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Corporate and Financial Weekly Digest

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SEC/CORPORATE

SEC Proposes Amendments to Rule 163(c)

On December 22, the Securities and Exchange Commission announced that it has proposed amendments to Rule 163(c) under the Securities Act of 1933 to enhance the capability of certain large companies to communicate with potential investors to assess the interest in the market for their securities offerings. The SEC believes that the proposed amendments to Rule 163(c) would facilitate capital formation and encourage more companies to conduct their offerings on a registered basis, which would enhance investor protection.

The proposed amendments would allow companies that are "well-known seasoned issuers" (WKSIs) to authorize an underwriter or dealer to act as its agent or representative to communicate about offerings of the issuer's securities before the filing of a registration statement if the following conditions are satisfied: (1) the underwriter or dealer receives written authorization from the WKSI to act as agent or representative prior to initiating any communication on the WKSI's behalf; (2) the WKSI authorizes or approves the written or oral communication before the agent or representative makes such communication to a potential investor; and (3) any authorized agent or representative that has made any authorized communication on behalf of a WKSI in reliance on Rule 163(c) must be disclosed in any prospectus in the registration statement filed for the offering to which such communication relates. Under the current Rule 163, only WKSIs themselves, and not any other offering participants, are permitted to communicate directly with potential investors prior to the filing of a registration statement.

In its release, the SEC cautions that Rule 163 communications, including communications made in reliance on the proposed amendments, are not exempt from Regulation FD compliance. Therefore if the authorized underwriter communicates material non-public information to persons enumerated in Regulation FD, a confidentiality agreement must be obtained or public disclosure made pursuant to Regulation FD.

Public comments on the proposed amendments to Rule 163 must be received by the SEC within 30 days after publication in the *Federal Register*.

Click here for the SEC press release.
Click here for the Proposed Amendments to Rule 163.

LITIGATION

Detrimental Reliance Required for Recovery of Actual Damages under the Truth in Lending Act

In an issue of first impression, the U.S. Court of Appeals for the Third Circuit ruled that a plaintiff must prove detrimental reliance for actual damages under the Truth in Lending Act (TILA).

Plaintiff Louis Vallies and defendant Sky Bank (Bank) entered into a Loan and Security Agreement in which the Bank financed the plaintiff's automobile purchase, including a premium for debt cancellation insurance. The Loan and Security Agreement did not calculate the premium charge into the "finance charge," nor did it itemize the premium separately. These failures violated TILA. However, the plaintiff obtained proper TILA disclosures from the car dealer in an agreement to which the Bank was not a party.

TILA provides for both statutory damages, which are assessed whenever there is a violation of TILA, as well as actual damages. Under the statute, a plaintiff may recover "any actual damage sustained by such person as a result of the failure" to comply with TILA.

After the parties settled the statutory damages claim, plaintiff prosecuted his claim for actual damages. The Bank moved for summary judgment on the grounds that plaintiff had not relied on the improper TILA disclosure, and therefore could not show reliance or actual damages. The district court granted the Bank's summary judgment motion holding that plaintiff had received TILA disclosures from a third party prior to execution of the Loan Agreement with the Bank, and thus plaintiff could not show detrimental reliance.

The Third Circuit affirmed, reasoning that TILA provided only a remedy for "actual damage[s] sustained" by a plaintiff as a result of the failure to disclose. Thus, there must be some detrimental reliance upon the disclosure statement by the plaintiff to sustain a claim for actual damages. Because Plaintiff had in fact received the proper disclosures from the third party car dealer, no detrimental reliance could be shown. (*Vallies v. Sky Bank*, No. 08-4160, 2009 WL 5154473 (3rd Cir. Dec. 31, 2009))

Expert Testimony Regarding "Bust-Out Scheme" Suppressed

The U.S. Court of Appeals for the Third Circuit affirmed the district court's grant of a motion brought by the U.S. Attorney's Office prior to defendants' criminal trial to exclude defendants' expert testimony regarding the existence and elements of a mafia "bust-out scheme."

Defendants were charged with, among other things, inflating the sales and misrepresenting the inventory of the company they managed (Company) through fraudulent accounting practices, and making false representations to the Securities and Exchange Commission in the annual and quarterly reports filed by the Company.

