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Corporate and Financial Weekly Digest

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LITIGATION

Ninth Circuit Applies SLUSA's "Preclusion" Provisions in Removed Action

The Ninth Circuit recently overturned a District Court decision, holding that the lower court applied the wrong standard in ruling that a lawsuit against an investment bank arising out of a securities transaction was properly removed to federal court and that state law claims asserted in the action were precluded under the Securities Litigation Uniform Standards Act of 1988 (SLUSA). Plaintiffs filed their suit in state court, alleging that the defendant committed negligent misrepresentation and professional negligence based on statements included in a fairness opinion it provided in connection with a merger and acquisition involving three corporate entities.

SLUSA, which was enacted as part of a congressional effort to rein in private securities litigation, normally operates to preclude state law claims based on securities fraud actions. However, under an exception in the statute, claims asserted under the law of the state in which the defendant issuer is incorporated are permitted in certain narrow circumstances. One element of the exception's applicability at issue before the Ninth Circuit was whether the defendant investment bank made a statement "on behalf of" one of two companies being acquired. Without such a statement, the exception would not apply.

The lower court ruled that the defendant investment bank could only be deemed to be making a statement "on behalf of" the company being acquired if it was an officer, director or employee of that company. Because it was not, the District Court ruled that the exception did not apply and that SLUSA precluded plaintiffs' state law claims. The Ninth Circuit rejected this narrow view of the "on behalf of" requirement, ruling instead that a common sense construction of the term was required and that the investment bank should be considered to be acting "on behalf of" the company being acquired when it makes a communication to the company's stockholders in the interest of, as a representative of, or for the benefit of the company. (*Madden v. Cowen & Co.*, No. 07-15900, 2009 WL 2413804 (9th Cir. Aug. 7, 2009))

Plaintiff Failed to Adequately Allege Loss Causation for Portion of Claims

Plaintiffs brought a federal securities class action suit raising allegations of misstatements in connection with stock options backdating and revenue recognition accounting manipulations. The U.S. District Court for the Southern District of New York ruled that, with one exception, plaintiffs failed to adequately allege the loss causation element of their Section 10(b) and Rule 10b-5 claims.

Plaintiffs relied on three separate disclosures, each of which was followed by a substantial decline in share price, to support their loss causation allegations. The first disclosure, which was followed by a 15.2% drop in share price, indicated that the defendant corporation had discovered errors that impacted prior quarters' financial disclosures but did not materially impact full year results. The second disclosure (followed by a 19.3% drop) reported, without explanation, that the defendant's CFO was leaving the company. Notably, on the same day that the CFO's departure was announced, the company also announced that it was not pursuing an expected corporate acquisition. Notwithstanding the sharp stock price declines, the Court ruled that neither of these disclosures sufficed. The first did not reveal to investors that the company's accounting practices were false and, thus, did not support plaintiff's claim that the disclosure of the challenged accounting practices, as opposed to disclosure of "bad news" generally, caused the loss. Similarly, the Court ruled that the disclosure of the CFO's departure, without explanation, did not alert investors to any improprieties that would establish loss causation. The Court also ruled that the plaintiffs failed to show that the price decline following the second disclosure was related to the alleged fraud as opposed to the announcement that the expected acquisition was not proceeding.

The Court did rule that a third disclosure, in which the defendant corporation announced that it had received a subpoena and notice of an investigation relating to the company's stock option program and certain accounting practices and policies, was partially sufficient to provide the basis for loss causation (this disclosure was followed

by a 22.3% decline in share price). The Court ruled that although the disclosure clearly related to the defendant corporation's stock options program and adequately demonstrated loss causation with respect to the backdating allegations, its references to unspecified accounting procedures were too vague in connection with the accounting practices allegations. In ruling that the stock options investigation disclosure sufficiently alleged loss causation, the Court noted but did not follow a line of California cases suggesting that the mere announcement of an investigation into a practice was not sufficient to support an inference of wrongdoing. (*Police and Fire Ret. Sys. of Detroit v. Safenet, Inc.*, No. 06 Civ. 5797, 2009 WL 2391849 (S.D.N.Y. Aug. 5, 2009))

BROKER DEALER

Large Options Positions Report to Change Under Options Symbology Initiative

The Financial Industry Regulatory Authority has issued a Notice summarizing changes to firms' reporting of positions to the Large Options Positions Report (LOPR) system as the Options Clearing Corporation (OCC) continues to implement the Options Symbology Initiative. Although the threshold for the LOPR will not change, significant changes to the submission of LOPR data and the LOPR layout will affect the reporting of both listed and conventional options positions. The Securities Industry Automation Corporation will no longer accept LOPR data after January 19, 2010, and the OCC will take over the collection and dissemination of all LOPR data. The milestone dates related to the implementation of the new LOPR are listed in the Notice.

