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Corporate and Financial Weekly Digest

August 10, 2007

SEC/Corporate

SEC Proposes Revisions to Regulation D

On August 3, the Securities and Exchange Commission proposed revisions to Regulation D to provide additional flexibility to issuers and to clarify and improve the application of the underlying rules by creating a new exemption for offers and sales to a new class of investors called "large accredited investors," revising the current definition of accredited investor, to shorten the time period for the integration safe harbor and to apply uniform disqualification provisions to all Regulation D offerings. The proposed changes are intended to build on the recommendations of the Advisory Committee on Smaller Public Companies to make it easier for smaller public companies to raise capital.

Large Accredited Investor Exemption

The SEC has proposed Rule 507 to Regulation D which would provide a new exemption from the registration provisions of the Securities Act of 1933, as amended, for offers and sales of securities to "large accredited investors." The exemption would permit publication of a prescribed form of written announcement of a proposed exempt offering where each purchaser meets the definition of "large accredited investor," but does not eliminate the prohibition on general solicitation and general advertising from the conditions of the exemption for other Regulation D offerings. The proposed definition of large accredited investor would be based on the "accredited investor" definition, but with higher and somewhat different dollar-amount thresholds.

Legal entities that are considered accredited investors if their assets exceed $5 million would be required to have $10 million in investments to qualify as large accredited investors. Individuals generally would be required to own $2.5 million in investments or have annual income of $400,000 (or $600,000 with one's spouse) to qualify as large accredited investors. Legal entities that are not subject to dollar-amount thresholds to qualify as accredited investors, generally government-regulated entities, would not be subject to dollar-amount thresholds to qualify as large accredited investors. Large accredited investors who participate in these exempt offerings would be considered "qualified purchasers" under Section 18(b)(3) of the Securities Act, thereby providing "covered security" status and the resulting preemption of certain state securities regulation. Issuers in Rule 507 transactions would not be allowed to sell securities to any investor who does not qualify as a large accredited investor.

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Proposed Revisions to Definition of "Accredited Investor"

The SEC also proposed changes to the term "accredited investor" to clarify the definition and reflect developments since its adoption. The SEC has proposed to add an alternative "investments-owned" standard for determining accredited investor and large accredited investor status. This standard would include definitions of "investments" and "joint investments" similar to those proposed by the SEC in December 2006 in the Private Pooled Investment Vehicles Release, part of the SEC's initiative to revise Regulation D as it relates to investments by individuals in certain private pooled investment vehicles relying on Rule 506.

For legal entities required to satisfy the $5 million assets test, the proposed amendment would add an alternative investments standard of $5 million. For individuals and spouses, the proposed amendment would provide a new alternative standard of $750,000 in investments that could be used instead of the current net worth standard of $1 million or annual income standard of $200,000 (or $300,000 with one's spouse). Further, the SEC has proposed a mechanism to adjust the dollar-amount thresholds in the definition of "accredited investor" to adjust for inflation starting on July 1, 2012 and every five years thereafter, to reflect any changes in the value of the Personal Consumption Expenditures Chain-Type Price Index. The SEC has also proposed to add several categories of permitted entities to the list of accredited and large accredited investors with the goals of reducing uncertainty and legal costs and promoting more efficient private capital formation.

Proposed Revisions to General Conditions to Regulation D.

The SEC has proposed to shorten the timing required by the integration safe harbor from six months to 90 days to help provide flexibility to issuers and relieve the burden, particularly on smaller companies, of the long delay in meeting their capital needs. Also, the SEC has proposed to apply uniform "bad actor" disqualification provisions to all offerings seeking to rely on Regulation D in order to prevent reliance on Regulation D if the issuer itself is disqualified or the presence of any of the enumerated persons disqualifies the issuer. Currently only Rule 505 provides such a disqualification.

http://sec.gov/rules/proposed/2007/33-8828.pdf.

