirmed dismissal of a Rule 10b-5 insider trading claim on the basis that the insiders knew of the accounting fraud because the complaint “fail[ed] to make any particularized allegation that any individual [defendant] knew about the accounting errors at the time of trading.” Id. at 794. The court similarly rejected the insider trading claim insofar as it was based on allegations that selling defendants knew the company had encountered “execution problems . . . that would cause it to miss quarterly projections.” Id. As the Eleventh Circuit parsed the complaint, that pleading failed to allege that the trading defendants knew of material problems when they sold, with the only specific example cited in the complaint being that the CEO knew of difficulties with a single contract, which was “hardly a particularized allegation that [the CEO] knew about material issues at Jabil before he traded.” Id.

The court affirmed dismissal of a proxy claim on the ground that the proxy votes obtained by the misstatement of the option award policy did not cause the plaintiffs harm. Id. at 796–97. That is, the harm did not derive from the “compensation scheme” approved by proxy votes or any other “transactions approved via the proxy solicitation materials,” and derived only “indirectly” from the “election of directors who violated” the company’s stated option award policies. Id. at 797.

Without any Exchange Act violation properly pled, the Eleventh Circuit held that the complaint could not support the statutory insider trading claim based on § 20A, 15 U.S.C. § 78t-1 (2006), which requires a “predicate violation.” Id.

716. See, e.g., Rosenberg v. Gould, 554 F.3d 962, 965 (11th Cir. 2009).
but sought to inform the public of a risk while conducting an investigation; whether statements about risk management are forward-looking depends on whether they expressly or implicitly predict future losses or whether they communicate present or historical facts about risk management steps taken.

The Exchange Act defines “forward-looking statement” to include “a statement containing a projection of . . . income . . . or other financial items” and “any statement of the assumptions” underlying such a projection. The statute provides two protections for such statements. First, if an issuer accompanies a forward-looking statement with “meaningful cautionary [language] identifying important factors that could cause actual results to differ materially from those in the forward-looking statement,” then (with exceptions not applicable to the cases summarized below), neither the issuer nor anyone acting on its behalf can be liable on the statement in a private action brought under the Exchange Act. Second, an issuer and those acting on its behalf are not liable in a private Exchange Act action based on a forward-looking statement unless the plaintiff can plead and prove that the defendants had “actual knowledge,” when they made the statement, that it was false or misleading.

The Third Circuit held last year that a ratio was a forward-looking statement because one number in the ratio was an estimate of future costs, and that the issuer was protected against private suits based on statements about that ratio because the issuer had warned that actual costs might exceed projections, with consequent damage to the company’s financial results. Both the Ninth and the Eleventh Circuits held that the two statutory protections for forward-looking statements are independent so that sufficient cautionary language can shield even a deliberately deceptive prediction from private lawsuits. The Second Circuit, after applying a Tellabs analysis in what the Second Circuit characterized as a close case, found inadequate allegations that the defendants had “actual knowledge” that their predictions of loss from a high-yield debt portfolio were false or misleading. In a case involving the “bespeaks caution” doctrine—a judge-made protection for forward-looking statements that is somewhat similar to the statutory protections—the Second Circuit ruled that some statements about risk management are forward-looking and some are not.

Statements about cost ratio protected by cautionary language. The shareholders suing under Rule 10b-5 in In re Aetna, Inc. Securities Litigation alleged that the defendants falsely stated that the company followed a “disciplined” pricing policy by “setting [health insurance] premiums in a fixed proportion to expected future medical costs,” a “proportion . . . known as the ‘medical cost ratio’ (MCR).”

720. See infra notes 724–35 and accompanying text.
721. See infra notes 736–43 and accompanying text.
722. See infra notes 744–70 and accompanying text.
723. See infra notes 771–83 and accompanying text.
724. 617 F.3d 272, 274, 276 (3d Cir. 2010).
Affirming the district court’s dismissal of the case, the Third Circuit reasoned that “‘disciplined’ pricing describes a policy of setting prices in relation to future medical costs.” Therefore, “whether Aetna’s pricing was, in fact, disciplined could not have been determined at the time defendants made the statements” since “the medical costs had not yet been incurred and could not be ascertained until later.” Accordingly, “to the extent that ‘disciplined’ pricing said anything about the current price of premiums, it did so in the form of a projection.” Finding the statements about disciplined pricing to constitute either “[s]tatements about future profitability [or] assumptions underlying management’s expectations about the future,” the court held that Aetna’s representations fell within the statutory definition of forward-looking statements. The court of appeals then held that Aetna had included cautionary statements adequate under the safe harbor statute to insulate the “disciplined” pricing statements from a private lawsuit through “language provid[ing] clear warning to investors that the accuracy of medical costs cannot be assured, actual medical costs may exceed projections assumed for purposes of setting premiums, medical costs in excess of projections cannot be recovered through higher premiums, and inaccurate medical cost projections can have a materially negative effect on profitability.” The court also held that the defendants’ statements were immaterial because they “contain[ed] only oblique reference to Aetna’s pricing policy” that were “too vague” to constitute “anything on which a reasonable investor would rely.”

725. Id. at 272, 285.
726. Id. at 281.
727. Id.
728. Id.
729. Id.
730. Id. at 283. Here is the Aetna language on which the Third Circuit relied:

Our ability to forecast and manage health care costs and implement increases in premium rates affects our profitability. Our profitability depends in large part on accurately forecasting health care costs and on our ability to appropriately manage future health care costs through underwriting criteria . . . .

* * *

Our ability to forecast health care and other benefit costs, detect changes in these costs, and achieve appropriate pricing affects our profitability. We continue to be vigilant in our pricing and have increased our premiums for new and renewal business in 2006. Premiums in the health business are generally fixed for one-year periods. Accordingly, future cost increases in excess of medical cost projections reflected in pricing cannot be recovered in the contract year through higher premiums. As a result, the Company’s results are particularly sensitive to the price increases it projects in advance of renewal of the business. There can be no assurance regarding the accuracy of medical cost projections assumed for pricing purposes, and if the rate of increase in medical costs in 2006 were to exceed the levels projected for pricing purposes, our results would be materially adversely affected.

731. Id. at 282–83 (ellipses in original).

This is solid and balanced growth that is representative of our dedication to disciplined pricing . . . . I will end my comments by reaffirming to you my personal commitment to continue to maintain discipline and rigor in everything we do at Aetna.
Significance and analysis. The Aetna plaintiffs did themselves no favor by characterizing their case as one dependent on “estimates,” and the opinion therefore did not face a more difficult question. The statement of a current intention that the defendant does not have—e.g., to carry out a promise—is a false statement for purposes of Rule 10b-5. That current intention is a matter of present fact, not a future fact and therefore should not constitute a forward-looking statement. Therefore, saying that a company intends to price in relation to a particular future cost—if made without any intention of doing so—should be a misstatement of present fact, even though the statement concerns a present intention about future conduct. And stating that a company is setting prices based on an anticipated future cost is a statement of current fact which is false if, in fact, the company is not—at the time of the statement—setting prices in that way. All of this emphasizes that the exact words the defendants speak or write, and how a plaintiff frames its claim, can determine whether the forward-looking-statement safe harbor applies or not. The substance of the statement and the claim can be virtually the same, yet in one case the safe harbor will defeat it and in another it will not.

The customer markets, both geographical and by customer type, are very dynamic and vary greatly in terms of cost, premium levels, competitors and complexity. We talk in terms of aggregated consolidated results, but there are always markets or specific customers that are functioning better or worse than others or versus expectation.

Our . . . book of business is constantly evolving and changing. As new business is written, cases get renewed and other cases lapse.

The plaintiff alleged that the seller “used the projections contained in the Business Plan to entice investors, but never intended...” (emphasis added).

Id. (ellipses in original). The Third Circuit’s view that the references to “discipline” in this passage were immaterial rested in part on the circumstance that, immediately before speaking the words set out above, the CEO/Chairman provided a much more complex context:

The customer markets, both geographical and by customer type, are very dynamic and vary greatly in terms of cost, premium levels, competitors and complexity. We talk in terms of aggregated consolidated results, but there are always markets or specific customers that are functioning better or worse than others or versus expectation.

Our . . . book of business is constantly evolving and changing. As new business is written, cases get renewed and other cases lapse.

(A303.) These remarks, while broad and vague, at a minimum convey the complexity of Aetna’s business, diversity of its customers, and variable nature of its portfolio of insurance contracts. They describe the difficulty of accurately predicting MCR and the heterogeneous nature of Aetna’s products, services, customers, and pricing. When read in context, no reasonable investor could infer that “dedication to disciplined pricing,” a vague and subjective statement, meant Aetna had applied (or failed to apply) a static, across-the-board formula to determine the price of premiums charged for all products and services. General statements about the company’s dedication to “disciplined” pricing and commitment to “discipline and rigor” could not have meaningfully altered the total mix of information available to the investing public. We therefore find the statements immaterial as a matter of law.

Id. (ellipses and alteration in original).

732. The court wrote: “Plaintiffs contend that, by engaging in “disciplined” pricing, Aetna is telling investors that, based upon what the Company currently estimates costs to be for the policies it is writing, these policies will be profitable.” Id. at 280.


