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Corporate and Financial Weekly Digest

**January 23, 2009**

## SEC/Corporate

### SEC Issues Report on Modernizing the Disclosure System

On January 16, the Securities and Exchange Commission released its 21st Century Disclosure Initiative Staff Report. In June 2008, the Chairman of the SEC established this Initiative, with a mandate to examine the current state of operating and investment company disclosure and to present a high-level outline of a plan to modernize the present disclosure system by improving transparency and making disclosure information more accessible and easier to use.

The staff focused on four guiding principles in proposing an interactive data-based approach to disclosure:

- **Disclosure information and other data should be submitted and stored in an interactive format.**
  - Financial and non-financial information should be electronically tagged (using eXtensible Business Reporting Language and/or another mark-up language). The tagged disclosure information would be stored electronically in a centrally organized interactive company file that would satisfy compliance requirements and would avoid repeated filing of the same redundant information year after year. The Initiative recommends that disclosure rules be rewritten to require that disclosure information be submitted in standardized or structured components that facilitate interactive data tagging and piecemeal updating or deletion of information in the company file.

- **The Commission should consider establishing a data warehouse.**
  - This would provide a single, consistent and integrated source of all data needed by Commission staff. The SEC's offices and divisions could then use separate compilations of this data to serve their individual purposes, while a master version is maintained in the data warehouse.

- **The Commission should consider providing multiple submission methods for disclosures.**
  - These would include filing disclosure information directly into a Commission-maintained portal as is currently the case for Section 16 filings; uploading disclosure information as is the case with most EDGAR filings; or taking advantage of technology that would allow the submitter's internal software to interface with the Commission's software.

- **The Commission should consider providing multiple dissemination methods for disclosures.**

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- Disclosures could be accessed directly from the Commission's website for investors seeking filings or it could be disseminated through other channels that could allow it to ultimately feed directly into third-party models or other applications; different users could have different levels of access to information.

The staff recommends that the SEC establish an advisory committee comprised of investors, filers, information intermediaries, and other primary users to give the Commission insight on the specifics of how to develop a modernized interactive data-based disclosure system, as outlined in the Initiative.

http://www.sec.gov/spotlight/disclosureinitiative/report.pdf

**Schapiro Approved as New SEC Chairman**

On January 22, the U.S. Senate unanimously confirmed the nomination of Mary Schapiro as chairman of the Securities and Exchange Commission. Schapiro, who has been chief executive of the Financial Industry Regulatory Authority as well as a former SEC commissioner, replaces Christopher Cox, who resigned on January 20.

http://www.reuters.com/article/ousiv/idUSTRE50M07320090123

## Litigation

**SEC Must Organize and Label Document Productions in Civil Litigation**

The U.S. District Court for the Southern District of New York ruled against the Securities and Exchange Commission on several discovery disputes arising in connection with the SEC's civil action against the CEO of a public company for violations of the federal securities laws. Specifically, the defendant sought an order directing the SEC to (i) identify responsive materials in the SEC's document production pursuant to the defendant's document request, (ii) perform a more expansive search for internal emails and documents relating to the allegations of the complaint, and (iii) produce documents the SEC asserted were protected by the deliberative process privilege.

The court first held that the SEC was obligated under Federal Rule of Civil Procedure 34 to identify responsive documents rather than "dump" millions of pages on the defendant. Under Rule 34, a party may produce documents "as they are kept in the usual course of business or must organize and label them to correspond to the categories in the request." After discussing the legislative history and meaning of the word "business" as it is used in the rule, the court held that a government investigation is "by its very nature not routine or repetitive," and as such is not covered in the "usual course of business." Instead, the SEC is required under Rule 34 to "organize and label them to correspond to the categories in the request."

