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CORPORATE & FINANCIAL

WEEKLY DIGEST

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SEC/CORPORATE

Mixed Signals on "Say-on-Frequency" Vote

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, public companies holding their annual meetings on or after January 21 will be required to include in their proxy statements a non-binding proposal soliciting shareholders' views on whether "say-on-pay" proposals should be submitted to shareholders on an annual, biennial or triennial basis. Proxy cards for such annual meeting will be required to provide shareholders with these three choices plus the ability to abstain.

Many companies have yet to decide whether to recommend one of these choices to shareholders and, if so, which choice to recommend. There have been conflicting reports with respect to the favored choice of public companies. On the one hand, *Compensia News* published a listing of 87 companies that filed proxy materials through January 8 containing "say-on-frequency" proposals, with a majority (45) favoring triennial "say-on-pay" votes. Twenty-five companies recommended annual votes, nine recommended biennial votes, and eight companies provided no recommendation. The listing of companies in each category does not provide any clear trend as between larger and smaller companies.

On the other hand, a Towers Watson poll of 135 publicly traded companies that had not yet filed proxy statements found that a majority of those surveyed expected to recommend annual "say-on-pay" votes. The Towers Watson survey also notes that most surveyed companies do not know the level of favorable shareholder vote that would be considered a "success" or otherwise indicative of preference. This is understandable, considering that shareholders will be required to be given four choices, that no one choice may actually receive a majority of the votes cast, and that in any event the vote is non-binding.

Click here to read the *Compensia News* report.
Click here to read the results of the Towers Watson poll.

BROKER DEALER

SEC Approves Consolidated Know-Your-Customer and Suitability Rules

The Securities and Exchange Commission has approved the Financial Industry Regulatory Authority's proposal to adopt consolidated rules governing know-your-customer and suitability obligations. The effective date for the new rules is October 7. The new know-your-customer rule, FINRA Rule 2090, will replace New York Stock Exchange Rule 405(1) and will require member firms to use reasonable diligence, in regard to the opening and maintenance of every account, to know the essential facts concerning every customer. The know-your-customer obligation arises at the beginning of the customer-broker relationship and does not depend on whether the broker has made a recommendation. Unlike NYSE Rule 405, FINRA Rule 2090 does not specifically address account opening, supervision or orders.

The new suitability rule, FINRA Rule 2111, will replace NASD Rule 2310 and will require a member firm or associated person to have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. The triggering event for the new rule will continue to be a broker-dealer's recommendation. Additionally, the new rule applies to recommended investment strategies or securities regardless of whether the recommendation results in a transaction or generates transaction-based compensation. The rule also clarifies the types of information that brokers must attempt to obtain and analyze as part of their suitability analysis, condenses the sections relating to the three main suitability obligations and harmonizes the institutional-investor exemption with the more common definition of institutional account in NASD Rule 3110(c)(4).

Click here to read FINRA Regulatory Notice 11-02.

FINRA Proposes Rules Affecting Broker-Dealers Participating in Private Placements

The Securities and Exchange Commission is requesting comments on a proposal to expand Financial Industry Regulatory Authority Rule 5122 to apply to all private placements in which a member firm participates, not just those in which the member firm (or its control entity) is the issuer. Current FINRA Rule 5122 generally requires that a member firm or associated person engaging in a private placement of unregistered securities in which it (or a control entity of such member) is the issuer: (1) disclose in the offering documents the intended use of offering proceeds, offering expenses and the amount of selling compensation to be paid to the broker-dealer and its associated persons; (2) submit the offering documents to the FINRA Corporate Financing Department prior to or at the time such documents are provided to a prospective investor; and (3) comply with the requirement that at least 85% of the offering proceeds raised may not be used to pay for offering costs, discounts, commissions or any other cash or non-cash sales incentives, and that such proceeds must be used for the business purposes disclosed in the offering documents. FINRA also is proposing to retain all of the current exemptions in the rule except for the existing exemption for offerings in which a member firm acts primarily in a wholesaling capacity. The proposed rule change makes several other changes affecting broker-dealers participating in private placements. Comments to the SEC must be received by March 14.

Click here to read FINRA Regulatory Notice 11-04.

FINRA Expands OATS to All NMS Stocks

Beginning July 11, the Financial Industry Regulatory Authority will begin phasing in the expansion of the Order Audit Trail System (OATS) rules to include orders for all national market system (NMS) stocks. This will effectively extend the OATS recording and reporting requirements to NMS stocks listed on markets other than the National Association of Securities Dealers Automated Quotations (e.g., New York Stock Exchange, NYSE Amex and NYSE Arca). The expansion of the OATS rules will be accomplished in three phases based on the symbol of the security on July 11, July 18 and July 25. FINRA will announce at a later time the details of which security symbols will be subject to OATS reporting during each phase.

Click here to read FINRA Regulatory Notice 11-03.

