Katten Muchin Rosenman LLP

Corporate and Financial Weekly Digest

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SEC/Corporate

Majority Vote for Directors - Recent Developments

On January 17, the American Bar Association's Corporate Laws Committee issued a preliminary report in which it stated that it will not recommend changing the Model Business Corporation Act default rule providing for the election of directors by plurality vote, because of potential "failed election" consequences and other concerns. Instead, the Corporate Laws Committee asked for additional comment on a majority voting bylaw standard that can be unilaterally adopted by the board or the shareholders and would retain a modified plurality rule under which a director would be elected by plurality vote but would not be seated for more than a 90-day transitional period if he or she receives more votes withheld than for his or her election. The remaining directors would then be empowered to fill the vacancy with any qualified individual. The full text of the preliminary report of the American Bar Association's Corporate Laws Committee is available at:
http://www.abanet.org/buslaw/committees/CL270000pub/directorvoting/20060117000000.pdf

Shareholder activists continue to campaign for majority voting for directors and a number of companies and organizations have responded recently. Most notably:

- a number of companies, including Pfizer, have adopted modified plurality policies which require a director to tender his or her resignation if such director does not receive a majority vote;
- other companies, including Intel, have adopted both a majority vote standard and a director resignation policy;
- the Securities and Exchange Commission has refused no-action requests by Hewlett Packard and by Gannett & Co. to exclude majority vote proposals from their 2006 proxy materials on the grounds that they had "substantially implemented" majority voting through adoption of a director resignation policy; and
- Institutional Shareholder Services (ISS) has stated that it strongly supports full-fledged majority voting as a general principle.

Absent changes in state law, which appear unlikely unless the American Bar Association Corporate Laws Committee changes its position, the campaign for majority voting for directors is likely to be waged on a company by company basis over the next few years.

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Banking

FinCEN and Federal Banking Agencies Issue Guidance on Suspicious Activity Reports

On January 20, the Financial Crimes Enforcement Network (FinCEN) and the federal banking agencies – the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision – issued guidance to notify institutions when a Suspicious Activity Report (SAR) may be shared with a holding company or other controlling company, or with the head office of a U.S. branch or agency of a foreign bank.

Highlights:

- FinCEN and the federal banking agencies are providing guidance to confirm that sharing a SAR with a controlling company in accordance with specified procedures is acceptable.
- A controlling company includes a bank or savings association holding company, or a company having the power directly or indirectly to direct the management or policies of an industrial loan company or a parent company, or to vote 25 percent or more of any class of voting shares of an industrial loan company or a parent company.
- Sharing a SAR within an organization is allowable for the head office, or for the controlling entity or party to discharge its oversight responsibilities with respect to enterprise-wide risk management and compliance with applicable laws and regulations.
- A bank or savings association (depository institution) may disclose a SAR to its controlling company or companies, whether domestic or foreign; and a U.S. branch or agency of a foreign bank may disclose a SAR to its head office outside the United States.
- Depository institutions, as part of their anti-money laundering program, must have written confidentiality agreements or arrangements, and proper internal controls in place to protect the confidentiality of the SAR.

http://www.fdic.gov/news/news/financial/2006/fil06005a.html

(See also a related report under *CFTC*, below)

Supreme Court Holds for National Banks in Closely Watched Venue Decision

National banks won a resounding victory from the U.S. Supreme Court on January 17 in an opinion entitled *Wachovia Bank v. Schmidt*. The case involved the question of whether national banks are "citizens," for purposes of diversity jurisdiction, in every state where they maintain a branch or only in the state in which it maintains its main office. In an 8-0 opinion, the Court rejected the argument that national banks are citizens of every state in which they maintain a branch for purposes of jurisdictional questions. (Justice Thomas did not participate in the decision.)

Typically, a corporation is deemed to be a citizen of both the state in which it is incorporated and the state in which they maintain their main office. National banks operate pursuant to a federal charter from the Office of the Comptroller of the Currency and thus have no "state" of incorporation. In this case, Wachovia Bank argued that it could not be sued in a South Carolina state court by a South Carolina resident who filed suit against Wachovia based on tax advice he had received after the sale of his company. Wachovia had the case moved to federal court on the basis of diversity jurisdiction. On appeal, the Fourth Circuit held in a 2-1 decision that national banks were citizens of every state in which they maintained branches. The Supreme Court reversed the Fourth Circuit's decision, holding that the word "located" and "established" in the national banking statutes were likely intended by Congress to have the same meanings, thereby making national banks citizens of only the states in which they maintained their main office. With respect to Wachovia, it was thus a citizen of North Carolina.

