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CORPORATE & FINANCIAL
WEEKLY DIGEST

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SEC/CORPORATE

SEC Proposes to Remove Form S-3 Credit Rating Qualification Conditions

On February 9, the Securities and Exchange Commission proposed rules amending the Securities Act of 1933 and the Securities Exchange Act of 1934 to replace rule and form requirements for securities offerings and issuer disclosure rules that rely on, or make special accommodations for, credit ratings to reflect the requirements of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 939A of the Dodd-Frank Act requires that the SEC (1) review any regulation issued by it that requires the use of an assessment of the credit-worthiness of a security or money market instrument and any references to or requirements in its regulations regarding credit ratings, (2) modify any regulations to remove any reference to or requirement of reliance on credit ratings, and (3) substitute in its regulations a standard of credit-worthiness with alternative requirements. The proposed rules are similar to rules proposed in 2008, which were not adopted by the SEC.

The proposed rules would remove credit ratings as one of the conditions for issuers seeking to use Form S-3 and Form F-3 when registering securities for public sale. The proposed rules would revise Instruction I.B.2 of Form S-3 and Form F-3, which currently permit issuers to register primary offerings of non-convertible securities if they are rated investment grade by at least one nationally recognized statistical rating organization (NRSRO). The revised Instruction I.B.2 would provide that issuers may use Form S-3 or Form F-3 to register an offering of non-convertible securities if the issuer has issued at least $1 billion of non-convertible securities in transactions registered under the Securities Act, other than equity securities, for cash during the past three years. The proposed rules also would:

- revise Rules 138, 139 and 168 of the Securities Act, Form S-4, Form F-4 and Schedule 14A, which currently reference Form S-3 and Form F-3 eligibility requirements related to credit ratings;
- delete Rule 134(a)(17) of the Securities Act, which currently permits the disclosure of security ratings issued or expected to be issued by NRSROs in certain communications deemed not to be a prospectus or free writing prospectus;
- rescind Form F-9, which permits Canadian issuers, under certain conditions, to register debt or preferred securities that have been rated investment grade by at least one NRSRO, or at one Approving Rating Organization, as defined in the National Policy Statement No. 45 of the Canadian Securities Administrators; and
- remove references to Form F-9 under the Securities Act and Exchange Act.

Under the proposed rules, some issuers that relied on the rating qualification for authority to use Form S-3 or Form F-3 may lose eligibility to use those Forms to conduct offerings. However, issuers may still conduct primary offerings of non-convertible debt securities on Form S-3 if they meet the $75 million public float requirement in Instruction I.B.1 of Form S-3 or if they meet the requirements of Instruction I.B.6 of Form S-3. At a February 9 SEC open meeting, Commissioners Troy Paredes and Kathleen Casey, while supporting the proposed rules, both voiced concerns for the loss of access to capital markets by issuers. Commissioner Paredes stated that he hoped commentators would address whether the proposed rules might limit the number of issuers that are Form S-3 eligible.

The proposed rules are the first in a series of upcoming SEC proposals in accordance with the Dodd-Frank Act to remove references to credit ratings contained within existing SEC rules and regulations.

Comments should be received on or before March 28.

Read more.

PRIVATE INVESTMENT FUNDS

Federal Reserve Clarifies Extension of Conformance Period for the Volcker Rule

On February 8, the U.S. Federal Reserve Board adopted a final rule to implement the conformance period for compliance with the Volcker Rule, which generally prohibits banking entities from engaging in proprietary trading and from investing in, sponsoring, or having certain relationships with a hedge fund or private equity fund. The Volcker Rule generally provides banking entities two years to bring their activities and investments into compliance and allows the Board to extend this conformance period under certain conditions. The prohibitions and restrictions of the Volcker Rule take effect on the earlier of July 21, 2012, or 12 months after the issuance of final regulations. The conformance period will generally extend through the date that is two years after the effective date, and this period may be extended by the Board for up to three additional one-year periods if the Board determines that such extension(s) would not be detrimental to the public interest. The Board clarified that it will not grant all three one-year extensions at a single time as requested by several commenters, but will instead grant up to three separate one-year extensions of the general conformance period.

To read the Federal Reserve adopting release, click here.
To read the Federal Reserve press release, click here.

