

# MORGAN LEWIS - ON SECURITIES

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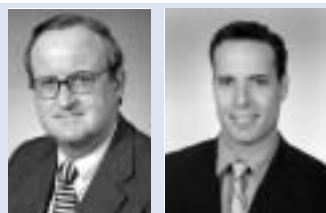
WINTER 2005

## RECENT DEVELOPMENTS IN TWO-STEP TENDER OFFER/SHORT-FORM MERGER TRANSACTIONS UNDER DELAWARE LAW

By STEPHEN P. FARRELL AND PATRICK J. EGAN

The ability of a controlling stockholder of a corporation to eliminate minority interests in "squeeze-out" or "cash-out" transactions is an essential tool to effectuate a broad range of corporate transactions, not the least of which is to gain or regain 100% ownership of a company. A wide range of mechanisms are available to controlling stockholders for squeezing out minority stockholders, including long-form mergers, short-form mergers, reverse stock splits, and tender offers followed by short-form mergers. Recent Delaware court decisions, however, have made the two-step tender offer/short-form merger an extremely attractive method for eliminating minority stockholders. This article will provide a brief overview of the necessary steps, as developed by Delaware judicial doctrine, to effect a successful tender offer/short-form merger, as well as address the inherent conflict between the summary nature of the short-form merger and the desire to protect the minority stockholders in squeeze-out transactions.

Delaware is the focus of this discussion because of its highly sophisticated, extensive and modern corporate law system. Delaware's unsurpassed body of corporate case law provides stability and reliability for corporate decision makers. As a result, Delaware is recognized as the national leader in the production of corporate rules and regulations.



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Federal securities laws and the rules of the stock exchanges and Nasdaq greatly impact the procedure and timing of a tender offer/short-form merger; however, a discussion of these laws and rules is beyond the scope of this article.

### DEVELOPING A ROAD MAP FOR A TENDER OFFER/SHORT-FORM MERGER

In the first step of a tender offer/short-form merger, the controlling stockholder sends each of the stockholders of the target an "offer to purchase" and a letter of transmittal, which the stockholders use to tender their shares. Under Delaware law, absent coercion or materially false or misleading disclosures, a controlling shareholder is under no obligation to offer a minimum price for the minority shares.<sup>1</sup> Furthermore, tender offers are generally regarded

as voluntary transactions that do not give rise to fiduciary duties by the controlling stockholders, except in cases where the offer is coercive or where the disclosure is materially false or misleading. If, however, coercion or materially false or misleading disclosure is not present, the tender offer will not be viewed under the entire fairness standard. Entire fairness is a standard that majority stockholders must satisfy in certain interested transactions under Delaware law, such as negotiated mergers. Under entire fairness, the majority stockholders are required to demonstrate both a fair price and fair dealing in connection with the transaction.<sup>2</sup>

Once the controlling stockholder or parent corporation obtains 90% of the target's shares, it will consummate a short-form merger to complete the squeeze-out. Section 253 of the Delaware General Corporation Law (the DGCL) outlines the procedure for a short-form merger between a parent and a subsidiary. A parent that owns at least 90% of the outstanding shares of each class of a subsidiary corporation's stock may merge the subsidiary corporation into itself, or, alternatively, may merge both itself and the subsidiary corporation into a third corporation. A short-form merger is effected unilaterally by a board resolution of the parent company. No resolution of the target's board of directors or approval of the target's stockholders is required.

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<sup>1</sup> See *Solomon v. Pathe Communications Corp.*, 672 A.2d 35 (Del. 1996). <sup>2</sup> See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

# SECURITIES OFFERING REFORM

By S. SCOTT LIEBERMAN AND INGRID A. MYERS

The Securities and Exchange Commission issued proposals to significantly change aspects of the registration and offering process under the Securities Act of 1933. (See Release Nos. 33-8501; 34-50624; IC-26649; International Series Release No. 1282; File No. S7-38-04). The proposed revisions should eliminate some restrictions on offerings, provide more timely investment information to investors without delaying the offering process and integrate the disclosures and processes under the Securities Act of 1933 and the Securities Exchange Act of 1934. The proposals address communications related to registered securities offerings, delivery of information to investors, and procedural restrictions in the offering and capital formation processes. The proposing release is titled "Securities Offering Reform." The following summary highlights some aspects of the Commission's proposals.

## ELIGIBLE ISSUERS

The flexibility granted to issuers under the proposed revisions depends on certain characteristics of the issuer. The Commission's proposals divide issuers into four categories:

- Well-known seasoned issuers – issuers eligible to register a primary offering on Form S-3 or F-3 that have been reporting under the Exchange Act for at least one year, have filed their reports on time and are current in their filings under that Act, and that either (i) have \$700 million of public float in common equity, or (ii) in the case of debt issuers, have issued \$1 billion in registered debt securities in the preceding three years;
- Seasoned issuers – issuers eligible to register a primary offering on Form S-3 or F-3;
- Unseasoned issuers – issuers that are required to file reports pursuant to Section 13 or 15(d) of the Exchange Act, but not eligible to use Form S-3 or F-3 to register a primary offering of their securities, and issuers that are not required to but are voluntarily filing reports pursuant to Section 13 or 15(d) of the Exchange Act; and
- Non-reporting issuers – issuers not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.

## OFFERING COMMUNICATIONS

The proposed revisions liberalize written communications before and during registered securities offerings, removing many of the "gun jumping" prohibitions. In addition, the Commission is proposing new safe harbors under Section 5 of the Securities Act for factual business information and forward-looking information.

During the 30-day period prior to filing, all non-reporting issuers would be able to publish "factual business information," which is the type of information they have regularly released to persons other than in their capacity of investors or potential investors. Reporting issuers, which include unseasoned, seasoned and well-known seasoned issuers, would be able to publish "factual business information" and "forward-looking statements." Communications made by an issuer (but not an underwriter) more than 30 days before the filing of a registration statement are exempt under the proposals if they do not reference a securities offering.

The proposals allow use of written communications that constitute offers, including electronic communications, outside the statutory prospectus. A written communication that constitutes an offer outside of the statutory prospectus is termed a "free-writing prospectus" that would be required to include certain information, contain a legend and be filed with the Commission. An issuer's written communication that satisfies the conditions of a free-writing prospectus could be used without violation of the gun-jumping provisions. After the registration statement has been filed, all issuers would be allowed to use a free-writing prospectus. Well-known seasoned issuers would be permitted to engage in unrestricted oral and written offers before filing a registration statement and would therefore be allowed to use a free-writing prospectus before filing a registration statement.

