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Corporate and Financial Weekly Digest

AUGUST 7, 2009

SEC/CORPORATE

SEC Delegates Authority to Director of Division of Enforcement

On August 5, the Securities and Exchange Commission amended its rules to delegate to the Director of the Division of Enforcement authority to issue formal orders of investigation. Pursuant to such an order, the enforcement staff of the SEC may issue subpoenas as part of an investigation under the federal securities laws. The amendment to the rule is intended to streamline the investigative process by reducing the time and paperwork previously associated with obtaining Commission authorization prior to issuing subpoenas. The Commission is adopting the delegation for a period of one year, and after that time, it will evaluate whether to extend it. However, formal orders issued during this one-year period will continue to remain in effect beyond the one-year period. Despite the delegation, if the Division Director determines it to be appropriate, a recommendation that a formal order be issued may be submitted to the Commission for its review.

To read the full text of the release, click here.

LITIGATION

Court of Appeals Upholds SEC's Barring of Accountant under SEC Rule 102(e)

The U.S. Court of Appeals for the District of Columbia denied an accountant's petition for review of the Securities and Exchange Commission's decision to bar him from practicing as an accountant before the SEC.

Petitioner Gregory Dearlove served as Deloitte & Touche's engagement partner in charge of the 2000 audit of Adelphia Communications Corporation. As the engagement partner, Mr. Dearlove led a team of 35 accountants charged with auditing Adelphia's financial statements, and personally signed Deloitte's 2000 independent auditor's report of Adelphia. In 2005, the SEC charged him with improper conduct resulting in the violation of applicable professional standards, including his approval of Adelphia's method of accounting for related party transactions. An administrative law judge concluded that Mr. Dearlove had violated SEC rules and regulations by engaging in one instance of highly unreasonable conduct and repeated instances of unreasonable conduct, and denied Mr. Dearlove the right to practice before the SEC.

Upon review, the SEC found that Mr. Dearlove had engaged only in repeated instances of unreasonable conduct and barred him from practicing before it, but granted him the right to apply for reinstatement after four years. Mr. Dearlove then petitioned the U.S. Court of Appeals for the D.C. Circuit to review the SEC's decision.

In reviewing the SEC's decision, the Circuit Court denied Mr. Dearlove's petition and determined, contrary to his assertions, that the SEC need not find that he violated the common law negligence standard of care, as evidenced by expert testimony, in order to conclude that he had engaged in unreasonable conduct under SEC Rule 102(e)(1)(iv)(B)(2). The Court held that the appropriate standard of care to consider under Rule 102 is provided by the Generally Accepted Auditing Standards (GAAS) only and that the SEC would not be required to receive expert testimony on the standard of care. The Court further found that the record contained substantial evidence to support the SEC's finding that Mr. Dearlove's conduct violated the standard of care as set forth in the GAAS, including, among other things, Mr. Dearlove's approval of Adelphia's practice of netting accounts receivable of related entities against one another. (*Dearlove v. SEC*, 2009 WL 2194872 (C.A.D.C. July 24, 2009))

Senators Introduce Legislation to Overturn *Central Bank* and *Stoneridge* Decisions

Senators Arlen Specter (D-PA), Edward Kaufman (D-Del.), and Jack Reed (D-RI) proposed new legislation, entitled Liability for Aiding and Abetting Securities Violation Act of 2009, that would provide a private right of action against third parties who aid and abet securities fraud. Passage of the bill would overturn the U.S. Supreme Court's decisions in *Central Bank of Denver v. First Interstate Bank of Denver* and *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc*.

Prior to the *Central Bank* decision, federal courts had implied a private right of action against secondary actors under Section 10(b) of the Securities Exchange Act of 1934. In *Central Bank*, the Supreme Court held that the implied private right of action applied to only "principal actors." The 2008 *Stoneridge* decision further narrowed the scope of the implied private right of action by holding that two companies that allegedly concealed the wrongdoing of another company could not be sued as primary violators under section 10(b) of the Securities Exchange Act by the other company's shareholders.

BROKER DEALER

FINRA Proposes Changes Regarding Fixed Price Offerings

The Financial Industry Regulatory Authority requested comment on a proposed rule governing fixed price offerings. The new rule, FINRA Rule 5141 (Sale of Securities in a Fixed Price Offering), would replace the provisions of current NASD Rules 2730, 2740 and 2750. The current NASD Rules generally prohibit the grant or reallowance of certain preferences (e.g., discounts, selling concessions, underwriting recapture or various economic equivalents) to persons outside of the offering syndicates formed to distribute the offered securities. The proposed rule would prohibit persons in these syndicates from offering, directly or indirectly, any securities at a "reduced price," i.e., any price below the stated public offering price, to any person or account that is not a member of such syndicate or selling group.

Read more.