The court next ruled on the SEC's refusal to produce certain internal documents because of undue burden. Despite the defendant's efforts to establish a search protocol that would balance production against its strain on agency resources, the SEC unilaterally limited its searches to compilations that returned no responsive results. The court held that the SEC's refusal was "patently unreasonable," and directed the parties to confer in order to develop a workable protocol as originally suggested by the defendant's counsel.

Finally, the court held that the SEC's refusal to produce certain documents on the basis of the deliberative process privilege was unfounded. Specifically, the court stated the SEC's privilege log was "deficient," and that the SEC's vague

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assertion of the privilege amounted to it asking the court "simply to take its word" that the documents were protected. Instead, the court directed the SEC to produce the documents for an *in camera* review, along with short memoranda explaining why each document is privileged. (*SEC v. Collins & Aikman Corp.*, 2009 WL 94311 (S.D.N.Y. Jan. 13, 2009))

### Defendant's Arguments for Smaller Disgorgement Figure Rejected

The Securities and Exchange Commission brought an action against a corporation's operators for allegedly conducting a classic "pump and dump" market manipulation scheme whereby they purchased for the corporation stock of another company, then disseminated false public information touting the company with the goal of selling their stock at an artificially higher price. One defendant, the controller of the corporation that purchased stock in accordance with the scheme, consented to the entry of judgment as well as the imposition of certain relief against him, but disagreed with the SEC as to the monetary amount of the relief. After considering evidence the defendant had introduced supporting his view of the appropriate disgorgement and penalty amounts, the U.S. District Court for the Southern District of New York held the defendant failed to make the required showing and that the SEC's calculation should be imposed.

Among other things, the court rejected the defendant's argument that the corporation's proceeds from the stock sales that were later used for the corporation's general business expenses should be deducted from the defendant's ill-gotten profits. Specifically, the court held that payments made to other directors of the corporation, payments made to repay corporate loans, and payments made to develop the corporate website were irrelevant "as general business expenses may not be subtracted from the disgorgement amount, and it does not matter how a defendant chooses to spend his ill-gotten gains."

Further, the defendant argued that the disgorgement figure should be reduced by the amount previously held in a corporate brokerage account which the SEC had frozen. The account lost a great deal of value in the period of time in which it was frozen, and the defendant argued that he should not be prejudiced by the SEC's delay in liquidating the account. The court rejected the defendant's argument, holding that the sum liquidated was the amount that was disgorged and the defendant was not entitled to a greater credit by reason of the fact that the account previously had a higher value. (*SEC v. Stone*, 2009 WL 82661 (S.D.N.Y. Jan. 13, 2009))

## Broker Dealer

### NYSE Arca Reduces Order Exposure Period

The Securities and Exchange Commission issued an order on January 5 granting accelerated approval of NYSE Arca, Inc.'s proposed rule change to its Rule 6.47A, Order Exposure Requirements – OX. The rule change reduces the exposure time during which order entry firms may not execute as principal against orders they represent as agent from three seconds to one second. The SEC believes that market participants should continue to have opportunities to compete for exposed bids and offers within a one-second exposure period, as NYSE Arca reported that a survey of its members indicated that firms could respond to orders within one second.

http://www.sec.gov/rules/sro/nysearca/2009/34-59194.pdf

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## BOX Proposes Changes to Rules Governing Doing Business With the Public

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On January 7, the Securities and Exchange Commission issued a notice of a proposed rule change filed by the Boston Stock Exchange (the Exchange) to amend several Boston Options Exchange (BOX) rules that govern doing business with the public. First, the Exchange proposes to restore the term "Registered Options Principal" (ROP) in place of "Registered Options and Securities Futures Principal" (ROSFP), both to alleviate any potential confusion that may have arisen when the term ROSFP recently replaced the term ROP and to provide consistency with the rules of the Financial Industry Regulatory Authority (FINRA), the Chicago Board Options Exchange (CBOE), the International Securities Exchange and the American Stock Exchange. Second, the Exchange proposes modifications of the BOX confirmation disclosure requirements in order to provide consistency with the confirmation disclosure requirements recently proposed by FINRA and the CBOE. Finally, the Exchange proposes to eliminate the definition of "closing purchase transaction," as the term was made obsolete by an earlier rule change.

