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Corporate and Financial Weekly Digest

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SEC/Corporate

SEC Launches New Initiative to Alert Investors About Potentially Fraudulent Investment Solicitations

On April 15, the Securities and Exchange Commission announced the launch of Public Alert: Unregistered Soliciting Entities or "PAUSE," its latest effort at targeting online boiler rooms, cold calls, and other potentially fraudulent financial solicitations circulating to unsuspecting investors. Such solicitations often use false claims of SEC registration, false U.S. addresses, endorsements from make-believe government agencies or international organizations, or false claims of affiliations with established brokerage firms to make their investment opportunities appear more credible. PAUSE will provide investors, in real time, with factual information that the SEC has received from investor complaints and other sources, including foreign regulators, about questionable e-mail or phone solicitations involving stock or securities sales. The SEC's PAUSE web pages initially list 56 unregistered soliciting entities and fictitious governmental agencies and international organizations that investors should avoid. The lists will be updated regularly based on information received by SEC staff.

For each soliciting entity on the PAUSE web pages, the SEC's staff has determined either that there is no U.S.-registered securities firm with that name, or that there is a U.S.-registered securities firm with the same or similar name but that solicitations appear to have been made by people not affiliated with that firm. The PAUSE web pages also include links to information bulletins from the SEC's Office of Investor Education and Advocacy describing common tactics of boiler-room solicitors, such as falsely offering to purchase low-value shares at above-market prices upon payment of specious "advance fees."

http://www.sec.gov/news/press/2008/2008-60.htm

California Franchise Tax Board Requests Additional Information for Refund Claims by Foreign Limited Liability Companies Having No Income from California

On April 14, the California Franchise Tax Board (FTB) issued Notice 2008-2 to inform limited liability companies that filed protective claims for refunds in connection with the court ruling in *Energetic Services, LLC v. Franchise Tax* (*Northwest*) that additional information is required to determine if their circumstances mirror those in *Northwest* so that their claims for refunds may be processed. The FTB issued Notice 2008-2 after deciding not to appeal the California state appellate court decision in *Northwest*.

In *Northwest* the Court of Appeal held that the fee imposed on foreign LLCs pursuant to former California Revenue and Taxation Code Section 17942 was unconstitutional as applied to *Northwest* because the fee was in fact a tax and was calculated based on the LLC's total income without any apportionment to

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For more information, contact:

Robert L. Kohl
212.940.6380
robert.kohl@kattenlaw.com

Mark A. Conley
310.788.4690
mark.conley@kattenlaw.com

Perri L. Melnick
310.788.4732
perri.melnick@kattenlaw.com

Palash I. Pandya
212.940.6451
palash.pandya@kattenlaw.com

reflect the LLC's activities conducted in California. The *Northwest* decision only addressed circumstances where a foreign taxpayer had no income from activities in California. The Court of Appeals held that assessing the LLC fee on an entity that had no income attributable to activities in California was unconstitutional and the fee should be refunded. The *Northwest* case did not address circumstances in which a foreign LLC earns income from activities only in California or from activities both inside and outside of California. (Two other pending court cases will address those situations.)

Although the FTB has allowed all foreign LLCs to file protective claims for refunds while the *Northwest* case and two other court challenges to the LLC fee have been pending, only foreign LLCs with facts similar to those in *Northwest* are currently eligible for a refund under the Notice. The FTB reportedly expects that less than 2 percent of the 162,000 foreign LLCs registered in California will be eligible for the refund because they have no income attributable to activities in California. The amount of fees paid by LLCs varies, depending on total income, but generally is between $800 and $11,790 per year.

The FTB stated that many of the protective claims it received did not contain enough information to determine if the taxpayers are currently eligible for a refund under the facts in *Northwest*. Foreign LLCs that had no California income must provide the following additional information in order to have their claims processed and refunds issued:

- the LLC's name and address, including the name and phone number of the managing member or designated contact person;
- the LLC's Secretary of State file number or FTB temporary LLC number (for unregistered entities) and Federal Employer Identification Number;
- taxable year(s) involved; and
- a statement that the LLC did no business in California for each of the taxable years for which the claim is filed.