SEC Adopts New Rule Defining "Significant Deficiency"

On August 3, the Securities and Exchange Commission issued a final rule defining the term "significant deficiency" as "A deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting." The new definition is supposed to aid senior management at companies which must certify pursuant to Section 302 of the Sarbanes Oxley Act of 2002 that they have communicated significant deficiencies to the audit committee and the company's auditors. In its June 27, 2007 interpretive guidance regarding management's assessment of internal control over financial reporting, the Commission included a revised definition of "material weakness." The new rule is effective September 10.

http://www.sec.gov/rules/final/2007/33-8829.pdf

Broker Dealer

NYSE Proposes Customer Notification of Fees Rule

The New York Stock Exchange LLC has proposed new Rule 405B which would require member organizations to provide their customers with written notice of all fees related to their customer accounts as well as require that the fees be reasonable and not unfairly discriminatory between customers. The new rule is a codification of guidance issued in NYSE Information Memo 05-41.

As proposed, Rule 405B(1)(a) would require member organizations to provide each customer with written notification of all fees that are in effect at the time the account is opened, or that will take effect within 30 days of the account being opened. Additionally, Rule 405B(1)(b) would require member organizations to mail written notice of increased fees, or imposition of any new fees, at least 30 days prior to the increase or imposition to the last known address of every customer whose account is subject to such fees. Further, member organizations would be required to post a notification of the types of fee changes, and the projected date of such changes, on their internet website (if they maintain a website).

Proposed Rule 405B(2) provides for methods of notification and would allow member organizations to either send a separate written notification to inform customers of fees or include the fee notices with account statements or newsletters. The Rule also provides for electronic delivery of written fee notices. Proposed Rule 405B(3) explains the fees covered by the rule to include commissions, charges for managed and non-managed accounts, and other account related charges, such as interest or dividend reinvestments, transfer or custody of securities, appraisals, safekeeping and margin. Additionally, proposed Rule 405B(4) would require that fees imposed on customers by member organizations be reasonable and not unfairly discriminatory; however, the proposed rule would not prohibit or restrict firms' ability to structure their pricing schedules based upon the uniqueness of their various customer relationships.

http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/E7-14990.pdf

SEC Approves Changes to NASD Issuer Directed Sales in IPO

The Securities and Exchange Commission recently approved The Financial Industry Regulatory Authority's (FINRA) proposed changes to NASD Rule 2790.

NASD Rule 2790 provides that, except as otherwise permitted under the Rule, (i) a member firm may not sell a new issue to an account in which a restricted person has a beneficial interest; (ii) a member firm may not purchase a new issue in any account in which such firm or associated person has a beneficial interest; and (iii) a firm may not continue to hold new issues acquired as an underwriter, selling group member, or otherwise. Rule 2790 exempts, for most purchasers, securities that are specifically directed by the issuer to be sold to that person. However, for securities directed to an account in which broker-dealer personnel, finders or fiduciaries, or certain members of their immediate family have a beneficial interest, the exemption is only applicable if such persons, or members of their immediate family, are employees or directors of the issuer, the issuer's parent, or a subsidiary of the issuer or the issuer's parent.

FINRA is now further limiting the exemption for issuer-directed securities in Rule 2790(d)(1) to exclude new issue securities directed to a broker-dealer.

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To the extent that broker-dealer personnel have a beneficial interest in the broker-dealer, the broker-dealer would already be subject to the limitations in Rule 2790(d)(1); however, the amendments establish a much more direct prohibition against purchases of new issues by broker-dealers, even if the securities are directed by the issuer.

FINRA has also added new paragraph (d)(2) to Rule 2790, which provides that the prohibitions on the purchase and sale of new issues do not apply to securities that are specifically directed by the issuer to restricted persons, provided that a broker-dealer: (i) does not underwrite any portion of the offering; (ii) does not solicit or sell any new issue securities in the offering; and (iii) has no involvement or influence, directly or indirectly, in the issuer's allocation decisions with respect to any of the new issue securities in the offering.