Defendants claimed that they, along with the Company, were victims of a mafia "bust-out scheme" by which criminals infiltrate into positions of authority in legitimate businesses to implement a fraudulent billing and invoicing scheme with the assistance of shell companies. The purpose of the scheme is to loot the assets of the company and drive it into bankruptcy. Defendants sought to introduce expert testimony that would outline such a scheme. The district court granted the government's motion to exclude the expert testimony because there was no evidence of any infiltration by organized crime and because such testimony would be irrelevant to defendants' knowledge of the scheme, and defendants were found guilty at trial. Defendants sought a new trial on the ground that, among other things, the exclusion was improper. The Third Circuit affirmed, holding that the testimony would have limited probative value and was unlikely to affect whether the jury believed that defendants were either guilty participants in the scheme or were innocent scapegoats. (*United States v. Cocchiola*, No. 08-1976, 2009 WL 5031367 (3rd Cir. Dec. 23, 2009))

BROKER DEALER

FINRA Proposes Changes to Membership Rules

The Financial Industry Regulatory Authority has issued Regulatory Notice 10-01 requesting comment on proposals relating to FINRA's membership rules. These rules allow FINRA, through its Membership Application Process (MAP), to assess the proposed business activities of potential and current member firms. The proposed amendments would revise the existing membership rules to streamline the standards of review for new and continuing membership applications, clarify certain administrative aspects of the MAP process, update or eliminate outdated terminology, require certain additional information about the applicant and incorporate certain provisions from the Incorporated New York Stock Exchange membership rules. In addition, under the proposed amendments, FINRA will require applicants to disclose certain information regarding their affiliates. Comments are due to FINRA by March 5.

Click here to read Regulatory Notice 10-01.

SEC Approves Supplement to Options Disclosure Document

On December 10, 2009, the Securities and Exchange Commission approved a supplement to the Options Disclosure Document (ODD). The ODD discloses certain characteristics and risks of trading standardized options. The supplement adds disclosure regarding the characteristics and special risks of dividend index options and language stating that the options markets may use methods other than those specified in the ODD to set exercise prices.

Click here to read the Financial Industry Regulatory Authority Information Notice.

NYSE Regulation Reminds Members of Regulation NMS Compliance

New York Stock Exchange Regulation, Inc. has issued Information Memo 10-1 to remind members and member organizations with a presence on the New York Stock Exchange and NYSE Amex Equity Floor (Floor) of their Regulation National Market System (NMS) obligations and that Regulation NMS applies to all Floor transactions. The Information Memo reiterates Regulation NMS's rules relating to preventing trade-throughs, displaying quotations that lock or cross protected quotations, and displaying, ranking or accepting quotations, orders or indications of interest in any NMS stock priced in an increment smaller than $0.01 if priced equal to or greater than $1.00 per share and providing best execution.

Click here to read Information Memo 10-1.

FINANCIAL MARKETS

CME Submits Revised Request to Hold CDS Margin with Segregated Funds

On December 21, 2009, the Chicago Mercantile Exchange (CME) submitted a revised petition to the Commodity Futures Trading Commission for an order pursuant to Section 4d of the Commodity Exchange Act. The requested order would permit the CME and futures commission merchants clearing through the CME to commingle collateral deposited by customers to support credit default swaps (CDS) cleared by the CME with segregated funds deposited on behalf of futures customers.

The CME submitted its original petition in August 2009. Among other changes, the revised petition includes enhancements to the financial safeguards applicable to CDS clearing. In particular, the petition describes the tranching of clearing member guaranty fund deposits based on a clearing member's participation in CDS clearing. Although the entire guaranty fund is potentially at risk to cover losses on cleared CDS in the event of a clearing member default, CME rules establish a CDS security deposit "tranche" (equal to 80% of all security deposits with respect to cleared CDS) which would bear such losses ahead of other tranches in the guaranty fund (including security deposits attributable to futures positions). In addition, because losses on CDS are likely to be determined later than losses on futures positions, due to the nature of the CDS default process, the CDS tranche is protected from futures specific losses until the CDS specific losses have been determined.

The CFTC has requested public comment on the CME's revised petition. The comment period closes on February 19.

The CFTC's press release regarding the CME request is available here.
The CME's revised petition is available here.