Had the Supreme Court upheld the Fourth Circuit decision, in states where national banks have a presence, such as a branch, the bank would not have been able to initiate lawsuits in federal court and would not have been able to remove cases from state to federal court.
http://scotus.ap.org/scotus/04-1186p.zo.pdf

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Broker Dealer

NASD Proposes and NYSE Announces Intent to Propose Rule on Entertainment

The National Association of Securities Dealers, Inc. issued Notice to Members 06-06 proposing a new rule, IM-3060, regarding business entertainment. The New York Stock Exchange, Inc. issued a January 23 press release stating that it will soon file with the Securities and Exchange Commission a similar rule proposal.

IM-3060 would supersede all previous interpretations of Rule 3060's entertainment limitations. The proposal contains three parts. The first part defines customer to include an entity or individual with an account or who may open an account with the member, and business entertainment to include any entertainment including, among others, entertainment at a business or educational conference and the travel and hotel costs of attending such a conference. Anything else of value given to a customer's employee comes within Rule 3060's limitations on gifts and gratuities. Entertainment does not include items, such as tickets to sporting events, etc., where the member firm's associated person does not accompany the customer or the employee of the customer. The second part would require member firms to adopt written policies and procedures covering the following: 1) determine and define permissible entertainment expenses; 2) preclude providing entertainment so lavish that an employee of a customer would feel obligated to direct business to the member without due regard to other transaction pricing considerations; 3) provide for effective supervision and compliance with these policies; 4) maintain detailed records of business entertainment expenses and make such records available to a requesting customer; 5) ensure that the persons fulfilling supervisory duties in this area are qualified and periodically monitor for compliance with the entertainment policies; 6) train and educate personnel regarding the firm's entertainment policies; and 7) prohibit the giving of anything of value that would violate applicable law or expose the member, the customer or recipient to civil liability to any governmental authority or agency. The third part requires the member firm to establish a supervisory system for these entertainment policies.
http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_015876.pdf

NASD Joins Other SROs in Proposing Rules Against Tape Shredding

The Securities and Exchange Commission has published for comment a rule proposal of the National Association of Securities Dealers to prohibit trade shredding. Proposed NASD Rule 3380 would mirror rules proposed by numerous other self-regulatory organizations. These rules would prohibit member firms from splitting an order into multiple smaller orders for execution for the primary purpose of maximizing the payments to the member firm, e.g., increasing the amount of revenue received by increasing the number of trades reported to a transaction reporting service such as the Consolidated Tape Association plan, the Consolidated Quote Plan and the Nasdaq UTP Plan.
http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/E6-663.pdf

NYSE Proposes Cross-margining for Index Options, Options and Securities Futures

The New York Stock Exchange has proposed to amend Rule 431(g) so as to permit a customer to cross margin its transactions in listed U.S. index options, security futures contracts and listed single stock options. In addition, if a member firm or an affiliate is a futures commission merchant that is a member of the related board of trade's clearing corporation, it may also cross margin related commodity futures contracts. IRA accounts are not eligible for this cross-margining. The member firm will have to establish a system for stress testing these various securities and commodity futures positions based on theoretical gains and losses at ranges of increases or losses from 6% to 8% for high capitalization market index options, 10% for low capitalization market index options, and 15% for listed security futures and single stock options. Customers eligible for cross margining are broker-dealers, members of a national futures exchange, and others with equity in their account of at least $5 million, but the $5 million minimum equity will be waived for accounts limited to listed security future contracts and listed single stock options.
http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/E6-668.pdf

SIA Favors a Single Industry SRO

In a January 25 press release the Securities Industry Association expressed a goal of separating regulation of broker-dealers from marketplace regulation. The SIA prefers a single self-regulatory organization (SRO) for the industry, supported by fees from the brokerage industry. The SIA expressed the view that a significant number, but not a majority, of the SRO's board members should be industry representatives, and that the SRO's budget should be subject to independent review and approval by the Securities and Exchange Commission after notice and comment.
http://www.sia.com/press/2006_press_releases/21845530.html

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Litigation

Expiration of Call Options Not a Purchase Under Section 16(b)

