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# Corporate and Financial Weekly Digest

Business/Financial News in Brief
**December 1, 2006**

## SEC/Corporate

### SEC Announces a Heavy Agenda for its December 4th Meeting

On November 27, the Securities and Exchange Commission announced the subject matter of its next open meeting. At the December 4 meeting, the SEC will consider whether to:

- approve the budget of the Public Company Accounting Oversight Board and will consider the annual accounting support fees under section 109 of the Sarbanes-Oxley Act of 2002;
- propose a new rule under the Securities Act of 1933, as amended, to revise the criteria for natural persons to be considered "accredited investors" for purposes of investing in certain privately offered investment vehicles;
- propose a new rule under the Investment Advisers Act of 1940, as amended, to prohibit advisers from making false or misleading statements to investors in certain pooled investment vehicles they manage, including hedge funds;
- propose amendments to Rule 105 of Regulation M that would further safeguard the integrity of the capital raising process and protect issuers from manipulative activity that can reduce issuers' offering proceeds and dilute security holder value;
- propose an amendment to the short sale price test of Rule 10a-1; and
- propose an amendment to the "short exempt" marking requirement of Regulation SHO.

The full text of the SEC release is available at http://www.sec.gov/news/digest/2006/dig112706.txt.

### Proposed Amendment to Definition of Covered Securities to Include Securities Listed on the NASDAQ Capital Market

The Securities and Exchange Commission has requested comments to a proposed amendment to Rule 146(b) under Section 18 of the Securities Act of 1933, as amended, to designate certain securities listed on the NASDAQ Capital Market (previously named the Nasdaq SmallCap Market) as covered securities for purposes of Section 18 of the Securities Act. Such request is in response to a petition filed by the NASDAQ Stock Market LLC (Nasdaq). Covered securities under Section 18 of the Securities Act are exempt from state law registration requirements.

The SEC has reviewed the listing standards for securities traded on the NASDAQ Capital Market and believes that the standards overall are not substantially similar to the New York Stock Exchange LLC, the American Stock Exchange LLC or the National Market System of Nasdaq, as is necessary for a security

listed on an exchange to be deemed a covered security pursuant to Section 18 of the Securities Act. However, in August, Nasdaq filed a proposed rule change to amend its quantitative listing standards for NASDAQ Capital Market securities and the SEC preliminarily believes that it could make a finding that the NASDAQ Capital Market's listing standards are substantially similar to the above referenced exchanges.

Comments to the proposed amendment should be received by the SEC on or before December 22.
http://www.sec.gov/rules/proposed/2006/33-8754.pdf

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## Banking

### FDIC Final Rules on Assessments and the Designated Reserve Ratio

The Federal Deposit Insurance Corporation (FDIC) Board of Directors has approved final rules to amend Part 327 of the FDIC Rules and Regulations governing assessments. One rule creates a new system for risk-based assessments and sets assessment rates beginning January 1, 2007. The other rule sets the designated reserve ratio (DRR) at 1.25 percent. The amendments are being made to implement the Federal Deposit Insurance Reform Act of 2005 (Reform Act). The final rules take effect on January 1, 2007.

Highlights:

- *Risk Categories*. The existing nine assessment rate categories are consolidated into four new categories. Risk Category I replaces the old 1A risk category.
- *Risk Category I Institutions*. Assessment rates for individual institutions in Risk Category I will differ, depending upon the risk posed by the institution. For most institutions, assessment rates will depend upon a combination of CAMELS component ratings and financial ratios. For large institutions that have long-term debt issuer ratings, assessment rates will depend upon these ratings and CAMELS component ratings.
- *Assessment Rates*. Effective January 1, 2007, assessment rates will range from 5 to 7 basis points for Risk Category I institutions and will be 10 basis points for Risk Category II institutions, 28 basis points for Risk Category III institutions and 43 basis points for Risk Category IV institutions.
- *Rate Calculator*: The FDIC has updated its assessment rate calculator to reflect the final rule and the adopted rates. The calculator enables institutions in Risk Category I to determine assessment rates under the final rule for given supervisory ratings and financial ratios or, for some large institutions, long-term debt issuer ratings.