While a free-writing prospectus would have to be filed with the Commission in most cases, it would not be a part of the registration statement subject to Section 11 liability under the Securities Act unless the issuer elected to file it as part of the registration statement. Nonetheless, any person using the

free-writing prospectus would be subject to liability for prospectuses under Section 12(a)(2) of the Securities Act and anti-fraud provisions of the federal securities laws.

## LIABILITY ISSUES

Under the proposals, for purposes of determining liability under Sections 12(a)(2) and 17(a)(2) of the Securities Act, the determination as to whether a material misstatement or omission exists will be assessed by looking at the information conveyed to investors when the investment decision is made, and information provided to the issuer after the time of the sale will not be taken into account. Thus, an issuer or underwriter may incur liability in connection with a free-writing prospectus delivered at or before the time of the sale.

Also included in the proposals are revisions that provide that information contained in a registration statement or prospectus will be modified or superseded by information contained in a document that is deemed part of or incorporated by reference into a registration statement or prospectus. In addition, information provided subsequent to a sale that is deemed part of or incorporated by reference into a registration statement or prospectus would not modify or supersede any information conveyed to an investor at the time of sale (including the time of the contract of sale) for purposes of determining the information conveyed to an investor at or prior to that time.

## SHELF REGISTRATION IMPROVEMENTS

The Commission is also proposing to improve the shelf registration process by:

- codifying the information that may be omitted at effectiveness from a shelf registration statement and added later;
- allowing issuers to register an unlimited number of securities, rather than that number reasonably expected to be sold within two years, but requiring the filing of a new registration statement every three years;
- eliminating "at-the-market" offering restrictions;
- allowing immediate takedowns from delayed shelf registration statements; and

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# HEDGE FUND UPDATE

By ETHAN W. JOHNSON AND PETER L. CEJAS

On October 26, 2004, the Securities and Exchange Commission adopted new Rule 203(b)(3)-2 and certain other rule amendments under the Investment Advisers Act of 1940, as amended (the "Act"). The new rule and amendments (collectively, the "New Rules") require hedge fund managers and other advisers to certain private investment companies exempt from registration under the Investment Company Act of 1940, as amended, to register with the SEC under the Act. The New Rules are designed to provide the protections afforded by the Act to investors in private investment companies and to enhance the SEC's ability to protect the nation's securities markets.

Each adviser required to register under the New Rules must have its registration effective, and must have in place all policies and procedures required under the SEC rules, by February 1, 2006.

## THE NEW RULES

The Act is the primary federal statute that regulates most advisers doing business in the United States and imposes certain registration, disclosure and substantive regulatory requirements on such advisers. Requirements under the Act include the filing of a Form ADV with the SEC, the delivery to clients of certain disclosure items, and compliance with regulations regarding recordkeeping, policies and procedures, advertising, proxy voting, cash solicitation payments, performance fees and custody of client assets. The Act contains various exceptions and exemptions from registration, the most common of which is set forth in Section 203(b)(3). This "private adviser" rule exempts an adviser from registration under the Act if it satisfies the following requirements: (i) the adviser had fewer than 15 clients during the preceding 12 months, (ii) the adviser does not hold itself out generally to the public as an investment adviser, and (iii) the adviser does not advise any SEC-registered investment company or company that elects to be regulated as a business development company.

Advisers have historically been permitted to count each private investment company as a single client for purposes of the private adviser exemption. The New Rules, however, change

this policy and now require advisers to count each investor of a "private fund," as defined below. Accordingly, all advisers to private funds, including subadvisers, will now be required to look through the private funds they advise and count each investor in such funds in order to determine whether they advise fewer than 15 clients.

## DEFINITION OF "PRIVATE FUND"

As stated above, advisers will now be required to look through the "private funds" they manage for purposes of counting the number of clients they advise. A "private fund" is defined under the New Rules as a company that (i) would be subject to regulation under the Investment Company Act but for the exception provided in either Section 3(c)(1) or Section 3(c)(7) thereof, (ii) permits investors to redeem or withdraw their interests in the company within two years of purchasing them, and (iii) offers interests that are based on the ongoing investment advisory skills, ability or expertise of the investment adviser. With respect to (iii) above, the SEC has cautioned advisers not to circumvent the New Rules by delegating advisory functions to subadvisers or by establishing so-called "manager of managers" structures.

*Offshore Publicly Offered Funds.* Certain funds will not be deemed to be private funds for purposes of the New Rules. The New Rules contain an exception to the definition of "private fund" for a company that "has its principal office and place of business outside the United States, makes a public offering of its securities outside the United States, and is regulated as a public investment company under the laws of a country other than the United States." The New Rules clarify that this exception applies to "any type of publicly offered fund, whether in corporate, trust, contractual or other form, so long as the fund is authorized for sale in the same jurisdiction in which it is regulated as a public investment company." Accordingly, certain publicly offered offshore funds, such as those that meet the UCITS requirements of the securities regulatory authority of a European Union member state, will not be deemed private funds and each such fund can therefore be counted as a single client for purposes of the Act.

## COUNTING INVESTORS OF PRIVATE FUNDS

The New Rules require advisers to count each investor of a private fund for purposes of the private adviser exemption. Generally, this means that an adviser must count each shareholder of a corporate fund, each limited partner of a partnership, each member of a limited liability company, and each beneficiary of a trust. Further, an adviser that advises individual clients directly will have to count those clients together with the investors in those private funds that it advises in determining its total number of clients. An adviser, however, is not required to count itself or certain of its knowledgeable advisory personnel who are "qualified clients" (i.e., who are "insiders") as clients. Advisers should note that they may not circumvent the New Rules by making private fund investors partners in their advisory firms to avoid counting the investors for purposes of the private adviser exemption.

*Fund of Funds.* Advisers will be required to look through "fund of funds" investors in counting their clients for purposes of the private adviser exemption. A "fund of funds" is defined under the New Rules as "any limited partnership (or limited liability company or other type of pooled investment vehicle) that invests at least 10 percent of its total assets in other pooled investment vehicles that are not related persons of the fund of funds, or related persons of the adviser or general partner of the fund of funds."

*Offshore Advisers.* The New Rules require advisers with principal offices and places of business outside the United States ("offshore advisers") to look through the private funds they manage, regardless of whether those funds are also located offshore, and count those investors that are U.S. residents as clients. An offshore adviser that in the preceding 12 months had more than 14 advisory clients (meaning U.S. investors in the adviser's private fund and other advisory clients) that are U.S. residents will generally have to register under the Act. Determination as to an investor's residence may be made at the time the investor makes an investment in the private fund. If an investor is a non-U.S. client at the time of

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# SEC ADMINISTRATIVE PROCEEDINGS IN FY 2004

By CHRISTIAN J. MIXTER

Fiscal year 2004 saw the continuing impact of the SEC's new rules on the timeliness of administrative proceedings (APs), as well as a return — after a one-year hiatus — of the administrative law judges' willingness to dismiss APs that fail to pass muster at hearing.

