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FALL 2004

A YEAR IN TURMOIL FOR MUTUAL FUNDS — VIEWS OF AN INDUSTRY INSIDER

By THOMAS S. HARMAN

Amid the frenetic backdrop of regulatory catch-up and leap-frog in the mutual fund industry over the last year, it is important to step back and observe the larger trends and try to discern what has fundamentally changed. That involves focusing on the industry's primary regulator, the SEC.

Initially outflanked by New York Attorney General Eliot Spitzer, the SEC has responded vigorously to alleged abuses in the Mutual Fund Industry. It has employed virtually all of its tools: information-gathering, jawboning, disclosure rulemaking, rulemaking that reshapes business practices, corporate governance rulemaking and enforcement actions. The enforcement actions, notably, often involved well-known fund families, significant sanctions and coordination with state authorities—all of which is unprecedented in the regulation of mutual funds. One literally has to go back to the 1920s and 1930s to find a similar moment in history when the misdoings and alleged misdoings of mutual funds were so prominently in the press.

The information gathering began almost immediately after Eliot Spitzer announced his first settled action early September 2003. It continues to grind away. Since then, the SEC has demanded information from large segments of the industry relating to, among other things, market timing, portfolio valuation by international stock funds, pension consultants, mutual fund transfer agents and fund relationships with investment bankers, and has made two different queries regarding index funds.



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In short order, the SEC also began to flex its rulemaking muscles in a variety of ways. It has proposed and adopted new disclosure enhancements, i.e., market timing and portfolio holding disclosure, that arguably look like regulation through disclosure. It has adopted proposed rules whose fate previously seemed uncertain, e.g., quarterly disclosure of portfolio schedules and the chief compliance officer rule. It has adopted a rule that would require advisers to have codes of ethics similar to those required of mutual funds. It has adopted new rules to strengthen corporate governance, e.g., independent chairman of the board, 75% of the board must be independent, and records of board deliberations regarding advisory agreements must be kept and

maintained. It has adopted significant revisions to substantive rules, e.g., Rule 12b-1, to prohibit the practice of tying portfolio execution to fund distribution, and Rule 22c-1, the forward pricing rule, a fundamental bulwark of the Investment Company Act of 1940. It has even proposed a rule that would require funds to impose a 2% redemption fee on certain short-term investors. Further, it has proposed revisions to require most private fund advisers to register under the Investment Advisers Act of 1940.

Last but not least, the SEC has instituted and settled a score of administrative proceedings against large fund families. The monetary damages and fines alone, putting aside other remedies, have exceeded \$2 billion. Significantly, the SEC has resisted wrapping advisory fee reductions into its settlements (unlike Mr. Spitzer), thus staying consistent with its historical reticence to being a rate-making agency. Instead, the SEC has incorporated procedural reforms into its settlements, e.g., independent chairman of the board, board elections every five years. By so doing it jump-started its fund corporate governance reforms.

What, then, should one take away from all this? First, the SEC is moving aggressively to address

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OUTSIDE DIRECTORS AND RED FLAGS

By JOHN F.X. PELOSO AND BEN A. INDEK

In the wake of recent corporate scandals, there has been a sharpened focus on the role of outside directors. As an example, SEC Enforcement Chief Stephen Cutler announced an intention to target outside directors for falling “asleep at the switch.”¹ That statement and others by SEC officials, together with a related civil action against an outside director, indicate that the SEC has trained its sights on outside directors who the SEC believes may have failed to react to red flags warning of corporate impropriety and failed to fulfill their fiduciary duties. This article will consider the SEC’s stated initiative in this area in the context of traditional standards of liability for outside directors as recently analyzed in state and federal courts.

THE CHANCELLOR CASE

In April 2003, the SEC filed a complaint against the Chancellor Corporation, and certain individuals associated with Chancellor, including outside director Rudolph Peselman, detailing a “multi-faceted financial fraud” involving “the creation of false corporate documents and fictitious accounting entries” leading to alleged material overstatements of revenue, income and assets.²

By naming the outside director as a defendant, *Chancellor* raised more than a few eyebrows. Although the complaint alleges that Peselman violated, *inter alia*, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, he is not charged with direct participation in the accounting fraud. Rather, in its release announcing the complaint, the SEC asserts that Peselman violated the antifraud provisions of the federal securities laws “by signing a number of false financial statements and, as an outside director with fiduciary responsibilities, by ignoring clear warning signs that financial improprieties were ongoing at the company and

by failing to ensure that the company’s public filings were accurate.”³

Specifically, the complaint alleges that Peselman signed restatements of financial results that contained misstatements and contradicted earlier statements he had signed. In doing so, Peselman “ignored . . . red flags.” “Indeed,” the complaint continues, “Peselman had completely neglected to fulfill his duties as a director and as an audit committee member. He failed to oversee Chancellor’s financial reporting, exercising no care to ensure that the company had appropriate accounting procedures and internal controls and that its financial records were adequate . . .”⁴

Calling the case against Peselman “the first salvo in this area” and a model for such enforcement actions, Enforcement Chief Cutler stated that he was unaware of any other SEC action against an outside director not directly involved in fraud. According to Cutler, “[t]his case signifies the Commission’s willingness to pursue cases against outside directors who were reckless in their oversight of management and asleep at the switch.”⁵

Cutler’s comments were echoed in a speech by SEC Chairman William H. Donaldson.⁶ Commenting on the Commission’s investigation of mutual funds, the Chairman stated that the SEC is “carefully looking at the role that independent directors played, if any, in the problems at these firms. We are asking whether the directors were aware of these abuses, and whether there were red flags that were ignored.” Donaldson added that the SEC would pursue aggressively those who harmed investors, “even if they turn out to be fund directors.” Mirroring the reference to fiduciary duties in the *Chancellor* action, the Chairman concluded his remarks by stating: “Investors must be able to see for themselves that fund companies, and

fund directors, are living up to their fiduciary obligations and the spirit underpinning all of our securities laws.”