The Reform Act also requires the FDIC to prescribe other implementing rules. On March 14, the FDIC's Board adopted an interim final rule implementing the substantive changes to the FDIC's insurance coverage rules, effective April 1 (The FDIC's Board adopted a final rule on September 5). On October 10, the FDIC's Board adopted a final rule governing the distribution and use of the $4.7 billion one-time assessment credit and a temporary final rule that expires at the end of 2008 governing dividends from the insurance fund. On November 2, the Board adopted final rules that: (i) make operational changes to the assessment system; (ii) require banks and savings associations to use the same FDIC sign and follow the same advertising rules; and (iii) establish penalties for institutions that fail to pay their deposit insurance premiums in a timely manner.

[FDIC: Reform of Deposit Insurance]

**OCC and NY Banking Department Sign MOU Regarding Consumer Complaints**

On November 30, the Office of the Comptroller of the Currency (OCC) and the New York Banking Department announced that they had signed a Memorandum of Understanding (MOU) with respect to the sharing of consumer complaint information between the two agencies.

Two weeks ago, the OCC and the Conference of State Bank Supervisors had created a template MOU for such purpose. The idea behind the creation of the template MOU stems from the belief that "consumers do not always know which regulatory agency – state or federal – supervises their bank." The MOU also creates procedures to ensure that consumer complaints are sent to the appropriate agency.
http://www.occ.treas.gov/ftp/release/2006-128.htm
http://www.csbs.org/AM/Template.cfm?Section=Press_Releases&Template=/CM/HTMLDisplay.cfm&ContentID=9095

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## Broker Dealer

**The Options Clearing Corporation Proposes Changes to Option Adjustment Methodology**

The Options Clearing Corporation (OCC) has proposed to amend its options adjustment methodology. The OCC proposal eliminates the need to round option strike prices and units of trading in the event of certain stock dividends, distributions, and splits. Currently, unless one or more whole shares are issued with respect to each outstanding share, the result is an adjustment to equity options that increases the deliverable and proportionately reduces the strike price. The OCC proposal attempts to eliminate potential windfalls by adjusting the deliverable, but not the strike price, and by settling any resulting fractional deliverables in cash, rather than rounding them down.

The OCC also has proposed changes to the definition of "ordinary" cash dividends and distributions—which generally do not trigger option adjustments—to abolish the so-called "10% Rule." Under the 10% Rule, a cash dividend is generally deemed "ordinary" if the amount does not exceed 10% of the value of the underlying stock on the declaration date. The OCC proposal provides that cash dividends will be considered ordinary, regardless of size, if declared "pursuant to a policy or practice of paying such dividends on a quarterly or other regular basis." The amendment also creates a de minimus threshold whereby dividends of less than $12.50 per contract would not trigger adjustment in any event.

The OCC amendments will apply only to corporate events announced on or after February 1, 2009. The comment period closes on December 12.
http://www.sec.gov/rules/sro/occ/2006/34-54748.pdf

**SEC Approves Amendments to NASD Rules Relating to Equity and Index Option Position and Exercise Limits and Reporting Obligations**

The Securities and Exchange Commission has approved amendments to NASD Rule 2860, regarding option position limits and reporting obligations The rule, as amended, extends position limits to over-the-

counter (OTC) index options, other than those which overlie the same index as an exchange-traded option and so-called "conventional index options."

The amended rule requires reporting of large positions in OTC index options based on indexes that underlie an exchange-traded option, and, in the case of "conventional index options," for such options based on indexes that are substantially similar to indexes that underlie an exchange-traded option.

