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SEC/Corporate

SEC Changes to Compensation Disclosure Provoke Debate

At the annual Reuters Regulation Summit in Washington, D.C., Securities and Exchange Commission Chairman Christopher Cox spoke out in defense of the SEC's most recent changes to the new executive compensation rules, which were reported on in last week's *Corporate and Financial Weekly Digest*.

Critics of the new interim rule, including the Council of Institutional Investors, have complained that the grant date fair value of equity compensation awards was removed from the simplified total compensation number that had been touted as the centerpiece of the new disclosure regime. Under the new rule only equity awards for the requisite service period which match the required financial statement disclosure under Statement of Financial Accounting Standards No. 123, are reflected in that total number. In most cases, this has the effect of only reporting grants that vested during the most recent fiscal year in the total number, rather than the total value of a grant including unvested portions. Critics charge that this makes the total compensation number less meaningful and a less useful yardstick to compare compensation among different companies.

Chairman Cox stressed that critics had misunderstood or overlooked the fact that the grant date fair value of all equity awards made during the year would still appear in detail in a new column in the required disclosure format, and that "100 percent of the options granted in a 12-month period have to be disclosed". Some commentators, such as Floyd Norris of the *New York Times*, agreed that it was a "judgment call" whether it was better to capture the full grant date fair value in the total compensation number, risking the inclusion of awards that had not been, and may never be, earned, or track the presentation of such awards as they appear in the financial statements.

Additionally, Ann Yerger of the Council of Institutional Investors noted that because employees eligible for retirement who would be able to keep an equity award at retirement are not considered to have a substantive service requirement under FAS 123R, the full grant date fair value of awards to retiree eligible employees will be included in their total compensation number. As a result, awards to retiree eligible employees appear larger than awards to other employees in the simplified total compensation number under the new interim rule, which adds to the lack of comparability. (*Reuters*, 1/8/07; *Society of Corporate Secretaries & Governance Professionals*, 1/11/07)

http://www.sec.gov/rules/final/2006/33-8765.pdf

Broker Dealer

No Action Letter Granted for a Centralized Trade Manager System

The Securities and Exchange Commission staff has granted no-action relief under the trade confirmation rule (Securities Exchange Act of 1934 Rule 10b-10) and the investment adviser recordkeeping rule relative to trades for customers (Investment Adviser Act of 1940 Rule 204-2(b)(3)) to Omgeo LLC.

SEC/CORPORATE

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Omgeo Central Trade Manager (Omgeo CTM) provides investment advisers with transaction information through a browser inquiry function in a form that can be viewed in three or fewer computer screens or through an electronic message from Omgeo CTM that contains all of the required Rule l0b-10 information, and that can be downloaded and printed.

Omgeo requested relief from Rule l0b-10 for broker-dealers using Omgeo CTM with respect to (i) certain trade information provided by Omgeo CTM to investment advisers; and (ii) the manner in which that information is provided. Additionally, Omgeo requested relief from Rule 204 with respect to an SEC registered investment manager treating printed or downloaded Trade Components Information (TCI) as (i) an original communication; and (ii) a confirmation, without receiving a confirmation meeting the requirements of Rule l0b-10 directly from the broker-dealer.

The SEC staff granted no-action relief based on the following requirements: (i) the broker-dealer will, on request, provide all of the information required by Rule l0b-10 to the beneficial owner of the account whose securities are the subject of a trade in a manner agreed upon by the broker-dealer and the beneficial owner, either when requested or on a regular basis; and (ii) until such time as a third party interaction feature is available in Omgeo CTM, the broker-dealer will use Omgeo CTM to satisfy the requirements of Rule l0b-10 only for trades settled delivery versus payment or receive versus payment.

As regards Rule 204, the SEC staff granted no-action relief to any registered investment adviser that participates in the Omgeo CTM system provided that the investment adviser downloads or prints a paper copy of the TCI. The SEC noted that, in this case, the TCI: (i) will contain all of the information required under Rule 10b-10; and (ii) if accessed through a browser inquiry, will be in a form that can be viewed in three or fewer computer screens.

http://www.sec.gov/divisions/marketreg/mr-noaction.shtml

Temporary Relief Provided for Broker-Dealer Recordkeeping Rules

Pursuant to a request by the Securities Industry Association, the staff of the Securities and Exchange Commission extended until 60 days after NASDAQ begins full operations as a national securities exchange relief for broker-dealers trading on NASDAQ from certain aspects of Rules 17a-3 (books and records), 17a-5 (reports of income and expense), and 17a-25 (securities transaction information) under the Securities Exchange Act of 1934.