CFTC

CFTC Issues Annual Guidance Letter Regarding CPO Reporting Requirements

The Division of Clearing and Intermediary Oversight (DCIO) of the Commodity Futures Trading Commission has issued its annual guidance letter to commodity pool operators (CPOs) and their accountants, summarizing annual CPO reporting obligations. The DCIO letter includes information regarding regulatory changes within the last year affecting CPOs, including the adoption by the CFTC of final regulations governing retail forex transactions and associated registration requirements, as well as the adoption by the National Futures Association (NFA) of Compliance Rule 2-46, which requires CPOs to be "fully registered" and Rule 4.7 exempt pools to file specified information with NFA on a quarterly basis. The letter also includes detailed guidance regarding the preparation and filing of CPO annual reports, including applicable deadlines and filing procedures.

The DCIO letter is available here.

LITIGATION

Government's Request to Serve Subpoena Duces Tecum on Galleon Granted

On October 16, 2009, Raj Rajaratnam was arrested and charged with trading or conspiring to trade in securities on the basis of inside information. Following his arrest, the government served his employer, Galleon Management LP, with three grand jury subpoenas. On December 15, 2009, a grand jury returned an indictment alleging that Mr. Rajaratnam traded or conspired to trade in the securities of nine identified issuers. On February 9, 2010, the grand jury returned a Superseding Indictment alleging that Mr. Rajaratnam conspired to trade in the securities of three additional issuers. By letter dated March 22, 2010, the government identified additional issuers not previously addressed in the Superseding Indictment.

On January 13, 2011, the government filed an application for leave to issue to Galleon a subpoena *duces tecum* returnable before trial pursuant to Rule 17(c) of the Federal Rules of Criminal Procedure. The subpoena requested, among other things: (1) OMS Data, a form of electronic trading record that identifies the portfolio manager and trader responsible for executing a given trade; (2) documents in which Mr. Rajaratnam acknowledged Galleon's insider trading policies; and (3) certain emails and other communications related to specific issuers. Mr. Rajaratnam, joined by Galleon, moved for an order denying the government's requests on the basis that the government was not entitled to pre-trial production under Rule 17(c). The court denied this motion on February 2 and granted the government leave to serve the subpoena.

In order to require production of documents prior to trial under Rule 17(c), "the moving party must show: (1) that the documents are evidentiary and relevant; (2) that they are not otherwise procurable reasonably in advance of trial by exercise of due diligence; (3) that the party cannot properly prepare for trial without such production and inspection in advance of trial and that the failure to obtain such inspection may tend unreasonably to delay the trial; and (4) that the application is made in good faith and is not intended as a general 'fishing expedition.'" (*U.S. v. Nixon*, 418 U.S. 683, 699-700 (1974))

Mr. Rajaratnam and Galleon alleged that the requested documents were "otherwise procurable reasonably in advance of trial," and that the government could "properly prepare for trial without such production." As to the first claim, movants argued that the government previously knew about all of the issuers identified in the Superseding Indictment and the March 22 letter and thus could have requested the documents in any one of the multiple grand jury subpoenas. By failing to make the requests in the grand jury subpoenas, Mr. Rajaratnam and Galleon argued that the government forfeited its chance to subpoena the additional documents pursuant to Rule 17(c).

The court rejected this argument because it would effectively require the government to "request enough documents that it might want to use at trial to avoid forfeiting the chance to obtain them under Rule 17(c), but not so many documents as to turn a grand jury subpoena into a trial subpoena. And the government would have to strike that delicate balance before it [knew] what defendants will be tried for what offenses."

As to the second point, the court held that because OMS Data is relevant to proving trading in furtherance of the alleged conspiracies, and using that data would expedite the trial by more clearly presenting evidence of trading, the third *Nixon* requirement is satisfied. (*U.S. v. Rajaratnam*, 2011 WL 335170 (S.D.N.Y. Feb. 2, 2011))

Securities Fraud Claims Dismissed for Failure to Plead with Particularity

Individual plaintiffs residing in Switzerland and France brought suit against four corporate defendants, as well as certain corporate officers thereof, for, among other things, violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Two of the corporate officers, Jason Beckman and Jason Colodne, moved to dismiss the Amended Complaint for failure to state a claim pursuant to Fed. R. Civ. P. 12(b)(6), and failure to plead fraud with particularity pursuant to Fed. R. Civ. P. 9(b).