Finally, the rule allows higher tiers of position limits for OTC options that overlie equity components of the FTSE All-World Index Series and that meet the volume and float criteria established by the options exchanges for standardized options on domestic equities. This represents an effort by the NASD to equalize the position limits for options on certain liquid foreign securities with those for options on comparably liquid domestic securities.
http://www.sec.gov/rules/sro/nasd/2006/34-54755.pdf

**NASD Proposes Additional Guidance on Mark-Ups in Debt Securities Transactions**

In proposed interpretation IM-2440-2, the NASD seeks to provide additional guidance regarding the calculation of mark-ups (and mark-downs) in debt securities transactions other than municipal bonds. Under NASD Rule 2440, dealers are required to sell securities to their customers at a fair price, including any mark-up in sales price that the dealer receives from, or any mark-down in purchase price that the dealer pays to, such customers. An important element in determining whether such mark-ups (and mark-downs) are fair and reasonable is the prevailing market price of the security. Under proposed IM-2440-2, the dealer's contemporaneous cost (proceeds) is presumed to be the best measure of the prevailing market price of the debt security, unless the dealer demonstrates that a subsequent change in interest rates or the credit quality of the security, or a subsequent release of news affecting the perceived value of the security, overcomes that presumption. In such cases, the prevailing market price is determined first by considering a series of three ranked factors (contemporaneous pricing of interdealer transactions, pricing of dealer purchases from certain institutional accounts, and interdealer quotes, respectively), or if none of those factors are available, then a second set of non-exclusive, unranked factors is applied. It is only in this second set of factors that the dealer may resort to the market price of "similar" securities, as described in the interpretation, and it is only after exhausting both sets of factors that a dealer may resort to prices or yields derived from economic models to determine the prevailing market price.
The proposed interpretation would not apply to transactions in non-investment grade debt securities with qualified institutional buyers (QIBs) under Securities Act Rule 144A if the dealer determines that the QIB is able to independently evaluate the risk and exercise independent judgment in the transaction.

The comment period closes on December 19.
http://www.sec.gov/rules/sro/nasd/2006/34-54799.pdf

**NASD and NYSE Propose Plan to Consolidate Member Regulation Operations**

As widely reported in the financial press, the NASD and the New York Stock Exchange (NYSE) announced a plan on November 28 to consolidate their member regulation operations into a new self-regulatory organization (SRO). The details of this plan are available at the NASD and NYSE web sites. The transaction is expected to close during the second quarter of 2007 and requires the approval of the SEC, as well as an NASD member vote on the proposed amendments to the NASD's by-laws. After the proposed combination, the new SRO will be responsible for current NASD responsibilities, including market regulation by contract for NASDAQ, as well as NYSE member firm regulations. NYSE Regulation will continue its oversight of the NYSE market.
http://www.nasd.com/RegulatoryConsolidation/index.htm
http://www.nyse.com/pdfs/TransactionFactSheet.pdf

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## United Kingdom Developments

### FSA and CFTC Sign New MOU

On November 20, the Financial Services Authority (FSA) announced that it had signed a new Memorandum of Understanding (MOU) with the U.S. Commodities and Futures Trading Commission (CFTC) designed to strengthen cooperation on the exchange of regulatory information to support cross-market surveillance operations. The MOU provides for the exchange of information between the FSA and the CFTC to facilitate cross border oversight of U.K. and U.S. derivatives exchanges in order to address potential abusive or manipulative trading practices that may occur.
http://www.fsa.gov.uk/pubs/mou/cftc.pdf

### FSA Fines U.S. Equities Salesman for Inappropriate Conduct

On November 23, the Financial Services Authority (FSA) announced that it had fined SP, a former U.S. equity sales executive, £20,000 for breaches of Principles 2 and 3 of the FSA's Statements of Principle for Approved Persons (failing to exercise due skill, care and diligence and to observe proper standards of market conduct when carrying out his function as an approved person).

SP received an analyst's email concerning a U.S. company, BSX. The email was worded in such a way as to appear that it might have contained inside information about BSX's prospects. The email did not in fact contain inside information.