For more information on the Options Symbology Initiative, see the July 24 edition of *Corporate and Financial Weekly Digest*.

Click here to read FINRA Regulatory Notice 09-47.

NYSE Regulation Issues Guidance on Handling of Large Orders

NYSE Regulation, Inc. (NYSER) has issued regulatory guidance on the appropriate handling of large orders. The guidance is based on the results of NYSER's recent survey of large and medium New York Stock Exchange and NYSE Amex LLC member organizations regarding their supervision and control of large agency and proprietary orders that may have a significant market impact, particularly at or near the close of markets. The guidance identifies certain common elements of effective supervision of large order trading and facilitation in connection with the requirements under NYSE Rule 342 for member organizations to maintain written policies, procedures and supervisory controls reasonably designed to assure compliance with all rule requirements, including detecting and preventing potentially violative conduct in connection with the handling of large orders that may have a market impact. The common elements discussed relate to a firm's written policies and procedures, identification of supervisory personnel, reports, pre- and post-trade reviews, issue escalation, pro-active trading limitations and customer disclosures.

Click here to read NYSER Information Memo 09-40.

OTC DERIVATIVES

Treasury Releases Proposal to Regulate OTC Derivatives

The U.S. Treasury Department has proposed legislation to provide for comprehensive regulation of the OTC derivatives market. The Over-the-Counter Derivatives Markets Act of 2009 would implement the recommendations regarding OTC derivatives set forth in the Treasury's June 17 white paper "Financial Regulatory Reform: A New Foundation." Among other things, the bill would:

- Require the central clearing and trading of standardized OTC derivatives
- Impose substantial capital and margin requirements with respect to non-standardized derivatives in order to encourage the move to centrally cleared, standardized instruments
- Provide for the registration and regulation of "swap dealers" and "major swap participants"
- Provide the Securities and Exchange Commission and Commodity Futures Trading Commission with authority to deter market manipulation, fraud and other abuse and to set position limits and require large trader reports
- Tighten the definition of eligible investors that are able to engage in OTC derivatives transactions

The proposed legislative language can be found here.
The Treasury's press release can be found here.

A Katten *Client Advisory* that more fully describes the proposed legislation can be found here.

Comment Period Ends for ISDA Dispute Resolution Protocol

The comment period for the second phase of the International Swaps and Derivatives Association (ISDA) 2009 Protocol for Resolution of Disputed Collateral Calls closed on August 7. The Protocol is designed to provide standardized timing and methods for the resolution of collateral valuation disputes among market participants. Under the Protocol, market participants would have a three-day time period, which could be extended by mutual agreement, in which to transfer undisputed amounts of collateral, identify the precise transactions giving rise to a dispute, consult informally on valuation methodologies and resolve the dispute either informally or by using the formal resolution procedures prescribed in the Protocol. The ISDA has not yet determined whether the Protocol will be published as an industry best practices guideline, a legally binding protocol or a stand-alone amendment which may be incorporated into ISDA agreements by mutual agreement. The ISDA intends to finalize the Protocol by the end of September.

A copy of the Protocol is available here.

CFTC

CFTC Proposes to Amend Bankruptcy Rules to Establish Cleared OTC Derivatives as a Separate Account Class

The Commodity Futures Trading Commission has proposed to amend its Bankruptcy Rules, 17 CFR Part 190, to establish cleared over-the-counter derivatives as a separate account class for the purpose of calculating "net equity" and "allowed net equity" for each customer in the event of the bankruptcy of a futures commission merchant. The proposed amendment would define "cleared OTC derivatives" to include only those positions, and funds deposited to margin, guarantee or secure such positions, that are required to have been (i) segregated in accordance with a rule, regulation or order issued by the Commission, or (ii) held in a separate account for cleared-only contracts in accordance with the rules or bylaws of a derivatives clearing organization. The proposed amendment further provides that, to the extent cleared OTC derivatives are permitted to be held in a customer segregated account, the positions will be treated as futures for purposes of calculating customer net equity.

