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SEC Beat

Securities law beyond Dodd-Frank Act

By Stephen M. Honig

The Dodd-Frank Act is the most far-reaching securities legislation in a generation, but I'll leave its analysis to the deluge of client alerts and webinars out there.

Aside from Dodd-Frank, there are other important securities changes that lawyers need to be aware of, including the Securities and Exchange Commission's "proxy plumbing" release; a 2nd Circuit opinion affecting M&A disclosures; and FINRA's regulation of brokers undertaking Regulation D offerings.

Leaky Plumbing

SEC Release No. 34-62495, promulgated last July, calls for public comment before Oct. 20 on various proxy solicitation issues which will likely lead to Commission rule-making next year. Comment is sought in the following areas:

Because institutional investors often lend out their securities, or because the clearance process sometimes results in a "fail to deliver," securities intermediaries often report proxies that either exceed or fall below the number of shares held of record, and the SEC seeks advice on establishing a method of reconciliation, as well as broker/dealer disclosure of methodology to investors.

Since it is difficult to determine whether shares have been voted in accordance with instructions, the SEC is seeking a cost-effective confirmation mechanism.

Institutional lenders of shares often reserve the right to vote, but must receive redelivery prior to the record date; the SEC is exploring ways of increasing time available to institutional shareholders to "recover" shares.

Communicating with shareholders is complex. The SEC requires broker/dealers and banks to provide issuers with a list of non-objecting beneficial owners for direct communication, but objecting beneficial owners, which may include large institutional investors, are hard to reach. The SEC seeks comments on proxy mechanisms or mandatory disclosure of beneficial owners, important now that brokers are more restricted in exercising uninstructed proxies.

The SEC seeks ways to educate investors on proxy voting, including improving use of the Internet for distributing proxy materials. The SEC recently expanded E-proxy disclosure to foster shareholder communication, but companies may nonetheless decrease use of E-proxy as they reach out directly to retail shareholders to overcome the loss of votes suffered due to Dodd-Frank's further limitation on broker voting of undirected shares.

The SEC seeks commentary concerning conflicts by proxy advisory firms, which have both issuers and institutional investors voting on shareholder matters as clients. The SEC also is interested in whether the expanded role of proxy advisory firms renders those firms proxy solicitors or investment advisors by reason of making recommendations to investors.

How can you align economic interests with the vote? "Empty voting" occurs where shareholders undertake a hedging transaction but retain voting powers while their economic interest is no longer at risk, or where a shareholder sells securities after the record date but before the vote. Some possibilities include setting voting record dates closer to the meeting date or the recent development under certain state laws to provide separate record dates for meeting notice and for voting.

M&A Disclosures

In April, the 2nd U.S. Circuit Court of Appeals confirmed the 2009 Southern District opinion in *Vladimir v. Bioenvision, Inc.* While the opinion does not forge new ground, it illustrates various ways in which target companies can end up being sued. Read the opinion by District Judge Sidney Stein. The brief Circuit Court decision simply reaffirms the two fundamental principles in public M&A: first, that a corporation is not under some general duty to disclose material facts merely because a reasonable investor would be delighted to learn them and, second, that there is no general duty to disclose merger negotiations, only a duty to announce definitive merger agreements.

In *Vladimir*, Genzyme Corporation acquired the pharmaceutical company Bioenvision, Inc. The plaintiffs, who were sellers of Bioenvision stock before public announcement of the acquisition, brought a class action against Bioenvision, its officers and directors for breach of duty to disclose the acquisition discussions. The acquisition was effected at a higher price than prior market -- as is typical -- and the plaintiffs sold shares too low because they did not know of the pending acquisition. The case was pleaded primarily on violations of Section 10(b) of the '34 Act and Rule 10b-5.

Conceding that there is no general duty to disclose merger discussions until the agreement becomes binding, the plaintiffs asserted numerous bases to undermine this general rule. They argued that the target's continuous statements about its business plans, without mentioning a merger, constituted affirmative representations that the company would not be sold. Throughout the period, Bioenvision was asserting that its primary focus was to continue its business, make requisite strategic alliances, and move forward with its primary goal of developing technologies for cancer treatment. Since the company was at the time in merger discussions, failure to disclose those discussions did not constitute mere silence with no duty to speak, but rather a material misstatement.

The court dismissed claims that such press releases created an obligation to announce merger negotiations.

The court further held that a press release relating to a shareholder's exercise of fixed price warrants to purchase more company shares was not misleading, finding that the exercise of a warrant or option at a previously negotiated fixed price, described in the press release as "a vote of confidence in the Company's executive capabilities and substantial future prospects," does not of itself require announcement of merger discussions "because the insider by then is already bound by the terms of the option" and "the potential for abuse of inside information is minimal."

The court similarly gives short shrift to the plaintiff's arguments based upon similar statements by the company to investors and analysts at an investor conference, and the failure to update "subsequent events" in the 10-Q to reveal the negotiations.

Bioenvision did not fall under prior cases that did give rise to an obligation to disclose merger discussions: there were no assertions that "nothing was going to change in the company's near future," no statement that the company's financial structure would not change in the foreseeable future, and no statement by a company officer that he was "not aware of any corporate developments which would affect the market of its stock."

Absent any such statement giving rise to an obligation to disclose pending merger talks, the court found that the target's silence was permissible.

Action was also brought against a 5-percent shareholder who had been contacted by Genzyme in advance of the company approaching Bioenvision. Such an approach is not unusual when an acquirer seeks to sound out major target shareholders. Plaintiffs claimed the 5-percent shareholder must amend its Schedule 13D when it learns of the proposed merger. In a way, the court is end-gamed: the company need not itself make such disclosure, but to require a 5-percent shareholder to disclose would, in turn, virtually compel company disclosure (if the shareholder must disclose, the company will be left looking foolish at best if it remains silent). The court inevitably found against the plaintiffs on the 13D claim.

Brokers in Regulation D Offerings

In April, FINRA (the self-regulatory organization for broker/dealers) "reminded" broker/dealers that they had obligations to investigate issuers in private placements under Regulation D. The regulation offerings are exempt from registration, but not anti-fraud provisions, and broker/dealers have a duty under both federal securities laws and FINRA rules to conduct reasonable investigation before recommending securities.

Additionally, broker/dealers can only recommend such securities if they meet general investor suitability requirements. FINRA's "Regulatory Notice" 10-22 reminds brokers that they have a "special relationship" to the customer, and such obligation requires that "a reasonable investigation has been made and that [the broker's] recommendation rests on the conclusions based on such investigation." Failure to meet this duty violates Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act, and FINRA rules.

There is also detailed discussion concerning brokers affiliated with an issuer, and concerning heightened responsibility for private placement memoranda where the broker/dealer either prepares or assists in the preparation of the memoranda (and broker/dealers typically do have input in the contents).

Since the thrust of the notice is that a broker cannot "rely blindly" upon a company for relevant information, company counsel in private placements should anticipate a heightened diligence process (more akin to a public offering) by placement agents and their counsel. Difficulty arises in determining the scope of investigation. The notice lists a variety of factors suggestive of scope. Smaller companies and younger companies require greater diligence.

Broker/dealers are called upon to maintain documentation of their investigation. Counsel thus might expect more formality in diligence meetings, preparation of meeting minutes, checklists, requests for written response and written reassurances. Section IIIA of the notice also sets forth some diligence specifics with which in-house counsel should become acquainted prior to undertaking a brokered Regulation D offering.

For brokerages whose private placement diligence has been spotty, the notice is a cautionary pronouncement, with company counsel likely to bear the impact through greater deal diligence and perhaps increased investment banker expenses.

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