FIDUCIARY DUTIES: THE PROVINCE OF STATE LAW

The *Chancellor* action and the public comments of Messrs. Donaldson and Cutler together reflect the SEC’s intent to target outside directors for negligent activity (or inactivity) and breaches of fiduciary duty, presumably invoking the antifraud provisions of the federal securities laws. The obvious question is whether the federal securities laws provide the statutory basis for the Commission to pursue that campaign.

Almost 30 years ago, in *Sante Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), the United States Supreme Court considered and expressly rejected the application of the antifraud provisions of Section 10(b) and Rule 10b-5 to all breaches of fiduciary duty. Rather, the Court recognized that a “claim of fraud and fiduciary breach . . . states a cause of action under any part of Rule 10b-5 only if the conduct alleged can fairly be viewed as ‘manipulative or deceptive’ within the meaning of the statute.” Twenty years later, this principle was reiterated by the Court in *United States v. O’Hagan*, 521 U.S. 642 (1997). In ruling on the government’s misappropriation theory of insider trading, the Court recognized as a predicate for liability under Section 10(b) in that context that there needed to be an underlying breach of fiduciary duty. Although finding such a duty in that case, the Court nevertheless again stated that “§ 10(b) is not an all-purpose breach of fiduciary duty ban; rather it trains on conduct involving manipulation or deception.” (In *O’Hagan*, the Court found this requirement satisfied by the defendant’s trading activity using the information obtained by the breach of duty.)

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¹ SEC to Target Directors in Fraud Cases, Cutler Says, Bloomberg Report (August 20, 2003). ² Complaint, *SEC v. Chancellor Corp.*, 03 Civ. 10762 (D. Mass.) at ¶ 1. ³ Litigation Release No. 18104 (April 24, 2003) (emphasis added). ⁴ *SEC v. Chancellor Corp.*, Complaint at ¶¶ 5, 48, 53, 59-60. Peselman’s answer to the complaint asserts nine defenses including *inter alia* a failure to state a claim on which relief can be granted, and assertions that the claims are barred because the Commission cannot prove scienter and because Peselman acted in good faith and in reliance on the company’s accountants and auditors. ⁵ SEC to Target Directors in Fraud Cases, Cutler Says, Bloomberg Report (August 20, 2003). ⁶ William H. Donaldson, “America’s Need for Vigilant Mutual Fund Directors”, Speech at the U.S. Securities and Exchange Commission Mutual Fund Directors Forum (January 7, 2004).

OBTAINING A LISTING ON THE LUXEMBOURG STOCK EXCHANGE

By RACHEL A. GONZALEZ

Obtaining a listing on the Luxembourg Stock Exchange (the “Exchange”) is a process that differs in significant respects from obtaining a listing on an exchange or regulated market in the United States, or receiving an effectiveness order from the U.S. Securities and Exchange Commission in respect of a registration statement. In many respects obtaining a listing on the Exchange is easier – certainly, the comment process can be less time-consuming than an SEC comment process. On the other hand, obtaining a listing in Luxembourg can be frustratingly bureaucratic and some requests or comments can be puzzling to U.S. securities lawyers.

The purpose of this article is to give you practical tips on how to obtain a listing on the Exchange.

WHY LUXEMBOURG?

You probably have seen Luxembourg listings most frequently in the context of Rule 144A/Reg S debt offerings for foreign private issuers, in particular, issuers in the UK. As a general matter, the United Kingdom imposes a withholding tax on the payment of interest on a debt security to non-UK resident holders, unless an exemption is available under either UK domestic law or an applicable double tax treaty. One such exemption is the “quoted Eurobond” exemption. If the debt security is listed on a “recognized” stock exchange, such as the Luxembourg Stock Exchange, there is no withholding.

Sometimes the admission of a security to the Luxembourg Stock Exchange is also beneficial for securities law and tax considerations in non-European countries. For example, we understand that certain jurisdictions in Asia accord beneficial securities law and tax treatment to offerings of debt securities when a listing is obtained on certain enumerated exchanges, including the Luxembourg Stock Exchange.

THE LUXEMBOURG LISTING RULES

Admission to listing on the Exchange requires both compliance with the Exchange’s admission requirements and ongoing compliance with its rules and regulations for issuers

with securities listed thereon. These rules and regulations are formalized in the following publications, which may be found on the Exchange’s website (www.bourse.lu):

- “Admission to Official Stock Exchange Listing and Public Offer of Transferable Securities - 1 January 1991 (1999 edition)” (the “Admission Requirements”); and
- “Rules and Regulations of the Luxembourg Stock Exchange” (the latest revision to which was by Ministerial Decree in March 2003) (the “Rules and Regulations”).

Any company intending to make a public offer of transferable securities on the Exchange or to apply for the admission of transferable securities to official listing on the Exchange must notify (with at least two weeks’ prior notice) the Exchange by submitting an application file containing the following:

- Draft listing particulars, public offer prospectus, and offering memorandum.
- Any additional information supplemental to, but not included in, the draft listing particulars, public offer prospectus or offering memorandum.
- Supporting documents as follows:
 - (a) organizational documents of the issuer;
 - (b) draft underwriting or subscription agreement;
 - (c) fiduciary agreement (trust indenture or trust deed);
 - (d) deposit agreement;
 - (e) annual reports for the last three fiscal years together with latest interim accounts for the issuer, if available;
 - (f) draft of legal notice provided for by Articles 33 to 80 of the Law on Commercial Companies of 1915 (the principal corporate legislation in Luxembourg) to be filed with the Luxembourg District Court (a notice specifying the name of the issuer and the details of the transferable securities to be listed).