734. See Iowa Pub. Emps.’ Ret. Sys. v. MF Global, Ltd., 620 F.3d 137, 144 (2d Cir. 2010) ("[A] statement of confidence in a firm’s operations may be forward-looking . . . even while statements or omissions as to the operations in place (and present intentions as to future operations) are not.") (emphasis added).

735. In another decision focusing on forward-looking statements, the Fifth Circuit affirmed a Rule 10(b)-5 judgment as a matter of law in favor of defendants sued for selling natural gas interests by using a business plan that included projected production volumes and projected revenues. Arkoma Basin Project Ltd. P’ship v. W. Fork Energy Co., 384 F. App’x 375 (5th Cir. 2010). The plaintiff alleged that the seller “used the projections contained in the Business Plan to entice investors, but never intended...” (emphasis added).
Whether cautionary statements protect deliberately deceptive statements. The Exchange Act provides not only that private plaintiffs cannot sue on a forward-looking statement accompanied by meaningful cautionary language, but also that private plaintiffs cannot sue on such a statement unless they plead and prove that the defendant made the forward-looking statement with “actual knowledge” that it was false or misleading.\textsuperscript{736} The word “or” separates the two protections—(i) immunity through cautionary language, or (ii) immunity through plaintiffs’ inability to prove that defendants had actual knowledge that the statement would mislead. In 2010, the Ninth Circuit reaffirmed the principle that “if a forward-looking statement is identified as such and accompanied by meaningful cautionary statements, then the state of mind of the individual making the statement is irrelevant, and the statement is not actionable regardless of the plaintiff’s showing of scienter.”\textsuperscript{737} The court of appeals specifically rejected the plaintiffs’ argument that “a sufficiently strong inference of actual knowledge would overcome a claim of safe harbor protection even for statements identified as forward-looking

to take steps to complete those projections.” \textit{id.} at 380. The Fifth Circuit found that “there is no evidence that Appellees knew that the projections contained in the Business Plan were false when made,” and observed that the seller actually “completed Phase I and made serious efforts to complete Phase II of the Business Plan on schedule,” \textit{id.} at 380–81, with Phase III frustrated by “equipment shortages and the loss of cash flow from two unproductive wells,” \textit{id.} at 378, all of which occurred after the sale to the plaintiff. The court of appeals also repeated the Fifth Circuit rule that “projections of future performance not worded as guarantees are generally not actionable under the federal securities laws as a matter of law.” \textit{id.} at 380 (quoting ABC Arbitrage Plaintiffs Grp. v. Tchuruk, 291 F.3d 336, 359 (5th Cir. 2002) (internal quotation omitted)).

\textsuperscript{736} The statute grants protection against liability in investor suits if and to the extent that—

(A) the forward-looking statement is—

(i) identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or

(ii) immaterial; or

(B) the plaintiff fails to prove that the forward-looking statement—

(i) if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or

(ii) if made by a business entity[,] was—

(I) made by or with the approval of an executive officer of that entity; and

(II) made or approved by such officer with actual knowledge by that officer that the statement was false or misleading.


\textsuperscript{737} In re Cutera Sec. Litig., 610 F.3d 1103, 1112 (9th Cir. 2010) (emphasis added). In a January 31, 2007, press release, Cutera “projected first quarter and year end revenues in 2007 of $26 million and $126 million respectively, a growth of 25% over the previous year” and lauded its program to increase sales through its junior sales representatives. \textit{id.} at 1106. On May 7, 2007, the company reported only $23.3 million in Q1 revenues, blaming the shortfall in part on “the unsuccessful implementation of [the] junior sales program.” \textit{id.} at 1107 (quoting company) (alteration in original). The plaintiffs alleged that Cutera violated § 10(b) of the Exchange Act by failing to disclose, in January, “material information about the weakness of its junior sales force” and by fraudulently predicting that revenues would increase by 25 percent. \textit{id.} at 1109.
and accompanied by meaningful cautionary language. The Eleventh Circuit reached the same conclusion based largely on the same reasoning.

**Significance and analysis.** Plaintiffs’ lawyer William Lerach used to call the forward-looking statement protections a “license to lie” precisely because the conjunctive “or” between the two protections appears to shield knowingly false projections if the company accompanies the protections with cautionary words. But the first protection in the statute only applies where the cautionary language “identif[i]es important factors that could cause actual results to differ materially from those in the forward-looking statement.” Courts have interpreted that language to require that the warnings include “those sources of variance that (at the time of the projection) were the principal or important risks” that could yield materially different results or “risks of a significance similar to” the one that frustrated the realization of the forward-looking statement. Working with formulations such as these, why couldn’t courts interpret the first forward-looking protection—in those instances where a company deliberately published misleading projections—to require that the cautionary language state that the company might be purposely misleading the public? Wouldn’t that risk be a “principal or important” one and a “risk[] of a significance similar to” whatever event down the road frustrated the prediction?

One counter might be that this interpretation effectively deletes the “or” between the two statutory protections. But surely that is not so in an operational sense. There would still be cases in which a prediction was saved by the second protection (because plaintiffs could not allege or prove that defendants had actual knowledge that a prediction was misleading) even though the first protection did not apply (because the company supplied no cautionary language with its projection). At least logically, if not practically, the first protection could save a

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The Ninth Circuit affirmed the district court’s dismissal of the action, id. at 1106, because (i) the complaint did not provide “a factual basis for the claim that Cutera knew about the weakness of its junior sales force by January 31, 2007,” and (ii) the projection was protected by cautionary language in which the company stated that

factors like Cutera’s “ability to continue increasing sales performance worldwide” could cause variance in the results. Cutera affirmatively warned that its ability to compete and perform in the industry depended on the ability of its sales force to sell products to new customers and upgraded products to current customers, and that failure to attract and retain sales and marketing personnel would materially harm its ability to compete effectively and grow its business.

Id. at 1110, 1112.

738. Id. at 1112.


740. *I Told You So*, CFO Mag., Sept. 2002, at 62, 67. For a review of the several decisions bearing on this issue, see Marc D. Sokol & Howard S. Suskin, *Circuits Split Over Whether the PSLRA’s Safe Harbor Applies to Knowing Misrepresentations*, 21 SEC. LITIG. J. 1 (2010). In a decision summarized for other holdings below at notes 744–70 and accompanying text, the Second Circuit called this a “thorny issue.” Slayton v. Am. Express Co., 604 F.3d 758, 772 (2d Cir. 2010).


projection (if the company said it might lie) even when the second protection did not apply (because the company did deliberately lie in the projection). Moreover, if the “or” separating the two protections really intends that the two be independent of one another, the second protection arguably cannot reach into the first protection and remove actual lying as a risk that the cautionary language must reveal.

Tellabs used to find deficient allegations that defendants had “actual knowledge” that forward-looking statement was misleading. On May 15, 2001, the defendants in Slayton v. American Express Co. stated in a first quarter 10-Q that the company had lost $182 million on its high-yield bond portfolio in the three months covered by that report, but that “‘[t]otal losses on these investments for the remainder of 2001 are expected to be substantially lower than in the first quarter.’”744 The 10-Q included a general identification of “forward-looking statements” as those using such words as “‘expect,’” “‘believe,’” and “‘anticipate,’”745 and cautioned that “[f]actors that could cause actual results to differ materially from these forward-looking statements include . . . potential deterioration in the high-yield sector, which could result in further losses in [the] investment portfolio.”746 On July 18, 2001, American Express announced that it was taking another $826 million write-down on its high-yield bond portfolio.747

Affirming a district court decision748 dismissing a § 10(b) claim alleging that the stated expectation for substantially lower losses on the high-yield bonds after Q1 was fraudulent,749 the Second Circuit addressed first whether the challenged statement—that the company expected total losses for the last three quarters of 2001 in high-yield investments to fall substantially below $182 million—constituted a “forward-looking statement” protected by statute.750 The statement “fit[] comfortably” within the statutory definition of such statements, the court held, because that definition includes both “‘a statement containing a projection of . . . income . . . or other financial items’ and ‘a statement of future economic performance.’”751 The plaintiffs had argued that the American Express expectation, however, could not be protected by the statute because the statute states that it does not apply to projections “‘included in a financial statement prepared in accordance with [GAAP].’”752 The court of appeals rejected this argument, holding that the GAAP exclusion did not apply because the challenged statement appeared in the Management Discussion and Analysis (“MD & A”) portion of the American Express 10-Q, and “regulations suggest that the SEC views the financial statement and the MD & A as wholly different; there is no suggestion that the MD & A is viewed as a subset of a financial statement.”753

744. 604 F.3d 758, 762–63 (2d Cir. 2010) (quoting 10-Q) (alteration in original).
745. Id. at 769 (quoting Form 10-Q).
746. Id. at 764 (quoting Form 10-Q) (first alteration and ellipses in original).
747. Id.
748. Id. at 762, 778.
749. Id. at 765.
750. Id. at 766–68.
752. Id. at 767 (quoting 15 U.S.C. § 78u-5(b)(2)(A)).
753. Id. at 768.
The court then turned to whether American Express had insulated its statement with cautionary language sufficient to avoid liability in a private lawsuit.\footnote{754}{Id. at 768–73.} That PSLRA protection applies only to language that the issuer “‘identify[s] as a forward-looking statement,'” and the plaintiffs argued that the company had not specifically identified the expectation regarding further high-yield losses as such.\footnote{755}{Id. at 769.}