CFTC

Industry Groups Respond to DOJ Recommendation Regarding Tighter Ownership Restrictions for DCMs, DCOs and SEFs

The ABA Securities Association, the Clearing House Association, the Financial Services Roundtable, the Futures Industry Association, the International Swaps and Derivatives Association, and the Securities Industry and Financial Markets Association (the Industry Groups) have submitted a comment letter with the Commodity Futures Trading Commission in response to a comment letter submitted by the U.S. Department of Justice (DOJ) urging the implementation of more-stringent rules relating to ownership and conflicts of interest for designated contract markets (DCMs), derivatives clearing organizations (DCOs) and swap execution facilities (SEFs).

The Industry Groups' comment letter urges the CFTC to refrain from imposing limitations on the aggregate voting power that may be held by major dealers and financial institutions in DCMs, DCOs and SEFs. The Industry Groups argue that, contrary to the DOJ's assertion, imposing aggregate voting limitations would decrease rather than promote competition within the markets for derivatives trading and clearing because the ability to offer ownership interests is vital to the ability of newly formed exchanges and clearinghouses to attract the liquidity necessary to successfully compete against incumbents. Furthermore, the Industry Groups argue that aggregate voting limitations are not necessary to prevent abuse and anti-competitive governance arrangements in the industry given the other tools available to the CFTC to monitor and regulate DCMs, DCOs and SEFs. Finally, the Industry Groups also urge the CFTC to avoid imposing burdensome composition requirements with respect to integral board committees of DCMs, DCOs and SEFs, including in particular DCO risk management committees, arguing that doing so will also impede the ability of newly formed exchanges and clearinghouses to attract the participation required to successfully compete against incumbents.

The original DOJ comment letter can be found here.
The Industry Groups' comment letter can be found here.

LITIGATION

Investors' Securities Fraud Claims Against Escrow Company Denied

Plaintiffs sued an escrow company for its role in a Ponzi scheme in which, according to a finding of fraud contained in a separate default judgment, non-parties Bradley Holcom and Jose Pinedo stole more than $6.4 million of plaintiffs' investments. Plaintiffs asserted claims for, among other things, securities fraud under Sections 10(b) and 20(a) of the Securities Exchange Act, and aiding and abetting fraud. Defendant Citizens Title & Trust, Inc. moved to dismiss the securities fraud and aiding and abetting fraud claims, which motion was granted by the U.S. District Court for the Southern District of California.

Plaintiffs invested cash with Mr. Holcom and Mr. Pinedo to allow them to purchase real property in Arizona, in exchange for which plaintiffs would receive an interest in the related promissory note and deed of trust. Plaintiffs contend that Mr. Holcom and Mr. Pinedo purchased properties with plaintiffs' money, but rather than providing the investors with security interests in the properties, plaintiffs received a worthless "investment contract." The real property, which had been purchased with plaintiffs' money but actually was owned by Mr. Holcom and Mr. Pinedo or their controlled entities, subsequently would be sold to innocent third parties. According to plaintiffs, Citizens opened escrow accounts, acted as the escrow holder, and executed and delivered promissory notes and deeds of trust in connection with these transactions.

Plaintiffs contended that Citizens knew Mr. Holcom and Mr. Pinedo intended to defraud plaintiffs and actively participated in the entirety of the fraudulent scheme.

In granting Citizens' motion to dismiss the Section 10(b) claim, the court found that plaintiffs had not only failed to allege either a misstatement or omission of material fact by Citizens upon which plaintiffs relied and which proximately caused plaintiffs' injury, but also that plaintiffs failed to raise a strong inference that Citizens intentionally or recklessly made false or misleading statements that injured plaintiffs. As to the Section 20(a) claim, the court held that plaintiffs failed to show that Citizens exercised the requisite control over Mr. Holcom or Mr. Pinedo to induce them to engage in acts that violated the securities laws. (*Meram v. Citizens Title and Trust, Inc.*, 2011 WL 11463 (S.D.Cal. Jan. 3, 2011))

District Court Denies Media Executives Summary Judgment in SEC Action

The Securities and Exchange Commission brought an enforcement action against three former executives of a major media company, alleging that the executives improperly reported $1 billion in online advertising revenue. The SEC alleges that, in 10 separate transactions, the media company declined discounts or lower prices for goods, services, or the settlement of disputes, and instead paid inflated prices that were offset, dollar for dollar, by sums ostensibly paid for online advertising (collectively referred to as the "'round trip' transactions"). This advertising "revenue" artificially inflated the media company's revenues for the years 2000 through 2003.

The SEC asserted claims for securities fraud, aiding and abetting liability, record keeping violations, and misrepresentations to auditors, and each of the three executives moved for summary judgment. The court denied the motions filed by Mark Wovsaniker, head of Accounting Policy, and Steven Rindner, Senior Vice President of Business Affairs, in their entirety. The motion filed by John Michael Kelly, who held positions as CFO, COO and CEO during the relevant time period, was denied as to the securities fraud and aiding and abetting claims, but granted as to the remaining counts.