WORKING WITH A LUXEMBOURG LISTING AGENT

A company seeking an Exchange listing generally does not deal directly with the Exchange. The primary contact with the Exchange on behalf of an issuer is the Luxembourg listing agent, which must be a Luxembourg-based bank. Typically, counsel to the issuer works closely with a Luxembourg listing agent to advocate disclosure positions on behalf of the issuer; however, it is the listing agent who interacts directly with the Exchange. If a significant disclosure issue arises, counsel to the issuer may participate in a conference call with the reviewer at the Exchange, though this is somewhat unusual.

THE PROCESS

The Luxembourg listing agent, under its own letterhead, submits a proposed offering memorandum or prospectus and solicits comments in respect thereof. The Exchange assigns a reviewer and that reviewer prepares comments for approval by his or her supervisor. The comments are then issued to the listing agent as a formal comment letter, in French with an English language translation.

The Exchange’s response time varies significantly based on workload and staff availability, and an initial response may take 10 to 20 days. Obtaining a listing during the summer, especially in August, is likely to take longer.

Once the listing agent receives the comments, they are formatted into a response letter on the listing agent’s letterhead and passed on to the issuer’s counsel. Issuer’s counsel, in consultation with the listing agent, the issuer and the underwriters and their counsel, drafts responses for inclusion in the response letter and modifies the offering document accordingly. An experienced listing agent can be helpful in deciding how to respond to the comments.

A completed comment response package is submitted to the Exchange for further review.

The Exchange, in reviewing modified offering materials submitted by the issuer, reserves the

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EXPANDED NEW FORM 8-K REQUIREMENTS BECAME EFFECTIVE IN AUGUST

BY HOWARD A. KENNY

Effective August 23, 2004, public companies are now required to comply with new Form 8-K requirements. The Securities and Exchange Commission ("SEC") has added eight new reportable items, transferred two items from the periodic reports and expanded disclosures under two existing items. The form itself has been reorganized into topical categories under a new numbering system. In addition, the filing deadline for most items is four business days after the occurrence of an event triggering the disclosure requirements of the form.

These amendments are responsive to the "real time disclosure" mandate in Section 409 of the Sarbanes-Oxley Act of 2002, which stated that public companies should disclose, on a "rapid and current basis," material information regarding changes in a company's financial condition or operations as the SEC determines to be necessary and useful for the protection of investors and the public. All companies subject to the reporting requirements of the Securities Exchange Act, other than foreign private issuers, will be subject to the new requirements. The stated purpose of these amendments is to enhance investor confidence in the fairness and integrity of the securities markets by providing more timely access to a greater range of information concerning significant corporate events than is currently required by Form 8-K.

Aside from the increased number of required disclosure items and accelerated filing deadline, the biggest change is the need for public companies to assess the "materiality" of a variety of events. The former requirements under Form 8-K tended to be fairly objective and allowed a company to easily determine whether a filing is required. The new requirements depend upon an event occurring, and such event being material to the company, thus introducing a greater degree of subjectivity. A company should consider in advance appropriate materiality thresholds, and these should be periodically reexamined and adjusted as necessary. Because of the short filing deadline, an assessment of whether a filing will be required should be made well in advance of the triggering event. For example, when negotiating an agreement, the determination as to whether it will be "material" and filed should be made very early in the process, not after its execution. *The following summarizes the new Form 8-K requirements.*

NEW DISCLOSURE ITEMS

ITEM 1.01. ENTRY INTO A MATERIAL DEFINITIVE AGREEMENT

- This item requires disclosure of any material definitive agreement not made in the ordinary course of business. Materiality is defined by reference to Item 601(b)(10) of Regulation S-K, which sets out the types of "material contracts" that must be filed as exhibits. A company must also disclose any material amendment to a material definitive agreement, even if the underlying agreement previously has not been disclosed. The disclosure must include (i) the date the agreement was entered into or amended; (ii) a brief description of any material relationship between the company or its affiliates and any of the parties, other than in respect of the material definitive agreement or amendment; and (iii) a brief description of the terms and conditions of the agreement or amendment that are material to the company.

ITEM 1.02. TERMINATION OF A MATERIAL DEFINITIVE AGREEMENT

- Under this item, if a material agreement, as defined in Item 1.01, is terminated and such termination is material to the company, the company must disclose (i) the date of the termination; (ii) the identity of the parties; (iii) a brief description of any material relationship between the company or its affiliates and any of the other parties, other than in respect of the material definitive agreement; (iv) a brief description of the material circumstances surrounding the termination; and (v) any material early termination penalties incurred by the company.
- An agreement that terminates by its terms or as the result of full performance will not trigger the disclosure requirements.

ITEM 2.03. CREATION OF A DIRECT FINANCIAL OBLIGATION OR AN OBLIGATION UNDER AN OFF-BALANCE SHEET ARRANGEMENT OF A REGISTRANT

- This item requires disclosure if a company becomes obligated under a direct financial

obligation, or if the company becomes directly or contingently liable for an obligation arising out of an off-balance sheet arrangement, in either case, that is material to the company. The company must disclose (i) the date on which the company becomes directly or contingently liable on the obligation; (ii) a brief description of the transaction; (iii) the amount of the obligation and the maximum potential amount of future payments that the company may be required to make; and (iv) a brief description of the other material terms and conditions.

