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Corporate and Financial Weekly Digest

April 4, 2008

SEC/Corporate

President Nominates Two Democrats to Be SEC Commissioners

On March 28, President Bush announced his intention to nominate two Democrats, Luis Aguilar and Elisse Walter, to fill empty seats at the Securities and Exchange Commission. By law, the five person commission may not have more than three members from the President's political party. The Commission has been operating with only three Republican commissioners since Annette Nazareth left in January and Roel Campos left last September.

Elisse Walter is a former deputy director of the SEC's corporation finance division. She is currently serving as a Senior Executive Vice President for Regulatory Policy & Programs at the Financial Industry Regulatory Authority.

Mr. Aguilar is a former SEC attorney who also served as General Counsel of INVESCO. He is currently a partner at the law firm McKenna, Long & Aldridge, LLP.

While Senate Majority Leader Harry Reid submitted Walter's and Aguilar's names to the White House for consideration in November, their nominations had been stalled by political infighting over the approval of appointments at several other federal agencies.

Democratic lawmakers have urged the SEC to postpone any major rule changes until the Commission is fully staffed. However, late last year, a divided commission voted 3-1 along party lines to restrict shareholder proposals that sought to influence the composition of corporate boards. It is believed that a full commission would allow SEC Chairman Christopher Cox to again consider this issue and to move forward on other issues.

If Walter is confirmed by the Senate she will fill the seat previously held by Annette Nazareth with a term expiring on June 5, 2012. If Aguilar is confirmed he will fill the seat previously held by Roel Campos for the remainder of the term ending on June 5, 2010.

http://www.whitehouse.gov/news/releases/2008/03/20080328-6.html

Litigation

Plaintiffs Plead Scienter Adequately on Failure to Disclose Related-Party Transaction

Purchasers of common stock sued the company, two of its officers and a director for failure to disclose certain related-party transactions under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Plaintiffs alleged, among other things, that defendants failed to disclose the company's

SEC/CORPORATE

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hiring of a distributor that ultimately gave the two officer defendants one-third of all commission payments it received. Plaintiffs alleged that defendants had an "indirect material interest" in the transaction, and thus had a duty to disclose the transaction to its investors. Defendants moved to dismiss the complaint for failure to plead scienter adequately. Defendants argued that the complaint failed to show that they understood that the transaction was a disclosable related-party transaction and, if it was, that it was too small (i.e., not material) to warrant disclosure.

In denying the individual defendants' motion, the Court held that plaintiffs plead scienter adequately. The fact that defendants had replaced an old distributor with a new one, which ultimately delivered to them one-third of all commission payments, raised a strong inference that defendants were aware that their material interest in the transaction needed to be disclosed. Given defendants' high-level positions within the company and their compliance with disclosure rules for related-party transactions on other occasions, it was implausible to suppose that defendants did not know that the transaction was a related-party transaction. The Court rejected the materiality argument on the ground that transactions of equally small value were repeatedly disclosed by the company. (*Zagami v. Natural Health Trends Corp.*, 2008 WL 794540 (N.D. Tex. March 26, 2008))

Plaintiffs Fail to Allege 10b-5 Claims Against Secondary Actors

A federal district court partially granted defendants' motion to dismiss plaintiffs' Section 10(b) and Rule 10b-5 claims against a company and its affiliated individuals, arising out of falsified financial statements. Plaintiffs, purchasers of the stock of the company, alleged, among other things, that defendants had engaged in false material representation of revenues, which were artificially enhanced through the booking of fictitious sales. Defendants moved to dismiss on the ground that, among other things, the complaint failed to adequately plead scienter.

The Court dismissed plaintiffs' claims against defendants who were secondary participants to the alleged fraudulent scheme pursuant to the Supreme Court's recent decision in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008). The Court emphasized that, under *Stoneridge,* the conduct of a secondary actor must satisfy each of the elements for 10b-5 liability. The Court noted that allegations of defendants' liability for merely participating in a fraudulent scheme do not defeat defendants' objection that plaintiffs did not in fact rely on the defendants' own deceptive conduct. The Court stated that plaintiffs failed to particularize any material misstatements or omissions by the secondary participants that plaintiffs had relied on during the class period. Therefore, the Court partially granted defendants' motion to dismiss plaintiffs' claims against the secondary actors. (*Katz v. Image Innovations Holdings, Inc.*, 2008 WL 762105 (S.D.N.Y. March 24, 2008))

Broker Dealer

FINRA Highlights 2008 Inspection Priorities

The Financial Industry Regulatory Authority (FINRA) released its inspection priorities for the coming year in a letter to members on March 24. The letter noted that most firms would get a 30-day advance notice of their inspection pursuant to their inspection cycle.

Areas of concern for 2008 inspections include:

- Senior Investors: Examinations found issues regarding sales pitches masquerading as educational seminars, misleading advertising and sales materials, poor supervision, product suitability and outright fraud.

