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Corporate and Financial Weekly Digest

**January 30, 2009**

## SEC/Corporate

### SEC Issues Updated Compliance and Disclosure Interpretations for Rules Under the Securities Act

On January 26, the Securities and Exchange Commission's Division of Corporation Finance issued updated Compliance and Disclosure Interpretations (CDI) of rules adopted under the Securities Act of 1933, as amended.

The CDI includes an interpretation relevant to issuers that are "well-known seasoned issuers" (WKSI) but are in danger of losing their WKSI status due to a decline in stock price. Issuers that meet the WKSI requirements can offer securities pursuant to an automatic shelf registration statement which allows for an unlimited amount of securities to be registered on a "shelf" basis and allows an issuer to pay SEC filing fees on a delayed basis only at the time securities are offered off the "shelf". Question 198.06 of the CDI provides that an issuer with WKSI status that is offering securities pursuant to an automatic shelf registration statement filed with the SEC, but that will no longer be a WKSI at the time it files a Form 10-K, may subsequently continue to offer and sell securities under the automatic shelf registration statement, but only if, prior to filing the Form 10-K, the issuer amends the automatic shelf registration statement so that it conforms to the requirements that apply to a Form S-3 filed in reliance on General Instruction I.B.1 or I.B.2 of Form S-3. Specifically, the following conditions must be satisfied:

- Prior to filing the Form 10-K, the issuer must file a post-effective amendment to the automatic shelf registration statement to register a specific amount of securities and to pay the associated SEC filing fee.

- The prospectus included in the post-effective amendment to the automatic shelf registration statement may not omit information in reliance on provisions of Rule 430B of the Securities Act that are available only to automatic shelf registration statements and instead must contain all information required to be included in a Form S-3 filed in reliance on General Instruction I.B.1 or I.B.2.

- The issuer must remain eligible to use Form S-3 in reliance on General Instruction I.B.1 or I.B.2 at the time of the filing of the Form 10-K.

Promptly after the Form 10-K is filed, the issuer must file either a post-effective amendment or a new Form S-3 registration statement to convert the Form S-3 to a non-automatic shelf registration statement. Pending the SEC's declaring the new filing effective, the issuer may continue to offer and sell securities using the amended automatic shelf registration statement.

http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm

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**NYSE'S Global Market Capitalization Standard for Listed Companies Temporarily Reduced to $15 Million**

Effective on January 22, the New York Stock Exchange, LLC temporarily lowered the average global market capitalization required of listed companies from $25 million to $15 million. This temporary reduction will apply through April 22. All of the NYSE's other listing criteria will continue to apply during this period.

According to the NYSE's submission to the Securities and Exchange Commission, as a consequence of the current market crisis, the number of companies listed on the NYSE whose average global market capitalization has fallen below $25 million over a 30-day trading period has been significantly higher than the historical norm. The NYSE believes that in many of these cases, companies have experienced stock price declines because of unusual market conditions rather than company-specific problems, and that their market capitalizations may return to prior levels "once the current market turbulence passes."

While under the SEC's rules, a self-regulatory organization's proposed rule change normally does not become operative for 30 days after the date of its filing with the SEC, the NYSE requested, and the SEC granted, a waiver of the 30-day delay, with the result that the NYSE's rule change became operative immediately upon filing with the SEC on January 22.

http://apps.nyse.com/commdata/pub19b4.nsf/docs/5B6DD09BC69667538525754B00661D3E/$FILE/NYSE-2009-06%20SECAppOrd%201.27.09.pdf
http://www.nyse.com/press/1232709549311.html

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**Court Dismisses Section 10(b) Claim Based Upon Acquisition of Shares Given As Part of Settlement**

To resolve a prior dispute between the plaintiffs, who made a series of loans to the defendant corporation, and the defendants, the parties decided to enter into a settlement agreement in which plaintiffs would receive a payment of cash plus shares of defendant corporation's common stock. After entering into the settlement agreement, the defendant corporation announced, that it had failed to follow Generally Accepted Accounting Principles revenue recognition procedures, resulting in $8 million in liabilities for the fiscal year. After making this announcement, the defendant corporation's stock price dropped significantly, resulting in the plaintiffs selling their shares of the corporation's stock at a very low price.