The Second Circuit, however, held that (i) “[n]othing in the statute indicates that to be adequately identified, a forward-looking statement must be contained in a separate section or specifically labeled,”\footnote{756}{Id.} (ii) “[t]he May 15 statement is plainly forward-looking—it projects results in the future,” and (iii) “[i]t is also accompanied by a statement of the common-sense proposition that words such as ‘expect’ identify forward-looking statements.”\footnote{757}{Id. Turning to the issuer’s cautionary language—warning of “‘potential deterioration in the high-yield sector, which could result in further losses in [the] investment portfolio’”\footnote{758}{Id. at 764.}—the Second Circuit found these words “vague” and insufficient to protect the forward-looking statement because the caution “‘verge[d] on the mere boilerplate, essentially warning that ‘if our portfolio deteriorates, then there will be losses in our portfolio.’”\footnote{759}{Id. at 772. The court also noted that American Express had placed exactly this language in “numerous reports as early as January 2001,” found that this language “appeared both before and after the defendants reported the $182 million loss,” and therefore concluded that “[t]he consistency of the defendants’ language over time despite [learning new information relating to possible high-yield losses] belies any contention that the cautionary language was ‘tailored to the specific projection.’”\footnote{758}{Id. at 773 (quoting Institutional Investors Grp. v. Avaya, Inc., 564 F.3d 242, 256 (3d Cir. 2009)).}

Without the protection of adequate cautionary language, the American Express statement could support a private claim, provided that the plaintiffs could plead and prove that the company expressed its expectation for lower high-yield losses in the last three quarters of 2001 with “actual knowledge,” by an executive officer making or approving that statement, that the expectation “‘was false or misleading.’”\footnote{760}{Id. at 770. Since the plaintiffs brought their claim under the Exchange Act, the PSLRA pleading rules required that they allege specific facts raising a “strong inference” that the defendants had this “required state of mind.”\footnote{761}{PSLRA § 101(b), 15 U.S.C.A. § 78u-4(b)(2) (West 2009 & Supp. 2011).} In evaluating the adequacy of the complaint against this standard, the Second Circuit applied the Supreme Court’s holding in \textit{Tellabs, Inc. v. Makor Issues & Rights, Ltd.} that “[a] complaint will survive . . . only if a reasonable person would deem the inference of [the required state of mind] cogent and at least as compelling as any opposing inference one could draw from the facts alleged.”\footnote{762}{Slayton, 604 F.3d at 774 (quoting Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 324 (2007)) (ellipses in original).}
Here, the plaintiffs alleged that—around the time of the May 15, 2001, statement—(i) the CEO of American Express Financial Advisors (“AEFA”) received a fax from the American Express CFO “‘advising [the AEFA CEO] that American Express was facing additional losses on its high-yield debt investments beyond those already booked,’” (ii) the American Express President/COO was told in a meeting that “‘even the investment-grade [collateralized debt obligations] . . . showed potential deterioration’” in an amount so opaque the AEFA CEO could not estimate a range of future losses, and (iii) American Express, which had previously relied on outsiders to evaluate the risk, appointed a former American Express treasurer and a current senior vice president of risk management to conduct a new analysis. All of these facts “support[ed] an inference that the defendants actually knew that they did not know the extent of the deterioration and therefore had no reasonable basis for predicting that very range by stating that ‘[t]otal losses on these investments for the remainder of 2001 are expected to be substantially lower than in the first quarter.’”

On the other hand, the American Express COO was “‘stunned’” when informed in July 2001 of the huge additional losses, which resulted in part from more conservative assumptions than those previously employed. Moreover, the plaintiffs pled no motive for deception which, while not fatal, required “under [the court’s] holistic review [that] . . . [the plaintiffs’] circumstantial evidence of actual knowledge . . . be correspondingly greater.” Finally, a number of facts affirmatively suggested that the defendants had not sought to deceive, including (i) the new effort that American Express undertook in May, with its own personnel, to reevaluate the high-yield debt portfolio; (ii) the more conservative assumptions that the company used in that reevaluation; and (iii) the prompt announcement in July, after the completion of that review, of a further $826 million write-down. These facts suggested that American Express “was endeavoring in good faith to ascertain and disclose future losses.” Putting it all together, the Second Circuit found this a “close case,” but one in which “the inference of fraudulent intent is

763. Id. at 763. The plaintiffs relied on an article in the Wall Street Journal Asia. Id.
764. Id. at 775 (quoting joint appendix) (alteration in original).
765. Id. at 764 (quoting joint appendix).
766. Id. at 776.
767. Id. at 777. The court used these words:

Ordering an investigation as soon as they learned that the investment-grade CDOs might be deteriorating, and directing [the former treasurer] and [the senior vice president of risk management] to use conservative assumptions, was “a prudent course of action that weakens rather than strengthens an inference of scienter.”

Moreover, the losses reported in July were the product of using different assumptions, representing the first time American Express drew its own conclusions rather than relying on reports generated by outside CDO managers, and also of the Company’s subsequent business decision to reduce the level of its high-yield portfolio. These new assumptions and decisions undermine any inference that the defendants suspected the magnitude of losses reported in July when they made the May 15 statement.

Id. (internal citations omitted).
768. Id. at 777.
not ‘at least as compelling as any opposing inference one could draw from the facts alleged.’

Significance and analysis. Slayton provides what may be an archetypical case in which the higher scienter standard for statutorily protected forward-looking statements makes a difference. In the ordinary Rule 10b-5 case, a plaintiff may plead and prove scienter by showing that a defendant acted with severe recklessness. Making a statement without knowing whether it is true or false—which is essentially what the plaintiffs alleged in Slayton—may reach severe recklessness. But it does not amount to “actual knowledge” that the statement is false or misleading.

Application of “bespeaks caution” doctrine to statements about risk management. Defendants making forward-looking statements that do not fall within the statutory protection discussed above may nevertheless enjoy the protection of the “bespeaks

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769. Id. (quoting Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 322, 324 (2007)).
770. Id. at 773.

The Ninth Circuit’s rather odd decision, In re Oracle Corp. Securities Litigation, 627 F.3d 376 (9th Cir. 2010), deserves a brief note. The decision affirmed summary judgment, id. at 395, in an action against the corporation and three officers under Rule 10b-5, and against two of the officers under § 20A of the Exchange Act, id. at 383 (citing 15 U.S.C. § 78t-1(a)). The plaintiffs’ case had two parts. First, the plaintiffs alleged that the defendants committed fraud by making and then repeating a forecast for Oracle’s third quarter in its fiscal year 2001, id. at 387–88, with that quarter running from December 1, 2000, to February 28, 2001, id. at 383. On December 14, 2000, the company predicted twelve cents earnings per share (“EPS”) for Q3 2001, id., and the Executive Vice President repeated that guidance on February 13, 2001, id. at 390.

The Ninth Circuit proceeded through its analysis of the prediction and its repetition without referring to the forward-looking statement statute at all, probably because the Ninth Circuit found no evidence that the two statements were false. The court’s reasoning on falsity, however, is flawed. The court rested its analysis on a 1996 case holding that, in order to prove that a forward-looking statement is materially misleading, ‘a plaintiff must prove either (1) the statement is not actually believed [by the speaker or author], (2) there is no reasonable basis for the belief, or (3) the speaker is aware of undisclosed facts tending seriously to undermine the statement’s accuracy.’ Id. at 388 (quoting Provenz v. Miller, 102 F.3d 1478, 1487 (9th Cir. 1996)). Strangely, Provenz failed to cite Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991). A prediction is, at heart, an opinion, and Virginia Bankshares held unequivocally (albeit in a § 14(a) setting) that “mere disbelief . . . should not suffice for liability.” Id. at 1096. Accordingly, Provenz (and derivative Oracle) is wrong in stating that a plaintiff can show that a forecast is false simply by showing that the speaker or writer did not believe it. Instead, as Virginia Bankshares teaches, an actionable opinion “in a commercial context” must “rest on a factual basis,” id. at 1093, so that proving it false involves “demonstrat[ing] something false or misleading in what the statement expressly or impliedly declare[s],” id. at 1096. All of this Virginia Bankshares analysis means, therefore, that a plaintiff must, in order to prove a forecast false, show it to be objectively false—which certainly would be the case if, in the words of Provenz, the forecast had “no reasonable basis,” as a prediction (in the words of Virginia Bankshares) “impliedly declare[s]” that it rests on such a basis.

