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Corporate and Financial Weekly Digest

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SEC/Corporate

SEC Approves Market-Based Options Valuation

In a January 25 letter, the Securities and Exchange Commission's Chief Accountant, Conrad Hewitt, gave financial services firm Zions Bancorporation permission to implement its market-based system to determine the value of options granted to employees, subject to certain modifications to eliminate the effect of forfeiture rates on pricing. This is the first time the SEC has allowed the use of a market-based model instead of academic models to determine the cost of stock-based compensation. Many commentators contend that academic models overvalue options and expect that market-based models will lead to lower compensation expense when options are granted.

In order to determine the market price of its options, Zions created Employee Stock Option Appreciation Rights Securities (ESOARS), which are derivative securities that mimic options granted to executives and other employees. ESOARS are securities that entitle holders to receive specified payments from Zions upon the exercise, if any, from time to time of stock options comprising a reference pool of stock options that Zions has granted to its employees. Such "tracking securities," when sold at auction, are intended to establish the market value for a company's stock options. Zions tested the ESOARS in June 2006, selling the securities in a small public auction. The market price determined by the auction came to about 68% of the Black-Scholes price.

The SEC also noted that, because of two factors, the June 2006 auction price may not have been representative of the fair value of the underlying employee share-based payment awards, and the June 2006 auction may not have been a sufficient basis for valuing the options. Accordingly, the SEC recommended that each ESOARS auction be analyzed to determine whether it results in an appropriate market pricing mechanism. Factors to be considered include:

- The size of the ESOARS offering relative to market demand
- The number of bidders and their independence
- Any technological flaws in the auction process
- Bidder perception concerning costs of holding, helping or trading the securities
- Comparing the auction price to the price determined by an academic model

The SEC "encouraged" Zions to share with them the results and analysis of future auctions.

SEC/CORPORATE

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In his letter, Chief Accountant Hewitt noted that an auction-based estimate of fair value may have advantages over a model-based approach and expressed hope that the interplay of academic models and alternatives such as auction-based models could lead to improvements in option pricing.

http://www.sec.gov/info/accountants/staffletters/zions012507.pdf

Broker Dealer

SEC Staff Allows Pooling of Commissions to Pay Soft Dollars

In response to a no-action request submitted by Goldman Sachs & Co. the staff of the Securities and Exchange Commission advised that it would not recommend enforcement action if providers of research services, within the safe harbor of Securities Exchange Act Section 28(e), were paid out of a commission pool and did not register as a broker-dealers. Each money manager would direct Goldman Sachs to credit commissions it generated to a separate pool. Goldman Sachs would pay out of that pool dollar amounts specified by the money manager to a research provider as directed by the money manager. This could be construed as the research provider receiving compensation related to securities transactions and require broker-dealer registration under current no-action letters. However, the staff took a no-action position, and conditioned it essentially on compliance with previously issued soft dollar guidelines. These include:

- the money manager is responsible for independently determining the value of the research services in accordance with its good faith determination under Section 28(e) (such determination may be based on input from the service provider);
- Goldman Sachs is not involved in determining the value of the research services to the money manager;
- the service provider receives payment for research services from a pool of commissions that, by agreement between Goldman Sachs and the money manager, Goldman Sachs has set aside for obtaining the research services;
- payment to the service provider is not conditioned, directly or indirectly, on the execution of any particular transaction or transactions in securities that are described or analyzed in the research services; and
- the service provider provides the research services in return for payment from a pool of commissions, but does not perform other functions that are typically characteristic of broker-dealer activity (e.g., solicit brokerage transactions, accept customer orders, hold customer accounts, hold customer funds or effect securities transactions).

http://www.sec.gov/divisions/marketreg/mr-noaction/2007/goldmansachs011707-15a.pdf

NYSE and NASD Revise Research Analyst and Research Report Rules

The New York Stock Exchange LLC, in Information Memorandum 07-11, and the National Association of Securities Dealers, Inc., in Notice to Members 07-04, announced revisions to Rules 472 and 2711, respectively. Based upon such revisions, the following six items are

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excluded from the definition of research reports: (i) discussions of broad based indices (e.g., S&P 500); (ii) comments on economic, political or market conditions; (iii) analysis of demand and supply for a sector, index or industry; (iv) statistical summaries of multi-companies' financial data; (v) recommendations to increase or decrease holdings in particular industries or sectors; and (vi) notice of price target changes. Research reports within the meaning of the rules has been redefined to exclude: (i) communications to less than 15 persons; (ii) periodic reports to holders of discretionary accounts or mutual fund shares; (iii) internal communications not given to customers; and (iv) statutory prospectuses.

Public appearances now include appearances before 15 or more persons (but not if these persons represent fewer than 15 clients) or an appearance where members of the press are present. Password protected webcasts, conference calls or similar events with 15 or more existing customers are not deemed to be public appearances, if such customers have previously received the most current research report and the appearing analyst corrects and updates disclosures that have become inaccurate or misleading.