Shortly thereafter, plaintiffs filed this action, alleging, among other things, that the defendant corporation, its accounting firm, and certain of its officers violated section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 by deceiving the plaintiffs to induce them to enter into a settlement agreement in which plaintiffs accepted shares of the defendant corporation's stock at artificially inflated prices. The defendants filed a motion to dismiss, which the court granted, because the plaintiffs failed to plead scienter adequately or allege fraud with particularity. More specifically, the court held that the plaintiffs failed to identify any specific overstatements or misstatements about the corporation's financial condition. In addition, the court held that while the complaint alleged that the individual defendants were responsible for various SEC filings and press releases through which false information was conveyed, the plaintiffs failed to specify any statements within these filings that were fraudulent. Finally, the court held that the plaintiffs failed to establish a strong inference of scienter, and the complaint lacked any allegations that defendants had a motive or opportunity to commit fraud. The court stated that although the plaintiffs alleged that the defendants acted so as to effectuate a stock settlement with the plaintiffs at an artificially inflated value of the stock, this allegation did not constitute an assertion of concrete and individual gain to each defendant resulting from the fraud. (*Bui v. Industrial Enterprises of America, Inc*., 2009 WL 130180 (S.D.N.Y. January 15, 2009))

**Court Grants SEC's Request for Permanent Injunction, Disgorgement and Civil Penalty**

In 2006, the Securities and Exchange Commission brought a civil action against the defendant, alleging a conspiracy to fraudulently manipulate the prices of 24 stocks. On the same day, the defendant was arrested in connection with a parallel criminal investigation, and, after a jury trial, was found guilty of securities fraud. After the defendant was sentenced, the SEC sought (i) an order permanently enjoining the defendant from violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5; (ii) an order requiring the defendant to disgorge his gains from the allegedly fraudulent scheme; and (iii) a civil penalty. The SEC made a summary judgment motion, contending that it was entitled to summary judgment because all of the material facts that would entitle it to the relief it sought were litigated against the defendant in the criminal proceeding. The court stated that because the defendant had an opportunity to contest the securities fraud charges at his criminal trial, he could not relitigate whether he had engaged in securities fraud as outlined in the indictment. However, the court rejected the SEC's argument that its findings at sentencing had preclusive effect. Nevertheless, the court granted the partial summary judgment for the SEC.

The court noted that for the SEC to get injunctive relief to proscribe future violations of securities laws, it must demonstrate that there is a substantial likelihood of future violations of illegal securities conduct. The court held that the fact that the defendant was convicted of 15 counts of securities fraud demonstrated that the defendant's securities violations were not isolated, and he therefore had a substantial likelihood of future violations. The court further held the defendant should be disgorged of $290,193.14 of profits because disgorgement need only be a reasonable approximation of profits causally connected to the violation, and it was undisputed that the defendant realized at least that amount in fraudulent gains. The court rejected the SEC's argument that disgorgement should be approximately $621,000, the amount of profits the court found at sentencing, because the sentencing findings could not be given preclusive effect. Finally, the court decided that pursuant to 15 U.S.C. § 77t(d)(1), which provides that the SEC may seek civil penalties, the defendant was eligible for a civil penalty as high as $100,000 for each of his violations. The court imposed a civil penalty of $290,193.14 because the defendant's conduct was egregious, the conduct was not isolated, and the defendant acted with clear knowledge that he was engaged in wrongdoing. (*SEC v. Zafar*, 2009 WL 129492 (E.D.N.Y. January 20, 2009))

**Delaware Supreme Court Confirms Fiduciary Duties of Officers**

The Delaware Supreme Court has, for the first time, explicitly held that officers of a Delaware corporation owe the same fiduciary duties to the corporation as do its directors.