http://www.sec.gov/rules/sro/bse/2009/34-59211.pdf

## FINRA Proposes Limits to Forex Leverage Ratios

The Financial Industry Regulatory Authority (FINRA) issued a Regulatory Notice requesting comment on a proposed rule prohibiting any member firm from allowing a customer to: (i) initiate any forex position with a leverage ratio of greater than 1.5 to 1; and (ii) withdraw money from an open forex position that would cause the leverage ratio for such position to be greater than 1.5 to 1. FINRA stated that it has "observed a potential migration of retail forex activity" from futures commission merchants to broker-dealers and proposed the limits to better protect investors. According to FINRA, requiring greater initial deposits for retail forex will reduce the likelihood that small exchange rate fluctuations will cause drastic investor losses and will help reduce the risks of excessive speculation in these products.

http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117743.pdf

## FINRA Issues Guidance Regarding Resales of Unregistered Securities

The Financial Industry Regulatory Authority (FINRA) issued a Regulatory Notice to remind member firms of their responsibilities when participating in resales of restricted securities. A member firm is generally required to have written procedures in place to ensure that it does not become a participant in an illegal unregistered distribution. FINRA issued the Notice because it had recently detected a number of instances during examinations where firms failed to recognize certain "red flags" indicative of illegal, unregistered distributions. The Regulatory Notice describes different procedures implemented by member firms to address compliance in this area that FINRA found effective. Although the procedures varied, FINRA found that the best ones tended to include "a mandatory, standardized process that requires formal approval of the proposed resale transaction" along with thorough documentation practices.

http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117716.pdf

## Structured Finance and Securitization

### FDIC Adding Covered Bonds to Liquidity Guarantee Plan

On January 16, the Federal Deposit Insurance Corporation announced that it will propose changes to its Temporary Liquidity Guarantee Program. The proposed changes will extend the maturity of the guarantee for covered bonds from 3 years to up to 10 years. If accepted, the changes will take effect this month, and will be part of the larger effort to stabilize the banking system and to increase lending. More information will be available soon.

http://www.fdic.gov/

### CBO Issues Report on TARP Transactions

On January 16, the Congressional Budget Office (CBO) released a report titled, "The Troubled Asset Relief Program: Report on Transactions Through December 31, 2008." The report, issued pursuant to the provisions of the Emergency Economic Stabilization Act of 2008, evaluates the U.S. Treasury Department's activities under the Program (TARP), including capital purchases and loans to automotive companies.

Additionally, the report provides a comparison of the CBO's and the Office of Management and Budget's (OMB) estimates of the costs and calculations of TARP transactions. The CBO estimates that distributing the first third of TARP will cost taxpayers $64 billion, 26% of the funds given out so far, while the OMB estimates it will cost $55 billion. The numbers, otherwise known as subsidy rates, are the difference between what the Treasury paid for investments and the market value of the investments. The subsidy rates for AIG and GMAC are over 50%.

http://www.cbo.gov/ftpdocs/99xx/doc9961/01-16-TARP.pdf.

### HUD Releases Announcement Regarding Ginnie Mae MBS in H4H

The Department of Housing and Urban Development (HUD) issued a memo for all participants in Ginnie Mae programs on January 16. The memo states that under the Hope for Homeowners Program (H4H) lenders may offer borrowers mortgages with 30- to 40-year terms and that "in order for an H4H mortgage to qualify for inclusion in a Ginnie Mae mortgage-backed security, the mortgage must be for a term of either 30 or 40 years." The memo also sets forth that for securities with issue dates of February 1 or later, Ginnie Mae will allow lenders to pool 40-year H4H mortgages into new 40-year Multiple Issuer Pool "M FS" pools. The new M FS pools are "subject to the same edits and requirements as the 30-year M FS pool type".