Third party research reports of another member firm, a non-member affiliate or independent third party that a firm distributes or makes available must disclose the distributing firm's ownership of the subject securities, investment banking relationship with the subject company, market making activities in the subject security and any other actual material conflicts of interest. A firm supervisor or supervisory analyst must review and approve third party research to confirm (i) the accuracy of disclosures regarding the distributing firm, and (ii) that the content does not contain untrue statements of material fact or is otherwise false or misleading based upon a reading of the report or based on information otherwise possessed by the member firm. Third party research distributed under a soft dollar arrangement is not subject to the above listed disclosure requirements.

Pitch books for investment banking cannot disclose analyst ratings in their industry, but may identify the analysts who will cover the company. Also, analysts may attend road shows or firm-wide sales presentations if (i) they are not in the same room, (ii) they can only listen, and (iii) they are not identified as being present.

http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_018360.pdf

http://apps.nyse.com/commdata/PubInfoMemos.nsf/0/85256FCB005E19E88525726D007919F2/$FILE/Microsoft%20Word%20-%20Document%20in%2007-11.pdf

Private Investment Funds

Complaint Filed for Conducting a Web-Based Public Offering

On January 31, Massachusetts regulators filed an administrative complaint against Bulldog Investors General Partnership and affiliated entities thereof, as well as their principals, including Phillip Goldstein, alleging that the respondents engaged in an unregistered, non-exempt, public offering of securities in Massachusetts in violation of the Massachusetts Uniform Securities Act (the Mass. Act).
Bulldog Investors General Partnership is a general partnership that offers investments opportunities in three distinct hedge funds (collectively, Bulldog) operating "activist" investment strategies. Bulldog and Phillip Goldstein are best known for successfully challenging the

PRIVATE INVESTMENT FUNDS

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Securities and Exchange Commission rule requiring that investment advisers to most hedge funds register with the SEC as such.

The alleged violations of the Mass. Act stem from an interactive web site operated by the respondents. The complaint alleges that potential investors in Bulldog have "unrestricted access to general advertising and offering materials" through this web site, thereby resulting in a violation of the Mass. Act. According to the administrative complaint, prospective investors are able to access and print both Bulldog's advertising and offering materials via this web site after acknowledging that they have read a disclaimer stating that such materials are not a solicitation or offer. (At present, the web site www.bulldoginvestors.com states that it is "currently being updated.") The complaint further alleges that the web site has "no meaningful restriction on access to the advertising or offering materials based on a prospective investor's state of residence, investment sophistication or financial background." The operation of this web site and the provision of advertising and offering materials, the complaint alleges, constituted a public offering of securities in Massachusetts for which there is no exemption available under the Mass. Act.

The complaint, filed by the Massachusetts Securities Division of the Office of the Secretary of the Commonwealth (the Division), seeks (i) a cease and disorder against the respondents, (ii) assessment of an administrative fine, and (iii) such other actions as necessary to ensure that the offering and sale of securities in Massachusetts are in accordance with the Mass. Act.

While the complaint alleges violations of Massachusetts rather than federal law, in arguing that the operation of the web site constituted a public advertisement and offering, the Division relied in large part on guidance from the SEC. Such guidance, the Division stated, provides that a hedge fund manager's web site must be password-restricted, whereby only pre-screened qualified investors are allowed to view fund-specific information.

http://www.sec.state.ma.us/sct/sctbulldog/bulldogidx.htm

Banking

FDIC Announcement Affects ILCs

On January 31, the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) announced that it would continue for an additional year its moratorium on applications for deposit insurance and change in control notices for industrial loan companies (ILCs) submitted by commercial companies. ILC applications submitted by financial companies were not included in the moratorium.

Related to these announcements, the FDIC also published for public comment a proposed rule (Part 354) which provides a framework for consideration of applications or notices for "industrial banks owned by financial companies not subject to federal consolidated bank supervision." Comments on this proposal are due 90 days after publication in the *Federal Register*.

According to the press release, "the comments received during the original moratorium demonstrated that the growth of the ILC industry, the trend toward commercial company ownership of ILCs and the nature of some ILC business models have raised significant questions about the risks to the deposit insurance fund." The press release also pointed out that the moratorium will give Congress additional time to address issues related to the ownership and operation of ILCs.

BANKING

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According to the press release, 58 ILCs currently operate in 7 states. Currently pending before the FDIC are eight ILC applications for deposit insurance and one notice of change in control for an existing ILC. Given the new parameters for review as part of this announcement, four of the filings will be subject to the continued moratorium and the FDIC may move forward with the remaining five applications.

http://www.fdic.gov/news/news/press/2007/pr07007.html

United Kingdom Developments

FSA Publishes Rules to Implement EU MiFID Directive

On January 26, the Financial Services Authority (FSA) issued its final rules for the implementation of the EU Markets in Financial Instruments Directive (MiFID).

MiFID is the single largest change in European financial services legislation since 1995 and will replace and expand the EU Investment Services Directive (ISD). MiFID's aim is to allow financial services institutions in the EU to provide their services across EU borders and establish EU branches. It is a core part of the EU's Financial Services Action Plan aimed at stimulating the adoption of common standards and promoting cross-border "passporting" of financial services throughout the EU.