The Amended Complaint alleges that plaintiffs were presented with an "investment opportunity" called the BLF, which was essentially a fund that made bridge loans to friends and clients of the Chimay family in order to facilitate business transactions. Plaintiffs claim that their investments were not used to facilitate bridge loans, but rather, were used for the defendants' personal benefit. Defendants' offer and sale of the purportedly fraudulent investment scheme ultimately resulted in the alleged misappropriation of plaintiffs' $4.2 million.

Mr. Beckman and Mr. Colodne first moved to dismiss the Section 10(b) claim under Rule 12(b)(6), arguing that the BLF investment was a loan, rather than a security. An investment contract is a security if there is (1) an investment of money, (2) in a common enterprise, and (3) with profits derived solely from the efforts of others. (*SEC v. Howey, Co.*, 328 U.S. 293 (1946)) The court rejected defendants' argument and concluded that the transaction at issue constituted a security.

The court found that plaintiffs invested money in the BLF, a common enterprise with the Chimays and others. The element of "common enterprise" was established because plaintiffs tied their fortunes to the fortunes of others who invested in the BLF, and the assets contributed by the plaintiffs to the BLF were (or at least were supposed to be) pooled with the assets of the Chimay family and others and used for a common purpose (the making of short-term bridge loans). Finally, plaintiffs put money into the BLF with the expectation that the anticipated profits would be derived solely from the efforts of persons other than themselves.

Mr. Beckman and Mr. Colodne also sought to dismiss the Section 10(b) claim on the grounds that plaintiffs failed to plead either material misrepresentation or scienter as against them with the requisite particularity under Fed R. Civ. P. 9(b). The court concluded that the Amended Complaint did not adequately plead what, if anything, Mr. Beckman and Mr. Colodne said to one of the investors at a 2009 meeting to induce that investor to contribute more money to the fund, and that a second investor didn't have any contact with Mr. Beckman or Mr. Colodne at all. Moreover, plaintiffs made no attempt to allege facts indicative of an agreement among defendants to defraud plaintiffs.

Accordingly, the court dismissed the fraud causes of action without prejudice. (*Jacquemyns v. Spartan Mullen Et Cie, S.A.,* 2011 WL 348452 (S.D.N.Y. Feb. 1, 2011))

BANKING

FDIC Proposed Rule Requires Certain Bank Staff to Complete Training on Deposit Insurance Coverage

The Board of Directors of the Federal Deposit Insurance Corporation (FDIC) approved on February 9 a notice of proposed rulemaking that would require certain employees of insured depository institutions (IDIs) to complete training, provided by the FDIC, on the fundamentals of FDIC deposit insurance coverage. In addition, the proposed rule would require IDI employees, when opening deposit accounts, to provide customers with the FDIC's publication, Deposit Insurance Summary, if the customer will have more than the Standard Maximum Deposit Insurance Amount (SMDIA)—$250,000—at the institution. The proposed rule also would require every IDI to provide a link to the FDIC's Electronic Deposit Insurance Estimator (EDIE) on its website.

Read more.

FDIC Approves Final Rule of Assessments, Dividends, Assessment Base and Large Bank Pricing

The Board of Directors of the Federal Deposit Insurance Corporation (FDIC) on February 7 approved a final rule on Assessments, Dividends, Assessment Base and Large Bank Pricing. The rule, which is quite detailed and complicated, implements changes to the deposit insurance assessment system mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act and revises the assessment system applicable to large banks to eliminate reliance on debt issuer ratings and make it more forward-looking. Dodd-Frank required that the base on which deposit insurance assessments are charged be revised from one based on domestic deposits to one based on assets, and that the amount of assessments collected be revenue neutral as between the current system (based on liabilities) and the new system (based on assets). FDIC Chairman Sheila Bair said, "The rule should keep the overall amount collected from the industry very close to unchanged, although the amounts that individual institutions pay will be different."

The final regulation followed a series of FDIC proposed regulations dating back to April 2010, and the final rule encompasses all of these proposed rules. According to the FDIC, the new large bank pricing system will result in higher assessment rates for banks with high-risk asset concentrations, less-stable balance sheet liquidity, or potentially higher loss severity in the event of failure. Over the long term, large institutions that pose higher risk will pay higher assessments when they assume these risks rather than when conditions deteriorate. The final rule also retains the unsecured debt adjustment, which lowers an institution's assessment rate to recognize the buffer that long-term unsecured and subordinated debt provides the Deposit Insurance Fund (DIF). This adjustment is "recalibrated" in the final rule to ensure that the incentive for issuing this debt remains the same with the change to a larger assessment base. "In light of the interest rate environment and the assessment rate benefit we provide, I encourage banks to issue more long-term unsecured debt to lock in low rates and provide greater stability to their funding," Chairman Bair said. It remains to be seen whether and to what extent banks will add such debt to their balance sheets; recently, the emphasis has been on adding tangible capital.

