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Corporate and Financial Weekly Digest

April 20, 2007

SEC/Corporate

SEC Considers Arbitration Policy

On April 16, the Wall Street Journal reported that the Securities and Exchange Commission is currently exploring a new policy that would permit companies to resolve shareholder complaints through arbitration, presumably limiting class actions. The policy would allow companies to amend their bylaws to permit arbitration, a change which in many cases might require shareholder approval as well as amendment to current law. While the policy discussion is still in its early stages and may not result in any changes, the arbitration issue was raised by a blue-ribbon committee in November 2006 led by Harvard Law Professor Hal Scott and encouraged more recently by Treasury Secretary Henry Paulson. SEC Chairman Christopher Cox in an interview on April 13 stated cautiously "I don't believe arbitration is a panacea." The policy is a part of a series of initiatives discussed by the SEC designed to ease regulatory and legal burdens on U.S. companies. (*Wall Street Journal*, 4/16/07, p. A1)

Definition of "Covered Securities" under Rule 146(b) of the Securities Act is Amended

On April 18, the Securities and Exchange Commission issued a final rule adopting an amendment to Rule 146(b) under the Securities Act of 1933 to designate securities listed, or authorized for listing, on the Nasdaq Capital Market tier of The NASDAQ Stock Market LLC as covered securities under Section 18(b) of the Securities Act. Covered securities are exempt from state law registration requirements as provided in Section 18(a) of the Securities Act. The amendment to Rule 146(b) also includes adding securities "authorized for listing" on a market named in Rule 146(b).

http://www.sec.gov/rules/final/2007/33-8791.pdf

Broker Dealer

NYSE Rescinds Series 12 Examination

NYSE Regulation, Inc. announced that the Series 12 examination is being rescinded. The Series 12 examination qualifies a candidate as a Securities Manager and has generally been utilized by individuals employed by a broker/dealer whose business is limited solely to equity and non-municipal fixed income securities. The Series 12 examination is used as an alternative to the Series 9/10 - General Securities Sales Supervisor examination for qualification as a Branch Office Manager of a NYSE member firm pursuant to NYSE Rule 432. Persons may also qualify as a Branch Office Manager by passing NASD Series 24, General Securities Principal examination.

The Series 12 examination is being rescinded because its content is now covered by the Series 10 examination, which is the general securities portion

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of the Series 9/10 examination. Notably, there is an overlap in the topics covered by the two examinations: Sales Supervision; Account Supervision; Compliance, Recordkeeping and Financial Responsibility; and Regulations Affecting the Operation of Securities Markets. The primary difference between the Series 12 and the Series 10 is that the Series 12 does not cover municipal securities.

Candidates who request to take the Series 12 prior to April 23 will be registered to take the Series 12. If a candidate requests a Securities Manager registration on or after that date, they will automatically be registered to take the Series 10 examination. Individuals wishing to take the Series 12 examination must make the appropriate request through the Central Registration Depository on or before Friday, April 20. Individuals who have made an appropriate request by April 20 will have 120 days to take the Series 12 examination.

http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256FCB005E19E8852572BA006B4024/$FILE/Microsoft%20Word%20-%20Document%20in%2007-32.pdf

NYSE Proposes Modified Definition of Program Trading and Reporting

The New York Stock Exchange LLC has filed a rule proposal with the Securities and Exchange Commission to (i) modify the definition of program trading, (ii) issue guidance on the definition of program trading and (iii) replace the Daily Program Trade Report with a simplified audit trail requirement.

As presently defined, program trading is either index arbitrage or the purchase or sale of a basket of 15 or more stocks with a total market value of not less than $1 million. The amendment will eliminate the $1 million floor, but will retain index arbitrage.

The proposed rule also states that program trading includes the purchase of stocks as part of a coordinated trading strategy. In its SEC filing, the NYSE noted customer driven parameter based trading, e.g., trading in which the customer specifies certain desired execution conditions such as timing, pricing, quantity or marketplace as in algorithmically driven trades that are generated by operation of a computer program based on market information, would no longer be program trading in most instances. Other trading strategies, such as volume-weighted-average-price (VWAP), statistical arbitrage and other computer driven trading strategies would generally not be deemed to be program trading.