- Direct financial obligations include long-term and short-term debt, and capital and operating leases. Trade payables are not included. The term "off-balance sheet arrangement" has the meaning set forth in the SEC rules regarding Management's Discussion and Analysis.
- Disclosure is also required if the company enters into a facility, program or similar arrangement that could give rise to material financial obligations in connection with multiple transactions, and an additional Form 8-K is required when material obligations, in the aggregate, have been incurred.
- In a helpful exception for companies that raise debt financing through a shelf registration, such as a medium-term note program, no Form 8-K is required for a security sold pursuant to an effective registration statement, provided that the prospectus relating to the sale contains the information required by the Form 8-K.

ITEM 2.04. TRIGGERING EVENTS THAT ACCELERATE OR INCREASE A DIRECT FINANCIAL OBLIGATION OR AN OBLIGATION UNDER AN OFF-BALANCE SHEET ARRANGEMENT

- This item requires a company to file a Form 8-K if a triggering event causing the increase or acceleration of a direct financial obligation of the company occurs and the consequences of the event are material to the company. The company must provide (i) the date of the triggering event; (ii) a

brief description of the agreement or transaction under which the direct financial obligation was created and is increased or accelerated; (iii) a description of the triggering event; and (iv) the amount of the material direct financial obligation that may arise, increase or become accelerated as a result of the triggering event.

- If a triggering event occurs causing a company's obligation under an off-balance sheet arrangement to increase or be accelerated, or causing a company's contingent obligation to become a direct financial obligation of the company, and the consequences of the event are material to the company, the company must disclose (i) the date of the triggering event; (ii) a brief description of the off-balance sheet arrangement; (iii) a brief description of the triggering event; (iv) the nature and amount of the obligation, as increased if applicable, and the terms of payment or acceleration that apply; and (v) any other material obligations that may arise, increase, be accelerated or become direct financial obligations as a result of the triggering event or the increase or acceleration of the obligation under the off-balance sheet arrangement or its becoming a direct financial obligation of the company.
- No filing is required until all conditions precedent to the triggering event have occurred, such as the giving of notice by the creditor; excluding, however, the mere passage of time.

ITEM 2.05. COSTS ASSOCIATED WITH EXIT OR DISPOSAL ACTIVITIES

- This item requires disclosure when the board of directors or a committee of the board of directors (or authorized officers if board action is not required) commits the company to an exit or disposal plan or otherwise disposes of a long-lived asset or terminates employees under a plan of termination, under which the company will incur material charges under generally accepted accounting principles. The company must disclose (i) the date on which the commitment was made; (ii) a

description of the course of action including the facts and circumstances leading to the expected action; (iii) an estimate of the total amount expected to be incurred for each major type of cost associated with the course of action; (iv) an estimated amount expected to be incurred in connection with the action; and (v) the company's estimated amount of the charge that will result in future cash expenditures.

ITEM 2.06. MATERIAL IMPAIRMENTS

- This item requires disclosure when a company's board of directors (or authorized officers if board action is not required) concludes that a material charge for impairment to one or more of its assets, including, without limitation, an impairment of securities or goodwill, is required under generally accepted accounting principles applicable to the company. The company must disclose (i) the date of the conclusion that a material charge is required; (ii) a description of the impaired asset or assets and the facts and circumstances leading to the conclusion; (iii) the estimated amount of the impairment charge; and (iv) the estimated amount of the impairment charge that will result in future cash expenditures.
- However, note that no disclosure is required pursuant to this item if the conclusion regarding the material charge is made in connection with the preparation, review or audit of financial statements at the end of a fiscal quarter or year and the impairment is disclosed in the company's Exchange Act report for that period. Any regular impairment analysis that is timed to coincide with the preparation of quarterly or annual statements will not have the potential of triggering a Form 8-K filing.

ITEM 3.01. NOTICE OF DELISTING OR FAILURE TO SATISFY A CONTINUED LISTING RULE OR STANDARD; TRANSFER OF LISTING

- This item requires a company to report any notice from the national securities exchange or national securities association that is the principal trading market for a class of the company's securities, indicat-

ing (i) that the company or such class of its securities does not satisfy a rule or standard for continued listing; (ii) that the exchange has submitted an application under Exchange Act Rule 12d2-2 to the SEC to delist such class of the company's securities; or (iii) that the association has taken all necessary steps under its rules to delist the security from its automated inter-dealer quotation system.

- A company that receives this type of notice must disclose (i) the date that it received the notice; (ii) the listing requirement or standard that the company fails, or has failed, to satisfy; and (iii) any action or response that, at the time of filing, the company has determined to take in response to the notice.
- In addition, a company that notifies its exchange or association that it is aware of any material noncompliance with a listing requirement or standard must disclose (i) the date the company provided such notice to the exchange or association; (ii) the listing requirement or standard that the company fails, or has failed, to satisfy; and (iii) any action or response that, at the time of filing, the company has determined to take regarding its noncompliance.
- A company also must disclose when it has taken definitive action to cause the listing of a class of its securities to be withdrawn from the national securities exchange, or terminated from the automated inter-dealer quotation system of a registered national securities association that is the principal trading market for those securities, including by reason of a transfer of the listing or quotation of its securities to another securities exchange or quotation system, describing the action taken and stating the date of the action.

ITEM 4.02. NON-RELIANCE ON PREVIOUSLY ISSUED FINANCIAL STATEMENTS OR A RELATED AUDIT REPORT OR COMPLETED INTERIM REVIEW

- This item requires disclosure when a company's board of directors (or authorized officers if board action is not required)

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things it knew about for years, e.g., revenue sharing, and things it likely knew little about, e.g., market timing. Second, it is studying the industry more intensely and comprehensively than it has in years. It appears to be focusing, in particular, on conflicts arising in connection with portfolio execution issues. Third, it is expanding the prospectus disclosure that must be made to fund investors about a variety of conflicts of interest. Fourth, it is enhancing the power of the board by strengthening its independence and giving it compliance support. Finally, it is significantly expanding the compliance function within the fund industry by requiring funds and advisers to have written procedures reasonably designed to prevent, detect and correct violations of the federal securities laws.

