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Please note that *Corporate and Financial Weekly Digest* will not be published on September 3. The next issue will be distributed on September 10.

SEC/CORPORATE

SEC Adopts Shareholder Access Rules

On August 25, the Securities and Exchange Commission adopted final rules, effective 60 days following publication in the *Federal Register*, permitting shareholders or groups of shareholders to access the proxy statements of public companies for the purpose of nominating directors.

Under new Rule 14a-11, the holder or holders of 3% or more of the shares of the company entitled to vote on the election of directors, who continuously owned such shares for at least three years, will be permitted to nominate, and have included in the company's proxy statement, the greater of one nominee or nominees representing 25% of the company's board of directors.

The Rule requires that the nominating shareholder(s) file with the company and the SEC a new Schedule 14N in which the nominating shareholder(s) must make several representations and disclosures regarding its background and intentions and provide detailed information with respect to its nominees. There also are provisions permitting the company to challenge the qualifications under the Rule of either the nominating shareholder(s) or its nominees.

In addition, the SEC has amended Rule 14a-8(i)(8) to require companies to include in company proxy materials shareholder proposals that would amend, or request an amendment of, the company's governing documents regarding nominating procedures related to shareholder nominations, provided that those proposals may not conflict with new Rule 14a-11. Permitted amendments would be those that, for example, seek to reduce the minimum ownership or holding requirements provided under Rule 14a-11 or otherwise lessen its requirements for nominating shareholders.

Smaller reporting companies (filers which have a pubic equity float of $75 million or less) are not subject to Rule 14a-11 until three years following its effective date.

Click here to read a Katten *Client Advisory* providing a more detailed analysis of the new rules.
Click here to access the SEC's final Rule.

BROKER DEALER

FINRA Proposes Changes to Know Your Customer and Suitability Rules

On August 13, the Securities and Exchange Commission published a notice that the Financial Industry Regulatory Authority proposes to adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) as part of the

Consolidated FINRA Rulebook. The proposed Know Your Customer and Suitability rules are based largely on the following:

- Incorporated NYSE Rule 405(1) (Diligence as to Accounts);
- NASD Rule 2310 (Recommendations to Customers (Suitability)); and
- both rules' related interpretative materials (together, the Existing Rules).

The proposed rules would delete the Existing Rules; however, the proposed rules seek to clarify and strengthen the core features of the Existing Rules.

Know Your Customer

The proposed Know Your Customer rules would impose the following obligations on broker-dealers in regards to the opening and maintenance of every account:

- to use "due diligence"; and
- to know the "essential facts" concerning every customer.

The proposed supplementary materials would define "essential facts" as those required to (a) effectively service the customer's account; (b) act in accordance with special handling instructions for the account; (c) understand the authority of each person acting on behalf of the customer; and (d) comply with applicable laws, regulations and rules.

These obligations would arise at the outset of the customer/broker relationship regardless of whether the broker has made a recommendation. Moreover, the proposed Know Your Customer rules would eliminate the existing requirement to learn the essential facts relative to "every order."

Suitability

The proposed Suitability rules would impose a reasonableness standard on broker-dealers in determining whether a transaction or investment strategy is suitable for a customer. This suitability assessment would require the broker-dealer to use reasonable diligence to ascertain the customer's investment profile. Relevant customer information would include, but would not be limited to, the following:

- age,
- other investments,
- financial situation and needs,
- tax status,
- investment objectives,
- investment experience,
- investment time horizon,
- liquidity needs, and
- risk tolerance.

The proposed Suitability rules explicitly cover the investment "strategy." While FINRA intends that "strategy" be interpreted broadly, the proposed Suitability rules expressly exclude the following communications, as long as they do not include a recommendation of a particular security:

- general financial and investment information, including (1) basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return and tax deferred investment; (2) historic differences in the return of asset classes (e.g., equities, bonds or cash) based on standard market indices; (3) effects of inflation; (4) estimating future retirement income needs; and (5) assessment of a customer's investment profile;
- descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, the benefits of plan participation, and the investment options available under the plan;
- asset allocation models that are (1) based on generally accepted investment theory, (2) accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor's assessment of the asset allocation model or any report generated by such model, and (3) in compliance with NASD IM-2210-6

(Requirements for the Use of Investment Analysis Tools) if the asset allocation model is an "investment analysis tool" covered by NASD IM-2210-6; and
- interactive investment materials that incorporate the above.

The proposed Suitability rules also codify three interpretations of the reasonableness standard imposed on broker-dealers with respect to ensuring customer suitability:

- **Objective Reasonable Basis**—The broker-dealer must have a reasonable basis to believe, based on adequate due diligence, that a recommendation is suitable for at least some investors.
- **Customer-Specific/Subjective Reasonable Basis**—The broker-dealer must have reasonable grounds to believe a recommendation is suitable for the particular investor.
- **Quantitative Reasonable Basis**—The broker-dealer must have a reasonable basis to believe the number of recommended transactions within a certain period is not excessive.