Allaire, alleging that the expiration without exercise of call options written by defendant constituted a purchase of Allaire stock and that the writing by defendant of a new set of calls constituted a sale of Allaire stock, sued for disgorgement of short swing profits on the ground that the two transactions properly could be matched under Section 16(b) of the Securities Exchange Act of 1934. The Second

Circuit, agreeing with the court below, held that Section 16(b) was inapplicable in the circumstances because, among other things, acceptance of Allaire's arguments would "contradict the statutory purpose of holding traders liable only for those transactions in which they can exploit their inside information for their own profit." In its view, Section 16(b) covers transactions where "the parties agree to the terms of sale, because that is the one in which the writer of the option can be deemed to be using his or her inside information to arrive at the option's terms on a favorable basis." (*Allaire Corp. v. Okumus*, No. 04-2149-CV, 2006 WL 20798 (2d Cir. Jan. 5, 2006))

Price Fixing Claim Sufficiently Detailed to Avoid Dismissal

In denying defendants' motion to dismiss a class action complaint alleging a price fixing conspiracy in violation of Section 1 of the Sherman Act against multiple manufacturers and sellers of Polyether Polyol, the Court held that allegations setting forth facts showing (1) the relevant products were manufactured by defendants; (2) that the product markets were conducive to price fixing; (3) that defendants' prices were "unexplainably interrelated" during the relevant time period; and (4) that defendants conspired in meetings to fix prices, were sufficient to state a claim. In doing so, it noted that "heightened pleading standards do not apply to antitrust claims." (*In re: Urethane Antitrust Litig*., No. 04-MD-1616-JWL, 2006 WL 133434 (D. Kan. Jan. 18, 2006))

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CFTC

Financial Crimes Enforcement Network Confirms that Securities Broker-Dealers, Futures Commission Merchants, and Commodities Introducing Brokers May Share Suspicious Activity Reports with Parent Entities

The Financial Crimes Enforcement Network (FinCEN), in consultation with staff of the Securities and Exchange Commission and the Commodity Futures Trading Commission, issued guidance on January 20 that confirms that a securities broker-dealer (BD), futures commission merchant (FCM), or introducing broker in commodities (IB) may share Suspicious Activity Reports (SARs) with its parent entities, both domestic and foreign, provided that the BD, FCM, or IB has as part of its anti-money laundering program written confidentiality agreements or arrangements in place specifying that the parent entity (or entities) must protect the confidentiality of the SAR through appropriate internal controls. In addressing this "critical issue," FinCEN determined that a BD, FCM, or IB may share a SAR with parent entities in order to discharge the parent entity's oversight responsibilities with respect to enterprise-wide risk management and compliance with applicable laws and regulations.

FinCEN also indicated in its guidance that it is considering whether a BD, FCM, or IB may share a SAR with domestic and foreign affiliates other than its parent entities and will issue guidance on this issue "shortly." FinCEN stated that, pending such further guidance, BDs, FCMs, and IBs should not share SARs with non-parent entities.
http://www.federalreserve.gov/boarddocs/srletters/2006/SR0601.htm

(See also a related report under *Banking*, above)

FIA and NFA Respond to CFTC's Request for Comments Regarding Self-Regulation

The Futures Industry Association and National Futures Association responded on January 23 to the Commodity Futures Trading Commission's recent request for comments regarding self-regulation and self-regulatory organizations (SROs), sharing similar views on the future of SRO boards of directors and disciplinary committees, and the transparency of the SRO process. Both FIA and NFA noted that SRO boards of directors and disciplinary committees must be diverse – comprised of both SRO members, or "market participants," and individuals without commercial ties to the SRO – so that they are not dominated by any one constituency. The FIA and NFA also stated that SRO boards of directors and SRO disciplinary committees should allow members and other market participants to have a voice in how they are regulated and disciplined. The FIA and NFA further argued that SROs must promote transparency. The FIA also suggested that the Commodity Exchange Act be amended to require prior CFTC approval of SRO rules and rule changes that would (a) change the terms and conditions of futures and options contracts that are already trading where the changes are expected to have a material and immediate impact on the traded price, or (b) materially affect the financial risks and obligations of participants in a derivatives clearing organization. Finally, the FIA and NFA noted that regulatory oversight committees may be useful in certain circumstances, such as where conflicts of interest may arise between an SRO's regulatory and market functions.
http://www.futuresindustry.org/downloads/regulatory/FIA_SROCommentLetter0106.pdf
http://www.nfa.futures.org/news/newsComment.asp?ArticleID=1523

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