This flurry of activity is at least partially motivated by the SEC's desire to head off congressional legislation. The SEC hopes that if it reforms the fund industry itself, then congressional action can be minimized. Given the clip at which the SEC is moving, and the fact that this is an election year with significant foreign and domestic issues on the agenda, it appears that the SEC will be permitted, at least for now, to reform things itself.

Of all of the potential rulemaking, private fund advisers and redemption fees may be the most problematic. The SEC has proposed that only managers of hedge funds—and not private

equity or venture capital funds—must register. Whether the SEC will have an adequate budget to examine and inspect those additional advisers in a meaningful way, and have the will to do so despite everything else that is transpiring, is another question. The proposed redemption fee rule opens another can of worms. The SEC has historically been ambivalent about redemption fees, viewing them as an impediment to the very notion of redemption, the hallmark of a mutual fund. The rule proposal is significant, then, if for no other reason than that it demonstrates the Commission's concern over market timing. Redemption fees, however, are already used by portions of the industry, particularly with respect to those funds, e.g., international stock, microcap, etc., most prone to being timed. This proposal deserves close scrutiny before being adopted and, given the likely opposition from within and without, may be modified in some respect.

The corporate governance changes (e.g., relating to the compliance officer) deserve further scrutiny. The SEC's focus on the content of fund disclosure, as well as the quantity and quality of disclosure provided by the fund industry, inevitably waxes and wanes over time. How much of it is read, understood or otherwise relied upon by investors is another question. Bolstering the independence of the board, and requiring it to have some sort of dedicated compliance staff, however, represents yet

another move by the SEC to leverage its own scarce resources by placing greater expectations upon and increasing the distance between boards and the mutual fund advisers. Further, requiring funds and their advisers to adopt written procedures reasonably designed to assure compliance with the federal securities laws not only creates, for the first time, a comprehensive safety net of written compliance procedures, it also could create a new wave of failure-to-supervise allegations against fund fiduciaries. For so long as the SEC and its staff concentrate their attention on the fund industry and its management, the new compliance officer and compliance policy rules, and the new corporate governance rules could prove the most far-reaching and profound of the SEC's many mutual fund initiatives. ■

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Thus we conclude that the fraud provisions of the federal securities laws may not be used as a weapon against every breach of fiduciary duty, absent evidence of manipulation and deception.

In contrast, director liability under state law is tied directly to breaches of fiduciary duty. Delaware, the benchmark for state corporate law, traditionally recognizes a triad of fiduciary duties: the duty of loyalty, the duty of care and the duty of good faith. Director liability is predicated on concepts of gross negligence in the exercise of, or conscious disregard of, these fiduciary duties. See generally *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001). As the

Delaware Chancery Court recently put it, director liability is premised on a "showing that the directors were conscious of the fact that they were not doing their jobs." *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003) (citing *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996)).

Even as the SEC is toughening its stance against outside directors, two Delaware Chancery Court decisions (both decided at the pleading stage) reflect that court's requirement that plaintiffs surmount a very high threshold for director liability. For example, in *Beam v. Stewart*, 833 A.2d 961 (Del. Ch. 2003), *aff'd*,

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Topic: Recordkeeping Procedures for Today's Electronic World

John McGuire
New Orleans, LA

NRS 19th Annual Fall Compliance Conference

Topic: Building Broker/Dealer and Rep Compensation Packages that Satisfy the Regulators

Steven W. Stone
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845 A.2d 1040 (Del. 2004), the court dismissed several breach of fiduciary duty claims against certain directors of Martha Stewart Living Omnimedia, Inc., finding that the directors had no duty to monitor Stewart in her personal affairs. The court also rejected plaintiff's claims related to the company's payment of premiums on a split-dollar insurance policy, in view of recent questions as to the propriety of such policies. Liability would lie, the court concluded, only if "the directors knew or should have known that a violation of the law was occurring" and "the directors took no steps in a good faith effort to prevent or remedy that situation." *Id.* at 976 (citation omitted).

In *In re The Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003), the court declined to dismiss plaintiffs' claims of breach of fiduciary duty and nondisclosure related to the approval of an employment agreement and severance for Michael Ovitz. In doing so, however, the court recognized the deference generally afforded directors, and the high benchmark required to impose liability.

"It is rare when a court imposes liability on directors of a corporation for breach of the duty of care, and this Court is hesitant to second-guess the business judgment of a disinterested and independent board of directors. But the facts alleged in the new complaint do not implicate merely negligent or grossly negligent decision making by corporate directors. Quite the contrary; plaintiffs' new complaint suggests that the Disney directors failed to exercise *any* business judgment and failed to make *any* good faith attempt to fulfill their fiduciary duties to Disney and its stockholders. . . ."

Id. at 278. The case was allowed to proceed past the pleading stage only because the complaint alleged "knowing and deliberate indifference to a potential risk of harm to the corporation" on the part of the directors. *Id.* at 289.

RECENT TRENDS IN THE FEDERAL ARENA

While the threshold for liability in Delaware is high, recent decisions under the federal secu-

rities laws suggest that plaintiffs must show more egregious activity by a director before the antifraud provisions of the federal securities laws may be applied. Even where directors' attention — or perhaps more properly, inattention — has failed to uncover gross impropriety, the courts have shown an unwillingness to uphold allegations against outside directors who are not alleged to have acted with requisite scienter to impose liability.