If the additional information is not provided, the FTB will hold any potential refunds until the other two pending court cases have been decided.

http://ftb.ca.gov/law/notices/2008/2008_2.pdf

Litigation

Court Refuses to Lift PSLRA Discovery Stay

Plaintiffs brought a shareholder derivative action, claiming the officers and directors of Asyst Technologies, Inc. (Asyst) violated federal and state securities law by backdating stock options and making false filings with the Securities and Exchange Commission. Following defendants' motion to dismiss the complaint, plaintiffs moved for an order lifting the discovery stay imposed by the Private Securities Litigation Reform Act (PSLRA).

Under the PSLRA, discovery is automatically stayed "during the pendency of any motion to dismiss." However, the statute allows the stay to be lifted if the Court finds that discovery is necessary to "preserve evidence" or to "prevent undue prejudice." Plaintiffs argued that they required relief from the stay because they would otherwise face undue prejudice because "other agencies such as the Securities and Exchange Commission and the Department of Justice have investigated Asyst's backdating conduct 'while plaintiffs have been left with nothing other than the publicly available information.'" Plaintiffs claimed that it was unfair for them to be "left behind" while government agencies proceeded with their investigations.

LITIGATION

For more information, contact:

Alan R. Friedman
212.940.8516
alan.friedman@kattenlaw.com

Brian L. Muldrew
212.940.6581
brian.muldrew@kattenlaw.com

The Court rejected the argument, holding that the plaintiffs had not shown that they would suffer the type of undue prejudice required under the PSLRA. While the Court recognized that the stay resulted in plaintiffs not being on "equal footing with the other investigative agencies," it ruled that this alone did not constitute undue prejudice. In addition, the Court found that the cases plaintiffs cited, where the discovery stay had been lifted, were distinguishable. In those cases, unlike the present case, plaintiffs faced the potential dissolution or substantial depletion of the defendant company's assets. (*In re Asyst Technologies, Inc.*, 2008 WL 916883 (N.D. Cal. April 3, 2008))

Exemption to Short Swing Profit Liability Includes Directors by Deputization

Shareholders of Beacon Power Corporation (Beacon) brought a derivative action against, *inter alia*, investors who were "directors by deputization" and also held more than 10% of Beacon's stock, alleging that such investors realized short swing profits in violation of Section 16(b) of the Securities Exchange Act of 1934. The District Court dismissed the complaint, and the plaintiffs appealed.

Section 16(b) provides that officers, directors and holders of more than 10% of a company's securities are liable to the company for any profits realized from the purchase and sale (or sale and purchase) of the company's stock within a period of six months. Under Supreme Court precedent and Securities and Exchange Commission practice the scope of Section 16(b) liability has been extended to include "directors by deputization," *i.e.*, shareholders who exercise the power to appoint directors to the Board of the issuer. Here, the defendants were directors by deputization who (with their affiliated companies) held more than 10% of Beacon's stock.

SEC Rule 16b-3(d)(1) limits the scope of Section 16(b) by exempting from liability the securities transactions of officers or directors so long as the transactions are "approved" by the Board or by a Board committee composed solely of two or more non-employee directors. Although the Rule does not expressly exempt directors by deputization, the Court ruled that they were also covered by the exemption. The Court then turned to the plaintiffs' argument that Rule 16b-3(d)(1) was, nevertheless, inapplicable because nothing in its provisions exempted shareholders holding more than 10% of a company's stock from Section 16(b) even if they were otherwise covered by the Rule.