New paragraph (d)(2) would not prevent an issuer from engaging a broker-dealer to provide advisory services (such as rendering advice regarding capital structure and capital raising) or other limited services, so long as the conditions set forth in paragraph (d)(2) continue to be satisfied. In addition, for purposes of compliance with new paragraph (d)(2), a member firm or associated person that wishes to purchase new issues in such offerings may rely on a written representation obtained in good faith from the issuer that the conditions in paragraph (d)(2) are satisfied. However, the firm or associated person may not rely upon any representation from the issuer that it believes, or has reason to believe, is inaccurate.

http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p036384.pdf

SEC Amends Regulation SHO

The Securities and Exchange Commission is adopting amendments to Regulation SHO that eliminate its grandfather provision and revise the close-out requirement for aged fails to deliver in threshold securities and sales of stock under Rule 144.

Regulation SHO defines a threshold security as an equity security for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more and that is equal to at least 0.5% of the issuer's total shares outstanding. Fails to deliver in threshold securities on the date an issue becomes a threshold security must be closed out within 13 consecutive settlement days. This includes fails to deliver arising both before and after the issue becomes a threshold security. However, fails in threshold securities on the date the amendment becomes effective (estimated as early to mid October 2007) will be allowed to be closed out within 35 consecutive settlement days. The SEC also amended Rule 203 of Regulation SHO to extend the close-out requirement to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act of 1933.

http://www.sec.gov/rules/final/2007/34-56212.pdf

SEC Approves NASDAQ Activation of PORTAL

The Securities and Exchange Commission has approved an application of the NASDAQ Stock Market LLC to adopt rules activating the PORTAL market to trade securities under Rule 144A. Brokers and dealers that are NASDAQ members would apply to and be granted access to PORTAL as PORTAL Dealers and PORTAL Brokers. They could submit quotations, two way, one way or on an undisclosed basis for securities that can be sold

under Rule 144A.

Qualified institutional buyers, as defined in Rule 144A, could apply and become PORTAL Qualified Investors. PORTAL Qualified Investors would have access to the quotations in PORTAL, but could not enter quotations or execute against those quotations. PORTAL Brokers and Dealers could negotiate both openly and anonymously and execute trades in PORTAL. Equity trades in PORTAL would be reported by NASDAQ to the OTC Reporting Facility of the NASD. Trades executed in PORTAL would be disseminated to PORTAL Brokers and Brokers and PORTAL Qualified Investors but would not identify the parties to the trade.

PORTAL bids, asks and executed trade information could not be disseminated other than to PORTAL Brokers, Dealers and PORTAL Qualified Investors. PORTAL trades that have been compared and confirmed would be forwarded to Depository Trust and Clearing Corporation for settlement. The SEC also granted NASDAQ an exemption from Securities Exchange Act of 1934 Rule 15c2-11 to allow quotations in PORTAL even if the broker or dealer lacked the information required under that rule. The SEC also gave no-action relief to allow trading in PORTAL of securities that are not registered under Section 12(b) of the Exchange Act and to allow foreign private issuers with securities quoted on PORTAL to continue to rely upon the exemption from registration under the Exchange Act contained in Exchange Act Rule 12g3-2.

http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/E7-15288.pdf

Investment Companies and Investment Advisers

Rule Released Prohibiting Fraud on Investors in Pooled Investment Vehicles

On August 3, the Securities and Exchange Commission issued its release announcing the adoption of Rule 206(4)-8 under the Investment Advisers Act.

The rule makes it a "fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of Section 206(4) of the Act for any investment adviser to a pooled investment vehicle to (i) [m]ake any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (ii) [o]therwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle." The term "pooled investment vehicle" includes funds that rely on Section 3(c)(1) and 3(c)(7) to avoid regulation as investment companies. The rule is intended to clarify, in light of the decision in *Goldstein* v. *SEC*, the Commission's ability to bring enforcement actions under the Investment Advisers Act against advisers who defraud investors or prospective investors, as opposed to a fund itself, which the Court in *Goldstein* said is the adviser's "client."