For example, in *In re WorldCom, Inc. Securities Litigation*, 02 Civ. 3288, 2003 WL 21219049 (S.D.N.Y. May 19, 2003), Judge Cote in the Southern District of New York addressed potential liability under Section 10(b) for certain directors who were members of the audit committee who were alleged to have totally missed what the complaint charges to have been a massive accounting fraud. Indeed, WorldCom acknowledged improperly treating \$3.8 billion in ordinary costs as capital expenditures in violation of GAAP; overstating earnings by \$3.3 billion; and that it would likely write off \$50 billion in goodwill. *Id.* at *5. Plaintiffs attempted to demonstrate that the audit committee members acted with conscious misbehavior or recklessness (i.e., scienter) based on (i) the magnitude of the fraud; (ii) the committee's general oversight responsibilities and commitment in SEC filings to review financial statements and internal controls; and (iii) certain alleged red flags that arose after the misrepresentations were made. Despite the alleged failure of the directors on the audit committee to catch this gross fraud, the court dismissed the claims, rejecting each of the enumerated theories as an insufficient basis for liability.⁷ *Id.* at *22-23.

Similarly, in *In Re Enron Corp. Securities, Derivative & "ERISA Litigation"*, 258 F. Supp. 2d 576 (S.D. Tex. 2003), the court dismissed Section 10(b) claims against certain Enron outside directors, based on a failure to adequately plead scienter. Plaintiffs, relying on minutes of various board and committee meetings, alleged that the outside directors had "if not actual knowledge of, at the very least access to full information about, and were severely reckless in disregarding" the activity at the center of the Enron fraud. The court

rejected this contention, finding plaintiffs' allegations, and the minutes upon which they relied, "too brief, general and imprecise to establish scienter. . . . At most they might suggest negligent failure to ask more questions or investigate the corporation's affairs in greater detail." *Id.* at 627-28.

CONCLUSION

None of this is meant to suggest that corporate directors, inside or outside, should be less than vigilant in dealing with the affairs of their corporations and carrying out their fiduciary responsibilities. Indeed, one might hope that such vigilance may help prevent future scandals.

That said, we need to recognize the basic distinction between negligent corporate behavior and breach of duty (with appropriate civil remedies) on the one hand and securities fraud which, these days, often leads to criminal prosecution, on the other. Congress authorized a variety of actions for securities fraud, both civil and criminal, against persons who can be shown to have acted with fraudulent intent and purpose; and the sanctions and penalties for such fraudulent activities are severe. However, it did not authorize such proceedings and penalties for nonmanipulative or deceptive breach of fiduciary duty or negligent behavior, which traditionally have been the province of state law and which may not merit the same sanctions and penalties. If we are to change that scheme, the proper approach would be through new legislation with appropriate opportunity for comment, including consideration of the correct interplay between state corporate law and the federal securities laws.

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⁷ The court allowed claims to proceed against another director defendant under unique circumstances.

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right to, and frequently chooses to issue new comments that were not raised in its first comment letter. This practice seems unusual to U.S. securities lawyers but a certain amount of flexibility on the part of the working group goes a long way when addressing any new comments.

The Exchange requires that revised offering documents be submitted in clean and blacklined format, with deletions marked with a strikethrough. “Caret” to mark deletions are no longer acceptable. Financial printers in Europe are developing the capability to mark deletions accordingly, but this is not yet universal. If the financial printer does not have this capability, issuer’s counsel will maintain a version of the offering document in order to run the appropriate blacklines.

CONTENTS OF THE PUBLIC OFFER PROSPECTUS AND LISTING PARTICULARS

The offering document must contain the information which, according to the particular nature of the issuer and of the transferable securities, “is necessary to enable investors and their investment advisers to make an informed assessment of the assets and liabilities, financial position, profits and losses and prospects of the issuer and of the rights attaching to such securities.” More specifically, the information to be included, as listed in Appendix III of the Admission Requirements, is as follows:

- (a) Information concerning those responsible for the offering document and the auditing of accounts.
- (b) Information concerning admission to the official stock exchange listing and the shares for which application is being made.
- (c) General information about the issuer and its capital.
- (d) Information concerning the issuer’s activities.
- (e) Information concerning the issuer’s assets and liabilities, financial position and profits and losses (including the last two balance sheets and profit and loss accounts).

- (f) Information concerning administration, management and supervision.
- (g) Information concerning the recent development and prospects of the issuer.

To the extent that these categories are not appropriate for the issuer’s activities, “equivalent information” may be provided. The Exchange routinely accepts offering documents that are formatted like a U.S.-style prospectus. A prospectus included in a registration statement that would meet the requirements for registration under the Securities Act of 1933 is likely to have most of the information that would satisfy the Exchange’s listing requirements. However, additional disclosure items not typically found in the Securities Act of 1933 prospectus are required, including, for example, undertakings with respect to the publication of notices required by the Exchange’s rules, the date of board approval of the offering, confirmation of the absence of a material adverse change to the issuer’s financial position since the date of the last audited financial statements and the absence of material litigation, and undertakings with respect to the maintenance of a Luxembourg listing agent and paying agent.

EXEMPTIONS FROM PUBLISHING CERTAIN INFORMATION

The Exchange may exempt the issuer from publishing certain information if it is of minor importance and not likely to affect an assessment of the issuer’s assets, liabilities, financial position and prospects.

FINANCIAL STATEMENT REQUIREMENTS

An issuer that does have securities which are traded on another exchange must include in its offering document audited balance sheets and profit and loss accounts for the previous two fiscal years, together with notes on the annual financial statements for the previous year. There must not be a gap of more than 18 months between the end of the fiscal year to which the last statements relate and the date of filing draft listing particulars with the

Exchange. If the issuer prepares consolidated annual financial statements only, they must be included. If more than nine months have elapsed between the end of the last financial year to which the last statements relate, an interim financial statement covering at least the first six of those nine months must be included.