The SEC granted relief with respect to SEC Rule 17a-3 and 17a-25 if a broker-dealer trades in NASDAQ-listed securities and non-NASDAQ exchange-listed securities and incorrectly identifies (i) NASDAQ as an exchange or an over-the-counter (OTC) market, (ii) NASDAQ securities as exchange-listed securities or OTC securities (and for non-NASDAQ exchange-listed securities, the transactions as having occurred on an exchange market or an OTC market), and/or (iii) with respect to SEC Rule 17a-3 only, a broker-dealer as a member of NASDAQ or NASD.

In addition, the SEC granted relief with respect to Rule 17a-5 for non-NASDAQ exchange-listed securities if a broker-dealer incorrectly classifies securities commission revenues generated by transactions in NASDAQ-listed and non-NASDAQ exchange-listed securities on FOCUS reports submitted to the broker-dealer's designated examining authority.

http://www.sec.gov/divisions/marketreg/mr-noaction.shtml#alpha

New Memorandum Issued on Principles of Federal Prosecution of Business Organizations

The Department of Justice issued "Principles of Federal Prosecution of Business Organizations" by Deputy Attorney General Paul McNulty replacing a similar title principles issued in January 2003 by then-Deputy Attorney General Larry D. Thompson. The memorandum outlines for U.S. Attorney nine factors to use when deciding whether to charge a corporation with criminal offenses.

Of particular interest is that the attorney client privilege and the attorney work product privilege are recognized. Assistant U.S. Attorneys can not request corporations to waive either privilege unless the U.S. Attorney and the Assistant Attorney General formally approve such a request with the subject corporation receiving a copy of such request. Further, corporations advancing attorney fees for criminal and civil prosecution of their officers or employees will not be considered as part of the corporate indictment process unless the advancement was intended to impede a government investigation. In such a case, the Deputy Attorney General must approve such a consideration.

www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf

http://www.usdoj.gov/opa/pr/2006/December/06_odag_828.html

SEC and Fed Repropose Bank "Broker" Exemptions

The Board of Governors of the Federal Reserve System and the Securities and Exchange Commission jointly issued proposed Regulation R to implement certain exceptions for banks from the definition of ''broker'' under Section 3(a)(4) of the Securities Exchange Act of 1934.

Regulation R would exempt banks from the definition of "broker" when acting as an agent where the bank: (i) sells Regulation S securities to purchasers outside the U.S.; (ii) resells eligible securities after their initial sale to purchasers outside the U.S., provided that the bank reasonably believed that the shares were initially sold under Regulation S; or (iii) resells an eligible security after its initial sale outside the U.S. on behalf of a registered broker-dealer or purchaser outside of the U.S., provided that the sale complies with Regulation S if the sale is made prior to the expiration of the compliance period specified in Regulation S. The bank could also effect riskless principal transactions in securities originally sold under Regulation S without coming within the definition of dealer.

Additionally, the proposed rules would exempt banks from the definition of "broker" to the extent that the bank acts as an agent engaging in or effecting securities lending transactions, and any securities lending services in connection with such transaction with or for a person that the bank reasonably believes to be: (i) a qualified investor; or (ii) an employee benefit plan that owns and invests on a discretionary basis not less than $25,000,000.

Regulation R also stipulates changes to the current policies on networking arrangements. Furthermore, Regulation R provides guidelines under which unregistered bank employees may receive more than nominal referral fees for referring institutional and other high net worth customers. Although the proposed rules prohibit incentive compensation for referrals, discretionary bonuses are permitted and may be transaction based.

Regulation R would expand the base over which a bank could include securities transaction fees as part of the fiduciary activities without coming within the definition of broker. Operating a sweep account would be permitted if the funds went into either a no load or a load money market fund if a prospectus is given to the customer.