On the other hand, proof that an opinion (including a forecast) is false also must include proof that it is subjectively false—i.e., that the speaker or writer did not believe it. Putting it another way, while subjective falsity is not sufficient, it is—like objective falsity—required. Indeed, the Ninth Circuit itself reached this conclusion just two years ago. See Rubke v. Capitol Bancorp Ltd., 551 F.3d 1156, 1162 (9th Cir. 2009) (fairness opinions actionable “only if the complaint alleges with particularity that the statements were both objectively and subjectively false or misleading”). Provenz’s disjunctive formulation, accordingly, is wrong. To be false, a prediction must be both disbelieved and have no reasonable basis (or, perhaps, made while withholding a fact throwing the prediction into serious doubt). Note that the Second Circuit last year made the same doctrinal mistake—agreeing with an SEC amicus brief and the parties that a prediction can be false if either subjectively or objectively false, Slayton, 604 F.3d at 774, whereas precedent requires that a prediction be both subjectively and objectively false in order to be false for Rule 10b-5 purposes.
caution” doctrine, which (somewhat like the statute) protects forward-looking statements that are accompanied by specific cautionary language describing the risks that frustrate the prediction that the forward-looking statement makes.\textsuperscript{771} The Second Circuit applied that doctrine last year in \textit{Iowa Public Employees' Retirement System v. MF Global, Ltd.}\textsuperscript{772} The plaintiffs, suing under §§ 11 and 12(a)(2) of the Securities Act,\textsuperscript{773} contended that the registration statement and prospectus for MF Global's initial public offering failed to disclose, among other things, material facts about Global's risk-management system.\textsuperscript{774} After the offering, a broker

Although off-base doctrinally, Oracle's result is sound. Since objective falsity is required and since the Oracle plaintiffs contended that the twelve cent EPS forecast had no reasonable basis, \textit{Oracle}, 627 F.3d at 388, their claim fell to undisputed evidence that Oracle had such a reasonable basis. The Ninth Circuit described an elaborate intra-corporate process by which Oracle made predictions—employing forecasts from sales representatives that were adjusted to take into account the known bias in those forecasts, \textit{id}.—resulting in forecasts that had proved “accurate but conservative . . . for seven consecutive quarters,” \textit{id}. From December 1, 2000, through February 4, 2001, that process produced internal Q3 estimates that supported the twelve cent EPS estimate, \textit{id}. at 384, and those internal estimates provided a reasonable basis for the December 14, 2000, public forecast, \textit{id}. at 389–90. While the internal forecast had dropped to eleven cents EPS on February 5, it rose to twelve cents again on February 12, \textit{id}. at 384, and that was the most recent internal estimate before—and therefore provided a reasonable basis for—the Executive Vice President’s repetition of the twelve cents guidance on February 13, 2001, \textit{id}. at 391. As the Ninth Circuit put it:

Companies generate numerous estimates internally, and they may reveal the projection they think best while withholding others, as long as the projection revealed had a reasonable basis. The most recent internal forecast to precede [the Executive Vice President's] statement supported Oracle's 3Q01 guidance, and his statement therefore had a reasonable basis.

\textit{Id}. at 391 (internal citation omitted). The court added: “The fact that the February 13 prediction proved incorrect in hindsight does not make it untrue when made.” \textit{Id}. at 390.

In the second part of their case, the plaintiffs alleged that Oracle had misrepresented “the functionality and success of [a new product called] Suite 11i” and had overstated the company's second quarter earnings. \textit{Id}. at 387–88. The Ninth Circuit upheld summary judgment on this part of the Rule 10b-5 claim because the plaintiffs failed to raise a genuine question of fact that these alleged omissions and misstatements caused the asserted loss. \textit{Id}. at 394. When Oracle announced on March 1 that it would miss the twelve cent EPS forecast and the price of the company's stock fell, the “overwhelming evidence produced during discovery”—consisting of analyst reports—showed that “the market understood [the] . . . miss to be a result of several deals lost in the final weeks of the quarter due to customer concern over the declining economy” rather than any problems with Suite 11i. \textit{Id}. at 393. As to the charge that the company had overstated its Q2 earnings, Oracle never restated those earnings and, hence, the market never learned that they were “false” and accordingly no decline in the price of Oracle stock could be linked to revelation that the second quarter numbers were misstated. \textit{Id}. at 394.

In one more holding of note, the Ninth Circuit affirmed summary judgment on the § 20A insider trading claims against the two Oracle executives. “Plaintiffs' inability to establish a triable issue on loss causation for their Suite 11i and 2Q01 claims ends their Section 20A claim” that the officers were liable for insider trading on that information. \textit{Id}. at 395.

\textit{771}. See P. Stolz Family P'ship L.P. v. Daum, 355 F.3d 92, 96 (2d Cir. 2004) (summarizing the doctrine: “A defendant may not be liable under § 12(a)(2) for misrepresentations in a prospectus if the alleged misrepresentations were sufficiently balanced by cautionary language within the same prospectus such that no reasonable investor would be misled about the nature and risk of the offered security.”).

\textit{772}. 620 F.3d 137 (2d Cir. 2010).

\textit{773}. \textit{Id}. at 139 (citing 15 U.S.C. §§ 77k, 77l(a)(2)).

at Global lost more than $141 million in trades that exceeded Global’s trading limits, and Global’s stock dropped by 28 percent. The district court dismissed all the risk-management allegations as barred by the “bespeaks caution” doctrine because the offering documents contained cautionary statements that its risk-management system could fail and that employees might make unauthorized trades. The Second Circuit held that the “bespeaks caution” doctrine “applies only to statements that are forward-looking.” The appellate court then rejected the trial court’s reasoning that the plaintiffs’ risk-management allegations rested on forward-looking statements simply because the alleged omissions involved the “failure to disclose the possibility that the risk management system might be unable to prevent future negative outcomes.”

The Second Circuit held that “while . . . predictions about the future can represent interpretations of present facts (and vice versa), there is a discernible difference between a forecast and a fact.” Thus, “[a] forward-looking statement (accompanied by cautionary language) expresses the issuer’s inherently contingent prediction of risk” while “a non-forward-looking statement provides an ascertainable or verifiable basis for the investor to make his own prediction.” Moreover, “a statement of confidence in a firm’s operations may be forward-looking—and thus insulated by the bespeaks-caution doctrine—even while statements or omissions as to the operations in place (and present intentions as to future operations) are not.” Adding, as an example, that “a statement specifying the risk of default is distinct from a statement of present or historical financial instability, even though they both bear upon the same risk,” the court then seemingly got to the point by stating that “characterizations of MF Global’s risk-management system—that the system was ‘robust,’ for example—invite the inference that the system will reduce the firm’s risk,” but “bespeaks caution does not apply insofar as those characterizations communicate present or historical fact as to the measures taken.” The Second Circuit remanded for the district court to apply

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775. *MF Global*, 620 F.3d at 139.
776. *Id.* at 140. The registration statement and prospectus included these words:

• “[O]ur risk-management methods may prove to be ineffective because of their design, their implementation or the lack of adequate, accurate or timely information. If our risk-management efforts are ineffective, we could suffer losses that could have a material adverse effect on our financial condition or operating results.”

• “[W]e are exposed to . . . risks relating to employee misconduct. Among other things, our employees could execute unauthorized transactions for our clients or for their own or any of our accounts.”

*Id.* at 140 n.5 (quoting prospectus, with 139–40 n.2 stating that the registration statement contained “substantially similar statements and wording in relevant part”) (alterations and ellipses in original).
777. *Id.* at 142.
778. *Id.* at 143 (quoting Rubin v. MF Global, Ltd., 634 F. Supp. 2d 459, 472 (S.D.N.Y. 2009) (district court opinion)).
779. *Id.*
780. *Id.*
781. *Id.* at 144.
782. *Id.*
the appellate court’s somewhat Delphic words and determine whether the risk-management allegations survived. 783

**Significance and analysis.** The risk-management cases now traveling through the courts demonstrate the fragility of the forward-looking statement protections—whether through the statute or the court-created “bespeaks caution” doctrine. A company could tell the market that it had “risk controls in place that decrease the probability that we will experience more than a 7 percent decline in loan failures in the next twelve months,” and courts might well find that statement forward-looking—therefore entitled to statutory or “bespeaks caution” protection. But if the company simply described its then-current controls without adding anything about the future effect of those controls, courts would likely find that description to lie outside the definition of forward-looking statements and therefore not entitled to either the statutory or judge-made “bespeaks caution” protection—even though the importance of the company’s description derived entirely from the estimated losses the controls would prevent in the future. Oddly, an issuer might think that sticking to the “facts” and simply describing the controls is the safest path when, because of the legal protections for forward-looking statements, the phrasing that predicts the controls’ future benefits may be easier to defend.

**SEC Rulemaking:** SEC rulemaking failed to include sufficient evidence to support determination that fee for depth-of-book data was constrained by competitive forces

The SEC approved fees that NYSE Arca proposed to charge for its depth-of-book data. 784 In *NetCoalition v. SEC*, the D.C. Circuit decided a challenge to that approv-

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783. Id. at 145. The court did make one unequivocal decision about forward-looking statements:

> Here, it is alleged for example that the prospectus “failed to disclose the material fact that [MF Global’s] Risk Management System protocols and procedures . . . did not apply to the Company’s employees . . . [when] trading for their own accounts.” That allegation specifies an omission of present fact, to which bespeaks caution does not apply: The applicability of MF Global’s risk-management system to employee accounts was ascertainable when the challenged statements were made. It was therefore error for the district court to rely on the bespeaks-caution doctrine to dismiss that claim.