## TIMELINESS OF APs AT THE ALJ LEVEL

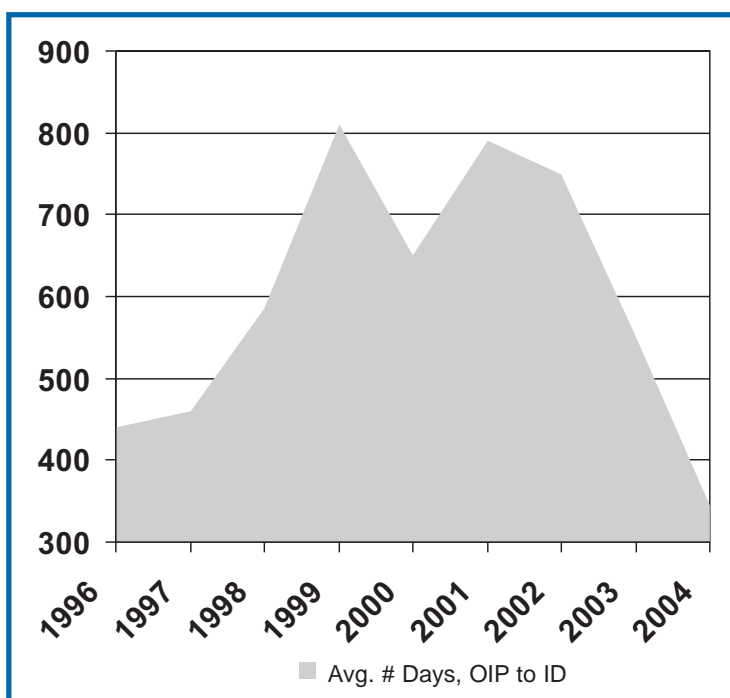
The Commission amended its Rules of Practice, effective July 17, 2003, in an effort to deal with "unnecessary delay" in APs. The amended rules impose a system under which the order instituting proceedings (OIP) in every contested proceeding will state whether the administrative law judge (ALJ) must issue his or her initial decision within 120, 210, or 300 days from the date of service of the order, and require the ALJ to adhere to sublimits on the length of the prehearing, transcript preparation, and decision-writing stages of the proceeding. Modifications to these time limits may only be granted by the Commission with the consent of the Chief ALJ. The Commission also amended Rule 161(b) to state that in deciding whether to extend time limits or grant other extensions, "the Commission or the hearing officer should adhere to a policy of strongly disfavoring such requests, except in circumstances where the requesting party makes a strong showing that the denial of the request or motion would substantially prejudice their case."

A more relaxed standard applies if one or more respondents offer to settle and request that the proceeding be stayed while the Commission considers the settlement offer (see Rule 162(c)). (For a more detailed discussion of the new rules and some of their ramifications, see Christian J. Mixter, "The SEC's New Administrative Proceedings Rules," 17 *INSIGHTS* 2 (Sept. 2003).)

Between the effective date of the amended rules and the end of FY 2004, 14 APs authorized under the new rules progressed to an initial decision (ID) by the ALJ — one in FY

2003, and 13 in FY 2004. Four were 300-day proceedings, eight were 210-day proceedings, and two were 120-day proceedings. Both of the 120-day cases were proceedings aimed at suspending or revoking the registration of a class of stock where the issuer had failed to file annual or periodic reports — a type of administrative action in which little serious resistance by the respondent would be expected. The eight IDs were all issued in "follow-on" APs, in which the respondent already has been criminally convicted or civilly enjoined for violating the law, and the only issue is whether a suspension or bar from a regulated activity is also in the public

results primarily from the lingering presence among the FY 2004 IDs of nine "old rules" cases with no time limits, one of which — the uncommonly long-running *Armstrong AP*, I.D. Rel. No. 248 — spent three years on interlocutory review before the Commission; the nine "old rules" cases took an average of 489 days through initial decision, compared to 168 days for the 13 "new rules" cases. A secondary factor is that in "new rules" cases, the time limits run from the date of service of the OIP on the respondents, whereas the only observable date from the ID, and the date on which the above calculations are based, is the somewhat earlier date when the OIP was issued.



## COMMISSION APPEALS FROM ALJ DECISIONS

To address delays at the SEC "appellate" level, the Commission shortened from 11 to seven months the unenforceable time limit that it gives itself under Rule 900 to decide petitions for review. Amended Rule 900(a)(1)(iii) requires the Commission to make findings if these self-imposed limits are to be exceeded. If a decision on a petition for review is expected to take more than seven, but less than 11, months, the Commission apparently must find that "unusual complicating circumstances" exist. If the case is expected to remain pending for more than 11 months, the Commission must determine that "extraordi-

nary facts and circumstances of the matter so require."

interest. The "default" category for all other APs appears to be the 300-day schedule. The FY 2004 decisions demonstrate that the SEC's new rules are having a profound effect on the average time taken to process the cases at the ALJ level. As shown by the chart above, FY 2004 saw the lowest average number of elapsed days between issuance of the OIP and issuance of the ID in any of the past nine fiscal years.

The fact that the 345 average days used in rendering the FY 2004 IDs exceeded the maximum 300-day limit set by the new rules

primary facts and circumstances of the matter so require."

The new rules appear to be having an effect at the Commission level as well. In FY 2004, the Commission issued 41 decisions on review of ALJ initial decisions and on appeals from SRO disciplinary rulings — 15 less than in FY 2003, but still a respectable number based on its record over the past nine fiscal years, during which the Commission's output bottomed out at 31 opinions in FY 2002. Of the 41 FY 2004 decisions, the petition for review by the Commission was filed after the effective date of

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# A SUMMARY OF THE FINANCIAL SERVICES AUTHORITY'S ENFORCEMENT PROCEDURES IN THE UNITED KINGDOM

By ROBERT FALKNER

## FINANCIAL SERVICES AUTHORITY (FSA) TRANSITIONS TO AN ENFORCEMENT-LED REGULATOR

It has long been recognised that the Securities and Exchange Commission in the United States is an enforcement-led regulator. Indeed, after the Worldcom and Enron scandals, when the SEC determined that a strong response was required, it brought more than 1,300 enforcement actions and obtained orders for penalties and disgorgements totalling a record \$5 billion in just two fiscal years, 2002 and 2003. On the other hand, historically, the FSA has frequently represented that it is not an enforcement-led regulator but is focused on regulation and day-to-day supervision. The FSA maintained that it looked on enforcement only as a last resort where, for example, a firm, despite receipt of supervisory guidance, nonetheless repeatedly acted in breach of the rules. There is no doubt, however, that the FSA, judged by its recent actions, is following the lead of the SEC and has become an enforcement-led regulator.