BROKER DEALER

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FINRA is also concerned about titles for salespersons suggesting a particular expertise in addressing senior investor needs.

- Deferred Variable Annuities: FINRA recently adopted Rule 2821 concerning broker-dealer compliance and supervisory responsibilities for deferred variable annuities.

- Anti-Money Laundering: Firms of all sizes, even those not holding customer monies, must implement AML regulations.

- Protection of Customer Information: A focus will be on how firms protect customer information stored on electronic devices such as hard drives, CDs, floppy disks and flash drives, laptops and PDAs when such devices are discarded. Firms offering online customer access are urged to assess their internal surveillance and develop plans for handling account intrusions. Also, procedures to prevent "hacking" customer accounts will be reviewed.

- Supervision: Supervision is underscored as a core element of all examinations. Firms should have procedures in place for reviewing and identifying individuals or business types that require enhanced scrutiny due to sales practice concerns, such as a pattern of customer complaints.

- Sales of New Products: Firms should have procedures for developing and vetting new products and ensure that registered representatives understand the products they are recommending and the suitability of the securities they recommend to customers.

- Fee-Based Accounts: Firms maintaining fee-based brokerage accounts should expect examiners to review those accounts in light of a 2007 Court of Appeals Decision vacating the rule that fee-based brokerage accounts were not advisory accounts.

- Transaction Reporting: Transaction reporting remains an examination focus in light of ongoing violations related to the timeliness and accuracy of reports.

- Information Barriers: Procedures to prevent the misuse of material, nonpublic information and insider trading should include monitoring systems, supervision, review of questionable activities and recordkeeping requirements. Firms should identify the appropriate departments or individuals with responsibility for executing the policy on monitoring for insider trading.

- Bank Sweep Programs: FINRA will continue to examine the programs of broker-dealers sweeping customer credit balances into deposits at banks, with a focus on ensuring that customer funds are protected at all times.

- Agency Lending Disclosure: Examiners will focus on pre-approval of principal counterparties, the adequacy of credit risk reviews performed, preparation of daily reconciliations at both the agent and underlying principal counterparty level, maintenance of books and records at the principal counterparty level, application of securities borrow deficit charges to the net capital computation, and inclusion of excess collateral received from agent lenders on securities borrow contracts as credit items in the customer reserve formula computation.

- Inventory Valuations: Firms are reminded to review controls in place to independently validate the pricing of inventory positions. Validation of prices to external third party sources has become more challenging as credit markets have become more illiquid.

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- Order Audit Trail System: Effective February 4, OATS reporting requirements were expanded to include OTC equity securities.

- Regulation NMS: Initial examinations indicate that some firms mistakenly may believe that Reg. NMS does not apply to them, either because they make markets in a limited number of NMS stocks or because they infrequently execute orders internally. Reg. NMS does not include any exception to the definition of "trading center" based on de minimis activity.

- Short Interest Reporting: NASD Rule 3360 requires firms to maintain a record of total short positions in all customer and proprietary accounts in OTC equity securities and exchange-listed securities. Effective September 2007, Rule 3360 was amended to increase the frequency of short interest reporting from monthly to twice a month. Each short interest report must be received by FINRA no later than the second business day after the relevant reporting settlement date.

http://www.finra.org/web/groups/corp_comm/documents/home_page/p038169.pdf

SEC Requires Electronic Filing of SRO Rule Change Proposals on Form 19b-7

The Securities and Exchange Commission is adopting proposed amendments to Rule 19b-7, dealing with filings relating to security futures, to require Self-Regulatory Organization (SRO) rule change proposals to be submitted to the Commission electronically on Form 19b-7 and posted on their Web site. As of April 25, the SEC will no long accept SRO rule changes in paper format.

The authorized user at the SRO will access a screen containing a template, referenced as Page 1, in which it can identify the SRO, enter a brief description of the proposed rule change, and enter a brief description of the SRO governing body action approval. The SRO will provide contact information and place the electronic signature of a duly authorized officer on this initial screen. The second screen will provide the SRO with a means to attach the proposed rule change and related exhibits in Microsoft Word format.

The SEC is also amending Rule 19b-7 to require each SRO to post proposed rule changes and amendments on their public Web site no later than two business days after filing. This will increase the availability of SRO proposed rules and facilitate the ability of interested parties to comment on proposed rule changes. SROs will be required to remove from their Web sites proposed rule changes filed under Section 19(b)(7) that are deemed not properly filed and returned to SROs or withdrawn by SROs, within two business days of the Commission's notification to the SRO that such proposed rule change was not properly filed or of the SRO's withdrawal.

http://edocket.access.gpo.gov/2008/pdf/E8-5998.pdf

SEC Approves Pilot Internet Portal for Municipal Securities Disclosure Documents

On March 28, the Securities and Exchange Commission approved on an accelerated basis a proposal by the Municipal Securities Rulemaking Board (MSRB) launching a new pilot program that will offer free, internet-based public access to municipal securities disclosure documents. The official statement (OS) and Form G-36(OS) documents that must be filed by a broker, dealer or municipal securities dealer acting as managing or sole underwriter for most primary municipal securities offerings will be available in PDF format for viewing, printing and downloading promptly after acceptance and processing

by the MSRB.

