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SEC/CORPORATE

SEC Issues New Interpretations on Form S-3 Eligibility, Incorporation of Proxy Statements in Annual Reports and Foreign Private Issuer Status

On August 11, the Securities and Exchange Commission's Division of Corporation Finance issued new Compliance and Disclosure Interpretations (C&DIs) on topics including the availability of Form S-3 for issuers filing shelf registration statements in reliance on General Instruction I.B.6 (limited primary offerings) of that form, the incorporation of information required by Part III of Form 10-K from proxy statements and foreign private issuer status.

The SEC's guidance included the following:

- An issuer with an effective shelf registration statement on Form S-3 filed in reliance on General Instruction I.B.6 may not file a prospectus supplement for a new offering of securities in an amount that exceeds the applicable volume limitation (described below), even if the actual amount sold does not exceed the volume limitation. General Instruction I.B.6 permits certain issuers to use Form S-3 to register securities if the aggregate market value of securities sold by the issuer in reliance on General Instruction I.B.6 during the 12 months immediately prior to, and including, the sale is no more than one-third of the issuer's public float. The new C&DI indicates that the capacity remaining under the one-third limitation is measured immediately prior to the registered takedown, and applies to the amount of securities offered for sale pursuant to the prospectus supplement, not the amount actually sold. When measuring the amount available for a later takedown, only the securities sold are counted against the one-third limit.

  Click here to view the C&DI described above (Question 116.22).

- Although the amount of securities available for a shelf takedown pursuant to General Instruction I.B.6 is generally measured by counting only the securities actually sold during the preceding 12 months, in the case of multiple, concurrent offerings, the securities that continue to be offered in all such concurrent offerings in reliance on General Instruction I.B.6 would count against the one-third limit.

  Click here to view the C&DI described above (Question 116.23).

- Where an issuer intends to incorporate the information required by Part III of Form 10-K by reference from the issuer's proxy statement, the issuer may only incorporate by reference from a *definitive* proxy statement filed within 120 days after the end of the issuer's fiscal year. If an issuer has filed only a *preliminary* proxy statement within the 120-day period, the issuer must file an amendment to the issuer's Form 10-K to include the Part III information within the 120-day period.

  Click here to view the C&DI described above (Question 104.17)

- If a foreign issuer that qualifies as a "foreign private issuer" on the last business day of its most recently completed second fiscal quarter (the determination date for foreign private issuer status) reincorporates in the United States, the issuer no longer qualifies for foreign private issuer status. Although the issuer qualified as a foreign private issuer on the relevant determination date, a U.S. domiciled company can never be a foreign issuer or a foreign private issuer and, as a successor to the foreign issuer's reporting obligations, the U.S. corporation must immediately begin filing Exchange Act reports on domestic issuer forms.

  Click here to view the C&DI described above (Question 110.01)

BROKER DEALER

SEC Considers Additional Safeguards to Prevent Market Disruptions

On August 11, the Chairman of the Securities and Exchange Commission announced that additional measures in response to the May 6 market plunge are being considered. The SEC has undertaken two policy responses already.

First, the SEC approved new rules that require the exchanges and the Financial Industry Regulatory Authority to pause trading in S&P 500 stocks if price fluctuations reach 10% within five minutes. In June, the SEC published for comment proposals to expand these rules beyond the S&P 500 to stocks listed in the Russell 1000 Index and another 344 exchange traded funds.

Second, the SEC published for public comment proposed rules from self-regulatory organizations setting clearer standards for breaking clearly erroneous trades. The SEC is currently reviewing the comments and hopes to approve these rules soon.

In addition to its immediate policy responses to the events of May 6, the SEC will also consider three additional measures to reduce the risk of sudden disruptions and clearly erroneous trades:

1) Deterring or prohibiting the use of "stub" quotes by market makers;
2) Studying the use of trading protocols at individual exchanges (e.g., using trading pauses, price collars and self-help rules); and
3) Instituting limit up/limit down mechanisms.

To read the SEC Chairman's speech to the Commodity Futures Trading Commission-SEC Joint Advisory Committee, click here.