For issuers that already have securities trading on an exchange elsewhere, the financial statement requirements may be satisfied if an offering document contains information regarded by the Exchange as “equivalent” to that required under the Admission Requirements and which has been published in Luxembourg in the previous 12 months. If the issuer has experienced significant changes to its financial position, updates to this original document may be required.

There is no explicit guidance as to what should be provided when the issuer is a new, special-purpose entity and therefore does not have historical financial information to provide. As noted above, the general requirement is that the offering document shall contain “the information which, according to the particular nature of the issuer and of the transferable securities concerned by the operation, is necessary to enable investors and their investment advisers to make an informed assessment of the assets and liabilities, financial position, profits and losses and prospects of the issuer and of the rights attaching to such securities.” As a practical matter, in the context of a securitization or similar transaction, the Exchange will require financial information demonstrating the relative quality of underlying assets of the issuer, including cash flows.

MINIMUM ISSUE SIZE

The minimum amount of an issue for admission of debt securities to official stock exchange listing is not less than 10,000,000 Luxembourg Francs (or currency equivalent). If this condition is not fulfilled, admission to listing may nonetheless be granted if the Board is satisfied that there will be an adequate market for the debt securities.

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concludes that any of the company's previously issued financial statements covering one or more years or interim periods no longer should be relied upon because of an error in such financial statements or if the company is advised by, or receives notice from, its independent accountant that disclosure should be made or action should be taken to prevent future reliance on a previously issued audit or completed interim review related to previously issued financial statements. A company must disclose (i) the date on which the conclusion was reached; (ii) an identification of the financial statements and years or periods covered that should no longer be relied upon; (iii) a brief description of the facts underlying the conclusion to the extent known to the company at the time of filing; and (iv) a statement of whether the audit committee, or the board of directors in absence of an audit committee, or authorized officer or officers, discussed with the company's independent accountant the subject matter giving rise to the conclusion or notice.

- This item also requires disclosure when a company is notified by its independent accountants that a previously issued audit opinion can no longer be relied upon.

EXPANDED DISCLOSURE ITEMS

ITEM 5.02. DEPARTURE OF DIRECTORS OR PRINCIPAL OFFICERS; ELECTION OF DIRECTORS; APPOINTMENT OF PRINCIPAL OFFICERS

- Item 5.02 broadens the scope of former Item 6 of Form 8-K.
- Disclosure is required if a director has resigned or refuses to stand for re-election to the board of directors since the date of the last annual meeting of shareholders because of a disagreement with the company, known to an executive officer of the company, on any matter relating to the company's operations, policies or practices, or if a director has been removed for cause from the board of directors. The company must disclose (i) the date of the director's resignation, refusal to stand for re-election

or removal; (ii) any positions held by the director on any committee of the board of directors at the time of the director's resignation, refusal to stand for re-election or removal; and (iii) a brief description of the circumstances representing the disagreement that management believes caused, in whole or in part, the director's resignation, refusal to stand for re-election or removal. In addition, any written correspondence from the director concerning the circumstances surrounding his or her resignation, refusal to stand for re-election or removal must be filed as an exhibit to the report on the Form 8-K regardless of whether the director requests that the company take such action.

- Disclosure is required when a company's principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer or any person performing similar functions retires, resigns, or is terminated from that position. Disclosure is also required when a director retires, resigns, is removed or declines to stand for re-election for reasons other than as specified above.
- Disclosure is required if the company appoints a new principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer or person performing similar functions. The company must disclose (i) the officer's name and position; (ii) the date of the appointment; (iii) information regarding the background of the officer and certain related transactions between the officer and the company; and (iv) a brief description of the material terms of any employment agreement between the company and the officer.
- Disclosure is required if a new director is elected to the board, except by a vote of security holders at an annual meeting or special meeting convened for such purpose. The company must disclose (i) the new director's name; (ii) the election date; (iii) a brief description of any arrangement or understanding pursuant to which the new director was selected as a director; (iv) any

committees to which the new director has been, or at the time of the disclosure is expected to be, named; and (v) information regarding certain related transactions between the new director and the company.

ITEM 5.03. AMENDMENTS TO ARTICLES OF INCORPORATION OR BYLAWS; CHANGE IN FISCAL YEAR

- A company with a class of equity securities registered under Section 12 of the Exchange Act, that amends its articles of incorporation or bylaws under circumstances where the proposal for the amendment was not disclosed in a proxy statement or information statement, must disclose (i) the effective date of the amendment; and (ii) a description of the provision adopted or changed by amendment and, if applicable, the previous provision.
- A company that determines to change its fiscal year from that used in its most recent filing with the SEC other than by means of a vote of security holders or an amendment to its articles of incorporation or bylaws must disclose (i) the date of such determination; (ii) the date of the new fiscal year end; and (iii) the form on which the report covering the transition period will be filed.

DISCLOSURE ITEMS TRANSFERRED, IN PART, FROM THE PERIODIC REPORTS

- Two disclosure requirements from Forms 10-Q, 10-QSB, 10-K and 10-KSB have been transferred, in part, to Form 8-K. Because these items generally will be disclosed in the Form 8-K, companies do not have to repeat these disclosures in annual and quarterly reports.