The FSA can publicly censure or impose a financial penalty on any investment business that has contravened a requirement imposed under the Financial Services and Markets Act 2000 (FSMA). Any financial penalty imposed by the FSA is ordinarily accompanied by a press release. The FSA also has the power to publish a statement of misconduct or impose a financial penalty upon an individual who has committed an act of misconduct (a failure to comply with FSA principles or for being knowingly concerned in the contravention of FSA rules and requirements). Again, any financial penalty will ordinarily be publicised by the FSA in issuing a press release. The FSA has the further power to withdraw approval for an individual to perform significant investment business functions or prohibit an individual from working in an investment business at all.

At the end of 2003, the Director of Enforcement of the FSA, Andrew Proctor, stated:

In November the Enforcement Division was moved outside the [supervisory] structure of the FSA and it will report directly to the Chief Executive in order to send a clear external message about the importance of enforcement....

I expect that you will see a substantial number of reported cases in the next weeks and months that will demonstrate that we are serious about focusing on things that matter. We shall continue to take that approach.

In June 2004, the Chairman of the FSA, Callum McCarthy, noted that over the previous 18 months the FSA had levied fines totalling £8.725 million for misselling and misleading advertisements and other breaches. He further pointed out that levying a fine can be only a small part of the total cost to a firm, since consumer compensation can also be required. Lloyds TSB was fined £1.9 million for the alleged misselling of precipice bonds, but agreed to pay compensation to customers of nearly £100 million; Lincoln Assurance was fined £485,000 for the alleged misselling of ten-year savings plans by a representative, but provided £8.8 million in compensation to customers. In fact, over the 18 months to June 2004, a total of £135.4 million was paid or set aside in compensation as a result of FSA action. This is in addition to the total redress of around £1 billion paid over (or set aside to be paid) to consumers for endowment policy misselling. The FSA has also imposed over £6.5 million of fines for breaches of the listing rules, market misconduct and other actions concerning orderly markets.

The FSA has taken public action against seven individuals in senior management positions since 2002, and has commenced criminal proceedings in another instance. The FSA has made it clear that firms and senior management should expect this to be a continuing and growing feature of the FSA approach. The FSA considers it to be an "obvious means of motivating senior management to meet the standards they are obliged to follow".

In September 2004, John Tiner, the Chief Executive of the FSA, set out the FSA's enforcement objectives:

- (1) to send a strong message to the board and senior management of a firm that the behaviour which had led to the fine was not appropriate and should not be repeated;
- (2) to attract publicity about the fine and so adversely affect the brand value and reputation of the company in the market place; and
- (3) to act as a general deterrent to the market.

In 2003/2004, the FSA's enforcement budget increased to £19 million, or nearly 10% of the FSA's mainstream regulatory activity costs.

In short, it is clear that the FSA has become an enforcement-led regulator, that it is resourced to initiate a large number of cases and that it intends to impose significant financial penalties upon firms and members of senior management of those firms that contravene FSA rules.

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DESIGN AND FORMAT BY Gina L. Craven

# WHAT IS THE ROLE OF A MUTUAL FUND DISTRIBUTOR IN ENFORCING A FUND'S PROHIBITION AGAINST MARKET TIMING?

By JOHN V. AYANIAN AND BETH D. KIESEWETTER

Since September 2003, the New York State Attorney General, the SEC and the NASD have taken steps to address market timing and related abuses. For the most part, however, these actions have been focused on mutual funds, investment advisers, and selling broker-dealers. One recently reported NASD enforcement action is noteworthy, not so much for the content of the allegations regarding market timing, but rather because the respondent was the principal underwriter — or mutual fund distributor. Specifically, on October 7, 2004, the NASD announced a censure and fine of Sentinel Financial Services Company in the amount of \$700,000 for failing to prevent market timing in three mutual funds offered by its affiliate, Sentinel Group Funds, Inc. The NASD stated that Sentinel failed to establish and maintain a reasonable supervisory system designed to detect and prevent market timing, in violation of the funds' stated policies and procedures. In connection with this action, mutual fund distributors were characterized as being uniquely situated to enforce mutual fund market timing policies.

Such statements in connection with the Sentinel settlement raise significant questions of supervisory responsibility for mutual fund distributors. The purpose of this article is to briefly describe the activities typically performed by mutual fund distributors, and the steps that such distributors should take given the currently evolving regulatory perception of their supervisory obligations.

## ARE ALL MUTUAL FUND DISTRIBUTORS IN A POSITION TO ENFORCE MUTUAL FUND MARKET TIMING POLICIES?

The NASD found that Sentinel's supervisory procedures and systems were not reasonably designed to ensure compliance with the Sentinel funds' policies relating to market timing and exchanges. Specifically, although Sentinel used various electronic tracking reports to detect instances of excessive trading, it was only able to do so after the trading had occurred. Further, the NASD indicated that Sentinel's written policies and procedures failed to provide a process of meaningful follow-up with respect to sending out notices to customers relating to excessive trading or a

mechanism for restricting excessive trading in related accounts.

Notwithstanding the allegations against Sentinel, it is important to evaluate the roles and responsibilities of the entities involved in the mutual funds distribution process. In turn, whether a mutual fund distributor should, as a regulatory matter, share the burden of enforcing a fund's market timing policies depends on the nature of the distributor's business activities. In this regard, most mutual fund distributors are not in a position to monitor for market timing or to enforce a fund's stated market timing policies.

Generally, the role of a mutual fund distributor is limited to acting as the principal underwriter of the mutual fund's shares, engaging in wholesaling of the funds to intermediaries that in turn offer the funds' shares to their customers, negotiating the terms and conditions of intermediary selling dealer agreements, and reviewing, and filing with the NASD's Advertising Department, as necessary, advertisements and sales material to be provided to the fund's shareholders or intermediaries. Although a mutual fund distributor must be a registered broker-dealer, it is most often the selling broker-dealer or other intermediary that has direct customer relationships, opens and maintains customer accounts, accepts customer funds or securities, and processes mutual fund transactions. As such, a mutual fund distributor, unless it performs certain sub-transfer agent functions, or opens brokerage accounts and provides retail brokerage services to customers, may not be in a position to have sufficient contact with a particular shareholder or information about a given shareholder's accounts, mutual fund holdings, and mutual fund trading activity to adequately enforce a fund's market timing policy. This is especially true with respect to mutual fund distributors that are not members of FundServ, but rather receive transaction information based upon a FundServ networking account level designation.