The Court, accepting arguments raised by the SEC in an *amicus* brief, held that the Rule 16b-3(d)(1) protection is available to a director by deputization who also owns more than 10% of the issuer's shares. The SEC reasoned that "the rationale underlying adoption of the Rule – *i.e.*, that the fiduciary constraints placed on officers and directors, coupled with the Board approval requirement, were sufficient to protect against the speculative abuse Section 16(b) was designed to prevent – was an equally effective safeguard even if the director was also a 10% shareholder." (*Roth v. Perseus, LLC et al.*, 2008 WL 961270 (2d Cir. April 10, 2008))

Broker Dealer

FINRA Grants Net Capital Relief Relative to ARS Loans

In an April 11 letter to the Securities and Exchange Commission, the Financial Industry Regulatory Authority (FINRA) announced it would grant relief from the requirement to charge net capital the amount of any non-purpose loans secured by auction rate securities (ARSs) for a limited period of time if the following seven conditions are met: (i) the pledged ARS is rated in the highest category by a nationally recognized statistical rating organization and not subject to credit review; (ii) the aggregate amount of credit extended on these loans does not exceed 25% of the broker's excess net capital; (iii) non-purpose credit extended to a single customer does not exceed 50% of the value of the pledged ARS; (iv) bank loans obtained to fund these loans are secured by these ARSs and have a maturity of no less than 6 months at the time credit is extended; (v) all such non-purpose loans will be treated as a scheduled capital withdrawal; (vi) the non-purpose loans extended and the bank funding should be treated as a debit and credit item in the 15c3-3a formula; and (vii) the broker-dealer must report monthly to FINRA the aggregate amount of these loans. FINRA expressed the view that this would bring greater liquidity to the ARS market.

http://www.finra.org/web/groups/rules_regs/documents/rules_regs/p038317.pdf

CBOE to List Binary Options on Indexes

The Chicago Board Options Exchange (CBOE) has filed a rule proposal with the Securities and Exchange Commission to list and trade binary options on broad based indexes. These would be indexes that have a market capitalization ratio of not less than 0.10 to the S&P 500 Index. The options would have a term to maturity of between one day and 36 months. A binary call option would pay a specified amount to the buyer if at expiration the index had a price equal to or in excess of the exercise price. A binary put option would pay the buyer a fixed amount if on the day the option expired the index settlement price was below the exercise price. In all other cases the buyer of the binary option would receive nothing. The Options Clearing Corporation has submitted to the SEC a proposed Supplement to the Options Disclosure Document to accommodate binary options on broad based indexes.

http://edocket.access.gpo.gov/2008/pdf/E8-8232.pdf

SEC Announces Next Steps for "Mutual Recognition"

In a March 24 press release, the Securities and Exchange Commission stated that it is contemplating taking the following actions as part of its program for mutual recognition for foreign broker-dealers and stock exchanges to gain access to U.S. institutional investors: (i) exploring agreements with foreign regulatory counterparts based upon a comparability assessment by the SEC and the foreign authority of each other's regulatory regime; (ii) adopting a formal process for engaging foreign regulators on the subject of mutual recognitions—either through rulemaking or other mechanisms; (iii) developing a framework for mutual recognition discussions with jurisdictions comprising multiple securities regulators, e.g. Canada and the European Union; and (iv) proposing reforms to Exchange Act Rule 15a-6 to improve the access of investors to foreign broker-dealers.

In a March 29 press release, SEC Chairman Christopher Cox and Australian Prime Minister Kevin Rudd announced that the SEC, the Australian Securities and Investment Commission and the Australian Treasury Department have begun formal negotiations for a mutual recognition system.

http://www.sec.gov/news/press/2008/2008-49.htm

http://www.sec.gov/news/press/2008/2008-52.htm

BROKER DEALER

For more information, contact:

James D. Van De Graaff
312.902.5227
james.vandegraaff@kattenlaw.com

Daren R. Domina
212.940.6517
daren.domina@kattenlaw.com

Patricia L. Levy
312.902.5322
patricia.levy@kattenlaw.com

Morris N. Simkin
212.940.8654
morris.simkin@kattenlaw.com

Janet M. Angstadt
312.902.5494
janet.angstadt@kattenlaw.com

Ross Pazzol
312.902.5554
ross.pazzol@kattenlaw.com

Lance A. Zinman
312.902.5212
lance.zinman@kattenlaw.com

Banking

OCC Amends Securities Offering Disclosure Rule for National Banks in Organization

Effective April 7, the Office of the Comptroller of the Currency (OCC) has amended its securities offering disclosure rules so that national banks in organization no longer need to include audited financial statements as part of a public offering of their securities. According to the OCC, this requirement has been eliminated because, "due to the very limited nature of the activities of a bank in the organizational phase, this requirement typically adds little information that is of benefit to potential investors or of significance in our review of an application for a national bank charter." Moreover, the OCC found that "obtaining audited financial statements can be time-consuming and costly for the organizing group without resulting in corresponding benefits."