In sustaining the securities fraud and aiding and abetting claims, the court determined that there were genuine issues of fact as to whether each executive acted with scienter, i.e., whether each knew the company was wrongly recognizing revenue as a result of the "round trip" transactions.

For example, Mr. Rindner argued that he did not have an accounting background, did not understand complex accounting rules and therefore did not know that the company was recognizing revenue improperly. However, the court found that the SEC had adduced sufficient evidence to suggest that Mr. Rindner knew that "round trip" transactions were improper (e.g., that Mr. Rindner instructed employees to refrain from "cross-referencing" the individual components of a "round-trip" transaction). As to Mr. Wovsaniker, the head of Accounting Policy, the court found that the SEC had raised genuine issues of fact as to whether he knew that the company's financial statements were inaccurate, including evidence suggesting that Mr. Wovsaniker approved the recognition of $23.8 million in advertising revenue from a party that had offered to settle a legal claim for $20 million in cash. Similarly, the court found genuine issues of fact as to whether Mr. Kelly, a CPA and CFO, knew that the media company declined discounts in exchange for advertising commitments in equal amounts.

Finally, the court granted summary judgment dismissing the SEC's request for disgorgement because the SEC "proffered no evidence that [the] court could use to reasonably approximate the percentage of Rindner's and Kelly's compensation that was causally connected to the alleged violations." (*Securities and Exchange Commission v. Kelly, et al.*, 1:08-cv-04612 (S.D.N.Y. Jan. 7, 2011))

BANKING

S.A.F.E. Act Registration Set

On January 4, the Federal Deposit Insurance Corporation announced its expectation, along with the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, the Farm Credit Administration, and the National Credit Union Administration (the Agencies), that the system for federal registration of residential mortgage loan originators (MLOs) will begin operation on or around January 31. The Agencies' rules implementing the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (S.A.F.E. Act) require MLOs to register with the Nationwide Mortgage Licensing System and Registry within 180 days of the date the Registry begins accepting federal registrations. The Agencies will confirm the opening date for federal registration closer to the actual date and will publish notice of that date in the *Federal Register.*

- The S.A.F.E. Act is intended to improve the accountability and tracking of residential MLOs, enhance consumer protection, reduce fraud and provide consumers with easily accessible information regarding an MLO's professional background.
- MLOs employed by Agency-regulated institutions will have 180 days from the date on which the Registry begins accepting federal registrations to complete initial registration. At present, the Agencies expect the initial registration period to expire on July 29.
- After the initial registration period expires, MLOs will be prohibited from originating residential mortgage loans until they successfully complete the federal registration process.
- The Agencies' rules provide a *de minimis* exception whereby MLOs that originated five or fewer mortgage loans during the previous 12 months are not required to complete the federal registration process.

Read more.

UK DEVELOPMENTS

FSA Announces Three Plead Guilty to Insider Dealing

On January 10, the UK Financial Services Authority (FSA) announced a guilty plea by three people accused of insider dealing. Christian Littlewood, a senior investment banker, his wife, Angie Littlewood, and a family friend, Helmy Sa'aid, pleaded guilty to the eight counts of insider dealing alleging that they had made almost £590,000 (approximately $930,000) profit from trades in a number of London Stock Exchange and Alternative Investment Market listed shares between 2000 and 2008.

Mr. Littlewood worked at Dresdner Kleinwort until 2007 and at Shore Capital from 2008 to 2009. His wife was a qualified barrister who had also worked as an investment banker. Mr. Sa'aid, a Singaporean national, was returned to the UK in March 2010 after being extradited from Mayotte, one of the Comoros Islands in the Indian Ocean.

Margaret Cole, the FSA's Managing Director of Enforcement and Financial Crime, said: "It seems that the penny is beginning to drop. These guilty pleas show that our strategy of a tough approach to insider dealing—and, in particular, demonstrating that we are prepared to fight difficult criminal prosecutions to trial—is paying off. Dedicated hard work, bold and innovative use of the tools at our disposal and close seamless cooperation between our markets, enforcement and intelligence functions underpin our successful track record in this complex area."

The trio's sentencing and confiscation hearing will take place in early February.

To read more, click here.

EU DEVELOPMENTS

ESMA Holds Initial Board Meeting

On January 11, the newly established European Securities and Markets Authority (ESMA) announced that its Management Board had held its first meeting.

At the meeting, the first six members of the Management Board were elected, including nominees from six EU national regulators, one of whom was the UK Financial Services Authority's Director of Markets. The Board also announced the adoption of internal rules for ESMA, including terms of reference for its decision-making process for the adoption of technical standards and guidelines. The Board also confirmed that all Level 3 measures previously issued by its predecessor entity, the Committee of European Securities Regulators, remain valid.

To read more, click here.

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