The effective date of the rule is September 10.

http://sec.gov/rules/final/2007/ia-2628.pdf

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Final Rule Issued for Correspondent Accounts Maintained by Certain Foreign Banks

The Financial Crimes Enforcement Network (FinCEN) announced yesterday the issuance of a final rule implementing a key provision of Section 312 of the USA PATRIOT Act, clarifying the risk-based procedures that U.S. financial institutions should use in tailoring their enhanced due diligence to assess the risks of some foreign banking relationships.

"As international anti-money laundering standards improve globally, risk assessments for foreign banks should become easier to conduct. Common standards are increasingly protecting both sides of the international relationship," said FinCEN Director James H. Freis, Jr. "U.S. banks can take comfort in the fidelity of their foreign customers and foreign banks will find it easier to process their U.S. transactions."

The rule states that U.S. financial institutions must identify, for due diligence purposes, the owners of these foreign banks if their shares are not publicly traded and also ascertain whether such foreign banks provide correspondent accounts to other foreign banks and therefore provide them with access to the U.S. financial system. In making their risk assessments financial institutions should consider, among other factors, the nature of the foreign banks' business, reasonably-available information on the foreign banks' anti-money laundering record, and information on the nature of the foreign supervisory regulations under which the bank is operating.

On January 4, 2006, FinCEN issued a final rule implementing the due diligence requirements for correspondent accounts for foreign financial institutions and the due diligence and enhanced scrutiny requirements for private banking accounts for non-U.S. persons. It concurrently issued a second notice of proposed rulemaking concerning the enhanced due diligence provisions, which is now finalized with this release. Today's announcement completes the implementation of Section 312 of the USA PATRIOT Act.

The final rule takes effect within 180 days for new accounts opened by U.S. financial institutions and 270 days for existing accounts from the date the regulation is published in the *Federal Register*.

http://www.fincen.gov/31_CFR_Part_103_312_EDD_Rule.pdf

OTS Issues Notice on Unfair or Deceptive Acts or Practices

The Office of Thrift Supervision (OTS), regulator of the nation's federal savings banks, announced on August 3 that it has issued an Advance Notice of Proposed Rulemaking (ANPR) seeking public comment on approaches for the OTS to consider in expanding its regulatory authority to address unfair or deceptive acts or practices (UDAP) in the OTS-regulated thrift industry.

The OTS is issuing the ANPR to solicit public comment on whether, and how, a UDAP regulation could provide greater clarity to supervised institutions and benefit customers of OTS-regulated entities by promoting fair and equitable practices in lending, deposit-taking and related activities. The ANPR solicits comment on the scope of entities, practices, products and/or customer relationships that should be covered by a revised UDAP regulation. It also seeks comment on whether there is a need for the OTS to expand its regulation in this area, and whether other approaches, including guidance, may be appropriate.

The ANPR reviews OTS legal authority for issuing a UDAP regulation and discusses various approaches that the agency could take, either individually or in conjunction with other initiatives, in issuing such a regulation. The ANPR seeks input on a wide range of issues and questions, including the potential approaches and the prospective benefits, costs and impacts of each.

http://www.ots.treas.gov/docs/7/73373.pdf

United Kingdom Developments

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Select Committee Reports on Private Equity

On July 30, the Treasury Select Committee of the UK House of Commons published a report following its hearings on the UK private equity industry. In its report, the Committee recommended that the tax regime in respect of debt versus equity arrangements should be reviewed, particularly the treatment of carried interests and the application of residence and domicile rules. The Committee also called for a clarification from the UK Government on the application of the UK's Transfer of Undertakings (Protection of Employment) Regulations to take-overs and the continued monitoring of the risks posed by high leverage and the use of covenant-lite loans.