During a series of calls to clients passing on the information in the email he had received concerning BSX, SP used language that embellished the information in such a way that the FSA concluded that he gave his clients the impression that he was passing them inside information. By doing so, SP failed to observe proper standards of market conduct.

The FSA further concluded that SP acted without due skill, care and diligence when he failed to consider whether or not the email might have contained inside information and as a result he did not discuss the email with his senior manager or compliance as required by his employer’s compliance procedures.

In deciding that a fine of £20,000 was the appropriate penalty, the FSA took into account the fact that SP did not form a positive belief that the information he had received was inside information; the fact that SP co-operated with the FSA, had agreed to settle this matter and had not previously been the subject of FSA disciplinary action.
http://www.fsa.gov.uk/pubs/final/Pignatelli.pdf

### FSA Sets Out Good Practice Guidelines for Valuation of Hedge Fund Assets

On November 29, the Financial Services Authority (FSA) released the text of a letter sent to by its Managing Director of Wholesale and Institutional Markets to the Valuations Sub-Committee of the International Organization of Securities Commissions.

The letter contains a non-exhaustive list of good practice valuation criteria, identified by the FSA during visits between March and May to fund managers it supervises in the areas of: (i) establishing appropriate systems and controls; (ii) compliance and corporate governance arrangements; (iii) high level pricing policies; and (iv) the timeliness and bases of the valuations.
http://www.fsa.gov.uk/pubs/international/iosco_letter_271106.pdf

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## Litigation

### Corporation's Conditioning of Advancement of Legal Fees Did Not Violate Indemnification Provision

Plaintiff, a former Director of defendant company's predecessor-in-interest, sued to enforce rights under indemnification agreement that company allegedly breached. Plaintiff's indemnification right tracked Del. Code §145(a) and covered any liability he might incur provided he acted in good faith and in a manner reasonably believed to be in (or not opposed to) the best interests of the company. The company also agreed to advance expenses for any covered lawsuit, provided Plaintiff executed an undertaking to repay if he was not entitled to be indemnified for such expenses. The Securities and Exchange Commission sued Plaintiff for insider trading after he sold all his company stock before adverse information about the company became public. Before agreeing to advance Plaintiff's legal expenses, company required Plaintiff to agree in an undertaking to return the advances if the SEC prevailed. Plaintiff opposed this condition and sought to limit the undertaking to the "good faith/best interest" language of the indemnification agreement, which arguably would not be contravened if he lost the SEC suit. Allegedly as a result of mounting financial pressure, Plaintiff agreed to company's terms. After Plaintiff lost the SEC lawsuit, the company successfully counter-claimed for the return of the $878,877.92 advanced to Plaintiff. The First Circuit affirmed. While recognizing that Plaintiff was under economic pressure as a result of company's refusal to make advances until Plaintiff agreed to company's language in the undertaking, the Court rejected Plaintiff's argument that the undertaking was unenforceable because it was signed under duress. The Court found that the Plaintiff could not prevail because he could not establish that the economic pressure placed on him was "unlawful" or "wrongful" (as required under Massachusetts law to establish duress). Under the Court's ruling, an act is not "wrongful" if there is a good faith belief by the "pressuring" party that its position is "a plausible one," and the Court determined that the company's position met that standard. (*Happ v. Corning, Inc., 466 F.3d 41 (1st Cir. Oct. 20, 2006))*