At present, for deposit insurance assessment purposes, an insured depository institution is placed into one of four risk categories each quarter, determined primarily by the institution's capital levels and supervisory evaluation. The total base assessment rates that can be levied on banks range from 7 points for Risk Category I institutions to 77.5 points for Risk Category IV institutions. An institution's assessment is determined by multiplying its assessment rate by its assessment base. Its assessment base is, and has historically been, domestic deposits, with some adjustments. Under the new asset-based rule, the total base assessment rates will range from 2.5 points to 45 points.

The FDIC, based on a series of assumptions, believes that approximately 84% of profitable institutions are projected to have a decrease in assessments in an amount between 0 and 10% of income. Another 14% of profitable institutions would have a reduction in assessments exceeding 10% of their income. "Only 91 institutions would have an increase in assessments, with all but 12 of them facing assessment increases between 0 and 10% of their income," according to the FDIC. Additionally, the FDIC believes that about 65% of unprofitable institutions are projected to have a decrease in assessments in an amount between 0 and 10% of their losses. Another 33% will have lower assessments in amounts exceeding 10% income. "Only 42 unprofitable banks will face assessment increases, all but 10 of them in amounts between 0 and 10% of losses," states the FDIC.

Additional rate schedules will go into effect when the DIF reserve ratio reaches various milestones. The final rule, except as specifically provided, will take effect for the quarter beginning April 1, and will be reflected in the June 30 fund balance and the invoices for assessments due September 30.

Read more.

FDIC Board Releases Proposed Rule Regarding Executive Compensation

On February 7, the Federal Deposit Insurance Corporation (FDIC) released a proposed joint rule that will also be released by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, the National Credit Union Administration, the Securities and Exchange Commission and the Federal Housing Finance Agency (the Agencies) regarding incentive-based compensation arrangements (Proposal). The Proposal is required by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

In summary, the Proposal would require the reporting of incentive-based compensation arrangements by a "covered financial institution" and prohibit incentive-based compensation arrangements at a covered financial institution that provide excessive compensation. In this regard, the Agencies have proposed standards to determine whether incentive-based compensation is "excessive" in a particular case. In addition, the Proposal prohibits arrangements that could expose the institution to inappropriate risks that threaten an institution's safety and soundness and could lead to a material financial loss. To accomplish this, the Proposal sets forth standards that are consistent with the principles set forth in the Interagency Guidance on Sound Incentive Compensation Policies (adopted June 2010) for determining whether an incentive-based compensation arrangement may encourage inappropriate risk-taking.

For purposes of this provision, a "covered financial institution" is a bank with total consolidated assets of more than $1 billion. Additional restrictions would be imposed for institutions with $50 billion or more in total consolidated assets.

Comments are due 45 days after publication in the *Federal Register*.

For more information, click here.

UK DEVELOPMENTS

FSA Bans and Fines Corporate Finance Advisor for Market Abuse

On February 7, the UK Financial Services Authority (FSA) announced that the Upper Tribunal (Tax and Chancery Chamber) had directed the FSA to fine David Massey £150,000 (approximately $240,000) and ban him from performing any role in a regulated financial services firm for engaging in market abuse.

On November 1, 2007, Mr. Massey shorted 2.5 million shares of Eicom at 8p per share, knowing, as an insider, that Eicom intended to issue new shares at 3.5p per share. Mr. Massey immediately acquired 2.6 million shares from Eicom at the lower price, using those to close out his short sale. His profit on the transaction was over £100,000 (approximately $160,000).

Mr. Massey was a Corporate Finance Executive at Zimmerman Adams International. Over a period of five years he had occasionally acted as a financial public relations consultant for Eicom. At the time of the transaction, Mr. Massey knew that Eicom was prepared to issue up to 3 million shares to him at a substantial discount.