Minority shareholders alleged that officers of First Niles Financial, Inc., a Delaware corporation and federally chartered bank, sabotaged the due diligence portion of an active sale process of First Niles. The sales process did not result in a board approved transaction, and First Niles was later recapitalized to eliminate smaller stockholders' voting rights. The plaintiffs alleged breaches of fiduciary duties by both directors and officers of First Niles, in the form of disclosure violations in connection with the recapitalization, failing to properly conduct the sales process and effecting the recapitalization.

Although the defendant officers and directors successfully moved to dismiss the complaint in the Chancery Court, the Supreme Court reversed. On the issue of whether the plaintiffs had pled sufficiently to state a claim against the officers, the Court held that the issue of whether "officers owe fiduciary duties identical to those of directors—has been characterized as a matter of first impression for this Court. In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold." The Supreme Court concluded that the complaint alleged sufficiently detailed acts of wrongdoing by the officer defendants to state a claim that they breached their fiduciary duties.

Interestingly, the Court acknowledged in a footnote that the consequences of a fiduciary breach by an officer might not be the same as for a director. For example, the Delaware corporate code permits a corporation, in its certificate of incorporation, to exculpate its directors from monetary liability for certain adjudicated breaches of the duty of care. However, this charter-based protection is not permitted by statute to be extended to officers. Accordingly, until such time as the statute changes, officers of a Delaware corporation would be well served to request an indemnification agreement to contractually provide them with the same protections. (*Gantler v. Stephens*, 2009 WL 188828 (Del.Supr. January 27, 2009))

## Broker Dealer

### NASDAQ Seeks to Modify Sponsored Access Requirements

The Securities and Exchange Commission is seeking comments on a NASDAQ proposal to amend Rule 4611(d) to adopt a modified rule for member firms that provide "Sponsored Access" to NASDAQ's execution system.

NASDAQ's proposal to amend Rule 4611(d) would define Sponsored Access as taking one of three general structures: Direct Market Access, Direct Sponsored Access and Third Party Sponsored Access. Direct Market Access occurs where the Sponsored Participant's orders pass through a member firm's systems before reaching the exchange. Direct Sponsored Access occurs where a Sponsored Participant is provided direct access to NASDAQ through a dedicated port. The proposal would require member firms to obtain contractual commitments from each Sponsored Participant provided with Direct Sponsored Access. Third Party Sponsored Access occurs where Sponsored Access is provided through a third party, such as a service bureau. The proposal would require member firms to obtain a contractual commitment from the service bureau to obtain from each Sponsored Participant a contractual commitment for the benefit of the member firm.

NASDAQ is also proposing that member firms be required to ensure that the Sponsored Access front-end or other functionality includes controls that systemically limit a member firm's financial exposure and ensure compliance with applicable regulatory requirements. NASDAQ is proposing that member firms be required to ensure that their compliance units receive timely reports of all trading activity by their Sponsored Participants sufficient to permit the member firms to comply with applicable SEC and NASDAQ recordkeeping and reporting requirements.

Comments are due by February 19.

http://www.sec.gov/rules/sro/nasdaq/2009/34-59275.pdf

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**FINRA Amends Trade Reporting Rules**

The Securities and Exchange Commission has approved amendments to Financial Industry Regulatory Authority (FINRA) trade reporting rules for over-the-counter equity transactions. The amendments become effective August 3 and replace the current "market maker"-based structure with a simpler, more uniform "executing party"-based structure. "Executing party" is defined as a member firm that receives an order for handling or execution or is presented an order against its quote, does not subsequently re-route the order, and executes the transaction. For transactions between member firms, the executing party must report the trade to FINRA, and for transactions between a member firm and a non-member firm or customer, the member firm must report the trade. Unless agreed otherwise, in situations between member firms where it is unclear who is the executing party, the sell-side must report the trade (i.e., a manually negotiated transaction). The executing party reporting structure will apply to trades in National Market System stocks, OTC Equity, Direct Participation Program and PORTAL equity securities. The amendments also require member firms with reporting obligations that act in a riskless principal or agency capacity on behalf of other member firms to submit non-tape reports to identify such other member firms as parties to the transaction.