ITEM 3.02. UNREGISTERED SALES OF EQUITY SECURITIES

- This item requires a company to disclose the sales of equity securities in a transaction that is not registered under the Securities Act. This disclosure is currently required in Item 2(c) of Forms 10-Q and 10-QSB and Item 5(a) of Forms 10-K and 10-KSB.
- No Form 8-K need be filed if the equity securities sold in the aggregate since the

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The Luxembourg Franc became obsolete with the introduction of the Euro at the beginning of 2002. It is curious therefore (especially since the Rules and Regulations have been amended since that time) that this figure is not now expressed in Euros. However, following the official conversion rate in effect upon the introduction of the Euro, 10,000,000 Luxembourg Francs equal approximately 250,000 Euros, or approximately US\$300,000 at the current exchange rate levels.

ONGOING REQUIREMENTS

In order to maintain a listing of debt securities on the Exchange, the issuer must, among other things, (i) maintain a paying agent and listing agent in Luxembourg; (ii) provide to the Exchange copies of its annual reports, including audited financial statements, and interim financial information made available to shareholders, and (iii) publish notices of any matters that might affect the securities in a newspaper having general circulation in Luxembourg. ■

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company's last report filed under this item or last periodic report, whichever is more recent, constitute less than 1% of the company's outstanding securities of that class (5% for a small business issuer). Periodic reports must still be filed for all issuances not reported on Form 8-K.

ITEM 3.03. MATERIAL MODIFICATIONS TO RIGHTS OF SECURITY HOLDERS

- This item requires a company to disclose material modifications to the rights of the holders of a class of the company's registered securities and to briefly describe the general effect of such modifications on such rights. Note that this disclosure requirement can be triggered by a modification to the documents governing the terms of the securities themselves or by the issuance of a new class of securities that has the effect of materially modifying the rights of the registered securities. The substance of the disclosure is the same as previously required by Items 2(a) and (b) of Forms 10-Q and 10-QSB.

SAFE HARBOR; ELIGIBILITY TO USE FORMS S-2 AND S-3 AND CHANGE TO RULE 144

- Companies are entitled to a limited safe harbor from public and private claims

under Exchange Act Section 10(b) and Rule 10b-5 for a failure to timely file a Form 8-K regarding seven of the new reporting requirements: Item 1.01 (Material Agreements), Item 1.02 (Termination of Material Agreements), Item 2.03 (Material Financial Obligations), Item 2.04 (Triggering Events Under Material Financial Obligations), Item 2.05 (Costs Associated with Exit or Disposal Activities), Item 2.06 (Material Impairment) and Item 4.02(a) (Restatement of Financials). The safe harbor only applies to a failure to file a report on Form 8-K. Thus, material misstatements or omissions in a Form 8-K will continue to be subject to Section 10(b) and Rule 10b-5 liability. In addition, the limited safe harbor only applies to Section 10(b) and Rule 10b-5, and not to the obligation under Section 13(a) or 15(d) to comply with the periodic reporting obligations. The safe harbor extends only until the due date of the periodic report of the company for the relevant period in which the Form 8-K was not timely filed.

- A company's failure to file timely reports of any of the safe harbor disclosures specified above will not affect the company's eligibility to use Forms S-2 and S-3 registration statements. However, a company

must be current in its Form 8-K filings with respect to those items at the actual time of a Form S-2 or S-3 filing.

- A company need not have filed all required Form 8-K reports during the 12 months preceding a sale of securities pursuant to Securities Act Rule 144 to satisfy the rule's "current public information" condition.

In order to maintain compliance with the SEC's requirements for adequate disclosure controls and procedures, companies should make the necessary adjustments to their existing disclosure controls and procedures to ensure compliance with the new Form 8-K requirements. A full text of the final rule is available at www.sec.gov/rules/final/33-8400.htm. ■

Howard Kenny is a Partner in the New York office of Morgan, Lewis & Bockius LLP. Teresa Minger, an Associate in the New York office, assisted in the preparation of this article.

U.S. JUSTICE DEPARTMENT'S ENRON TASK FORCE LEADER TO JOIN MORGAN LEWIS

Leslie R. Caldwell, who recently served as Director of the U.S. Department of Justice's special task force investigating the Enron corporate scandal, has joined Morgan Lewis as a partner in its New York City office.

Ms. Caldwell, one of the most respected and best-known federal prosecutors in the country, joins Morgan Lewis' Global Litigation Practice, where she will take the lead role in the firm's corporate investigations and criminal defense team.

In addition to leading Morgan Lewis' criminal defense team in New York City, Caldwell will spend considerable time in the firm's California offices, enhancing the litigation group's West Coast practice.

In 1987, Caldwell joined the U.S. Attorney's Office for the Eastern District of New York, where she worked, trying more than 30 cases, until 1998. From 1999 to 2002, Caldwell served as Chief of the Securities Fraud Section and Chief of the Criminal Division in the U.S. Attorney's Office for the Northern District of California, where she oversaw the prosecution of dozens of corporate and financial fraud cases.

In a June 14, 2004 article, *The Washington Post* reported Caldwell was one of the four attorneys most sought after by the nation's top law firms. She was named one of *Fortune*

magazine's "People to Watch" in February 2003, and has been profiled in *The New York Times*, *BusinessWeek*, *The Washington Post*, the *Houston Chronicle*, and the *San Francisco Chronicle*, among others. ■



LA MANAGING PARTNER JOINS UCLA'S FACULTY STAFF

John Hartigan, managing partner of the firm's Los Angeles office, has joined UCLA's program faculty for its eighth Director Training and Certification Program to be held on Oct 20 - 22, 2004. Mr. Hartigan will be teaching in the Governance and Nominating Committee Module on Oct. 20. The Director Training and Certification Program will be held on Oct. 21 and 22. The modules are individual seminars focused on audit, compensation and governance and nominating committees, and may be taken separately or with the Director Training and Certification Program. All events will take place at the Anderson School on the UCLA campus. ■

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