Comments must be submitted on or before September 14.

Read more.

BANKING

Administration Proposing New Fee Structure for Banks

According to recent reports in the press, the Obama administration is proposing to change the structure of fees that banks pay to their respective federal supervisory agencies. It has been reported that the new approach will involve a two-tiered, pay-for-regulation concept, whereby banks with more than $10 billion in assets would see increases in fees from their existing regulators and the new consumer protection agency that has been proposed by the Administration.

According to the *Washington Post*, Michael Barr, Assistant Treasury Secretary for Financial Institutions, stated, "We think the funding mechanism makes sense, though I understand not everyone in the industry is going to like it. The fee assessment is based on the risks and costs of supervision. The larger institutions require greater oversight, and in terms of consumers, they are reaching many, many more with more complicated products."

STRUCTURED FINANCE AND SECURITIZATION

U.S. Bankruptcy Court Denies Motions to Dismiss GGP Bankruptcy Cases

On August 11, the U.S. Bankruptcy Court for the Southern District of New York denied five motions to dismiss certain Chapter 11 bankruptcy cases filed by debtors, including a number of issuers of commercial mortgage-backed securities (CMBS), that are owned by mall operator General Growth Properties, Inc. (GGP). The movants, including special servicers of the CMBS issued by GGP, based their dismissal motions primarily on a claim that the debtor's cases were filed in bad faith.

That claim, in turn, was based largely on the fact that certain of the independent managers of the CMBS issuers were secretly fired by GGP and replaced with new independent managers prior to the bankruptcy filings. The court held neither such replacement of the independent managers nor any of the other allegations was grounds for dismissal of the filings. However, the court clarified that its ruling was not a general indictment of the bankruptcy-remoteness technology utilized by GGP and many other issuers in securitization transactions, stating:

> There is no question that a principal goal of the SPE [special-purpose entity] structure is to guard against substantive consolidation, but the question of substantive consolidation is entirely different from the issue whether the Board of a debtor that is part of a corporate group can consider the interests of the group along with the interests of the individual debtor when making a decision to file a bankruptcy case. Nothing in this Opinion implies that the assets and liabilities of any of the Subject Debtors could properly be substantively consolidated with those of any other entity.

Click here for the opinion.

EXECUTIVE COMPENSATION AND ERISA

FTC Delays Effective Date of "Red Flags" Rule; Confirms Limited Applicability to Benefit Plan Sponsors

The Federal Trade Commission (FTC) is responsible for enforcing the federal Red Flags Rule, which requires "financial institutions" and "creditors" to develop written programs designed to detect warning signs or "red flags" that indicate a potential case of identity theft. Although the Rule became effective January 1, 2008, full compliance was initially not required until August 1, 2009. In recent guidance, however, the FTC delayed the compliance date until November 1, 2009.

The FTC also issued guidance that answers several open questions regarding the Rule's application to employers that sponsor a 401(k) plan or offer a health flexible savings account (FSA). Specifically, the guidance provides:

- Merely allowing 401(k) plan participants to borrow money form their individual accounts does not, by itself, cause an employer to become a "creditor" under the Rule.

- An employer that otherwise meets the definition of "creditor" under the Rule, and thus is required to implement a written program to detect "red flags," is not required to include the individual 401(k) plan accounts of participants in its 401(k) plan in the red flag program, because the retirement plan accounts are set up between the individual participants and the 401(k) plan, which is a separate legal entity apart from the employer.

- An employer does not become a "creditor" subject to the Rule merely by offering and maintaining a health FSA.

A copy of the FTC's press release regarding the compliance extension can be obtained here.
A copy of the guidance regarding the application to employee benefit plans can be obtained here.