http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117758.pdf

**ISE Redefines Complex Orders**

The Securities and Exchange Commission has approved an amendment to International Securities Exchange Rule 722, which contains definitions of complex orders. The amendment eliminates the listing of specific types of strategies that would fall within the complex order definition. A complex order is now defined as "any order involving the simultaneous purchase and/or sale of two or more different options series in the same underlying security, for the same account, in a ratio that is equal to or greater than one-to-three (.333) and less than or equal to three-to-one (3.00)." The amendment also adds a limitation on delta neutral stock-option orders.

http://www.ise.com/assets/documents/OptionsExchange/legal/ric/2009/RIC-2009-05$Complex_Orders$20090116.pdf

## Structured Finance and Securitization

**Mortgage Bankruptcy Legislation Approved by House Judiciary Committee**

On January 27, the House Judiciary Committee approved H.R. 200, the Helping Families Save Their Homes in Bankruptcy Act of 2009. This legislation, if passed, would allow bankruptcy judges to modify residential mortgage loans by, among other things, extending the term of the loan, reducing the interest rate or reducing the principal amount owed, a practice which the current Bankruptcy Code prohibits. Prior to passing the bill, the committee agreed to several changes, including limiting the bill's application to mortgages originated before the legislation's effective date and allowing lenders some ability to receive a sliding share of home appreciation. The committee also adopted an amendment which would not allow cram-downs in situations where debtors obtained the mortgage fraudulently.

http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h200ih.txt.pdf

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**Treasury to Post TARP Investment Contracts**

On January 28, the U.S. Treasury Department announced a new policy to increase transparency of posting investment contracts for future completed transactions associated with the Troubled Asset Relief Program to the Treasury's website within 5 to 10 business days. For contracts already completed, documents will be posted on a rolling basis, beginning with the first nine contracts completed under the Capital Purchase Program and contracts for transactions closed under the Systemically Significant Failing Institutions program, the Targeted Investment Program and the Automotive Industry Financing Program. The Treasury is expected to make public all copies of existing investment agreements in the coming weeks.

http://www.treasury.gov/press/releases/tg04.htm

**Barney Frank Introduces New Bill to Promote Bank Liquidity and Lending**

On January 27, Representative Barney Frank (Massachusetts) introduced H.R. 703 to promote bank liquidity and lending through changes to deposit insurance rules, changes to the HOPE for Homeowners (H4H) refinancing program, and other enhancements.

The bill permanently increases the amount of Federal Deposit Insurance Corporation (FDIC) deposit insurance to $250,000, which is currently set to return to $100,000 on December 31. The bill extends the effective window for Deposit Insurance Fund restoration plans from five years to eight years. The bill increases the FDIC borrowing authority from the U.S. Treasury Department from $30 billion to $100 billion, or amounts greater than $100 billion if the Boards of Directors of the FDIC and Treasury determine it is necessary. The bill also allows the FDIC to make assessments on not only insured depository institutions, but also on depository institution holding companies, for repayments of losses to the Depository Insurance Fund resulting from actions taken regarding systemic risk.

The bill makes several changes to H4H, including removing the debt-to-income ratio requirement, increasing the maximum loan-to-value ratio from 90% to 93% and removing the prohibition on new second liens.

The bill also creates a servicer safe harbor that applies only to modifications, workouts or loss mitigation plans initiated before January 1, 2012. The safe harbor provides that any servicer that enters into a loan modification or workout plan with respect to a mortgage that meets the criteria of the rule is not liable to investors in residential loans or residential mortgage-backed securities, any trustees or other persons who make payments to such investors, or any insurers of those loans or securities. The servicer's ability to modify the loans is not limited by any provision or law or contractual provision, and the servicer is not required to repurchase loans from or otherwise make payments to a securitization vehicle on account of a modification, workout or loss mitigation plan for mortgages that have been securitized, if they meet the following criteria: default in payment on the mortgage has occurred or is reasonably foreseeable, the property is owner-occupied, and the servicer reasonably and in good faith believes the anticipated recovery under the modification or workout plan will exceed, on a net present value basis, the anticipated recovery to be realized through foreclosure.