## DO MUTUAL FUND DISTRIBUTORS NEED MARKET TIMING POLICIES AND PROCEDURES?

As a general matter, NASD Rule 3010 requires that broker-dealers establish and implement a supervisory system and supervisory procedures

reasonably designed to achieve compliance with applicable securities laws and regulations and with NASD rules. While market timing in and of itself does not violate the securities laws or NASD rules, the NASD issued Special Notice to Members ("Special NTM") 03-50 to "remind" member broker-dealers of their responsibility to have and implement policies and procedures reasonably designed to "detect and prevent . . . collusion with mutual funds and their affiliated persons to circumvent the mutual funds stated procedures" intended to prevent or control market timing.

Although typically not involved in processing customer transactions, mutual fund distributors should consider implementing written policies and procedures that prohibit any interaction or negotiation with intermediaries that may be deemed as collusion to circumvent the funds' market timing policies. Because of the limited role played by most mutual fund distributors vis-à-vis selling dealers, such policies and procedures are not "one-size-fits-all." Accordingly, mutual fund distributors should review their own written supervisory and compliance procedures to determine whether their procedures are appropriately tailored to their limited role and responsibilities with respect to mutual fund transactions.

## WHAT SHOULD MUTUAL FUND DISTRIBUTORS DO IN RESPONSE TO THE SENTINEL CASE?

In addition to reviewing their policies and procedures as noted above, mutual fund distributors should make certain that they are familiar with the market timing policies of the mutual funds for which they act as principal underwriter and distributor. Further, all broker-dealers — both mutual fund distributors and selling dealers — should review their selling agreements with the intermediaries that will, in turn, offer and sell fund shares to their customers to make certain that each of the party's roles and responsibilities with respect to the mutual fund are clearly defined. ■

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# RECENT DEVELOPMENTS UNDER DELAWARE LAW

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In a short-form merger, each stockholder of record, pursuant to Section 262 of the DGCL, receives an initial notice about the merger and information about the stockholder's appraisal rights either before the merger's effective date or within 10 days thereafter. After the controlling stockholder mails the appraisal notice, a dissatisfied stockholder that has not tendered its shares has 20 days to demand appraisal in writing from the continuing corporation. The demand must "reasonably inform the corporation of the identity of the stockholder and that the stockholder intends thereby to demand the appraisal."<sup>3</sup>

In *Glassman v. Unocal Exploration Corp.*,<sup>4</sup> the Delaware Supreme Court held that a Section 253 short-form merger, like a tender offer, is not subject to the entire fairness standard. Although the court recognized that "a parent corporation and its directors undertaking a short-form merger are self-dealing fiduciaries who should be required to show entire fairness," the court was persuaded by the legislative intent of Section 253. The court reasoned that because Section 253 was established for a purpose inconsistent with fair dealing, and was a "simple, fast, and inexpensive" way to accomplish a merger, an entire fairness review would be contrary to its intent.

In *In re Pure Resources, Inc.*,<sup>5</sup> the Delaware Chancery Court specified criteria for determining whether a tender offer is coercive. Vice Chancellor Strine stated that a tender offer by a controlling stockholder is non-coercive only when (1) it is subject to a non-waivable "majority of the minority" tender condition (not including affiliates of the target); (2) the controlling stockholder promises to promptly complete a short-form merger at the same price if it obtains more than 90% of the shares; and (3) the controlling stockholder makes no retributive threats. Combining a unilateral tender offer with a subsequent short-form merger results in a transaction that is not subject to the entire fairness standard.

*Next Level Communications, Inc. v. Motorola, Inc.*,<sup>6</sup> further addressed aspects of an effective tender offer/short-form merger. Here, the Delaware Chancery Court ruled that Motorola's squeeze-out merger was not coercive under the standards set forth in *Pure Resources*. The court found it significant that Next Level's board of directors formed an independent committee that responded to the tender offer free of Motorola's influence and was responsible for

preparing the Schedule 14D-9. The independent committee also retained legal and financial advisers and took an active role in responding to the tender offer.

## GILLILAND V. MOTOROLA, INC.

A recent ruling by the Delaware Chancery Court added a new twist to the existing framework for a tender offer/short-form merger. In *Gilliland v. Motorola, Inc.*,<sup>7</sup> a former stockholder of Next Level Communications, Inc. filed suit alleging breaches of fiduciary duty and statutory violations by Next Level and its parent, Motorola, Inc. The case, as did *Next Level Communications, Inc. v. Motorola, Inc.*, arose from Motorola's cash-out of the public minority of its subsidiary, Next Level. The principal issue in *Motorola* was whether the notice of short-form merger issued immediately after the completion of the tender offer can satisfy the parent company's fiduciary duty of disclosure when the notice contains merely the statutorily mandated information about the mechanics of perfecting a demand for appraisal and no other information relating to the value of the subsidiary or its securities.

Motorola launched a first-step tender offer for the minority-held common shares of Next Level. The Schedule TO and Offer to Purchase sent to Next Level's stockholders contained Motorola's analysis and projections for Next Level, a discussion of Next Level's products and industry, a detailed summary report prepared by JP Morgan for Motorola's management, and summary financial statements as required by the Securities and Exchange Commission. The independent committee of Next Level's board of directors concluded that the offer was inadequate and not in the best interests of the stockholders. Accordingly, the independent committee recommended against the offer and sent stockholders more optimistic projections. Motorola raised its offer and amended its Offer to Purchase to include supplemental disclosure. After receiving enough tenders to increase its ownership above the 90% threshold, Motorola acquired the remaining interests in Next Level by a Section 253 short-form merger.

Following the tender offer, in accordance with Section 262(d)(2) of the DGCL, Motorola sent the stockholders of record a notice of merger and appraisal rights. As required by Section 262, the notice informed the recipients of the approval and effective date of the merger and the right of stockholders that had

not tendered their shares to seek appraisal; the notice also included a complete copy of Section 262. The notice did not, however, disclose any other information about Next Level or refer to the tender offer documents.

Vice Chancellor Lamb noted that in a short-form merger, "the parent corporation bears the burden of showing complete disclosure of all material facts relevant to a minority shareholder's decision whether to accept the short-form merger consideration or seek an appraisal."<sup>8</sup> The controlling stockholder's duty is two-fold: (1) a statutory duty to apprise the stockholders of their appraisal remedy and the effective date of the merger, and to provide a copy of Section 262; and (2) a common-law fiduciary duty of providing substantive financial information relating to the value of the company. The court noted that the controlling stockholder need not provide all the information necessary for the stockholder to reach an independent determination of fair value. Only that information material to the decision of whether or not to seek appraisal must be provided.