UK DEVELOPMENTS

FSA Introduces Remuneration Code of Practice

On August 12, the UK Financial Services Authority (FSA) introduced a remuneration code of practice (the Code). It requires UK banks with regulatory capital exceeding £1 billion (approx. $1.65 billion) and investment firms with regulatory capital exceeding £750 million (approx. $1.24 billion) to establish, implement and maintain remuneration policies consistent with effective risk management. Currently 26 firms fall within the Code's regulatory capital scope.

The Code introduces a new rule that requires firms within its scope to have in place remuneration policies consistent with effective risk management. The FSA has also added eight principles to the Systems and Controls (SYSC) module of its handbook designed to clarify how the FSA will assess compliance with the Code.

Although the Code applies directly only to the largest UK regulated firms, the FSA has indicated that it expects all banks, broker-dealers, investment managers and building societies to take note of its provisions since it represents the FSA's view on good practice for all firms.

The FSA stated that the fundamental objective of its remuneration policy is to sustain market confidence and promote financial stability through removing the incentives for inappropriate risk taking by firms, and thereby to protect consumers. It considers the need to ensure that remuneration policies and practices are consistent with and promote effective risk management to be fundamental. The FSA expects firms' boards of directors and senior

management to focus on ensuring that the total remuneration amounts distributed by firms are consistent with good risk management and that individual compensation practices provide the "right incentives."

Changes to policies and procedures should be fully in place by January 1, 2010, and changes to remuneration structures and contracts should be implemented with effect from January 1, 2010.

Read more.

For more information, contact:

LITIGATION

Alan R. Friedman	212.940.8516	alan.friedman@kattenlaw.com
Brian Schmidt	212.940.8579	brian.schmidt@kattenlaw.com

FINANCIAL SERVICES

Janet M. Angstadt	312.902.5494	janet.angstadt@kattenlaw.com
Henry Bregstein	212.940.6615	henry.bregstein@kattenlaw.com
Gary N. Distell	212.940.6490	gary.distell@kattenlaw.com
Daren R. Domina	212.940.6517	daren.domina@kattenlaw.com
Kevin M. Foley	312.902.5372	kevin.foley@kattenlaw.com
Jack P. Governale	212.940.8525	jack.governale@kattenlaw.com
Arthur W. Hahn	312.902.5241	arthur.hahn@kattenlaw.com
Patricia L. Levy	312.902.5322	patricia.levy@kattenlaw.com
Robert M. McLaughlin	212.940.8510	robert.mclaughlin@kattenlaw.com
Marilyn Selby Okoshi	212.940.8512	marilyn.okoshi@kattenlaw.com
Ross Pazzol	312.902.5554	ross.pazzol@kattenlaw.com
Kenneth M. Rosenzweig	312.902.5381	kenneth.rosenzweig@kattenlaw.com
Fred M. Santo	212.940.8720	fred.santo@kattenlaw.com
Marybeth Sorady	202.625.3727	marybeth.sorady@kattenlaw.com
James Van De Graaff	312.902.5227	james.vandegraaff@kattenlaw.com
Meryl E. Wiener	212.940.8542	meryl.wiener@kattenlaw.com
Lance A. Zinman	312.902.5212	lance.zinman@kattenlaw.com
Krassimira Zourkova	312.902.5334	krassimira.zourkova@kattenlaw.com

BANKING

Jeff Werthan	202.625.3569	jeff.werthan@kattenlaw.com
Terra K. Atkinson	704.344.3194	terra.atkinson@kattenlaw.com
Christina J. Grigorian	202.625.3541	christina.grigorian@kattenlaw.com
Adam Bolter	202.625.3665	adam.bolter@kattenlaw.com

STRUCTURED FINANCE AND SECURITIZATION

Eric S. Adams	212.940.6783	eric.adams@kattenlaw.com
Rachel B. Coan	212.940.8527	rachel.coan@kattenlaw.com
Hays Ellisen	212.940.6669	hays.ellisen@kattenlaw.com
Reid A. Mandel	312.902.5246	reid.mandel@kattenlaw.com

EXECUTIVE COMPENSATION AND ERISA

Gary W. Howell	312.902.5610	gary.howell@kattenlaw.com
William B. Duff	212.940.8532	william.duff@kattenlaw.com

UK DEVELOPMENTS

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

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CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK PALO ALTO WASHINGTON, DC

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London affiliate: Katten Muchin Rosenman Cornish LLP.