http://www.ginniemae.gov/apm/apm_pdf/09-02.pdf

## CFTC

### CFTC Proposes Amendments to "Public Director" Definition

The Commodity Futures Trading Commission has requested comments on proposed amendments to the definition of "public director" in the acceptable practices previously adopted for designated contract market (DCM) Core Principle 15. The acceptable practices, which would operate as a "safe harbor," would require the inclusion of public directors on a DCM's board of directors and regulatory oversight committee, as well as the inclusion of public members on DCM disciplinary panels. The implementation of this aspect of the Core Principle 15 acceptable practices was stayed by the CFTC in November

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2007, due to uncertainty regarding the appropriate scope of the "public director" definition.

The proposed amendments retain as the central element of the "public director" definition a materiality test, under which a public director must be found to have "no material relationship" with the applicable DCM. However, the amendments would revise the supplemental "bright line" tests, which set forth certain relationships that were to be considered material *per se*. Generally, the revisions would narrow the application of the bright line tests by removing certain categories of persons from the bright line exclusions. The CFTC emphasized, however, that this is intended merely to shift the point of analysis back to the general materiality test for those categories of directors.

The comment period for the proposed amendments closes on February 20, but the stay of the acceptable practices remains in effect until further notice by the CFTC.

http://www.cftc.gov/newsroom/generalpressreleases/2009/pr5597-09.html
http://www.cftc.gov/stellent/groups/public/@lrfederalregister/documents/file/e9-891a.pdf

**CFTC Extends Conditions on Offering of Linked Contracts by FBOTs**

The Commodity Futures Trading Commission has published notice to foreign boards of trade (FBOTs) who provide direct access to members or participants in the United States regarding certain additional conditions on their no-action relief from the CFTC. These conditions were set out this summer in amendments to no-action letters previously issued to ICE Futures Europe and Dubai Mercantile Exchange, and affect FBOTs that list for trading by direct access from the United States any futures or option contract that settles against the price of a contract listed on a CFTC-regulated futures exchange (including "significant price discovery contracts" traded on an exempt commercial market). With respect to any such contracts, the FBOT is required to (i) adopt speculative position limits and position accountability levels (and related hedge exemptions) that are comparable to those established by the U.S. listing exchange; (ii) report to the CFTC on a quarterly basis any violations of applicable position limits, whether a hedge exemption was granted and whether disciplinary action was taken; (iii) publish daily trading information comparable to the information published by the U.S. listing exchange; and (iv) provide to the CFTC a daily report of large trader positions, in a format acceptable to the CFTC.

The CFTC notice also set forth a streamlined procedure for listing options on futures contracts for direct access from the United States.

http://edocket.access.gpo.gov/2009/pdf/E9-1153.pdf

**CFTC and FinCEN Agree to Information Sharing**

The Commodity Futures Trading Commission and the Financial Crimes Enforcement Network (FinCEN) have announced an agreement to exchange information in an effort to ensure that CFTC-regulated entities are in compliance with their anti-money laundering obligations under the Bank Secrecy Act (BSA). Under the information-sharing agreement, the CFTC will provide FinCEN with information regarding the anti-money laundering examination and enforcement activities of the CFTC and applicable futures self-regulatory organizations, and FinCEN will provide the CFTC with information intended to assist with BSA compliance activities.

http://www.cftc.gov/newsroom/generalpressreleases/2009/pr5601-09.html

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**Michael V. Dunn Named Acting Chairman of CFTC**

Commissioner Michael V. Dunn has been elected to serve as Acting Chairman of the Commodity Futures Trading Commission, following Commissioner Walter Lukken's resignation as Acting Chairman on January 20. Dunn will continue to serve as Acting Chairman pending the confirmation of Gary S. Gensler as Chairman of the CFTC by the U.S. Senate.