Id. at 142 (ellipses and alterations in original).

In one other holding of note, the appellate court affirmed the lower court’s dismissal of allegations that the offering documents “failed to disclose ‘that traders did not have limits when trading for clients, and that with the proper password anyone could access client accounts and trade in them at any time.’” Id. Both § 11 and § 12(a)(2) permit an affirmative defense that the asserted misrepresentation or omission did not cause the plaintiffs’ loss. Id. (citing 15 U.S.C. §§ 77k(e), 77l(b)). Where that affirmative defense is apparent from the complaint itself, a court properly grants a motion to dismiss on the basis of the defense. Id. Here

> neither the [$141 million] trading incident nor subsequent events revealed to the public that “anyone with the password could access client accounts . . . and trade at will therein,” as the plaintiffs allege. This allegation concerns a security risk, of client fund misappropriation—not the sort of risk made plain by and after the [alleged trading] losses. It is therefore ‘apparent’ on the face of the complaint” that the stock price decline (and the plaintiffs’ resulting losses) cannot be attributed to the prospectus’ failure to disclose that alleged fact; and the allegation was properly dismissed.

Id. at 145 (internal citation omitted) (last alteration and ellipses in original).

al.\textsuperscript{785} To meet the statutory standard for exchange fees, the charge for the depth-of-book data had to be “reasonable,” had to “promote just and equitable principles of trade,” could not “unfair[ly] discrimin[ate] between customers, issuers, brokers, or dealers,” and could “not impose any burden on competition not necessary or appropriate in furtherance of the purposes” of the Exchange Act.\textsuperscript{786} The SEC had approved the proposed fees using a “market-based approach” under which it first would determine whether the fees were “subject to significant competitive forces” and, if so, would then approve the fees “‘unless it determine[d] that there [was] a substantial countervailing basis to find that the terms’ violate[d] the Exchange Act or SEC rules.”\textsuperscript{787} The D.C. Circuit held that the Commission could use that criteria, and rejected the argument that the Exchange Act required the SEC to evaluate the proposed fees on the basis of the cost that NYSE Arca incurred to provide the data, because the statute did not require the SEC to use cost as the criterion for fee approval and legislative history suggested that Congress desired the SEC to “rely ‘on competition, whenever possible, in meeting its regulatory responsibilities for overseeing the SROs and the national market system.’”\textsuperscript{788}

The court found, however, that the Commission had failed to show that the NYSE Arca depth-of-order fees were subject to competitive pricing pressure.\textsuperscript{789} While the SEC had found that NYSE Arca would need to constrain its depth-of-order fees in order to attract order flow, that conclusion conflicted with the Commission's

\textsuperscript{785} 615 F.3d 525 (D.C. Cir. 2010). Depth-of-book data “consists of outstanding limit orders to buy stock at prices lower than, or to sell stock [] at prices higher than, the best prices on each exchange.”\textsuperscript{Id.} at 529–30 (footnotes omitted). As the court explained:

If a trader wants to buy a certain number of shares that exceeds the depth (volume of shares available) at the best price, depth-of-book data will tell him the number of shares available at prices inferior to the best price. In this way, depth-of-book data allows a trader to gain background information about the “liquidity” of a security on a particular exchange, i.e., the degree to which his total sale or purchase price will differ from what he would receive if the entire trade were made at the prevailing best prices. For instance, even a very large buy order for a security with high liquidity on a certain exchange will trade at or close to the best price while a similarly large order for a security with lower liquidity on that exchange will cost more in toto due to the fewer number of shares available at or near the best price.

A simplified example may help illustrate the concept of liquidity and the utility of depth-of-book data. Assume an investor wants to make an offer to sell 3,000 shares of company XYZ. The best bid price reflected in the core data at NYSE Arca for XYZ is 1,000 shares at $10. The investor knows he can sell up to 1,000 shares at $10 but he does not know at what price his remaining 2,000 shares will sell until after his order is placed. This is where depth-of-book data comes in. Assume further that NYSE Arca’s depth-of-book data tells the investor that, apart from the best bid price from the core data, an additional 1,000 shares of XYZ are available at the next price level of $9.99 and yet another 1,000 shares at $9.98. Before he places his order, then, he knows that his 3,000-share sale will fetch $29,970 (the sum of 3,000 shares sold in three 1,000-share blocks at $10, $9.99, or $9.98 each). Lower liquidity—i.e., fewer shares of XYZ available at or near $10—will result in a lower total sale price.

\textsuperscript{Id.} at 530 (footnote omitted).

\textsuperscript{786} Id. at 528 (quoting 15 U.S.C. § 78(b)(4), (5), (8)) (internal quotation marks omitted).

\textsuperscript{787} Id. at 532 (quoting Order Approving NYSE Arca Fees, supra note 784, at 74781).

\textsuperscript{788} Id. at 534–35 (quoting Order Approving NYSE Arca Fees, supra note 784, at 74781). The court added, however, that cost information could play a role in analyzing whether fees are subject to competitive pressure because “in a competitive market, the price of a product is supposed to approach its marginal cost.” Id. at 537. Here, the SEC had never required NYSE Arca to submit cost data. Id. at 538.

\textsuperscript{789} Id. at 537–44.
“repeated statements throughout the Order and in its briefs that depth-of-book data is simply not very important to most traders, even professionals” and rested in part on “self-serving” statements by officials from NYSE Arca and other exchanges. While the SEC also relied on two anecdotes—that Island ECN “lost fifty per cent of its substantial market share in [three exchange-traded] funds” after it stopped releasing its order book for those funds and that BATS ECN and the International Stock Exchange provide depth-of-order data without charge in order to increase order flow—those examples, while “show[ing] that depth-of-book market data is apparently important enough to at least some traders that it must be made available,” said “nothing about whether an exchange like NYSE Arca is constrained to price its depth-of-book data competitively.” The SEC also asserted that alternatives to the data—(i) core data on best prices, (ii) depth-of-book data from other exchanges, and (iii) pinging orders—constrained the NYSE Arca price. But (i) the circumstance that a trader could (and most traders do) use core data and not depth-of-book data said nothing about whether traders would respond to price change for the data; (ii) the court could not determine whether the depth-of-book data from other exchanges was a market substitute for the NYSE Arca data regarding a security “without knowing how actively the security is trade[d] on those [other] exchanges”; and (iii) a pinging order carried the price of actually executing a reconnaissance trade and so might not be an adequate substitute for depth-of-book information. Accordingly, the court vacated the SEC order approving the NYSE Arca fees for failure “to ‘disclose a reasoned basis’ ” and remanded the matter to the Commission for further action.

790. Id. at 540.
791. Id. at 541–42.
792. Id.
793. Id. at 542. The court defined core data so:
Core data for each NMS security consists of three things: (1) last sale reports, which include the price at which the latest sale of the security occurred, the size of the sale and the exchange where it took place; (2) the current highest bid and lowest offer for the security, along with the number of shares available at those prices, at each exchange; and (3) the “national best bid and offer,” or NBBO, which are the highest bid and lowest offer currently available in the country and the exchange(s) where those prices are available.

794. Id. at 543 (quoting Order Approving NYSE Arca Fees, supra note 784, at 74792).
795. Id. at 544 (quoting Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 177 (D.C. Cir. 2010)). That standard derives from the Administrative Procedure Act:

We review the Order under the APA’s arbitrary and capricious standard, i.e., we “hold unlawful and set aside agency action” that is “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law” or “unsupported by substantial evidence.” 5 U.S.C. § 706(2)(A), (E). Under the APA, the SEC is required to “examine the relevant data and articulate a satisfactory explanation for its action including a ‘rational connection between the facts found and the choice made.’” Motor Vehicle Mfrs. Ass’n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43, 103 S. Ct. 2856, 77 L. Ed. 2d 443 (1983) (quoting Burlington Truck Lines v. United States, 371 U.S. 156, 168, 83 S. Ct. 239, 9 L. Ed. 2d 207 (1962)).
Significance and analysis. The *NetCoalition* decision joins a number of others in recent years in which the D.C. Circuit has vacated SEC rules, including those in which the court found that the Commission failed to assemble sufficient evidence to justify new regulations. 796 Perhaps *NetCoalition*’s greatest significance, therefore, is either (i) that parties disagreeing with SEC rulemaking should seriously consider a court attack, or (ii) that the SEC should devote greater effort to complying with administrative requirements when adopting or approving rules.