In finding the notice to be insufficient, and therefore a breach of fiduciary duty, Vice Chancellor Lamb distinguished *Zirn v. VLI*.<sup>9</sup> In *Zirn*, the Delaware Supreme Court had found that limited disclosure in an appraisal notice was sufficient where substantial disclosure was provided in connection with a first-step tender offer, the terms of the tender offer were reached through arm's-length negotiations, and the appraisal notice included summary financial information and a description of how to obtain more complete SEC filings.

Vice Chancellor Lamb noted that, as in *Zirn*, substantial disclosure was made in connection with Motorola's first-step tender offer, and the participation and resistance of Next Level resulted in an amount of disclosure comparable to that in an arm's-length-negotiated acquisition. Nonetheless, he found the disclosure inadequate because it failed to (1) refer to available public filings with instructions for obtaining them and (2) include the type of summary financial information included in the *Zirn* notice (i.e., two years of stock price information and summary financial data). The court further noted that *Zirn* turned on the textured resolution of "the tension between the summary nature of the Section 253 procedure and the supplementary duties provided by common law"; however, it was unwilling to

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<sup>3</sup> DEL. CODE ANN. tit. 8, § 262. <sup>4</sup> 777 A.2d 242 (Del. 2001). <sup>5</sup> 808 A.2d 421,443 (Del. Ch. 2002). <sup>6</sup> 2003 WL 549083 (Del. Ch. Feb. 26, 2003) <sup>7</sup> 859 A.2d 80 (Del. Ch. 2004) <sup>8</sup> *Id.* at 86 (citing *Shell Petroleum, Inc. v. Smith*, 606 A.2d 112, 114 (Del. 1992)). <sup>9</sup> 681 A.2d 1050 (Del. 1996).

# SECURITIES OFFERING REFORM

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- allowing seasoned issuers with \$75 million in public float to identify selling shareholders in a prospectus supplement instead of through a post-effective amendment.

The Commission is also proposing to establish a more flexible “automatic shelf registration” process that may be used by well-known seasoned issuers, with the intention of providing such issuers ready access to the capital markets. Under the proposed automatic shelf registration process, well-known seasoned issuers, could among other things:

- register an unspecified number of different specified types of securities (without allocating between primary and secondary offerings) on a Form S-3 or F-3;
- add securities of additional classes to an already effective registration statement;
- exclude certain information (such as the plan of distribution) from the base prospectus and include such information in a prospectus supplement; and
- use “pay as you go” registration fees, which could be paid in advance or upon each takedown.

Under the proposed automatic shelf registration process, shelf registration statements by well-known seasoned issuers would become effective automatically, without staff review, and the staff would continue to focus on reviewing the Exchange Act reports of these issuers.

## EXPANDED ABILITY TO INCORPORATE BY REFERENCE; ELIMINATION OF FORMS S-2 AND F-2

The proposals allow reporting issuers to incorporate by reference previously filed Exchange Act reports into a Securities Act registration statement on Form S-1 or F-1, subject to certain conditions. As now proposed, incorporation by reference of subsequently filed Exchange Act reports would not be allowed for Forms S-1 and F-1; it would continue to be allowed for Form S-3 and F-3 filers. Forms S-2 and F-2 would be eliminated entirely.

## PROSPECTUS DELIVERY REFORMS

The Commission’s proposals include changes to prospectus delivery requirements, focusing on “access equals delivery,” which assumes that

investors have Internet access. Issuers and their intermediaries will be able to satisfy delivery requirements without delivery of a final prospectus if the final prospectus is timely filed with the Commission.

The Commission is also proposing that for each transaction involving a sale by an issuer or underwriter to a purchaser or a sale in which final prospectus delivery requirements apply, each underwriter, broker or dealer participating in a registered offering, or the issuer if the sale is effected by the issuer, may send a notice to each purchaser not later than two business days after the completion of the sale in lieu of the final prospectus, stating that the sale was made pursuant to a registration statement or a final prospectus. An investor could request a final prospectus, but it would not have to be provided before settlement.

## RESEARCH REPORTS

Rules 137, 138 and 139 under the Securities Act currently permit a broker or dealer, under certain circumstances, to publish research which constitutes an offer around the time of a registered offering without violating Section 5. The proposals expand slightly the safe harbors available to broker-dealers for research reports under those rules.

The proposals provide a definition of “research report.” Also, the circumstances where offering and non-offering participants may disseminate reports during an offering have been expanded.

A broker or dealer that is not participating in a registered offering would not be considered to be engaged in a distribution, and thus would not be considered an underwriter under Rule 137. The proposals seek to expand the rule to apply to securities of any issuer, including non-reporting ones.

Rule 138 allows a broker or dealer that participates in the distribution of one type of a specific issuer’s securities to publish or distribute research on a different type of securities. The proposals seek to expand the categories of eligible issuers. The proposed amendment to Rule 138 would cover research reports on all reporting issuers, rather than be limited to Form S-2- or F-2-eligible issuers, as the rule stands currently.

Rule 139 allows a broker or dealer participating in a distribution of securities of a seasoned issuer to publish research regarding the issuer of any class of securities if such research is distributed with “reasonable regularity in the normal course of business.” Under the proposals, reports could only be published for issuers that are timely in their periodic reports, with a minimum of one year of reporting history and S-3 or F-3 eligibility, so long as the broker or dealer had previously published a report for that issuer.

The proposals also seek to remove the prohibition on a broker giving a more favorable recommendation than the one it made in a prior industry-related report. Under the proposals, however, the reports must contain information similar to the type contained in prior reports.

In addition, the proposals provide that research reports under Rules 138 and 139 would not be considered general solicitations or offers in connection with Rule 144A offerings.

The proposals codify the SEC’s current position that publication or dissemination of research under Rules 138 and 139 is permitted in connection with registered offerings that are subject to the Exchange Act proxy rules.