The SEC also extended the exemption of banks from the definition of broker until July 2.

http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-9825.pdf

http://www.sec.gov/rules/proposed/2006/34-54947.pdf

http://www.sec.gov/rules/other/2006/34-54948.pdf

Private Investment Funds

US and European Regulators Explore Hedge Fund Borrowing

Representatives of the Securities and Exchange Commission, the Federal Reserve Bank, the United Kingdom's Financial Services Authority and Swiss and German regulators met in November with lenders to the hedge fund industry, including Goldman Sachs, Morgan Stanley, Bear Stearns, Merrill Lynch & Co., Lehman Brothers Holdings Inc., JPMorgan Chase & Co., Citigroup Inc., UBS AG, Credit Suisse Group and Deutsche Bank AG. The purpose of the meeting was to gain information on how lenders and prime brokers determine the collateral required from hedge funds.

Regulators are concerned that the margin required from banks to cover potential losses may be insufficient. SEC Commissioner Annette Nazareth said it is uncertain what steps, if any, regulators might take.

Tim Geither, President of the New York Federal Reserve Bank, stated that the matter is complicated and that it was difficult to "try to figure out whether you can bring about change that may be in the broader interests of all market participants."

http://www.bloomberg.com/apps/news?pid=20601102&sid=aMFZqx2S1aWg

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Banking

Final Statement Released on Complex Structured Finance Activities of Financial Institutions

The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission (collectively, the Agencies) released on January 5 a final statement with respect to complex structured finance activities of financial institutions (the Statement). The Statement, which states that the transactions it covers are an "essential part of U.S. and international capital markets," represents supervisory "guidance" for institutions supervised by the four banking agencies and a policy statement for institutions supervised by the Securities and Exchange Commission. The guidance and statement are the culmination of efforts to prevent banks and other financial institutions from committing, aiding, or abetting violations of applicable laws, regulations and accounting principles in connection with complex structured financial transactions (CSFTs). The Agencies stated that "in some cases, certain CSFTs appear to have been used in illegal schemes that misrepresented the financial condition of public companies to investors and regulatory authorities."

The Agencies believe that it is important for a financial institution engaged in CSFTs to have policies and procedures that are designed to allow the institution to effectively manage and address the full range of risks associated with its CSFT activities, including the elevated legal or reputational risks that may arise in connection with elevated risk CSFTs. For this reason, the Final Statement describes the types of risk management principles that the Agencies believe may help a financial institution to identify elevated risk CSFTs and to evaluate, manage, and address these risks within the institution's internal control framework. The Statement provides examples of transactions that may warrant additional scrutiny by an institution. These examples include, among other things, transactions that appear to the institution to:

- Lack economic substance or business purpose;
- Be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year-end or at the end of a reporting period for the customer; or

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- Raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements.

The Statement continues to provide that a financial institution should decline to participate in an elevated risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risks to the institution or would result in a violation of applicable laws, regulations or accounting principles. The Statement also describes the types of risk management systems and internal controls that may help a financial institution engaged in CSFTs to identify those CSFTs that may pose heightened legal or reputational risk to the institution, and to evaluate, manage, and address those risks. Additionally, the Statement provides that the board of directors and senior management of an institution should establish a "tone at the top" through both actions and formalized policies that sends a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics.

Another section of the Statement also describes the types of training, reporting mechanisms, and audit procedures that institutions should have in place with respect to elevated risk CSFTs. The Statement also provides that a financial institution should conduct periodic independent reviews of its CSFT activities to verify and monitor that its policies and controls relating to elevated risk CSFTs are being implemented effectively and that elevated risk CSFTs are accurately identified and receive proper approvals.

While careful to state that the Statement does not impose a binding legal requirement on financial institutions because it is guidance, institutions should thoughtfully consider the guidance recognizing that failure to comply could lead to supervisory difficulties.

http://www.federalreserve.gov/BoardDocs/Press/bcreg/2007/20070105/default.htm

United Kingdom Developments

MiFID Connect Issues Draft Guidelines on UK Implementation of MiFID

On January 11, the British Bankers Association (BBA) published draft guidelines prepared by the industry group MiFID Connect in respect of the proposed rules for the implementation of the Markets in Financial Instruments Directive (MiFID) in the UK. The guidelines will be subject to review by the UK Financial Services Authority (FSA) and may be revised further by MiFID Connect once the final rules on MiFID implementation are published by the FSA at the end of this month. The MiFID Connect guidelines cover: (i) investment research; (ii) suitability and appropriateness; (iii) best execution; (iv) conflicts of interest; and (v) outsourcing.

http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=600&a=8158

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Litigation

Securities Claims Fail to Meet "In Connection With" Requirement

A federal District Court dismissed the Securities and Exchange Commission's securities fraud claims under § 10(b) of the Securities Exchange Act of 1934 and § 17(a) of the Securities Act of 1933 against defendant Clark, who was allegedly engaged in a "pump and dump" scheme involving Roanoke Technology Corporation stock.