### Presence of Disputed Facts Prevented Grant of Summary Judgment on 1933 Act Claim

Plaintiffs sought summary judgment on their claim that the defendant corporation (Quovadx) made material omissions in its Registration Statement in violation Section 11 of the Securities Act of 1933. Plaintiffs identified multiple omissions relating to Quovadx dealings with Infotech Network Group (Infotech), one of its major business relationships. These omissions centered on Quovadx's failure to disclose details relating to both a Distribution Agreement and an Outsourcing Agreement that Quovadx entered into with Infotech, including failing to disclose Infotech's inability to provide security as required under the Distribution Agreement, Infotech's failure to make payments when due under the Distribution Agreement, Infotech's lack of any prior experience as a software distributor, and Quovadx's pre-payment of amounts to Infotech under the Outsourcing Agreement to enable Infotech to obtain the required security under the Distribution Agreement. After noting that the SEC's disclosure requirements applied because Infotech exceeded the 10% of revenues threshold and that such regulations also required disclosure of any "unusual" or "infrequent" events or any significant economic changes materially affecting operating

income or revenue, the Court turned to the alleged omissions. The Court ruled that the omission of Infotech's prior experience – even though defendant admitted to knowing this fact prior to the time that it filed its Registration Statement – was not, standing alone, material for purposes of Section 11. As to the other alleged omissions, the Court found them to either involve disputed issues of fact or to raise fact questions as to whether defendant knew of the omitted information at the time it filed the Registration Statement. As a result, while suggesting that Plaintiffs' 1933 Act claim might ultimately be successful, it ruled that the presence of these disputed facts prevented it from granting summary judgment to Plaintiffs. (*Special Situations Fund III, L.P. v. Quovadx, Inc., 2006 WL 3328089 D. Co. Nov. 15, 2006))*

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## CFTC

### NFA Proposes Amendment Regarding FCMs' Eligibility to Guarantee IBs

The National Futures Association (NFA) has filed with the Commodity Futures Trading Commission (CFTC) for approval an amendment to Section 2 of NFA's Financial Requirements to increase the minimum net capital eligibility requirement for FCMs that enter into guarantee agreements with IBs to $750,000. The purpose of the amendment is to conform Section 2 with the recent amendment to Section 1 of NFA's Financial Requirements, which increased FCMs' general minimum net capital requirement to $500,000 from $250,000. Under CFTC Rule 1.10(j), FCMs that enter into guarantee agreements with IBs must maintain at least 150% of the minimum net capital requirement for FCMs.
http://www.nfa.futures.org/news/newsRuleSubLetter.asp?ArticleID=1682

### CFTC Adopts Electronic Filing Requirements for Introducing Brokers' Certified Annual Financial Reports

The Commodity Futures Trading Commission (CFTC) has amended its rules governing the filing of certified financial statements by introducing brokers. Rule 1.10(b)(2)(iii) has been revised to require IBs and applicants for IB registration to file certified financial statements, Forms 1–FR-IB, with the National Futures Association (NFA) electronically rather than in paper form. In addition, Rule 1.10(h) has been revised to provide that IBs that are registered as broker-dealers may file certified Financial and Operational Combined Uniform Single Reports (FOCUS Reports) in lieu of Form 1–FR-IB either electronically or in paper form. Finally, the CFTC has amended Rule 1.31 to provide that paper copies of electronically filed certified Forms 1-FR or FOCUS Reports must be retained by IBs in hard copy for a period of five years.
http://www.cftc.gov/files/foia/fedreg06/foi061122a.pdf

### NFA Proposes Amendment to Reduce Exchange Members' Assessment Rate

The National Futures Association (NFA) filed for approval with the Commodity Futures Trading Commission (CFTC) an amendment to NFA Bylaw 1301(a) to reduce the rate of assessments that exchanges pay to NFA from $.01 to $.005 for each round-turn transaction in a commodity futures contract. The purpose of the amendment is to restore balance between smaller exchanges and larger exchanges. NFA states that it believes the current rate has led to the smaller exchanges paying a disproportionate amount in assessments relative to larger exchanges. The proposed amendment will not materially impact the overall amount of exchange assessments NFA collects since the assessments larger exchanges pay will continue to be capped at a maximum of $150,000 pursuant to NFA Bylaw 1301(a).
http://www.nfa.futures.org/news/newsRuleSubLetter.asp?ArticleID=1685

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