FINRA Seeks Expansion of the Audit Trail System to All NMS Stocks

On August 6, the Financial Industry Regulatory Authority proposed an expansion of its Order Audit Trail System (OATS) to include the trading of all national market system securities (NMS stocks) on all national securities exchanges. Currently, FINRA requires all of its members to record in electronic form and report to OATS on a daily basis order, trade and quote information for all over-the-counter trades and NMS stocks listed on NASDAQ. From this information OATS creates a time-sequenced record of orders and transactions, which is then used by the Securities and Exchange Commission and the national exchanges and securities associations (SROs) to conduct surveillance and investigations for potential violations of federal securities laws and exchange/association rules.

On May 26, the SEC announced a rule proposal which would require the SROs to develop a consolidated audit trail system. Under the proposal, the SROs are to work together to implement a consolidated order tracking system with respect to NMS stocks and listed equity options.

The SEC's proposed consolidated audit trail is still in the proposal stage and may be several years away from providing a means by which the SEC and the SROs can use the data to surveil the equity markets. In the interim, FINRA believes that extending the OATS recording and reporting requirements to NMS stocks listed on all national exchanges will greatly enhance its audit trail and its ability to identify illicit activity.

FINRA's proposed rule change was filed with the SEC on August 6. The SEC is expected to seek public comment on the proposal prior to its potential effectiveness.

FINRA's August 6 filing is available here.

See also Katten's Client Advisory titled SEC Proposes Major Initiative to Build a Consolidated Audit Trail for Equities and Options.

CFTC

CFTC Reissues Proposed Rules for Segregated Funds Acknowledgment Letters

The Commodity Futures Trading Commission has reissued its proposal to amend CFTC Regulations 1.20, 1.26 and 30.7, relating to the acknowledgment letters that futures commission merchants (FCMs) and derivatives clearing organizations (DCOs) are required to obtain from depositories that hold customer segregated and/or secured amount funds.

In response to comments on its previous proposal, the CFTC's amended proposal includes a required form of acknowledgment letter. FCMs and DCOs would be required to update the acknowledgment letters within 60 days of any change in the name of the FCM or DCO, of the bank, trust company, FCM or DCO that has received the funds, or of any change in the account number. Finally, the CFTC has proposed to create an electronic filing system for the required acknowledgement letters.

The proposal would require FCMs and DCOs to obtain updated acknowledgment letters in compliance with the new requirements within 90 days after the publication of final regulations in the Federal Register. The proposed rules would, however, leave intact that portion of Regulation 1.20 that makes it unnecessary for an FCM to obtain an acknowledgment letter from a DCO whose rules provide for the segregation of customer funds in compliance with the Commodity Exchange Act and CFTC regulations.

The comment period for the CFTC proposal expires on September 8.

Read more.

LITIGATION

Misrepresentation of Lehman Guaranty Supports Securities Claim

An investment company's representation that certain energy bonds were backed by the State of Georgia—when they were in fact guarantied by Lehman Brothers Holdings, Inc.—could subject the firm to liability for securities fraud.

Investor Paul Prager contacted FMS Bonds, Inc. in April 2008 to pursue conservative investment opportunities. An FMS advisor recommended that he purchase a recent issue of natural gas bonds, which the advisor described as municipal bonds that were backed by the State of Georgia. The bonds were actually guarantied by Lehman, however, and Mr. Prager lost $112,000 of his $200,000 investment after the investment bank filed for bankruptcy.

Mr. Prager sued FMS for violations of Securities and Exchange Commission Rule 10b-5 and the Securities Exchange Act of 1934. FMS sought dismissal of the securities claims, arguing that Mr. Prager had not alleged particularized facts about how FMS had misled the plaintiff or about Mr. Prager's reliance on the misstatements. The U.S. District Court for the Southern District of Florida rejected these arguments, holding that the allegation that FMS described the bonds as "safe" investments backed by Georgia provided sufficient details about FMS's alleged deception and about the factual assertions that Mr. Prager relied upon. (*Prager v. FMS Bonds, Inc.*, 2010 WL 2950065 (S.D. Fla. July 26, 2010))

Manager's Investment in LLC Not an Investment Contract

The managing partner of a mining venture cannot pursue federal securities claims against his estranged partners because he exerted substantial control over the enterprise.