http://www.cftc.gov/newsroom/generalpressreleases/2009/pr5602-09.html

**CFTC Approves Mini Futures Contracts on HSI and HSCEI for Trading by U.S. Persons**

The Commodity Futures Trading Commission staff has issued a no-action letter to Hong Kong Futures Exchange Limited (HKFE) approving HKFE's mini futures contracts based on the Hang Sang Index (HSI) and Hang Sang China Enterprises Index (HSCEI) for trading by U.S. persons.

http://www.cftc.gov/newsroom/generalpressreleases/2009/pr5603-09.html

## ERISA

**Liability for Late Transfer of 401(k) Contributions – Not a "Unique" Situation**

In *Chao v. Unique Manufacturing Co.*, a federal district court determined that a business consultant brought in to run a distressed company was a fiduciary to the company's 401(k) plan and liable for the failure to transfer employee 401(k) contributions to the plan.

Regulations under the Employee Retirement Income Security Act of 1974 (ERISA) provide that employee contributions to a 401(k) plan become assets of the plan as of the earliest date (not later than 15 days) they can be segregated from the employer's assets. If contributions are held beyond that date, the persons responsible for the delay are subject to fiduciary liability for failure to transfer the funds. Delays of this type occur frequently by oversight or because of cash flow problems. Late transfer of 401(k) contributions is a prime area of ERISA enforcement by the U.S. Department of Labor (DOL).

In *Unique*, a management consultant was retained "to provide management, financial advisory and investment banking services in connection with the Company establishing a private placement to raise capital or sell the Company." The consultant had signing authority for the corporate bank account. Beginning before his retention, and continuing during it, employee contributions to the 401(k) plan were deducted from payroll but retained in the corporate account. In an enforcement action, the DOL sued the company, the consultant and the former president of Unique who had signing authority for the bank account prior to the consultant, seeking to have the employee contributions, plus a "lost opportunity" amount, restored to the plan.

The court held that the consultant was a fiduciary to the plan because he had "practical control" of the bank account where the contributions (which were plan assets) were held. As a fiduciary, he failed to ensure that the assets were transferred to the plan and allowed them to be spent on corporate expenses. This was despite the consultant's arguments that he was initially unaware of the failure to transfer, then tried to remedy it, but was rebuffed by the executor of the estate of the company's late owner. The former president, who was also trustee of the 401(k) plan, was found liable for the failure to remit contributions prior to the consultant's retention.

DOL enforcement activity in this area can be expected to continue. For any


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company with a 401(k) plan (or other plan with employee contributions), anyone who comes to have "practical control" of company finances is potentially liable for late contributions. This could include a manager, business consultant, or private equity firm, among others. Due diligence on procedures for handling employee contributions, currently and historically, is necessary, as is a good payroll agent. *(Chao v. Unique Manufacturing Co.*, 2009 WL 63064 (N.D.Ill., Jan. 7, 2009))

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### Supreme Court Agrees to Hear Preemption Case

On January 16, the U.S. Supreme Court agreed to hear a case involving the authority of states to examine the lending practices of national banks and their operating subsidiaries. National banks and their operating subsidiaries are regulated by the Office of the Comptroller of the Currency (OCC).

The case arose because of actions by the New York Attorney General's office begun in 2005. At that time, then state Attorney General Eliot Spitzer began investigating evidence of possible racial discrimination in residential real estate lending by a variety of institutions, including national banks and their operating subsidiaries. According to the Attorney General's office, data in required Home Mortgage Disclosure Act (HMDA) filings prompted the opening of such investigation.