According to the Complaint, Roanoke's president and CEO, Smith, who was also named as a defendant, issued misleading press releases to inflate the value of Roanoke's stock, and then sold the Roanoke stock to reap the benefits. During that time, Smith and Clark allegedly engaged in a kickback

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scheme to help Smith "funnel money" out of Roanoke. Pursuant to the alleged scheme, Clark received Roanoke stock as payment for consulting services he did not provide and paid a portion of the proceeds from the sale of such stock to Smith in the guise of a loan.

Notwithstanding the alleged kickback scheme, which the Court accepted as true for purposes of the dismissal motion, the Court ruled that the SEC had failed to show a "connection" between Clark's "bad acts" and the fraudulent sale of Roanoke stock. The Court noted the SEC's failure to allege that Clark was aware of the falsity of Smith's public statements (allegedly made to inflate the value of the stock) or that Clark had made any misleading statements. The Court held that "simply listing Clark's 'bad acts' on the one hand and his securities transactions on the other," without alleging any fraudulent conduct in which Clark engaged (*e.g.*, whom he intended to defraud and misrepresentations directed to that end) or that he aided and abetted Smith's fraud, was insufficient to state a claim under § 10(b). (*Securities And Exchange Commission v. Roanoke Technology Corp.*, 2006 WL 3813755 (M.D. Fla. Dec. 26, 2006))

Plaintiffs Sufficiently Plead Short-Swing Profits Claim

Plaintiffs, Capitol First Corporation and its shareholders, asserted, among other things, § 16(b) claims under the Securities Exchange Act of 1934 against defendants, former controlling shareholders for failing to disclose their short-swing transactions in Capitol stock and for realizing improper short-swing profits. Plaintiffs alleged that defendants made their transactions in connection with a scheme to cause restricted shares to be reissued as free-trading shares and to be "immediately and actively" traded in order to create the appearance of an active market demand for Capitol stock and, accordingly, artificially inflate the stock price.

The Court held that plaintiffs' allegations that defendants, owners in excess of 10% of Capitol's common stock, purchased and sold shares of Capitol's stock within a six month period and profited from these short-swing transactions, were sufficient to maintain a § 16(b) action. The Court sustained plaintiffs' claim that the defendants' shares could be aggregated to satisfy § 16(b)'s 10% threshold because they were alleged to have acted in concert with each other in furtherance of a commonly held objective with respect to the Capitol stock.

In denying the dismissal motion, the Court rejected the defendants' argument that plaintiffs were required to allege that *the same* individual shares were purchased and sold within a six month period in order to state a § 16(b) claim. The Court also rejected defendants' contention that the claim was barred under the two-year statute of limitations. Although the lawsuit was filed more than two years after the last transaction, the Court ruled that plaintiffs' allegations, if true, would equitably toll the statute of limitations. (*Capitol First Corporation v. Todd*, 2006 WL 3827329 (D.N.J. Dec. 27, 2006))

CFTC

CFTC Adopts Final Rule Governing FCM Withdrawals of Equity Capital

The Commodity Futures Trading Commission has adopted final amendments to CFTC Rule 1.17 which provide that the CFTC may, by written order, temporarily prohibit the withdrawal of equity capital by a futures commission merchant (FCM) that would reduce the FCM's excess adjusted net capital by 30% or more. Please refer to the October 6, 2006 edition of the *Corporate and Financial Weekly Digest* for a more detailed description of the rule amendments, which have been adopted substantially as proposed. The revised provisions take effect on March 12.

http://www.cftc.gov/files/foia/fedreg07/foi070110a.pdf

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NFA Proposes to Continue Securities Futures Qualification by Training

The Securities and Exchange Commission seeks comments regarding the National Futures Association's (NFA) decision to extend, until December 31, 2009, the terms of its Interpretive Notices allowing registrants to qualify for security futures activities through training rather than by examination. The period for qualifying by training was scheduled to expire on December 31, 2006, at which time an examination was to replace the current training program. However, based on the relatively small number of individuals trading securities futures products, the NFA has concluded that developing and adopting an examination to replace the training program is not cost-effective at this time.

The comment period closes on January 29.

http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/E6-22658.pdf

http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=1208

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