Finally, the bill mandates that Troubled Asset Relief Program funds be made available to smaller community financial institutions, including private ones, on comparable terms to other institutions.

http://www.house.gov/apps/list/speech/financialsvcs_dem/mu020409.shtml
http://www.govtrack.us/congress/bill.xpd?bill=h111-703

## Private Investment Funds

### Proposed Hedge Fund Transparency Act

On January 29, Senators Charles Grassley and Carl Levin introduced the Hedge Fund Transparency Act (HFTA) as a bill in the U.S. Senate. HFTA would apply to entities that rely on the exemptions currently provided by Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, which include most hedge funds and private equity funds. HFTA would also move these exemptions to Section 6(a) of the Investment Company Act to (as stated by Sen. Levin in his Senate floor speech) "make clear that hedge funds really are investment companies."

If enacted in the form proposed, each private investment fund relying on the current 3(c)(1) or 3(c)(7) exemption with assets of $50 million would be subject to (i) SEC registration, (ii) an annual filing, and (iii) a duty to maintain books and records required by the Securities and Exchange Commission and cooperate with any SEC examination or request for information. The annual filing would be publicly available and include the following information:

- the name and address of the primary accountant, primary broker and each owner of the fund (including each natural person who is a beneficial owner);
- affiliations with other financial institutions;
- any minimum investment requirement; and
- the current value of "assets" and "assets under management."

HFTA would make certain anti-money laundering (AML) requirements applicable to any private investment fund relying on the current 3(c)(1) or 3(c)(7) exemption (irrespective of whether the fund has assets of $50 million), including requirements to:

- report suspicious transactions;
- provide account information and documentation to authorities within 120 hours of an AML-related request;
- use risk-based due diligence policies, procedures and controls reasonably designed to ascertain the identity of and evaluate any foreign investor (including beneficial owners); and
- establish AML programs, including at a minimum: (i) development of internal policies, procedures and controls; (ii) designation of a compliance officer; (iii) ongoing employee training; and (iv) an independent audit function.

The bill tasks the SEC and the Secretary of the Treasury, respectively, with implementing the substance of the bill. A copy of the bill is available at:

http://levin.senate.gov/newsroom/supporting/2009/hedgefundsbill.012909.pdf

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## Banking

### FDIC Proposes Regulatory Change in Interest Rate Restrictions on Institutions That Are Less than Well-Capitalized

On January 27, the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) proposed for comment amendments to regulatory interest rate restrictions that apply to insured depository institutions that are not "well capitalized." The basis for such interest rate restrictions is found in the Prompt Corrective Action statutes and regulations enforced by the FDIC.

Pursuant to the proposed rule, affected insured depository institutions would

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generally be permitted to offer the "national rate" of interest plus 75 basis points. According to the proposal, the "national rate" would be defined, for deposits of similar size and maturity, as an average of rates paid by all insured depository institutions and branches for which data are available to the FDIC. Where the "national rate" does not represent the prevailing rate in a particular market, the depository institution would be permitted to offer the prevailing rate plus 75 basis points.

According to the FDIC's press release, the proposed rule applies only to a "small minority" of banks that are less than well capitalized. It further states that, as of the third quarter 2008, there were 154 banks that reported being less than well capitalized out of more than 8300 banks nationwide.

Comments are due 60 days after publication in the Federal Register.

http://www.fdic.gov/news/news/press/2009/pr09009.html

## UK Developments

### Chairman of the FSA Sets Out Regulatory Reform Agenda

On January 21, Lord Adair Turner, chairman of the UK Financial Services Authority (FSA), gave The Economist's Inaugural City Lecture in London. He set out his views on the root causes of the global financial crisis and on the implications for future regulation of the financial system.

Lord Turner said he believed the "originate and distribute" model of financing lending had a role to play in the future, but needed to be reformed, with less complexity and opacity. He also said that over the last decade the scale of proprietary trading has created risks and that financial innovation has, in many cases, delivered minimal economic value and actually increased the dangers of financial instability.