In the end, the particular decision on the depth-of-book pricing may prove of small consequence to the SEC and the exchange, as the exchange filed on November 9, 2010, a notice of proposed rule change with additional arguments that its depth-of-market fees are comparable to fees for similar data and are subject to competition.797

**Securities Litigation Uniform Standards Act:** exception for state or political subdivision properly read literally to require that members of class be “named”; misrepresentation can be “in connection with” purchase of security for SLUSA purposes even when the purchase occurs eighteen months after the misrepresentation

If plaintiffs in a “covered class action”—a lawsuit brought on behalf of more than fifty persons—allege “an untrue statement or omission of a material fact in connection with the purchase or sale” of a “covered security” (essentially one traded on a national exchange or issued by a mutual fund that is a registered investment company), SLUSA requires that the action be brought in federal court and be based on federal securities law. 798 The Sixth Circuit strictly construed an exemption from this statute last year. 799 The Second Circuit applied the statute to state law claims based on alleged misrepresentations that retirement investments would adequately support the plaintiffs, with the court doing so even though the alleged misrepresentations were made months before the investments.800

**State and political subdivision, and state pension plan, exemption.** The statute exempts a number of lawsuits from its coverage, including any action by “a State or political subdivision thereof or a State pension plan” which is brought “on its own behalf, or as a member of a class comprised solely of other States, political subdivisions, or State pension plans that are named plaintiffs, and that have authorized participation in such an action.”801 The statute defines “State pension plan” as “a pension plan established and maintained for its employees by the government of the State or political subdivision thereof, or by any agency or instrumentality

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796. Fin. Planning Ass’n v. SEC, 482 F.3d 481 (D.C. Cir. 2007); Chamber of Commerce v. SEC, 443 F.3d 890 (D.C. Cir. 2006); Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006); Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005).


799. See infra notes 801–14 and accompanying text.

800. See infra notes 815–26 and accompanying text.

thereof. The Sixth Circuit interpreted this exemption last year in *Demings v. Nationwide Life Insurance Co.*

A county sheriff who sponsored a deferred compensation plan for his employees “filed a class-action lawsuit, individually and in his official capacity,” suing “on behalf of all public employers who sponsor” such plans. Participants in the sheriff’s plan could direct money in their accounts to mutual funds selected by Nationwide entities. The complaint alleged that Nationwide received revenue-sharing money from those mutual funds and their advisors but did not disclose that fact. While the sheriff pled state law causes of action only for breach of fiduciary duty and unjust enrichment, the district court—in a ruling not challenged on appeal—held that SLUSA preempted the case; “although [the sheriff] did not specifically use the words ‘untrue statement’ or ‘omission’ in his complaint,” the essence of the charge “was that Nationwide misrepresented [the] relationship with mutual fund advisors or, at a minimum, failed to disclose material facts about the relationship.”

On an unsuccessful appeal from a district court decision dismissing the case as SLUSA-barred, the sheriff relied on the SLUSA exemption for State pension plans. The Sixth Circuit noted that “the plain language of this statutory exemption does not seem to encompass a county sheriff.” The exemption applies to actions brought by a pension plan itself, not an individual “on behalf of” a plan, and the Sixth Circuit accordingly agreed with the district court that the sheriff’s suit, “on its face, was not brought by a state, political subdivision thereof, or state pension plan on its own behalf.” The court went on to find that the class specified in the complaint did not meet the SLUSA exemption’s description of one composed of “other states, political subdivisions, or state pension plans that are named plaintiffs, and that have authorized participation in such action.”

The requirement that members of the “class” be “named,” with the participation of each “authorized,” resulted from (i) the circumstance that the statute defined “covered class actions” simply as multi-party actions (i.e., those with more than fifty plaintiffs), and (ii) Congress’s determination that the exemption for State actors not “serv[e] as a loophole through which abusive suits could be brought on behalf of pension funds and municipalities that have no interest in bringing suit, simply in order to extort a large settlement out of the defendant.”

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803. 593 F.3d 486 (6th Cir. 2010).
804. Id. at 489. The plans operated under 26 U.S.C. § 457(b) (2006). Id. at 488.
805. Id. at 488–89.
806. Id. at 489.
807. Id.
808. Id. at 490.
809. Id. at 491.
810. Id. at 492.
811. Id. at 493.
813. Id. (quoting 15 U.S.C. § 77p(f)(2)(A) (emphasis added)).
814. Id. at 494 (quoting H.R. REP. NO. 105-640, at 16 (1998)).
Significance and analysis. The dynamics of creating a class of “named” state pension plans or pension plans of state subdivisions—with each one “authorizing” suit—are hard to imagine. Perhaps a plaintiff’s firm with contacts at a number of large state plans could communicate with each one of them, suggesting that they in turn contact the plans at lower levels of the state. Or perhaps a figure at the head of such a plan, motivated by public spirit or the desire for publicity, could organize a group of plans for a suit. But the Demings decision reads the exemption literally and precludes a plaintiff’s firm, or a single public pension plan, from simply filing a putative class action—in state court based on state law—on behalf of all state-created plans allegedly victimized by a securities fraud.

Temporal proximity of misrepresentation to related purchase. The plaintiffs in Romano v. Kazacos sued on behalf of former employees of Xerox and Kodak, pleading state-law claims for negligence, breach of fiduciary duty, negligent misrepresentation, breach of contract, and unfair and deceptive trade practices. The complaints alleged that retirement specialists at Morgan Stanley advised that the plaintiffs—and other members of the classes they purported to represent—could retire early and live comfortably on the investments of lump sum retirement payments. In fact, the value of the plaintiffs’ investments declined precipitously, with consequent detrimental effects on their lives. The individual and entity defendants removed the cases to a federal district court, which held that SLUSA precluded the actions, a holding that the Second Circuit affirmed here. The court of appeals held that the complaints rested on misrepresentations because, for example, they alleged that the defendants “made ‘uniform misrepresentations’ to [the plaintiffs] about whether [the plaintiffs] could afford to retire early without depleting their investment accounts.” The cases rested on purchases of “covered securities” because the plaintiffs’ money was invested in mutual funds and “covered securities” include those “‘issued by an investment company that is registered . . . under the Investment Company Act.’” The “more difficult question” was “whether . . . the . . . complaints alleged misrepresentations . . . in connection with the purchase or sale of covered securities.” The Supreme Court has held that a fraud is “in connection with” a purchase or sale of a security if the fraud and the transaction “‘coincide.’” In this case, the representations—that “the future returns on their retirement assets would be sufficient to sustain their retirement income for the rest of their lives”—were made up to eighteen months before the actual investment of

815. 609 F.3d 512, 515–16 (2d Cir. 2010).
816. Id. at 515.
817. Id.
818. Id. at 517, 524.
819. Id. at 521.
820. Id. at 520 & n.3.
821. Id. at 521 (emphasis added).
822. Id. (quoting SEC v. Zandford, 535 U.S. 813, 822 (2002)).
823. Id. at 523 (emphasis omitted).
retirement monies. Nevertheless, the court held “that the time that [e]lapsed is not determinative here because, as defendants argue, ‘this was a string of events that were all intertwined.’”

Significance and analysis. Romano demonstrates again the great difficulty of the “coincide” test for the “in connection with” element, at least to the extent that the Supreme Court has suggested that coincidence of a misrepresentation and a transaction is necessary to prove that element. The alleged misrepresentations in Romano clearly centered on the return from the investments. Those misrepresentations seem naturally to be “in connection with” the investments in the sense that the returns would be dependent on the success of the investments. Indeed, the misrepresentations seem to be archetypically “in connection with” the investments. When next offered the opportunity to do so, the Court should clarify the “in connection with test” so that lower tribunals can stop dancing around the ill-advised emphasis on whether the fraud and the purchase or sale “coincide.”

Sarbanes-Oxley Clawback: Second Circuit follows Ninth Circuit in holding that only the SEC can sue for the clawback and adds that a settlement in a private derivative case can neither release a clawback claim nor provide for indemnification to reimburse payment on such a claim

Section 304 of the Sarbanes-Oxley Act provides that, if an issuer restates financials “as a result of misconduct,” the CEO and CFO shall pay back to the issuer “any bonus or other incentive-based or equity-based compensation received by that person from the issuer” during the twelve months immediately following the first publication or SEC filing of the financials and “any profits realized from the sale of securities of the issuer” during that twelve-month period. The statute gives the SEC the power to “exempt any person from” the reimbursement obligation. In 2008, the Ninth Circuit held that § 304 does not create a private right of action so that only the SEC—and not the issuer or a shareholder suing on the issuer’s behalf—can sue under § 304.