The portal will provide:

- Online search functionality;
- A comprehensive display of relevant information concerning the security;
- Direct access to the OS submitted by the underwriter;
- Price information from the MSRB's Real-Time Transactions Reporting System; and
- Any advanced refunding document submitted by the underwriter.

In response to one comment expressing concerning over the economic harm the portal would inflict on private data vendors, the SEC noted that proposal only modernizes the delivery method for documents which are already available in paper format at the MSRB public access facility. The pilot program will run for up to one year from the date it becomes operational, subject to earlier termination on SEC consideration and approval of a permanent system.

http://edocket.access.gpo.gov/2008/pdf/E8-6837.pdf

Banking

Treasury Releases Blueprint for Stronger Regulatory Structure

On March 31, the U.S. Treasury released its "Blueprint for a Modernized Financial Regulatory Structure." The report contains a series of short-, intermediate- and long-term recommendations for reform of the U.S. regulatory structure overseeing various financial institutions.

Included in the short-term recommendations are proposals to modernize the President's Working Group and to include the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation as members of the Working Group. Also included are proposals to make enhancements to the process of expanding access to Federal Reserve lending channels and to create a new federal commission (the Mortgage Origination Commission) to "evaluate, rate, and report on the adequacy of each state's system for licensing and regulating participants in the mortgage origination process."

Mid-term recommendations include transitioning the federal thrift charter to a national bank charter and merging the OCC and OTS, merging the Securities and Exchange Commission and the Commodities Futures Trading Commission, and establishing a federal insurance regulatory structure.

Long-term goals relate to creating an optimal regulatory structure with three distinct regulators: a market stability regulator (the Board of Governors of the Federal Reserve), a prudential financial regulator (the roles of the OCC, OTS and National Credit Union Administration), and a new business conduct regulator (most roles of the CFTC and SEC and some roles of bank regulators).

Many of the Blueprint recommendations, especially those categorized as mid-term and long-term, will require the passage of new legislation. The Blueprint has been praised and criticized by Administration officials, industry participants, legislators, special interest groups, and the financial press. Absent more crises that test the limits of the Fed's ability to resolve them, it is not expected that such recommendations will become law in the near future.

http://www.ustreas.gov/press/releases/hp896.htm

BANKING

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United Kingdom Developments

FSA Launches Consultation on Amended Client Assets Regime

On March 31, the UK Financial Services Authority (FSA) published *CP08/6: Review of the Client Assets Sourcebook (CASS)*. The consultation paper seeks views on the FSA's proposals for reforming CASS following the implementation of the EU Markets in Financial Instruments Directive (MiFID) in the UK on November 1, 2007.

The current CASS contains different regimes applying respectively to business both in and out of the scope of MiFID. The proposed new rules are intended to be more "principle based" (consistent with the FSA's move towards more principles-based regulation) and also streamline CASS by creating a regulatory framework which applies to all UK firms' investment business whether or not within the scope of MiFID.

The consultation closes on June 30.

www.fsa.gov.uk/pubs/cp/cp08_06.pdf

EU Developments

CESR Finalizes Advice on US, Chinese and Japanese GAAP

On March 31, the EU Committee of European Securities Regulators (CESR) published its advice to the European Commission on the equivalence of US, Chinese, and Japanese Generally Accepted Accounting Practice (GAAP).

CESR recommended that the European Commission finds US GAAP equivalent to International Financial Reporting Standards (IFRS) for use in prospectuses and other material required to be filed with EU markets. Japanese GAAP may be considered equivalent after the Accounting Standards Board of Japan (ASBJ) achieves certain objectives set out in the Tokyo Agreement between the International Accounting Standards Board (IASB) and the ASBJ in August 2007.

Regarding Chinese GAAP, CESR recommended that the European Commission postpone a final decision until there is more information on the application of the new Chinese accounting standards by Chinese issuers, which is expected later this year for 2007 accounting periods.

www.cesr.eu/popup2.php?id=5004

CESR Publishes Responses to Consultation on Role of Rating Agencies in Structured Finance

On April 1, the EU Committee of European Securities Regulators (CESR) published responses that it received to its consultation on the role of credit rating agencies in structured finance. The consultation was launched in September 2007 in response to a European Commission request to review the role of Credit Rating Agencies (CRAs) and to consider a possible EU regulatory regime for CRAs to replace the current self-regulatory regime. CESR requested comments on the conclusions it had drawn from its market survey and evidence gathering from the rating agencies.

www.cesr.eu/index.php?page=responses&id=108

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