Reporting of OTC Transactions Executed Outside Normal Market Hours

The Securities and Exchange Commission approved a proposed rule change to amend Financial Industry Regulatory Authority trade reporting rules relating to over-the-counter transactions in equity securities executed outside normal market hours. FINRA members would be required to report trades that were executed during the hours that a FINRA Facility was closed within 15 minutes of the opening of the Facility. In addition, FINRA has proposed certain amendments to the requirements for reporting of trades that occur "outside normal market hours" across the various FINRA Facilities.

Read more.

SEC Approves Proposed Plan Regarding Options Order Protection and Locked/Crossed Markets

As reported in the April 10 edition of *Corporate and Financial Weekly Digest*, the Securities and Exchange Commission published for comment a proposed plan by the options exchanges that would replace the current intermarket linkage plan. By order dated July 30, the SEC approved the proposed plan (as modified in the release), thus authorizing the options exchanges to act jointly to implement the plan.

Read more.

CFTC

CFTC Issues Order Permitting Eurex Clearing to Operate MCO for OTC Derivatives

The Commodity Futures Trading Commission has issued an order that permits Eurex Clearing AG (Eurex) to operate a multilateral clearing organization for over-the-counter derivatives instruments in the United States. The order concludes that the supervision of Eurex by German financial regulator Bundesanstalt für Finanzdienstleistungaufsicht (BaFin) and the German central bank satisfies the standards set forth in Section 409(b)(3) of the Federal Deposit Insurance Corporation Improvement Act of 1991. BaFin and the CFTC previously have entered into agreements for the sharing of information regarding the clearing activities of Eurex.

The CFTC press release announcing the order is available here.
The order is available here.

CFTC Requests Comments on DCO Application by ICE Clear Europe Limited

The Commodity Futures Trading Commission has issued a request for public comment regarding the application of ICE Clear Europe Limited for registration as a derivatives clearing organization. ICE Clear Europe currently clears over-the-counter energy contracts traded on IntercontinentalExchange, Inc., an exempt commercial market, but is seeking registration to clear futures and options that are traded on or subject to the rules of a designated contract market, derivatives transaction execution facility and/or exempt board of trade.

The comment period closes on August 25.

The DCO application by ICE Clear Europe Limited is available here.

BANKING

FDIC Releases Additional Guidance for Banks Related to Allowance for Loan and Lease Losses

On August 3, the Federal Deposit Insurance Corporation (FDIC) released a Financial Institution Letter entitled "Allowances for Loan and Lease Losses in the Current Economic Environment: Loans Secured by Junior Liens on 1-4 Family Residential Properties" to FDIC-supervised institutions.

The Letter states that, at least quarterly, banks must analyze the collectability of their loans held for investment and maintain an allowance for loan and lease losses (ALLL) at a level that is appropriate and determined in accordance with generally accepted accounting principles (GAAP). According to the Letter, an appropriate ALLL covers estimated credit losses on individually evaluated loans that are determined to be impaired and on groups of loans with similar risk characteristics that are collectively evaluated for impairment. With respect to estimating credit losses on each group of loans with similar risk characteristics under applicable Financial Accounting Standards, however, banks should consider their "historical loss experience on the group, *adjusted for changes in trends, conditions, and other relevant factors* that affect repayment of the loans in the group as of the ALLL evaluation date."

In its conclusion, the Letter states that the FDIC "recognizes that determining the appropriate level for the ALLL for each group of loans with similar risk characteristics" under existing financial accounting guidance is "inevitably imprecise and requires a high degree of management judgment." The Letter continues, stating that "delaying the recognition of estimated credit losses on junior lien loans secured by 1-4 family residential properties by failing to properly consider the effect of more senior liens on the collectability of an institution's existing junior lien loans is an inappropriate application of GAAP."

For more information, click here.

STRUCTURED FINANCE AND SECURITIZATION

New York Fed Appoints PIMCO as Collateral Monitor

On August 4, the Federal Reserve Bank of New York posted changes to the terms and conditions, frequently asked questions and transaction documents for its Term Asset-Backed Securities Loan Facility (TALF). A notable change is the appointment of Pacific Investment Management Company LLC (PIMCO) as a second collateral monitor. Trepp, LLC, which was previously appointed, will continue to focus on commercial mortgage-backed securities (CMBS), while PIMCO will perform a broader collateral monitoring role with respect to the entire TALF portfolio, including both asset-backed securities and CMBS.

Read more.

Borrowers Request $6.9 Billion of TALF Loans for ABS in August

The Federal Reserve Bank of New York announced that borrowers requested approximately $6.9 billion of Term Asset-Backed Securities Loan Facility (TALF) loans on the August 6 loan subscription date for asset-backed securities (ABS). For the first time, approximately $1 billion of loan requests were made for floorplan ABS. Loan requests were also made for $2.5 billion of credit card ABS, $2.4 billion of student loan ABS, $555 million of auto ABS, $149 million of small business loan ABS, and $107 million of servicing advance ABS. The total amount of TALF loan requests to date is now approximately $37 billion.