Lastly, the proposed Suitability rules would amend the "institutional customer exemption." The Suitability rules center on whether there is a reasonable basis for the belief that an institutional customer is capable of assessing investment risk independently and whether the institutional customer is in fact exercising independent judgment.

To read the text of FINRA's proposed rule change, click here.

FINRA Proposes to Reinstitute Short Exempt Marking for Trade Reporting and OATS

On August 20, the Securities and Exchange Commission published a notice that the Financial Industry Regulatory Authority proposes to adopt rule changes to its trade reporting and Order Audit Trail System (OATS) in response to recent amendments to SEC Regulation SHO. Among other things, the amendments:

1) implement a "short sale circuit breaker" for National Market System stocks that once triggered prohibits the execution or display of short sale orders at a price less than or equal to the current national best bid for the remainder of the day and the following day; and
2) reinstitute a "short sale exempt" marking category, which allows broker-dealers to mark certain sell orders as "short exempt" once the short sale circuit breaker has been triggered.

The short sale circuit breaker described above is triggered by a 10% or more decrease in the price of the security from such security's closing price at the end of the regular trading hours on the prior trading day.

Trade Reporting

In response to the reinstitution of the short sale exempt marking category, FINRA proposes to change its trade reporting rules. Specifically, under the proposed rule changes, FINRA members would have to indicate on trade reports if a transaction is short sale exempt.

OATS

Likewise, FINRA's proposed rule changes would require FINRA members to record the designation of an order as short sale exempt when an order is received or originated.

To read the text of the text of the amendment to Regulation SHO, click here.
To read the text of FINRA's proposed rule change, click here.

CFTC

CFTC Signs Statement of Intent with Japanese Regulators

The Commodity Futures Trading Commission has signed a Statement of Intent (SOI) Concerning Cooperation, Consultation and the Exchange of Information with the Ministry of Economy, Trade and Industry of Japan (METI) and the Ministry of Agriculture, Forestry and Fisheries of Japan (MAFF).

The SOI establishes a framework for information sharing and facilitates cooperation in cross-border investigations of potential violations of commodity futures laws. The SOI is supported by a diplomatic Note Verbale exchanged by the governments of the United States and Japan. The Note confirms that information obtained under the SOI can be used by each country's criminal authorities.

METI has oversight over trading in precious metals, base metals, rubber and energy related products, and MAFF has jurisdiction over agricultural commodity trading.

The CFTC press release concerning the SOI can be found here.
The text of the SOI can be found here.

CFTC Seeking Public Input on Rulemaking for Dodd-Frank Wall Street Reform and Consumer Protection Act

The Commodity Futures Trading Commission has published a *Federal Register* notice seeking public input on the CFTC's proposed rulemaking areas to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act.

On July 21, the CFTC released the list of 30 areas of rulemaking for over-the-counter derivatives to implement the Act. The CFTC has made separate electronic mailboxes available for comments with respect to 29 of the 30 individual areas, as well as a general comment mailbox (the addresses for which mailboxes can be found in the *Federal Register* notice). The CFTC has indicated that the views of interested parties may be considered in the pre-proposal process but will not be treated as official comments on specific proposed rules.

The CFTC will accept submissions on each rulemaking topic until such time as it publishes a proposed rule for that topic in the *Federal Register*. Thereafter, it will accept official comments on such proposed rules until the close of the proposed rule's official comment period. All submissions provided to the CFTC will be published on the CFTC's website. The submissions will not be subject to pre-publication review, and personally identifying information will not be removed.

The CFTC press release regarding the *Federal Register* release can be found here.
The *Federal Register* release can be found here.

LITIGATION

Stay of Discovery Under PSLRA Does Not Apply During All Motions to Dismiss

Plaintiff brought a claim for securities fraud against a medical device corporation and certain employees, officers and board members of the corporation. Several defendants (the moving defendants) filed motions to dismiss the plaintiff's complaint on February 11, 2009. On September 4, 2009, the motions were granted in part and denied in part.

One defendant, Budimir Drakulic, was not served with the complaint until September 2, 2009. Mr. Drakulic moved to dismiss the complaint on October 8, 2009. In June 2010, while Mr. Drakulic's motion to dismiss was pending, plaintiff served him, as well as several co-defendants who had made the original motion to dismiss, with requests for production of documents and a notice of deposition. The moving defendants moved to quash the document requests and notice of deposition on the ground that automatic discovery stay provision of the Private Securities Litigation Reform Act (PSLRA) remained in effect as to all defendants while Mr. Drakulic's motion to dismiss was pending.