In his lecture, Lord Turner outlined three key long-term regulatory initiatives to reduce the probability and severity of future financial crises: (i) the introduction of new capital adequacy approaches including counter-cyclical capital requirements and requiring more capital to be held against risky trading strategies; (ii) creating a new liquidity regime focused on market-wide risk as well as individual firms' liquidity; and (iii) ensuring that financial activity is regulated according to its economic substance, not its legal form.

These themes will be developed further in the "Turner Report" on the regulation and supervision of the banking system, which is expected to be published in March 2009.

www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121_at.shtml

### Entertainment Rights plc Fined for Disclosure Delays

On January 23, the UK Financial Services Authority (FSA) fined Entertainment Rights plc (ERT) £245,000 ($351,000) for failing to disclose inside information to the market in a timely manner.

As a result of the variation of a DVD distribution agreement on July 10, 2008, which variation significantly amended the terms of the distribution agreement, the company's estimated 2008 profits were reduced by £9.7 million ($13.9 million). ERT delayed making an announcement, as it considered that there would be future opportunities to reduce the impact of the variation. ERT finally made an announcement of the variation 78 days later, on September 26, and its shares fell 55% on that day.

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The FSA found that the variation was inside information and the lack of timely disclosure led to a false market in ERT's shares for the 78 days in which disclosure was delayed. As in *Wolfson Microelectronics plc,* discussed in the January 23, 2009, edition of *Corporate and Financial Weekly Digest*, the FSA emphasized that justifying non-disclosure of information by offsetting negative and positive news is not acceptable. Companies should disclose both types of information and allow the market to determine whether they cancel each other out.

The FSA took into account that ERT fully co-operated with the FSA investigation and has since taken steps to strengthen its board. ERT also qualified for a 30% discount under the FSA early settlement discount scheme, without which the fine would have been £350,000 ($501,000).

www.fsa.gov.uk/pubs/final/ent_rights19jan09.pdf

**FSA Consults on Use of Firm Commissioned Reports**

On January 26, the UK Financial Services Authority (FSA) published consultation paper *CP09/05 Obtaining and using firm-commissioned reports*, setting out proposed guidance on the FSA's approach to using firm-commissioned reports in anticipation of a possible FSA enforcement action.

The FSA stated that it understands that when it investigates firms, the firms in question often decide to commission internal reports from law or accountancy firms, and firms often discuss the scope of their investigation with the FSA and agree to provide a copy of the final report. The FSA considers that several common issues have arisen, including whether firms must disclose internal reports and the waiver of privilege in the context of FSA investigations. The FSA therefore considers that it would be helpful to clarify its expectations in relation to reports which firms commission from their legal or other advisers.

The consultation closes on February 23.

www.fsa.gov.uk/pubs/cp/cp09_05.pdf

**FSA Bans Former Executives of Pacific Continental Securities UK Limited**

On January 28, the UK Financial Services Authority (FSA) banned the former chief executive of stockbroking firm Pacific Continental Securities UK Limited (PCS), Steven Griggs, and its former finance director, Charles Weston. They were also fined £80,000 ($114,500) and £95,000 ($136,000), respectively, for serious failures in the company that led to customers buying high-risk shares without suitable advice. The former CEO was banned from carrying out any significant influence functions at an FSA-authorized firm, and the former finance director was banned from carrying out any regulated activities.

PCS is now in liquidation. The FSA stated that if that had not been the case it would have been fined £2 million ($2.86 million). The FSA censured PCS for misleading customers and allowing its advisers to use inappropriate sales practices when giving advice on high-risk shares.

The FSA found that between April 1, 2005, and June 20, 2007, Griggs and Weston had acted without integrity and had failed to ensure that their customers were treated fairly or that the company was properly run. Particularly, PCS was using high-pressure sales tactics and was recommending shares to benefit PCS, not their customers. In addition, the

FSA found that PCS research was not honest and realistic and that there were inadequate compliance monitoring and training arrangements at the company.

www.fsa.gov.uk/pubs/final/steven_griggs.pdf
www.fsa.gov.uk/pubs/final/charles_weston.pdf
www.fsa.gov.uk/pubs/final/pacific_continental.pdf

* Click here to access the *Corporate and Financial Weekly Digest* archive.

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