The Committee's report strongly supported the work of Sir David Walker's group on a code of conduct for the UK private equity industry, covered in the July 20, 2007 edition of *Corporate and Financial Weekly Digest,* and the work of the UK Financial Services Authority on market abuse and the prevention of conflicts of interest.

http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtreasy/567/56702.htm

Tax Payers Entitled to Compound Interest When Tax Paid in Error

In a landmark judgment handed down by the UK's highest appeal court, the House of Lords, on July 18 (published on August 6), held that compound interest is recoverable in claims for restitution. The Court found that the UK Inland Revenue had been unjustly enriched by the mistaken payment to it by Sempra Metals Limited (Sempra) of corporation tax when the tax had been levied prematurely. The House of Lords observed that the restrictive rule against recovery of compound interest was out of step with present day economic reality. It is expected that the English courts will in future enable successful claimants to recover compound interest in a wider variety of circumstances.

http://www.publications.parliament.uk/pa/ld200607/ldjudgmt/jd070718/sempra.pdf

FSA Publishes Additional Feedback on MiFID Best Execution

On August 8, the Financial Services Authority published additional feedback on best execution issues it had not addressed in its previous guidance and also on issues arising from the publication of the Committee of European Securities Regulators (CESR) questions and answer document on best execution requirements under the EU Markets in Financial Instruments Directive (MiFID).

The FSA document addresses such matters as requirements for client consent, establishing contractual rights in addition to the regulatory obligation to give best execution, the availability of data for over-the-counter markets,

requirements for execution and transmission policies. The feedback also clarifies the FSA's position on the application of best execution in respect of quote-driven markets, corporate finance, venture capital and securities lending.

http://www.fsa.gov.uk/pubs/policy/ps07_15.pdf

LSE Specialist Fund Market Guidelines Published

On August 8 the London Stock Exchange (LSE) published guidance for new funds which apply for admission to its recently announced Specialist Fund Market covered in the July 14, 2007 edition of *Corporate and Financial Weekly Digest*. Among the matters covered are: the market's regulatory status; eligibility for admission; guidance on the admission process (including material on transferring from the LSE's Main Market or from AIM and grounds for refusing admission); regulatory considerations; the trading system and powers to suspend trading.

http://www.londonstockexchange.com/NR/rdonlyres/1B426275-F9FB-4D15-A5A4-75F9D4FEAB1E/0/SpecialistFundMarketGuidanceforadmission.pdf

EU Developments

Advice on Non-equities Transparency and Reports on Commodity and Exotic Derivatives Published

On August 9, the Committee of European Securities Regulators (CESR) published a document responding to requests from the European Commission for technical advice on Non-equities transparency. CESR has concluded, in co-operation with different market participants, that it has not recognized evident market failure in relation to market transparency which would warrant mandatory transparency for bonds and that some re-distribution of the existing transparency information could be useful to help retail participants.

CESR has also published an initial fact-finding exercise on the regulation and operation of commodity and exotic derivatives in European Union Member States in response to the European Commission's request for a compilation of responses from CESR.

http://www.cesr-eu.org/index.php?page=home_details&id=231

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Litigation

Injunctive Relief Proper Remedy in SEC Enforcement Action

The Securities and Exchange Commission filed a civil enforcement action against a defendant corporation and its principals seeking preliminary injunctive relief, a freeze of assets and the appointment of a temporary receiver. The SEC asserted that defendants engaged in the fraudulent and unregistered offer and sale of Secured Debt Obligations (SDOs) to the public, made misrepresentations and omissions to investors concerning the safety of the SDOs and the disciplinary record of the principals involved, and misappropriated investor funds in violation of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Noting that courts have broad equitable powers under section 20(b) of the Securities Act, the court granted the SEC's application. After setting out the standard for granting preliminary injunctive and other equitable relief in a civil enforcement action – *i.e.*, that there is a reasonable likelihood that