In connection with the investigation, letters of inquiry were sent from the Attorney General's office to certain mortgage lenders implicated in the HMDA data, including national banks and their operating subsidiaries. Thereafter, the OCC filed suit to prevent the investigation from continuing with respect to the entities it regulates. Both the U.S. District Court for the Southern District of New York and the U.S. Court of Appeals for the Second Circuit upheld the OCC's interpretation of 12 USC 484, which provides generally that visitorial powers for national banks are vested exclusively in the OCC. Nonetheless, the Supreme Court, in granting a writ of certiorari, framed the question as follows: "The Office of the Comptroller of the Currency has issued a regulation (12 C.F.R. § 7.4000) interpreting § 484(a) to preempt state enforcement of state laws against national banks, even when the state laws are not substantively preempted."

The case is set for expedited briefing.

http://www.supremecourtus.gov/docket/08-453.htm

### Treasury Issues Additional Executive Compensation Rules Under TARP

On January 16, the U.S. Department of the Treasury issued interim final rules for reporting and recordkeeping requirements with respect to executive compensation standards under the Troubled Asset Relief Program's Capital Purchase Program (CPP).

Pursuant to the new rule, an institution's chief executive officer must certify annually within 135 days after the end of such institution's fiscal year that the institution and its compensation committee have complied with the CPP's executive compensation standards. Additionally, the new rules require that, within 120 days of the closing date of the Securities Purchase Agreement (SPA) between a financial institution and the Treasury, the CEO of such institution must certify that the compensation committee has reviewed the senior executives' incentive compensation arrangements with the institution's senior risk officers. This is required to ensure that the compensation arrangements "do not encourage senior executives to take unnecessary and excessive risks that could threaten the value of the financial institution."

The certification required 120 days after the closing of an SPA and the annual certification at the end of the relevant fiscal year must be provided to the Troubled Asset Relief Program Chief Compliance Officer.

http://www.treasury.gov/press/releases/hp1364.htm

## Financial Markets

### GAO Releases Framework for Reform of U.S. Financial Regulatory System

On January 8, the U.S. Government Accountability Office (GAO) released "A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System," its report of a study undertaken in response to the current financial crisis. The GAO report describes the origins of the current financial regulatory system, as well as various market developments and changes that have created challenges for the current system, and provides an evaluation framework for use by Congress and others to shape potential regulatory reform efforts.

The report recommends that any new regulatory system have clearly defined regulatory goals; be appropriately comprehensive, flexible, adaptable, efficient and effective; provide consistent consumer and investor protection; ensure that regulators have independence, prominence, authority and accountability; and result in minimal taxpayer exposure.

http://www.gao.gov/new.items/d09216.pdf

### G30 Releases Recommendations for Financial System Reform

The Group of Thirty (G30) recently released a report of its Steering Committee, chaired by former Chairman of the Federal Reserve Board Paul Volcker, focusing on how the financial system might be organized, once the present crisis has passed, to better provide stability. "Financial Reform: A Framework for Financial Stability," presents 18 recommendations for interrelated changes in policies, practices, and market standards, organized under the following four core recommendations: (i) gaps and weaknesses in the coverage of prudential regulation and supervision must be eliminated; (ii) the quality and effectiveness of prudential regulation and supervision must be improved; (iii) institutional policies and standards must be strengthened, with particular emphasis on standards for governance, risk management, capital, and liquidity; and (iv) financial markets and products must be made more transparent, with better-aligned risk and prudential incentives.

http://www.group30.org/pubs/recommendations.pdf
http://www.group30.org/pubs/pub_1460.htm

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## UK Developments

### UK Company Fined for Disclosure Delay

On January 20, the UK Financial Services Authority (FSA) fined Wolfson Microelectronics plc (Wolfson) £140,000 ($193,000) for failing to reveal price-sensitive information to the market in a timely manner, leading to the creation of a false market in Wolfson shares for 16 days in March 2008.

On March 10, 2008, Wolfson was informed by Apple Computer, one of its major customers, that Apple would not be using Wolfson as a supplier of chips for its iPod MP3 player. It was estimated that this would represent a loss of $20 million or 8% of Wolfson's 2008 forecast revenue. At the same time, Apple also

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awarded Wolfson a contract to supply parts for the iPhone that should offset much of the loss from the iPod contract.