Mr. Massey initially attributed the deal to an associate at Zimmerman, and, when questioned about the deal by Zimmerman, he did not disclose his special relationship with Eicom.

Margaret Cole, Managing Director of Enforcement and Financial Crime at the FSA, said: "Massey's actions were unacceptable. He abused his position as an FSA approved person. ... He used the trust invested in him by both parties to create the opportunity to trade on the basis of inside information and he distorted the truth to hide his actions, profiting at the expense of other market users. This type of conduct threatens the integrity of the market and will not be tolerated by the FSA."

To read the Decision of the Upper Tribunal, click here.

FSA Circulates "Dear CEO" Letter on Transition to New Regulatory Structure

On February 7, the UK Financial Services Authority (FSA) published a "Dear CEO" letter from Hector Sants, FSA Chief Executive, about the transition to the new regulatory structure first announced in June 2010 (see the June 18, 2010, edition of *Corporate and Financial Weekly Digest*) under which the FSA will, by late 2012, be replaced by two separate regulators (the Prudential Regulation Authority (PRA) and the Consumer Protection and Markets Authority (CPMA).

This week's letter states that the process of implementing the new regime will commence on April 4, when a Prudential Business Unit (PBU) and a Consumer & Markets Business Unit (CMBU) will replace the FSA's current Supervision and Risk business units. Mr. Sants will head the PBU and Martin Wheatley, CEO designate of the CPMA, will head the CMBU.

Regulated firms will be contacted in April 2011 with more information on where their supervision will be allocated within the new regulatory structure. The FSA will publish consultative papers on the transition during the remainder of the first half of 2011.

To read the letter, click here.
To read a statement on banking by the Chancellor of the Exchequer, click here.

Former City Executive Banned for Performing a Significant Influence Function without FSA Approval

On February 9, the UK Financial Services Authority (FSA) announced that it had banned Daniel Hassell, formerly a consultant at Vantage Capital Markets LLP, from working for a regulated financial services firm. The FSA found that Mr. Hassell had performed a significant influence function at Vantage without FSA approval.

Vantage had three capital partners. Mr. Hassell's job title was consultant. The majority of Vantage's brokerage business was previously owned by Mr. Hassell. That business line generated around half of Vantage's revenues. Although Mr. Hassell was not a capital partner at Vantage, he received approximately one third of Vantage's profits, was, on occasion, presented as an owner in correspondence and generally exercised a significant influence over the firm.

When Vantage was formed, it had applied for Mr. Hassell to be an approved person. At that time he was being investigated by the FSA and the application was withdrawn.

In February 2007, the FSA told Mr. Hassell that he was no longer being investigated. Despite this, the FSA said that it would not approve him to perform a significant influence function due to issues arising from the investigation. Notwithstanding the FSA's statement to Vantage, Mr. Hassell continued to exercise a significant influence over the firm, as the FSA discovered in a supervisory visit in 2009.

In June 2010, the FSA fined Vantage £700,000 (approximately $1.1 million), after stage one discount, for failing to prevent Mr. Hassell from performing a significant influence function.

FSA Managing Director of Enforcement and Financial Crime Margaret Cole said: "Hassell acted in a significant influence role without FSA approval. This was despite the fact that he knew that the FSA did not regard him as a suitable person to manage the firm. Ensuring that the right people are running firms is a key element in our regulatory regime. Individuals who act without FSA approval can expect a tough response from the FSA."

Click here to read the final notice for Mr. Hassell.
Click here to read the final notice for Vantage.

FSA and Bank of England Announce New Draft Code of Practice for Auditors and Supervisors

On February 10, the UK Financial Services Authority (FSA) published for consultation a draft code of practice designed to improve audit effectiveness and ensure that supervisors are better informed about, and able to challenge, the firms they regulate.

The code of practice (the product of a joint FSA/Bank of England project) proposes increased coordination between auditors and supervisors. This should enhance the ability of the FSA to scrutinize specific accounting practices and related judgments and highlight emerging problems.

Principles are set out in the code for auditors and supervisors to follow when they deal with regulated firms. For certain firms, the code specifies a minimum level of formal meetings between the supervisor, the external auditor and the firm.

Andrew Bailey, Executive Director of the Bank of England, said, "With its emphasis on the importance of an open and constructive relationship, we are very pleased to be able to publish this draft code today as an important first step in redefining the nature of the auditor's role in the new regulatory framework."

Read more.

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