To accomplish this, the NYSE proposes issuing guidance to member firms. The guidance will focus on the primary investment objective of trading, as well as the linkage or dependency between or among simultaneous or near simultaneous trades in different securities relative to the investment objective. An execution of 15 or more stocks that is entered as part of a single investment strategy, including liquidation, rebalancing or realignment of a basket/portfolio, with the intent to execute all or most of the stocks would be a coordinated strategy, and a program trade.

The NYSE proposes to eliminate the requirement that member firms electronically file a report of program trades by the close of the second business day after the trade. Instead, NYSE would redefine two of the existing program trading related audit trail account types so member firms mark the specific program trading strategy at the time of order entry and execution.

http://apps.nyse.com/commdata/pub19b4.nsf/docs/0F8E259AC5AB2E02852572A6006FBE61/$FILE/NYSE-2007-34.pdf

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Banking

Proposed Model Privacy Form

The Federal Deposit Insurance Corporation, the other federal financial institution regulatory agencies, the Securities and Exchange Commission, the Federal Trade Commission, and the Commodity Futures Trading Commission (the agencies) have jointly published a Notice of Proposed Rulemaking (NPR) seeking comment on a model privacy form that financial institutions could use to satisfy the privacy notice requirements of the Gramm-Leach-Bliley Act (GLBA). The proposed privacy form would also provide consumers with the opportunity to limit certain information-sharing practices, as permitted by the GLBA and the Fair Credit Reporting Act. Comments on the proposed rule are due by May 29. Highlights follow:

- The Financial Services Regulatory Relief Act of 2006 (FSRRA) required the agencies to propose a model form that is succinct and comprehensible to consumers, allows consumers to easily compare financial institutions' privacy practices, and is in an easily readable type font.
- The agencies believe that the proposed model notice, developed through consumer research, meets the requirements of the FSRRA.
- The model notice would provide a compliance "safe harbor" for institutions that choose to use it when it is finalized.
- The NPR seeks comment on a variety of issues related to the model notice, including a proposed phase-out period for the sample notice clauses that were originally published in Appendix A of Part 332 of the FDIC's rules and regulations on June 1, 2000.

http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/07-1476.pdf

FDIC Issues Policy on Identity Theft

The Federal Deposit Insurance Corporation has updated its Supervisory Policy on Identity Theft. The policy describes the characteristics of identity theft. It also sets forth the FDIC's expectations that institutions under its supervision take steps to detect and prevent identity theft and mitigate its effects in order to protect consumers and help ensure institutions' safe and sound operations.

http://www.fdic.gov/news/news/financial/2007/fil07032a.html

Litigation

Securities Fraud Claims Dismissed as Time-Barred

The United States District Court for the District of New Jersey dismissed a securities fraud class action against Merck and certain of its officers and directors that asserted that defendants concealed information that Vioxx significantly increased the risk of heart attacks and made misleading statements about the drug's safety. Asserting claims under, *inter alia*, the Exchange Act of 1934, plaintiffs alleged that as a result of defendants' omission and misrepresentations they purchased Merck securities at artificially inflated prices. Defendants moved to dismiss on statute of limitations grounds, asserting that the Exchange Act claims were untimely because they were filed more than two years after plaintiffs discovered or should have discovered the facts constituting the alleged violation.

Under the Third Circuit's "inquiry notice" standard to determine when a plaintiff's Exchange Act claims accrue, the District Court ruled that the two-year clock begins to run when the plaintiff discovered, or in the exercise of

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reasonable diligence should have discovered, the general fraudulent scheme and its bearing on his investment. At such time, a plaintiff has an obligation to investigate the basis for his claims, and a failure to do so is at his peril. Applying the "inquiry notice" rule, the District Court found an abundance of "storm warnings" that triggered the accrual of plaintiffs' claims more than two years before plaintiffs filed their lawsuit, including, among other things, the Food and Drug Administration's release of a widely publicized warning letter (which the District Court characterized as containing "a direct and unequivocal accusation of fraud"), the filing of products liability and consumer fraud lawsuits that were predicated on the same alleged wrongdoing as plaintiffs' claims, and a "torrent" of publicity about the Vioxx controversy. (*In re Merck & Co, Inc.*, 2007 WL 1100820 (D.N.J.Apr. 12, 2007))