## EXCHANGE ACT REPORT DISCLOSURE

The Commission is also proposing changes with respect to Exchange Act reports. In particular, risk factor disclosure would now be required in Form 10-Ks, and voluntary filers would have to disclose that they are voluntary filers in their Exchange Act reports. Additionally, in what is probably the most controversial change to the Exchange Act report arena, an accelerated filer, including a well-known seasoned issuer, would be required to disclose written staff comments received more than 180 days before the issuer’s fiscal year-end if the issuer believes the comments are material, the comments are unresolved at the time of filing of the Form 10-K or Form 20-F and the issuer believes that the comments may not be resolved for a lengthy period of time. ■

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# HEDGE FUND UPDATE

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making the initial investment in the private fund, the offshore adviser may continue to count the investor as a non-U.S. client even if the investor later relocates to the United States. Alternatively, if a non-U.S. investor transfers his interest to a U.S. investor, the offshore adviser should count the transferee as a U.S. client. For purposes of determining whether an investor is a U.S. client or a non-U.S. client, the SEC has stated that it would not object if offshore advisers, in determining the residence of an investor, looked (i) in the case of individuals, to their residence, (ii) in the case of corporations and other business entities, to their principal office and place of business, (iii) in the case of personal trusts and estates, to the rules set out in Regulation S of the Securities Act, and (iv) in the case of discretionary or non-discretionary accounts managed by another investment adviser, to the location of the person for whose benefit the account is held.

## REGISTRATION WITH THE SEC: ASSETS UNDER MANAGEMENT

Under the Act, an adviser with more than 14 clients whose principal office and place of business are in the United States cannot (subject to certain exemptions) register with the SEC unless it manages at least \$25 million. If an adviser manages less than \$25 million, the adviser must comply with the investment adviser statutes of the state where its principal office and place of business are located. Offshore advisers, however, with more than 14 clients who are resident in the United States must register with the SEC, regardless of the amount of assets they have under management. In determining the amount of assets it has under management, an adviser must include the total value of its securities portfolios (including leverage). An adviser, however, may exclude proprietary assets invested in the fund, which include investments of certain insiders and their families.

## OFFSHORE ADVISERS TO OFFSHORE PRIVATELY OFFERED FUNDS

The New Rules provide that offshore advisers to offshore private funds may treat the funds as single non-U.S. clients for most purposes under the Act even though the funds have U.S. investors. Because the SEC generally does not

apply most of the substantive provisions of the Act to non-U.S. clients of offshore advisers, the substantive provisions of the Act generally would not apply to an offshore adviser's dealings with an offshore fund. This means that the requirements set forth in the Act's compliance rule, custody rule, and proxy voting rule will generally not be applicable to offshore advisers of offshore private funds. Offshore advisers required to register under the Act, however, will remain subject to the Act's antifraud provisions, will need to keep certain books and records as mandated by the SEC rules and will be subject to examinations by the SEC staff. The SEC is not prohibiting offshore advisers from representing themselves as SEC-registered advisers, despite not having to comply with many provisions of the Act, although substantial clarification and disclosure may be necessary to make such a representation not misleading.

## RECORDKEEPING

Rule 204-2 of the Act requires advisers to maintain certain books and records. For example, copies of performance records necessary to form the basis of any performance advertisements must be kept for a period of five years after the performance information is last used. Because newly registered advisers may be placed at a competitive disadvantage as a result of not being able to use certain performance data, the SEC has adopted an amendment to Rule 204-2 to permit newly registered advisers to market their performance data from periods prior to their registration with the SEC, even if they have not kept documentation that the SEC rules would otherwise require. Advisers are, however, required to retain whatever records they do have that support the performance history prior to their registration with the SEC. Once an adviser has registered with the SEC, it will have to comply with the recordkeeping rule going forward.

Further, the SEC recognizes that it is common for advisers to establish special purpose vehicles for operating certain private funds. In order to determine whether an adviser is meeting its fiduciary obligations with respect to those private funds for which it has created a special purpose vehicle, the SEC has also amended the recordkeeping rule to clarify that,

for purposes of Section 204 of the Act, "the books and records of a registered adviser include records of the private funds for which the adviser acts as investment adviser and the adviser or a related person acts as general partner, managing member, or in a similar capacity."

## PERFORMANCE FEES

The Act imposes restrictions on an adviser's ability to charge performance fees to its clients. In general, an adviser is permitted to charge a performance fee to clients that are deemed to be "qualified clients," meaning investors that have at least \$750,000 under management with the adviser or have a minimum net worth of \$1,500,000. In order not to disrupt existing compensation arrangements between an adviser and its clients, the SEC has added grandfathering provisions to Rule 205-3. Accordingly, existing owners of any private fund exempted pursuant to Section 3(c)(1) of the Investment Company Act may "retain their investment in a private fund and add to it." In addition, the amendment to Rule 205-3 "permit[s] newly-registered advisers to continue in effect advisory contracts they may have with other clients that are not Section 3(c)(1) funds." The New Rules, however, effectively raise the eligibility standards of new investors in private funds.

## CUSTODY

An adviser that has custody or possession of any client funds or securities (including the ability to deduct fees from an account) must comply with certain asset "safekeeping" requirements in Rule 206(4)-2 of the Act. Under Rule 206(4)-2, an adviser to a private fund generally must engage a qualified custodian to hold fund assets and provide audited annual financial statements of the private fund to investors within 120 days of the end of the fund's fiscal year. Rule 206(4)-2 has been amended to allow additional time for completion of audit work by extending the 120-day time period to 180 days.

## FORM ADV

The SEC registration form for advisers, Form ADV, is composed of two parts: Part I and Part II. Currently, Part I of Form ADV is filed electronically through the Investment Adviser Registration Depository and is publicly available over the Internet. Part II of Form ADV, which is

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## HEDGE FUND UPDATE

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given to prospective clients, is completed on paper and is not filed with the SEC (although the SEC has proposed to require it to be filed electronically). Form ADV requires disclosure of, among other things, (1) the ownership of the adviser; (2) the disciplinary histories of the adviser, certain affiliates of the adviser, and the adviser's officers, directors and employees; and (3) the adviser's management and trading practices, including any conflicts of interest. Form ADV has been amended under the New Rules to require that advisers to private funds identify themselves. There has been some concern that the identification of private funds in Form ADV may raise

general solicitation questions under the Securities Act. The SEC, however, has stated that the mere identification of a private fund in Form ADV will not render Section 4(2) of the Securities Act or Rule 506 thereunder unavailable.

### OTHER AMENDMENTS

Rule 203(b)(3)-1 of the Act provides for certain types of entities and persons to be deemed single clients for purposes of the Act. Rule 203(b)(3)-1 has now been amended to clarify that advisers may not count private funds as single clients. Both Rules 222-2 and 203A-3 have also been

amended to clarify that advisers and supervised persons may, for purposes of those rules, count clients as provided in Rule 203(b)(3)-1 without regard to the look-through requirements in Rule 203(b)(3)-2. ■

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## SEC ADMINISTRATIVE PROCEEDINGS IN FY 2004

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the new rules in 16; four of those review proceedings were decided in less than the standard seven months, eight were decided within seven months, three took eight months, and one took 11 months.