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defendants are engaged or are about to engage in violations of the federal securities laws – the court determined that the SEC had met its burden. Among other things, the court found that the evidence established a reasonable likelihood that defendants, acting with scienter, had misappropriated invested funds for their personal use and benefit and, in order to encourage investors, misrepresented that the SDOs were collateralized, guaranteed by a commercial bank and protected by multiple insurance policies, when, in fact, defendants knew that none of the representations was true. (*SEC v. Amerifirst Funding, Inc.*, 2007 WL 2192632 (N.D. Tex. July 31, 2007))

Claims of Corporate Mismanagement Dismissed

The District Court for the Southern District of New York dismissed both derivative and direct causes of action asserted against the trustees of an investment company organized as a business trust (the Trust) under Massachusetts law. Plaintiff alleged that the trustees violated §20(a) of the Investment Company Act (ICA) and breached fiduciary duties owed to shareholders in connection with their alleged failure to negotiate for more favorable fees in new advisory agreements approved by the Trustees and shareholders following the issuance of an allegedly false and misleading proxy statement.

In accordance with Massachusetts law governing derivative claims, Plaintiff made a written demand upon the Trustees to institute an action for the alleged breach, and after waiting the requisite 90-day statutory period, filed his complaint. After receiving the demand, the Board of Trustees formed an independent committee to consider it and, following the committee's review and plaintiff's commencement of the lawsuit, a quorum of the Board consisting entirely of independent Trustees, rejected the demand.

The Trustees moved to dismiss the derivative claim for failing to comply with Massachusetts' statutory requirement that the plaintiff plead particular facts showing that the Board's rejection of the demand was wrongful. Rather than come forward with such allegations, the plaintiff argued that the requirement did not apply because the Board did not reject the demand until *after* the filing of plaintiff's suit. The Court rejected the plaintiff's position, finding specific support in the legislative history demonstrating the Massachusetts legislature's intent that the requirement apply in cases where the Board's rejection of a demand occurs after the derivative lawsuit has been filed.

The court then addressed, and dismissed, the plaintiff's two "direct" claims. First, the court ruled that these claims, notwithstanding plaintiff's labeling them "direct," were, in fact, derivative claims. Because the alleged injury impacted plaintiff (and other shareholders) only to the extent of their proportional interest in the Trust and did not impact plaintiff in a manner that was separate and distinct from all shareholders of the Trust, the claims belonged to the Trust and, accordingly, could not be asserted because of plaintiff's failure to plead with particularity why the Board's rejection of its demand was wrongful. Second, the court found that, in any event, no private right of action existed under §20(a) of the ICA because no provision expressly conferred such a right and nothing in the statute or legislative history suggested that Congress intended for such a right to implied from the statute. (*Halebian v. Berv*, 2007 WL 2191819 (S.D.N.Y. July 31, 2007))

CFTC

Commissioner Dunn Addresses Alleged Energy Market Manipulation

Commissioner Michael V. Dunn, of the Commodity Futures Trading Commission, addressed the annual meeting of the American Public Gas

CFTC

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Association on August 7. His topic was alleged market manipulation in the energy derivative markets. Noting that "in the absence of a regulatory structure based on accountability and transparency, manipulative behavior may go undetected," Commissioner Dunn stated that Congress "needs to revisit energy regulation in light of the core objectives of the [Commodity Exchange Act]: protecting price discovery, guarding against fraud and manipulation, and preserving the effectiveness of futures and options markets as hedging tools." In Commissioner Dunn's view, Congress should consider (i) removing the section 2(h)(3) exemption, relied upon by markets such as IntercontinentalExchange, from the Commodity Exchange Act; (ii) providing explicit authority for the CFTC to approve foreign boards of trade (FBOTs) that wish to provide direct access to US customers, thereby allowing the CFTC to codify the no-action process for FBOTs; and (iii) directing the CFTC to harmonize its definition of manipulation with that of the Securities and Exchange Commission and the Federal Energy Regulatory Commission.

http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opadunn-8.pdf

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