Wolfson discussed the matter on March 12 with its investor relations advisors, who recommended that there was no need to disclose the negative news, and Wolfson delayed making an announcement on the basis of that advice.

Wolfson reconsidered the earlier advice and eventually sought advice from its lawyers and corporate stockbrokers, contacting them on March 20 just before the Easter holiday. In a conference call on March 25 after the Easter holiday, Wolfson's lawyers recommended disclosure. Wolfson disclosed the news early on the morning of March 27, and its share price went down roughly 18%.

The FSA considered that Wolfson's reliance on their investor relations advisors was insufficient. The breach of the disclosure obligation was quite clear. Their position might have been improved if they had consulted their lawyers earlier. The FSA stated: "Companies have the primary responsibility for meeting their disclosure obligations. While they may benefit from seeking advice from those in a position to comment on their regulatory requirements, they cannot rely, without due consideration, on such advice." The FSA emphasized that its position (set out in publications and previous enforcement cases) was that it was not acceptable to justify non-disclosure of information by offsetting negative and positive news. Companies must disclose both types of information and allow the market to determine whether they cancel each other out.

Since Wolfson had co-operated with the FSA's investigation it received a 30% discount of the £200,000 ($275,000) fine for early settlement.

www.fsa.gov.uk/pubs/final/Wolfson_20jan09.pdf

**FSA Publishes Results of MiFID Thematic Review**

On January 21, the UK Financial Services Authority (FSA) published the results of its thematic review of the implementation of a number of key "wholesale" requirements of the EU Markets in Financial Instruments Directive (MiFID). MiFID introduced certain new, more extensive requirements for FSA authorized firms, including new conduct of business and organizational requirements.

In September 2007, the FSA identified wholesale and retail business areas of MiFID that were a priority for its review. The wholesale priorities included: (i) best execution; (ii) inducements; (iii) investment research; (iv) client classification; (v) conflicts of interest; and (vi) senior management systems and controls. The thematic review was undertaken between June and November 2008 and included 43 wholesale firms.

www.fsa.gov.uk/pubs/international/mifid_sup_priorities.pdf

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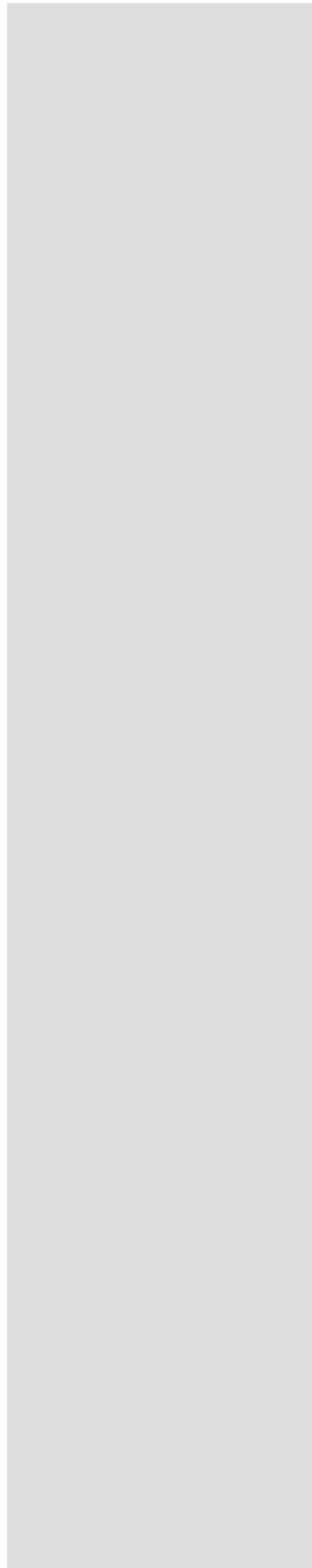

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