MiFID involves significant changes which will affect the organization and conduct of business of investment firms (key changes relate to best execution, conflicts of interest, client classifications and senior management responsibilities); operation of regulated markets; new pre- and post-trade transparency requirements for equity markets; the creation of a new regime for "systematic internalizers" of retail order-flow and more extensive transaction reporting requirements.

The UK met the EU's January 31 "transposition" deadline for MiFID. The EU intended that all member states would have their rules in place to allow a nine month period for financial institutions to complete their plans for implementation of the new MiFID requirements ahead of November 1 when the provisions come into force. The only other EU member states to meet the deadline were Bulgaria and Rumania each of which only became EU members on January 1, 2007. It is not yet clear when the remainder of the EU and in particular the other jurisdictions with developed financial services industries will enact their transposition rules.

http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/013.shtml

Litigation

Counter Claimant Unable to Pierce Corporate Veil

Plaintiff corporation (ENI), the owner and publisher of a nutritional newsletter and related trademark, entered into an Asset Purchase Agreement providing for Defendant's purchase of ENI's assets, including all of its rights in and to the newsletter and trademark. Under the Agreement, Defendant was required to use its best efforts to re-register the trademark (which had lapsed due to ENI's failure to file a required declaration of continued use) with the U.S. Patent and Trademark Office. The Agreement also required ENI to "fully cooperate" with Defendant's re-registration efforts. In the event that the re-registration succeeded, ENI was entitled to receive an additional payment.

UK DEVELOPMENTS

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After the Patent Trademark Office's initial rejection of the registration application, litigation ensued. In response to the claim that it had breached its "best efforts" obligation, Defendant counterclaimed against ENI and, under an alter-ego theory, its President (Goldblatt), asserting that they had not complied with the obligation to "fully cooperate" with the re-registration efforts. Applying New York law, the Court dismissed the alter ego counterclaim, finding that it had failed to assert facts showing that Goldblatt misused ENI for her own ends or that there was a relationship between the alleged breach of contract and any misuse of ENI's corporate form. (*Goldblatt v. Englander Communications, L.L.C.*, 2007 WL 148699 (S.D.N.Y. Jan. 22, 2007))

Scienter Pleading Requirement Satisfied by Plea Allocution

The Securities and Exchange Commission brought an action alleging violations of Section 10(b) of the Securities Exchange Act of 1934 against a hedge fund, two companies responsible for the management and administration of the hedge fund, and the President and COO of the two companies (Haligiannis). Criminal charges of securities fraud and investment advisor fraud were also brought against Haligiannis in connection with the same conduct at issue in the SEC's civil proceeding. While the civil lawsuit was pending, Haligiannis pled guilty to the criminal charges and made a plea allocution. Thereafter, the SEC moved for summary judgment in the civil action, relying in part on statements made in the allocution.

After noting that a violation of Section 10(b) requires that a defendant (i) have made a material misrepresentation or omission as to which he had a duty to speak, (ii) with scienter, and (iii) in connection with the purchase or sale of securities, the Court found that there was ample undisputed evidence to support the entry of summary judgment against the defendants. In the allocution, Haligiannis admitted that marketing materials and newsletters falsely inflated the fund's assets and performance and that statements sent to investors falsely inflated returns. The Court found that the scienter element of the claim was satisfied by Haligiannis's admission in the allocution that the inflated statements were sent to investors with knowledge of their falsity. Further, based upon its finding that Haligiannis exercised "exclusive control" over the corporate defendants, the court imputed Haligiannis's scienter to those entities. (*Securities and Exchange Commission v. Haligiannis, et al.*, 2007 WL 106174 (S.D.N.Y. Jan. 16, 2007))

CFTC

New Alternative Capital Requirement for FDMs Effective March 31

The Commodity Futures Trading Commission has approved amendments to Section 11 of National Futures Association's Financial Requirements, which replace the current alternative capital requirement for Forex Dealer Members (FDMs), based on 1% of net notional value, with a new requirement based on 5% of liabilities to retail forex customers. The CFTC also approved changes to NFA's Interpretive Notice entitled "Forex Transactions with Forex Dealer Members," which make clear that FDMs must maintain records of these liabilities. The new capital requirement and the corresponding amendment to the Interpretive Notice will become effective as of March 31.

http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=1739

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CFTC Issues New Governance Guidelines for Futures Exchanges

The Commodity Futures Trading Commission has issued new "acceptable practices" as a voluntary safe harbor for compliance with "Core Principle 15," a provision of the Commodity Exchange Act that requires exchanges to minimize conflicts of interest in their decision-making processes. The acceptable practices call for (i) exchange boards to consist of at least 35% public directors; (ii) each exchange to establish a board-level Regulatory Oversight Committee, composed entirely of public directors, to oversee the exchange's performance of its day-to-day self-regulatory functions; and (iii) each exchange disciplinary panel to have at least one public member.

The acceptable practices will be effective 30 days after publication in the Federal Register. However, existing exchanges will have two years or two board election cycles, whichever comes first, to implement the acceptable practices or otherwise demonstrate full compliance with Core Principle 15.

http://cftc.gov/files/opa/opafinalacceptablepractices-coreprinciple15.pdf

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