Read more.

ANTITRUST

Food Processor and Distributor Appeals Injunction under Robinson-Patman Act

For the first time in 40 years, a federal court has issued an injunction in a Robinson-Patman case barring a manufacturer from charging different prices to two different customers. If the injunction is upheld on appeal, the case will provide a new and potentially powerful tool for plaintiffs claiming that they are subject to price discrimination by their suppliers. Under the Robinson-Patman Act, sellers of manufactured products (the statute does not apply to the sale of services) cannot sell goods of like grade and quality at different prices to different customers who compete with each other, unless the price discrimination falls within certain exceptions to the statute.

The defendant, Michael Foods, Inc., a food processor and distributor of egg, dairy and potato products, sold its products to Feesers, Inc., a food distributor, at a different price than it sold its products to Sodexo, Inc., a food management service company. Feesers sued under the Robinson-Patman Act, alleging that Michael Foods' practice of charging a different price to Feesers than it did to Sodexo constituted illegal price discrimination. The court conducted a bench trial in 2008. On April 27, the U.S. District Court for the Middle District of Pennsylvania ruled in favor of Feesers and, in a highly unusual ruling, enjoined Michael Foods from engaging in unlawful price discrimination against Feesers. The case is now on appeal to the U.S. Court of Appeals for the Third Circuit. If the injunction is affirmed, the stakes in Robinson-Patman Act litigation will be raised significantly and product manufacturers will need to pay renewed attention to issues that arise when they charge different prices to different customers. (*Feesers, Inc. v. Michael Foods, Inc.*, 2009 WL 1138126 (M.D.Pa. April 27, 2009))

EXECUTIVE COMPENSATION

IRS Releases Guidance on Treatment of Backdated Stock Options Under Section 162(m)

In an internal memorandum released July 17, the Internal Revenue Service (IRS) addresses how the agency is handling the treatment of backdated stock options under Section 162(m) of the Internal Revenue Code (IRC). The IRS memorandum identifies two primary categories of cases that it was handling—(i) those that were the result of intentional manipulation of the grant date using the benefit of "hindsight" and (ii) those that were the result of poor recordkeeping and documentation. As a result of backdating or misdating practices, the options were determined to have been granted with an exercise price below the fair market value on the grant date and, therefore, became "discounted options." IRC Section 162(m) generally permits stock options that satisfy specified requirements to be treated as "qualified performance-based compensation" and, therefore, exempt from the $1 million limit on deductibility applicable to the compensation paid to certain key individuals at public companies. However, discounted stock options are not considered to be performance-based compensation because a portion of the compensation to be received upon exercise is not attributable to an increase in the company's stock price.

The memorandum states that the IRS will not treat backdated stock options as satisfying the performance-based compensation exception under IRC Section 162(m). In reaching this conclusion, the IRS focuses upon two key issues: (i) determining the date of grant of an option and (ii) whether an attempt to correct the exercise price after the date of grant will allow a backdated stock option to be treated as performance-based compensation. The IRS acknowledges that there is no clear guidance in the IRC Section 162(m) regulations for determining a stock option's grant date. In the cases thus far addressed by the IRS, the agency found it appropriate to use the "measurement date" that is commonly used for financial accounting purposes. However, the memorandum also indicates that more stringent standards applicable under other federal tax provisions (e.g., IRC Sections 421 and 409A) could be applied to future backdating cases.

In determining the grant date, the IRS indicates that it is looking for detailed, contemporaneous documentation of compensation committee actions in the form of minutes or unanimous written consent. The IRS's basis for this position is that taxpayers are required to maintain adequate records to establish an entitlement to a tax deduction. Interestingly, this appears to be a new standard for purposes of Section 162(m) that the IRS may be applying with the benefit of hindsight. Nevertheless, compensation committees may want to pay particular attention to the documentation and substantiation process they use for their stock option grants.

In examining different methods that have been employed by companies attempting to correct the backdating issue, the IRS takes a strong position that if an option is discounted on the grant date, it cannot later be changed to qualify as performance-based compensation. The two key correction methods identified were (i) "repricing" options through voluntary reimbursements made by the executives to the company, particularly used when the options had already been exercised, and (ii) voluntary side agreements between the company and the executives whereby the executives agreed to an increase in the exercise price, particularly used when the options had not yet been exercised. Regardless of the method used or the reasons for the modification, such as accounting or state law requirements or securities law considerations requiring reformation of the grant to comply with the governing equity plan document, the option will be treated as a discounted option for purposes of the deductibility exception under IRC Section 162(m).

Read more.

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