In 2010, the Second Circuit followed that Ninth Circuit holding in Cohen v. Viray. The district court in the Cohen case had approved a derivative case settlement that (i) released individual defendants “from any and all liability under § 304 of the Sarbanes-Oxley Act of 2002 to reimburse [the issuer] for any bonus or other incentive-based or equity based compensation received by them or either of them, or for any profits realized by them or either of them from the sale of any [of the issuer’s] securities”; (ii) provided that the issuer “shall indemnify” the individual defendants “against any liability under § 304 of the Sarbanes-Oxley Act”;
but (iii) added that “[n]othing contained in this Settlement is intended to limit the United States’ ability to pursue forfeiture, restitution or fines in any criminal, civil or administrative proceeding.” 832 In vacating the settlement, 833 the Second Circuit held that “§ 304 does not create a private cause of action.” 834 The court reached this conclusion because § 304 “makes no explicit provision for a private cause of action,” thereby raising a “presumption that Congress did not intend to create one.” 835 Moreover, Sarbanes-Oxley creates a private cause of actions in § 306, and “[t]he inclusion of a specific provision to this effect elsewhere in the statute ‘suggests that omission of any explicit private right to enforce other sections was intentional.’ ” 836 Section 3(b)(1) of Sarbanes-Oxley, on the other hand—which provides generally that the SEC can enforce Sarbanes-Oxley with all of the tools available for Commission enforcement of the Exchange Act—gives the SEC “authority to enforce § 304.” 837 Of course, as set out above, the SEC also has the right to exempt individuals from the reimbursement requirement. 838

Armed with this analysis, the Second Circuit held that the district court should not have approved the release provision in the settlement agreement because it “would nullify the right and remedy that Congress expressly provided in the statute” and “the SEC’s authority to pursue the § 304 remedy or to grant exemptions from the statute.” 839 The court similarly held the district court should not have approved the indemnification provision, as enforcing such a provision “would effectively bar the relief the SEC is authorized to seek” because, by the indemnification, the individuals could “pass that claim on to [the issuer] so that [the individuals] . . . would suffer no penalty at all.” 840 Such a result would “fly[] in the face of Congress’s efforts to make high ranking corporate officers of public companies directly responsible for their actions that have caused material noncompliance with financial reporting requirements.” 841 Implicitly addressing the argument that, since the issuer will receive the money from the § 304 reimbursement, the issuer should be able to effectively waive such a boon, the court added that “§ 304 relief is not solely intended to reimburse a company” but “also furthers important public purposes”—helping to “ensure[] the integrity of the financial markets” by “prevent[ing] CEOs and CFOs from benefitting from profits they receive as a result of misstatements of their company’s financials.” 842

832. Id. at 191.
833. Id. at 196.
834. Id. at 194.
835. Id. at 193.
836. Id. at 194 (quoting Bellikoff v. Eaton Vance Corp., 481 F.3d 110, 116 (2d Cir. 2007) (internal quotation omitted)).
837. Id. (quoting 15 U.S.C. § 7202(b)(1) (2006), which reads: “A violation by any person of this [Sarbanes-Oxley] Act . . . shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 . . . and any such person shall be subject to the same penalties, and to the same extent, as for a violation of that Act or such rules or regulations.”).
838. See supra note 828 and accompanying text.
839. Cohen, 622 F.3d at 194 (quoting appellant’s brief, with which the court expressly “agree[d]”).
840. Id. at 195.
841. Id.
842. Id. (quoting S. REP. NO. 107-205, at 23 (2002)) (emphasis omitted).
Significance and analysis. Company recoupment of incentive payments made on the basis of false financial results can rest on contracts, company policies, or law. Policies to recoup such payments proliferated in the second half of the first decade of this century, with the proportion of the 100 largest companies in the country having “clawback” policies rising from 18 percent in 2006 to 64 percent in 2008.\textsuperscript{843} Section 304 wrote clawbacks into the law. But that section’s text confused from the outset, over such matters as what would constitute the “misconduct” that was part of the clawback trigger\textsuperscript{844} and whether “misconduct” by the CEO or CFO was necessary in order that he or she incur the repayment obligation.\textsuperscript{845} Court decisions—like Cohen—holding that only the SEC has standing to sue under § 304 put the effectiveness of the section at the mercy of the Commission’s enforcement capacity and priorities. Moreover, the § 304 recoupment applies only to two officers (CEO and CFO) and imposes a crude measure—depriving each officer of all bonuses, all incentive payments, all equity compensation, and all stock profits over a twelve-month period, not just the extra amounts that the executive received as a result of the bad numbers.

Section 111(b) of the Emergency Economic Stabilization Act (“EESA”) of 2008, as amended by the American Recovery and Reinvestment Act of 2009, provided that companies receiving support through the Troubled Asset Relief Program (“TARP”) meet executive compensation standards, including “the recovery by such TARP recipient of any bonus, retention award, or incentive compensation paid to a senior executive officer and any of the next 20 most highly-compensated employees . . . based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate.”\textsuperscript{846} But that standard affected only TARP-assisted companies, and TARP was designed as a temporary measure.

\textsuperscript{843} David Bogoslaw, Shareholder Value: Time for a Longer View?, BLOOMBERG BUSINESSWEEK (Mar. 17, 2009), http://www.businessweek.com/investor/content/mar2009/pi20090317_247202.htm.
\textsuperscript{844} See Harold S. Bloomenthal, SARBANES-OXLEY ACT IN PERSPECTIVE § 11:6, at 724 (2009–2010 ed.) (suggesting that misconduct could include negligence).
\textsuperscript{845} Compare Rachael E. Schwartz, The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean, 64 BUS. LAW. 1 (2008) (arguing that no personal misconduct by the CEO or CFO is necessary), with John Patrick Kelsh, Section 304 of the Sarbanes-Oxley Act of 2002: The Case for a Personal Culpability Requirement, 59 BUS. LAW. 1005 (2004) (arguing that such personal misconduct is required). A district court facing this question held that “the text and structure of Section 304 require only the misconduct of the issuer, but do not necessarily require the specific misconduct of the issuer’s CEO or CFO” and that the “legislative history supports this textual reading.” SEC v. Jenkins, 718 F. Supp. 2d 1070, 1074 (D. Ariz. 2010).
\textsuperscript{846} 12 U.S.C.A. § 5221(b)(3)(B) (West Supp. 2010). The Treasury issued the following regulation to accomplish this statutory mandate:

To comply with the standards established under section 111(b)(3)(B) of EESA, a TARP recipient must ensure that any bonus payment made to a [Senior Executive Officer] or the next twenty most highly compensated employees during the TARP period is subject to a provision for recovery or “clawback” by the TARP recipient if the bonus payment was based on materially inaccurate financial statements (which includes, but is not limited to, statements of earnings, revenues, or gains) or any other materially inaccurate performance metric criteria. Whether a financial statement or performance metric criteria is materially inaccurate depends on all the facts and circumstances. However, for this purpose, a financial statement or performance metric criteria shall be treated as materially inaccurate with respect to any employee who knowingly engaged in providing inaccurate information (including knowingly failing to timely correct inaccurate
Proxy changes in 2009 required companies to disclose “[h]ow the [company’s] compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short term and the long term, such as through policies requiring claw backs.” But this requires disclosure, not adoption of policies or incorporation of them into employment contracts. And the disclosure of an existing policy does not necessarily reflect active efforts to recoup now-no-longer-justified payments when restatements occur.

The end, however, may be in sight for the simple notion that an executive must give back an incentive award paid because his or her company supposedly reached financial milestones that restated figures later show the company did not attain. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires the SEC to issue a rule requiring national exchanges to incorporate into their listing standards a requirement that listed companies “develop and implement a policy” that

in the event . . . the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.

This new requirement would apply more broadly than § 304—with the new listing standards extending to all “executive officers.” It does not require that a restatement triggering the recoupment result from “misconduct” but only from a failure to comply with financial reporting requirements. It recaptures only compensation that would not have been paid but for the false numbers. And it appears to be mandatory—with the policy being one by which the issuer “will recover” the clawback amount.

Additional Cases: no private right of action, under § 13(a) of the Investment Company Act, for an alleged change in investment policy; sophisticated buyer could not rely, in Rule 10b-5 action, on pre-agreement representations when deal document information) relating to those financial statements or performance metrics . . . . The TARP recipient must exercise its clawback rights except to the extent it demonstrates that it is unreasonable to do so, such as, for example, if the expense of enforcing the rights would exceed the amount recovered. For the purpose of this section, a bonus payment is deemed to be made to an individual when the individual obtains a legally binding right to that payment.

31 C.F.R. § 30.8 (2010).
849. Exchange Act regulations define “executive officers” to include “president, any vice president . . . in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions.” 17 C.F.R. § 240.3b-7 (2010).
included merger and integration clause; variable life insurance policies are treated as a whole for CAFA securities exclusion, instead of being divided into a “security” component and an insurance component; membership at hunting preserve was not an “investment contract”; ownership interest in single member LLC can be an “investment contract”

Aside from the cases summarized in the subject-matter specific sections above, the courts of appeals authored additional securities opinions of interest in 2010. These decisions addressed whether Investment Company Act (“ICA”) § 13(a) creates a private cause of action, whether a merger clause could defeat the reliance element in a Rule 10b-5 claim based on a transaction between sophisticated parties, whether variable life insurance policies would be disaggregated to determine whether claims based upon them would be subject to CAFA, and whether hunting preserve memberships and interests in single-member LLCs were “investment contracts.”

No private right of action under ICA § 13(a). In Northstar Financial Advisors, Inc. v. Schwab Investments, the Ninth Circuit held that investors in a mutual fund had no private right of action to sue the fund for “unlawfully deviat[ing] from the investment policies set forth in its registration statement, to the detriment of the fund’s shareholders and in violation of § 13(a) of the [Investment Company Act].” Noting that “the Second Circuit has held that there is no private right to enforce five other sections of the ICA,” the Ninth held that the words of § 13(a)—which focused on the regulated fund rather than on the shareholders investing in it—contained no “‘rights-creating’” language for the shareholders and therefore did not imply that Congress intended to create a private action for shareholders. Moreover, the structure of the ICA argued against a private right of action under § 13(a) because “Congress’s enactment of . . . two express private rights of action elsewhere in the ICA, without the enactment of a corresponding express private right of action to enforce § 13(a), indicates that Congress did not, by its silence, intend a private right of action to enforce § 13(a).”