Notably, in the final rule, the OCC retained the right to request audited financial statements in circumstances where doing so would be in the best interest of investors or would further the safe and sound operation of the national bank. The notice regarding this change was published on October 18, 2007.

http://www.gpoaccess.gov/fr/

EU Developments

OECD Supports Recommendations of Financial Stability Forum

On April 15, the Committee on Financial Markets of the Organization for Economic Co-operation and Development called for the development of a more modern and dynamic framework for financial sector regulation based on the recommendations of the Financial Stability Forum (FSF).

The FSF published a report titled *Enhancing Market and Institutional Resilience* on April 7 which set out its analysis of the causes and weaknesses that have produced the recent market volatility and liquidity crisis and included its recommendations for increasing the resilience of financial markets and institutions.

The FSF recommendations include: (i) strengthening prudential oversight of capital, liquidity and risk management; (ii) enhancing transparency and valuation; (iii) changing the role and uses of credit ratings; and (iv) implementing robust arrangements for dealing with stress in the financial system.

www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf

European Commission Consults on Amending the Capital Requirements Directive

The European Commission has launched a public consultation on possible changes to the Capital Requirements Directive. The Commission is seeking comments on proposals on the following matters:

- a harmonization of the definition of hybrid capital,
- capital requirements for default risk in the trading book,
- a definition of the significance of risk transfer,
- technical changes to the securitization framework, and
- a series of changes to ease the administrative burden.

Each of the above was among the matters highlighted in Commissioner

BANKING

For more information, contact:

Jeff Werthan
202.625.3569
jeff.werthan@kattenlaw.com

Christina J. Grigorian
202.625.3541
christina.grigorian@kattenlaw.com

Adam Bolter
202.625.3665
adam.bolter@kattenlaw.com

EU DEVELOPMENTS

For more information, contact:

Martin Cornish
44.20.7776.7622
martin.cornish@kattenlaw.co.uk

Sam Tyfield
44.20.7776.7640
sam.tyfield@kattenlaw.co.uk

Edward Black
44.20.7776.7624
edward.black@kattenlaw.co.uk

Sean Donovan-Smith
44.20.7776.7625
sean.donovan-smith@kattenlaw.co.uk

McCreevy's speech to the European Parliament's Committee on Economic and Monetary Affairs reported in the April 11, 2008 edition of *Corporate and Financial Weekly Digest*. The full consultation paper addresses the issues raised in more detail. Responses are requested by June 16.

ec.europa.eu/internal_market/bank/docs/regcapital/consultation_en.pdf

* Click here to access the *Corporate and Financial Weekly Digest* archive.

Katten

Katten Muchin Rosenman LLP

www.kattenlaw.com

Charlotte
401 S. Tryon Street
Suite 2600
Charlotte, NC 28202-1935
704.444.2000 tel
704.444.2050 fax

Chicago
525 W. Monroe Street
Chicago, IL 60661-3693
312.902.5200 tel
312.902.1061 fax

Irving
5215 N. O'Connor Boulevard
Suite 200
Irving, TX 75039-3732
972.868.9058 tel
972.868.9068 fax

London
1-3 Frederick's Place
Old Jewry
London EC2R 8AE
+44.20.7776.7620 tel
+44.20.7776.7621 fax

Los Angeles
2029 Century Park East
Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel
310.788.4471 fax

New York
575 Madison Avenue
New York, NY 10022-2585
212.940.8800 tel
212.940.8776 fax

Palo Alto
260 Sheridan Avenue
Suite 450
Palo Alto, CA 94306-2047
650.330.3652 tel
650.321.4746 fax

Washington, DC
1025 Thomas Jefferson Street, NW
East Lobby, Suite 700
Washington, DC 20007-5201
202.625.3500 tel
202.298.7570 fax

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