Derivative Action Dismissed for Failure to Plead "Demand Futility"

Following the release of a highly publicized list of companies, including CNET, "at risk" for options backdating and CNET's announcement that it had appointed a special committee of independent directors to investigate its stock option practices, Plaintiffs filed a derivative action alleging claims under sections 10(b), 14(a), and 20(a) of the Exchange Act of 1394 and section 304 of Sarbanes-Oxley. CNET moved to dismiss the complaint based upon plaintiffs' failure either to make a demand upon the Board prior to filing the lawsuit or to plead with sufficient particularity that making a demand would have been "futile."

Applying Delaware law (the State of CNET's incorporation) to determine if the "futility" exception applied, the Court ruled that the demand requirement is only excused if "under the particularized facts alleged, a reasonable doubt is created that (i) the directors are disinterested and independent and (ii) the challenged transaction was otherwise the product of a valid exercise of business judgment." Plaintiffs argued that the exception applied, alleging that none of CNET's directors were disinterested because each received and ratified backdated options and because certain of the directors were on CNET's Compensation Committee.

After finding that plaintiffs could only satisfy the lack of director "disinterest" prong if three or more of CNET's six directors were disinterested, the Court carefully examined the circumstances of each of the eight instances of alleged backdating. The Court ruled that only three of the grants sufficiently pled facts supporting an inference of backdating and that only one director on the CNET Board at the time of the demand requirement had received options pursuant to these grants. The Court further ruled that mere service on the Compensation Committee did not establish a lack of disinterest, especially where CNET's options plan permitted the Compensation Committee to delegate decisions to CNET executives and where no allegations were made that the directors on the Committee had chosen the date of the grant. Accordingly, the Court dismissed the complaint because plaintiffs failed to plead with particularity that a majority of the Board was not disinterested. (*In re CNET Networks, Inc.*, 2007 WL 1089690 (N.D.Cal. Apr. 11, 2007))

CFTC

CFTC and FinCEN Issue Guidance on Application of CIP Rules to Give-Up Arrangements

The Commodity Futures Trading Commission and the Financial Crimes Enforcement Network (FinCEN) have issued guidance clarifying the application of customer identification program (CIP) regulations to give-up arrangements. The guidance confirms that, in give-up arrangements, only clearing brokers are subject to CIP requirements. The agencies noted that, although an executing broker in a give-up arrangement facilitates trades for a

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customer, and the give-up arrangement may be governed by a written agreement, it is only the clearing broker that establishes a formal relationship with the customer for the purposes of the customer identification program rule.

http://www.cftc.gov/opa/press07/opa5321-07.htm

CFTC Letter Regarding Natural Gas Markets Made Public

The Commodity Futures Trading Commission's response to a request from the Senate Energy and Natural Resources Committee (Committee) for information regarding CFTC oversight of, and enforcement efforts in, the natural gas markets was made available this week. By letter dated February 6, the Committee had requested information regarding the CFTC's monitoring of trading on the New York Mercantile Exchange (NYMEX) and the Intercontinental Exchange (ICE) and asked for specific information regarding potentially anomalous market behavior detected during 2006, including end-of-month trading that might have affected the accuracy of price indices published by *Platts, Natural Gas Intelligence* and ICE. In its response, dated February 22, the CFTC set out details regarding its surveillance of trading on NYMEX and ICE, including its issue of two "special calls" to ICE in late 2006 for position data in ICE's most heavily traded gas swap contracts. However, the CFTC declined comment on specific anomalous trading patterns identified by its surveillance staff, citing confidentiality concerns.

http://www.cftc.gov/files/opa/opacftcbingamanletter022207.pdf

Effective Date Set for NFA Interpretive Notice Regarding FDM Electronic Trading Systems

The National Futures Association's recently approved Interpretive Notice to its Compliance Rule 2-36(e), which sets out guidelines for the supervision of electronic trading systems by forex dealer members (FDMs), will become effective July 1. The Notice provides guidance to FDMs in creating required written procedures regarding their electronic trading systems and sets out details regarding related recordkeeping obligations.

http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=1812

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