850. See infra notes 855–62 and accompanying text.
851. See infra notes 863–65 and accompanying text.
852. See infra notes 866–75 and accompanying text.
853. See infra notes 876–78 and accompanying text.
854. See infra notes 879–83 and accompanying text.
855. 615 F.3d 1106, 1113, 1116 (9th Cir. 2010) (quotation at 1113). Section 13(a) provides, in relevant part:

No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities—

(3) deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement . . . .

Id. at 1109–10 (quoting 15 U.S.C. § 80a-13(a)). The plaintiffs charged that the funds’ investment policies prohibited concentration of more than 25 percent in any industry, while the funds in fact put more than 25 percent of assets into mortgage-backed securities and collateralized mortgage obligations. Id. at 1113–14; see also Northstar Fin. Advisors, Inc. v. Schwab Invs., 609 F. Supp. 2d 938, 940 (N.D. Cal. 2009) (district court opinion).
856. Northstar Fin. Advisors, 615 F.3d at 1108.
857. Id. at 1115–16 (quoting Alexander v. Sandoval, 532 U.S. 275, 288 (2001)).
858. Id. at 1117.
The one significant argument in favor of a § 13(a) private claim rested on a 2007 amendment to § 13 providing that “no person may bring any civil, criminal, or administrative action against” a mutual fund or its investment advisor “based solely” on a fund’s divestment from investments in Sudan. The plaintiff argued, and the district court concluded, that Congress’s use—in the § 13 amendment—of the phrase “no person may bring any civil . . . action against” reflected the legislature’s understanding that there was indeed a private action under § 13(a); otherwise there was no need to cut it off. The Ninth Circuit, however, held that the Amendment barred actions “brought under any state or federal law” for divestment of Sudanese investments and so was not targeted on any perceived private § 13(a) claim. Moreover, Congress later added a subsection explicitly stating that the immunity provided by the Amendment should not “be construed to create [or] imply . . . a private right of action . . . under [§ 13(a)] or any other provision of [the ICA].”

Merger clause precluded reliance on pre-document representations. In One Communications Corp. v. JP Morgan SBIC LLC, the Second Circuit affirmed dismissal of a Rule 10b-5 action brought by the successor in interest to the purchaser of a telephone company. The parties to the deal documented the acquisition in an agreement containing a provision “clearly provid[ing] that the agreement is integrated” and further providing that the purchaser could not “rely on representations or warranties that were ‘inconsistent with or in addition to the representations and warranties’ set forth in the agreement.” Recognizing that “whether a plaintiff reasonably relied on a representation depends on the entire context of the transaction, including the sophistication of the parties, the content of written agreements, and the complexity and magnitude of the transaction,” the Second Circuit found “that reliance on pre-agreement representations was unwarranted as a matter of law” because the record reflected that the purchaser was a “sophisticated investor.”

Application of Class Action Fairness Act (“CAFA”) to securities cases. CAFA permits defendants to remove to federal court certain class actions that plaintiffs file in state court on behalf of classes with more than 100 members. CAFA does not apply

859. Id. at 1112 (quoting 15 U.S.C. § 80a-13(c)).
860. Id. at 1120.
861. Id.
862. Id. at 1121 (quoting 15 U.S.C. § 80a-13(c)(2)(A)) (last two alterations in original). In the Northstar case, the district court had denied the defense motion to dismiss but certified that decision for interlocutory appeal. Id. at 1108. The Ninth Circuit reversed the lower court. Id. at 1122.
863. 381 F. App’x 75, 82 (2d Cir. 2010).
864. Id. at 79.
865. Id. The court also held that the portion of the plaintiff’s case based on violation of the warranty that the sold company had complied in all material respects with applicable law and was in all material respects in compliance with such law failed because the complaint did not “identify which named defendants were even aware of [the alleged legal] violations, much less that any defendant had the required scienter.” Id. at 80. This holding recalls the Ninth Circuit’s decision in Glazer Capital Management, LP v. Magistri, 549 F.3d 736, 743–46 (9th Cir. 2008) (plaintiff could not employ theory of collective scienter in case alleging that warranty of legal compliance was false).
to a class action “that relates to the rights, duties (including fiduciary duties), and obligations relating to or created by or pursuant to any security (as defined under section 2(a)(1) of the Securities Act of 1933).” In *Lincoln National Life Insurance Co. v. Bezich*, the plaintiff filed a state court class action alleging that Lincoln National breached the terms of variable life insurance policies by deducting charges from policyholder accounts that were not based on expected mortality. After the defendant removed the case to federal court under CAFA, the district court remanded to state court on the basis of the securities law CAFA exclusion, and the Seventh Circuit denied the insurer’s petition for review. The insurance policies permitted insureds to allocate money between an account that simply accumulated policy payments (a “General Account”) and an account with a value dependent on investments (a “Separate Account”). The insurer appeared to concede that the Separate Account was a security. But Lincoln National contended that the General Account was not a security and that the CAFA analysis should take that into consideration. While the Seventh Circuit conceded that it is sometimes appropriate to divide an insurance product into a security component and a component that is not a security, that was not the correct analysis here, where an account holder could allocate any amount of the policy—including all of it—to the Separate Account so that the challenged deductions were taken both from the funds insureds “have presently placed in the Separate Account and those [in the General Account] that they have the right to move to the Separate Account.” Under these circumstances, “the Lincoln policy as a whole is a ‘security’ for CAFA purposes and cannot be viewed as two separate contracts, one within the statute and the other outside its coverage.”

Membership for hunting preserve was not an “investment contract.” The Second Circuit in *Libaire v. Kaplan* affirmed dismissal of a Rule 10b-5 case brought by a plaintiff who alleged fraud in connection with the payment of his annual dues to North Fork Preserve, Inc., a company running a hunting preserve. The court of appeals held that the membership was not a security because it failed to satisfy the criteria for an “investment contract.” That test requires that the purchaser make the investment “premised on a reasonable expectation of profits,” and that

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868. 610 F.3d 448, 448 (7th Cir. 2010).
869. Id. at 448–49, 451. Technically, the Seventh Circuit held that it had no jurisdiction since jurisdiction would be based on CAFA and CAFA did not apply. Id. at 451.
870. Id. at 449.
871. Id. at 450.
872. Id.
873. Id. at 450–51 (citing SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967), which the court of appeals characterized as concluding that the Securities Act registration requirement applied to the promise in a deferred annuity plan that was a security but not to a distinct promise that was not a security).
874. Id. at 451.
875. Id.
876. 395 F. App’x 732, 734 (2d Cir. 2010).
877. Id. at 734–35.
was not the case here, where the plaintiff was motivated to pay the dues in order to consume the pleasure of hunting rather than to make a profit.\textsuperscript{878}

Single-member LLCs were “investment contracts.” In \textit{Affco Investments 2001, L.L.C. v. Proskauer Rose, L.L.P.},\textsuperscript{879} the Fifth Circuit affirmed a trial court holding that tax shelter LLCs were “investment contracts.”\textsuperscript{880} The LLCs were tax shelters generating losses “through a mechanism of offsetting digital options.”\textsuperscript{881} While three of the LLCs were single-member entities and the plaintiffs argued that they retained control over those entities and so defeated the element of the “investment contract” test requiring that profits be derived from the efforts of others, the Fifth Circuit noted that the plaintiffs failed to plead that “they exercised any managerial authority,” and indeed pled that, “under the terms of the investment contracts, the LLCs were to be ‘under the direction of,’” and “‘managed by,’” various investment consulting and brokerage entities for the purpose of implementing the tax scheme.”\textsuperscript{882} The plaintiffs actually “portrayed themselves as passive investors who depended—both in reality and according to their investment contracts—upon the efforts of others for their profits” and so pled themselves into the “investment contract” definition.\textsuperscript{883}

\begin{footnotesize}
\begin{enumerate}
\item[878.] Id. (quoting \textit{Golden v. Garafalo}, 678 F.2d 1139, 1141 (2d Cir. 1982)). \textit{Garafalo} rested on \textit{United Housing Foundation v. Forman}, 421 U.S. 837, 852–53 (1975) (“[W]hen a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply.”).
\item[879.] 625 F.3d 185 (5th Cir. 2010). See \textit{supra} notes 388–94 and accompanying text for a summary of the \textit{Proskauer} opinion as it addresses an attorney’s primary liability under Rule 10b-5 participation in the creation of tax shelter investments.
\item[880.] \textit{Affco Invs. 2001}, 625 F.2d at 190–91.
\item[881.] Id. at 187.
\item[882.] Id. at 191.
\item[883.] Id. The conclusion that the LLC interests were securities was important to the trial court’s holding, affirmed by the court of appeals, that the plaintiffs could not bring a Racketeering Influenced and Corrupt Organizations (“RICO”) action. Id. RICO specifically excludes “claims based on ‘any conduct that would have been actionable as fraud in the purchase or sale of securities.’” Id. at 189 (quoting 18 U.S.C. § 1964(c)).
\end{enumerate}
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