Marc Nunez formed Sand Specialties and Aggregates, LLC (SSA) with five other partners, four of whom promised to commit $800,000 to the project. Mr. Nunez oversaw certain financial operations of SSA while an operational partner, who was not an investor, handled SSA's mining activities. When the other four investors failed to contribute their share of the funds, disclosed that they could not fulfill this obligation, and began to utilize SSA property for their own benefit, Mr. Nunez sued them and SSA for securities fraud under the Securities Exchange Act of 1934.

The defendants sought dismissal of the securities claim, arguing that Mr. Nunez's financial contribution to SSA could not be considered an investment contract because he exercised substantial control over the business. Mr. Nunez contended that he was induced into purchasing an interest in SSA by promises of like contribution, and that his reliance on the expertise of the operational partner showed that he qualified as a passive investor under the Exchange Act. The U.S. District Court for the Eastern District of Louisiana ruled that Mr. Nunez's control over SSA's finances ensured that he could protect his financial interests in the company, thus his contribution could not be considered an investment contract under federal law. (*Nunez v. Robin*, 2010 WL 3021618 (E.D. La. July 29, 2010))

BANKING

Federal Reserve Implements Gift Card Rule

The Federal Reserve Board on July 11 announced its approval of an interim final rule implementing recent legislation modifying the effective date of certain disclosure requirements applicable to gift cards under the Credit Card Accountability Responsibility and Disclosure Act of 2009. For gift certificates, store gift cards, and general-use prepaid cards produced prior to April 1, the legislation and interim final rule delay the August 22 effective date of these disclosures until January 31, 2011, provided that several conditions are met. While the Gift Card Amendment delays the effective date for certain disclosure requirements set forth in the Credit Card Act, the Gift Card Amendment does not address the status of additional requirements adopted in the Board's final gift card rule. As a result, persons seeking to take advantage of the relief afforded by the Gift Card Amendment may be unable to do so if certain of these additional provisions were to apply after August 22. For example, Section 205.20(e)(1) prohibits any person from selling or issuing a certificate or card unless the consumer has had a reasonable opportunity to purchase a certificate or card with at least five years remaining until the certificate or card expiration date. Thus, a card produced prior to April 1 that has a card expiration date of less than five years could not be sold under the final gift card rule, notwithstanding the provisions of the Gift Card Amendment. Therefore, in order to carry out the intended purpose of the Gift Card Amendment, this interim final rule also delays the effective date of certain of these supplemental requirements. This interim final rule revises Sections 205.20(c) and (g) of the final gift card rule ("Form of Disclosures" and "Compliance Dates," respectively) and adds a new Section 205.20(h) ("Temporary Exemption").

The interim final rule is effective August 22. The Board is, however, seeking public comment on the interim final rule. Comments on the interim final rule must be submitted within 30 days after publication in the *Federal Register*, which is expected shortly.

Read more.

Banking Agencies Request Information on Alternatives to the Use of External Credit Ratings in Risk-Based Capital Rules

On August 10, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Office of Thrift Supervision (collectively, the Banking Agencies) issued an advanced notice of proposed rulemaking regarding the use of credit ratings in the Banking Agencies' risk-based capital rules (the Proposal). The issuance is in response to the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires federal agencies to review, no later than one year after enactment, any regulation that requires use of an assessment of creditworthiness of a security or money market instrument and any references to, or requirements in, regulations regarding credit ratings. Where feasible, the Banking Agencies are also required to remove references or requirements to rely on credit ratings and to substitute an alternative standard of creditworthiness.

The Proposal describes where the Banking Agencies rely on credit ratings in their regulations. It also includes an informative table that provides an overview of where credit ratings are referenced in such regulations and used as a basis for capital requirements. The Banking Agencies will use the information they collect in response to the questions set forth in the Proposal to begin to develop an alternative to the use of credit ratings in their respective capital rules.

Comments are due to the Banking Agencies within 60 days after publication in the *Federal Register*.

For more information, click here.

FDIC Releases Proposed Guidance on Overdraft Payment Programs

On August 11, the Federal Deposit Insurance Corporation (FDIC) released proposed guidance affecting all FDIC-supervised institutions regarding automated overdraft payment programs (Proposal). The Proposal focuses on ways for banks to monitor their overdraft programs for chronic or excessive use by consumers. It also addresses compliance and safety and soundness issues related to overdraft programs.