### THE MERITS: STATISTICAL RECAP OF INITIAL DECISIONS BY THE ALJs

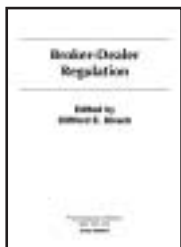
In FY 2004, the SEC released 22 IDs that represented first-time adjudications of enforcement cases; 14 were original APs (in which the ALJ was called upon to decide liability as well as sanction), and eight decided follow-on proceedings. In contrast to FY 2003, in which none of the IDs dismissed the Division of Enforcement's case, the ALJs dismissed three cases in FY 2004, closer to the average for FY 1996-2003, but still less than in FY 2000-2002, each of which saw five dismissals. As in every one of the past nine years, all of the dismissals were ordered in original APs, and none in the follow-on APs. The Division's historical failure rate in original proceedings (defined as the number of ALJ dismissals divided by the number of original proceedings decided) now stands at 24% for FY 1996-2004. The judge-by-judge dismissal data over those nine years continues to vary widely, as follows:

ALJ	Dismissal Rate in Original APs
Chief Judge Brenda P. Murray	8 percent (2/25)
Judge James T. Kelly	13 percent (2/16)
Judge Robert G. Mahony	25 percent (5/20)
Judge Carol Fox Foelak	32 percent (7/22)
Judge Lillian P. McEwen	50 percent (11/22)

The "survival rate" for ALJ dismissals within the Commission — which dropped to 52% last year — has bounced back to 59% because the Division determined not to petition for review in two of the three FY 2004 dismissals, and the Commission decided to let ALJ dismissals stand in two proceedings while setting aside only one ALJ dismissal during FY 2004. The "survival rate" for ALJ dismissals issued over the past nine fiscal years is computed as follows:

$$(5 \text{ (Dismissals Affirmed by SEC) plus } 11 \text{ (Dismissals Where No Review Was Sought)}) \text{ divided by } (29 \text{ (Total Dismissals) minus } 2 \text{ (Dismissals Where Petition for Review Was Still Pending)}) = 59\%$$

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## NY PARTNER CONTRIBUTES TO PRACTISING LAW INSTITUTE BOOK

Last year, Ben Indek was asked to contribute a chapter to a new Practising Law Institute book titled *Broker-Dealer Regulation*. The book was published in February and includes his chapter on the "Establishment and Maintenance of a Supervisory Structure."

## RECENT DEVELOPMENTS UNDER DELAWARE LAW

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conclude that the impetus to streamline the short-form procedure can ever justify a complete absence of financial disclosure in a notice of merger issues pursuant to Section 262 of the DGCL.

### IMPACT OF THE *MOTOROLA* DECISION

The *Motorola* decision will impose few additional burdens in connection with tender offers followed by short-form mergers for public companies, which will typically have the financial information required by *Motorola* readily available. The *Motorola* court even noted that if the required information is "publicly available, it will always be a simple exercise to identify the relevant disclosure documents and either include them in the notice, or extract and disclose summary information from them, and advise stockholder[s] how to obtain more complete information."<sup>10</sup> What impact, however, will the *Motorola* decision have on a two-step tender offer/short-form merger for a non-public Delaware company? Non-public or private companies may not have readily available current financial information of the kind required in *Motorola*, and obtaining such information may be costly and time-consuming, potentially delaying the squeeze-out of the minority stockholders.

The *Motorola* decision did acknowledge that "voluminous disclosure is not always required" to accompany the short-form notice of merger and that the information to be provided is "highly contextual."<sup>11</sup> The court was also aware of the obvious conflict between protecting minority stockholders by requiring full disclosure and the fact that Section 253 is a summary procedure established as a simple way to perform a squeeze-out merger. The court stated that

this tension is resolved through an analysis of the specific facts of the case. If the potential for deception or misinformation is present (e.g., in cases involving corporate self-tenders and cash-out mergers that are not contested), greater disclosure may be required. While this narrative is instructive for public companies, it creates uncertainty for non-public companies. As a result of this seemingly inconsistent approach, it is likely that Delaware courts will revisit this issue in the future. In the meantime, a controlling stockholder of a public or non-public Delaware corporation that wishes to comply with the rulings discussed in this article should do the following:

- Conduct a unilateral tender or exchange offer subject to a non-waivable "majority of the minority" tender condition, specifically excluding all affiliates of the controlling stockholder.
- Promise to promptly complete a short-form merger at the same price if it obtains more than 90% of the shares.
- Make no retributive threats.
- Make full disclosure, including a fair summary of the substantive work performed by the investment bankers retained to advise the independent board committee, the key assumptions that they used in forming their conclusions, and the range of values that were generated.
- If the target is a public company, include at least two years of stock price information, summary financial data and a description of how to obtain more complete SEC filings. ■

## CALENDAR OF *Events*

### march 2005

**29** NRS CCP Compliance Training  
Topic: Federal, State and SRO Securities Regulation: The Cornerstone of Compliance  
John W. McGuire  
New York, NY

**Money Market Institute**  
Topic: Wrap Trading  
Monica L. Parry  
Philadelphia, PA

**31** 5th Annual World Series of ETFs/  
Information Management Network  
Topic: Viewpoint on Current and Future Policy—Implications and Opportunities for ETFs  
John W. McGuire  
Key Biscayne, FL

### april 2005

**2-6** SIA Compliance & Legal Division 2005 Annual Seminar  
Topic: Investment Advisors II Workshop  
Steven W. Stone  
Topic: Litigating with SROs  
Ben A. Indek  
Palm Desert, CA

**20** National Regulatory Services 20th Annual Spring Compliance Conference  
Topic: Best Practices for Dealing with Email Retention, Maintenance & Review  
Steven W. Stone  
Scottsdale, AZ

**28** ALI/ABA Securities Litigation Conference  
Topics: SEC Enforcement Developments 2005 & SEC Administrative Trials; State Securities Investigations  
Christian J. Mixer  
Washington, DC

### may 2005

**2** NSCP East Coast Regional Meeting  
Topic: BD Regulatory Audits  
Ben A. Indek  
New York, NY

**17** Financial Research Associates 3rd Annual Investment Adviser Compliance Forum  
Topic: Best Execution, Brokerage Practices & Changes to Soft Dollar Requirements  
Steven W. Stone  
New York, NY

<sup>10</sup> 859 A.2d at 88. <sup>11</sup> *Id.*

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