In support of their motion, the moving defendants argued that the PSLRA was unambiguous and that the automatic discovery stay applied "during the pendency of any motion to dismiss." The district court rejected the moving defendants' argument and denied their motion. The court reasoned that while the language of the statute appeared plain on its face, the automatic stay provision did not account for situations where there were multiple defendants making multiple motions to dismiss and was therefore ambiguous. The court pointed out that the purpose of the PSLRA's automatic stay provision is to minimize expensive discovery in frivolous securities class actions by permitting discovery only after the court had sustained the legal sufficiency of the complaint. The court noted that it had already sustained the legal sufficiency of the primary allegations in the complaint when it ruled on

the motions to dismiss by the moving defendants. As a result, the purpose underlying the PSLRA's stay provision would not be undercut by permitting discovery to proceed against the moving defendants during the pendency of Mr. Drakulic's motion because that discovery would be needed regardless of the outcome of the motion. (*Latham v. Stein*, Nos. 6:08-2995-RBH and 6:08-3183-RBH, 2010 WL 3294722 (D.S.C. Aug. 20, 2010))

Fiduciaries Did Not Breach Duty of Prudence by Failing to Divest Investments in Company Shares

Plaintiffs, former employees of two energy providers, brought a consolidated class action, alleging that the fiduciaries of the companies' employee savings plans breached their fiduciary duties under the Employee Retirement Income Security Act by maintaining the savings plans' significant investment in stock of one of the companies, Constellation Energy Group, Inc. Plaintiffs asserted that defendants knew or should have known that the investment was imprudent because Constellation was engaging in risky business practices, such as the trading of large amounts of energy in unregulated markets.

Defendants moved to dismiss the complaint on the grounds that they did not have the discretion to divest the stock, and thus could not be held accountable for the poor plan performance as a result of the decrease in the stock's value. Defendants further argued that, in any event, they were entitled as fiduciaries to a presumption that they acted prudently by investing the assets in employer stock. Plaintiffs opposed defendants' motion to dismiss the breach of prudence claim, arguing (1) that the fiduciaries had discretion to divest the Plans of the Stock, and (2) that Fourth Circuit precedent rejected the presumption of prudence that defendants were seeking.

The court granted defendants' motion to dismiss the breach of prudence claim, holding that, even assuming the fiduciaries had the discretion to divest the stock and that no presumption of prudence was warranted, the plaintiffs' complaint would still fail to state a cause of action because it lacked any allegation concerning the purported events that allegedly should have triggered the duty of divest. The court pointed out that the alleged risky business practices that plaintiffs argued warranted divestiture had been pursued since 2001, with highly profitable results, and that plaintiffs failed to point to any change in Constellation's practices at the start of the class period. In so holding, the court noted that investment in high-risk companies cannot be deemed to be "prudent when they succeed and imprudent when they fail." (*In re Constellation Energy Group, Inc.* Erisa Litigation, No. CCB-08-2662, 2010 WL 3221821 (D. Md. Aug. 13, 2010))

UK DEVELOPMENTS

FSA Fines Zurich Insurance for Loss of Customer Details

On August 24, the UK Financial Services Authority (FSA) announced that it had fined the UK branch of Irish company Zurich Insurance Plc (Zurich UK) £2.275 million (approximately $3.5 million) after 46,000 customers' confidential information was lost. This is the highest fine imposed to date on a single firm for failings in data protection.

In August 2008, Zurich UK outsourced certain data processing to its South African affiliate Zurich SA. The data losses occurred when Zurich SA transferred data stored on an unencrypted back-up tape to a data storage center as part of a routine transfer. A lack of inter-company communication meant that a year passed before Zurich UK was informed of the incident. The data loss left the customers vulnerable to theft and financial loss.

The FSA found that Zurich UK had not taken reasonable care to ensure that its systems and controls were sufficient to cope with the risks involved in the outsourcing arrangement nor to prevent the customer data being used for financial crime. (It appears that the lost data was not misused and no customers were compromised.)

As Zurich UK settled early, the original fine of £3.25 million (approximately $5 million) was reduced by 30%.

Read more.

FSA Signals Fundamental Changes to Trading Activity Regulation

On August 25, the UK Financial Services Authority (FSA) published a discussion paper (*The Prudential Regime for Trading Activities - a Fundamental Review* DP10/4) proposing fundamental changes to the regulation of the trading activities of banks and investment firms. The FSA considers that its proposed regulations will address key elements of risks currently posed to the financial system.

The proposals cover three key areas:

1) **Valuation**—more comprehensive regulation of valuation of trading positions and investigations into valuation uncertainty
2) **Coverage, coherence and the capital framework—**a restructuring of the capital framework, improving coherence and reducing structural arbitrage in the banking and finance sector
3) **Risk management and modelling—**measures targeting firms' risk management and modelling standards, aligning both with regulatory objectives

The closing date for responses is November 26. The FSA anticipates that it will issue a feedback statement and final rules in the first half of 2011.

The discussion paper can be found here.

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