Included in the Proposal is a requirement that the bank's board and management regularly review their overdraft programs' features and operation as well as a requirement to impose daily limits on a customer's costs related to overdrafts.

Ad hoc overdrafts, however, are not covered by the Proposal (i.e., those occasions where a bank employee infrequently uses his discretion in a specific instance to pay an item or not).

New rules adopted by the Board of Governors of the Federal Reserve System regarding account overdrafts addressed only overdraft fees charged to consumers to cover automated teller machine and point-of-sale overdrafts.

For more information, click here.

FDIC Amends Rules to Reflect New Insurance Coverage

On August 10, the Federal Deposit Insurance Corporation Board of Directors adopted a final rule amending its insurance regulations (12 C.F.R. Part 330) and advertising regulations (12 C.F.R. Part 328) to conform with provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which permanently increased the standard maximum deposit insurance amount (SMDIA) from $100,000 to $250,000. This permanent increase in the SMDIA became effective July 22 and is retroactive to January 1, 2008.

Read more.

UK DEVELOPMENTS

FSA Cracks Down on Sales of Private Funds

The UK Financial Services Authority (FSA) has recently publicized widespread failings in the marketing of "unregulated collective investment schemes"—a category of fund products which includes almost all private funds including all hedge funds other than those established within the Undertakings for Collective Investment in Transferable Securities (UCITS) framework. This does not mean that such funds cannot be sold in or from the UK but it emphasizes the need for great attention to the details of the relevant regulations before, and while, doing so.

The FSA announced that it had just completed a project examining the promotion and sale of unregulated collective investment schemes to retail customers by financial advisors. The FSA stated that it had uncovered widespread failings by financial advisor firms in understanding the regulatory requirements for the promotion of these funds, a lack of understanding of the market within which these schemes operated and of the risks of investment in these funds. This has resulted in firms marketing and selling these funds to customers who were not eligible to purchase them. The FSA is bringing enforcement proceedings against a number of regulated firms.

Read more.

FSA Hedge Fund Surveys Conclusions Published

The UK Financial Services Authority (FSA) recently published a report entitled "Assessing possible sources of systemic risk from hedge funds." It sets out the FSA's key findings and conclusions from two surveys it conducted in April 2010—the Hedge Funds as Counterparties Survey (HFACS) and the Hedge Fund Survey (HFS). The FSA intends to continue conducting these surveys every six months to help monitor trends in hedge funds. (The results of the October 2009 surveys, published in February 2010, were reported in the February 26 edition of *Corporate and Financial Weekly Digest*).

The HFACS has been conducted every six months since 2005. It asks some of the largest FSA-authorized banks with exposures to hedge funds about their credit counterparty risks. The HFS was introduced in October 2009 to complement the HFACS. It surveys the 50 largest FSA-authorized investment managers, on this occasion with a combined total of $345 billion in hedge fund assets under management. The survey asks questions about the assets the firms managed and the larger funds for which they undertake management activities.

The report's conclusions, which were in line with the FSA's expectations of an increase in risk appetite and improved market conditions since the previous survey in October 2009, were:

- hedge funds are using more leverage;
- hedge funds are borrowing more through repurchase agreements and less through prime brokerage;
- with the exception of corporate bonds, positions held by the surveyed hedge funds did not comprise a particularly large proportion of any total asset class;
- measures such as performance, open positions, concentration of positions, overall exposure of funds by LMV vs. SMV and prime brokerage cash balances to net equity ratio suggest hedge funds have a higher risk appetite at April 2010 compared to six months earlier; and
- hedge funds appear to have further diversified their credit exposures to bank counterparties.

The FSA reported that there was no material change in the systemic risk to financial stability as against the survey six months previously. That survey had concluded: "The HFACS data suggests that on October 31, 2009, major hedge funds did not pose a potentially destabilizing credit counterparty risk across the surveyed banks. HFS data shows a relatively low level of 'leverage' under our various measures and suggests a contained level of risk from hedge funds at that time."

To read the report in full, click here.

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