CFTC

CFTC Adopts Revised Adjusted Net Capital Requirements for FCMs and IBs

The Commodity Futures Trading Commission has adopted amendments to the minimum adjusted net capital requirements for futures commission merchants (FCMs) and introducing brokers (IBs). Under the amendments, the minimum dollar amount of adjusted net capital has been raised to $1 million for an FCM and $45,000 for an IB. The amended rules also include customer and noncustomer positions in cleared over-the-counter (OTC) derivative instruments (whether cleared in the United States or abroad) in the calculation of an FCM's "risk-based" adjusted net capital requirement, and require FCMs to take charges to their regulatory capital (haircuts) for cleared OTC positions that are carried in proprietary accounts in a manner comparable to those that are required for exchange-traded futures and options.

In response to comments received to the CFTC's original rule proposal, the amended rules increase the risk margin requirement for noncustomer positions to equal the requirement for customer positions (8%), in lieu of increasing the requirement for both customer and noncustomer positions to 10%, as originally proposed. The CFTC's original proposal also included a request for comments as to the advisability of increasing the CFTC's adjusted net capital requirements for FCMs that are also securities broker-dealers to an amount equal to the sum of the applicable CFTC and Securities and Exchange Commission capital requirements. The CFTC received no comments in favor of this potential change, and has proposed no further amendments to these requirements.

The rule changes will take effect on March 31.

The *Federal Register* release containing the final rules is available here.

CFTC Adopts Amendments to FCM and IB Electronic Filing and Financial Reporting Requirements

The Commodity Futures Trading Commission has adopted amendments to its regulations regarding the financial reports and other notices that must be filed with the CFTC by futures commission merchants (FCMs) and introducing brokers (IBs). Among other things, the amendments allow FCMs to electronically file any filing or other notice submitted pursuant to CFTC Regulation 1.10, including financial "early warning" notices. The rule changes also amend the list of supporting documentation that must be filed by an FCM or IB that falls below its minimum adjusted net capital requirement, as well as the timeframe for filing such documentation, to facilitate more immediate filing.

The amended rules took effect on January 4.

The *Federal Register* release containing the final rules is available here.

Effective Date for NFA Interpretive Notice on Use of Online Media and Social Networking Sites

National Futures Association (NFA) has set the effective dates for its Interpretive Notice and rule amendments regarding the use of online social networking groups and other media to communicate with the public.

The new NFA Interpretive Notice makes clear that NFA's rules on promotional materials apply to communications with the public through online media and social networking sites, and provides guidance to NFA members as to their responsibilities with respect to such communications. The Interpretive Notice became effective on December 24, 2009.

The accompanying rule amendments expand Compliance Rule 2-29 to require NFA approval of any audio or video advertisements accessible by members of the public (including via audio podcasts and Internet video postings) that make specific trading recommendations or profit claims. These amendments will take effect on February 1, and any such audio or video advertisements posted online after January 31 must have been reviewed and approved in accordance with the amended rule.

NFA's Notice to Members regarding the effective dates is available here.
The original NFA rule filing is available here.

CFTC Approves Mini Nikkei 225 Index Futures for Trading by U.S. Persons

Commodity Futures Trading Commission staff has issued a no-action letter to the Singapore Exchange Derivatives Trading Limited (SGX-DT) approving SGX-DT's mini futures contract based on the Nikkei 225 Stock Index for trading by U.S. persons.

A copy of the CFTC no-action letter is available here.

BANKING

Federal Banking Agencies Redefine Community Reinvestment Asset Thresholds

On December 23, 2009, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency and the Office of Thrift Supervision approved a joint final rule amending the Community Reinvestment Act (CRA) to make the annual adjustment to the asset-size threshold used to define "small bank" and "intermediate small bank" under the CRA. "Small bank" or "small savings association" means a bank that, as of December 31 of either of the prior two calendar years, had assets of less than $1.098 billion. "Intermediate small bank" or "intermediate small savings association" means a small bank with assets of at least $274 million as of December 31 of both of the prior two calendar years, and less than $1.098 billion as of December 31 of either of the prior two calendar years. The decrease is based on the annual percentage change in the Consumer Price Index (CPI). These asset-size threshold adjustments took effect on January 1. The final rule will be published soon in the *Federal Register*.

Read more.

Financial Institution Regulators Issue Guidance on Interest Rate Risk

The Federal Reserve on January 7 released an advisory reminding depository institutions of supervisory expectations for sound practices in managing interest rate risk. This advisory, adopted along with the other financial regulators, reiterates the importance of effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing, and internal controls related to the interest rate risk exposures of depository institutions. It also clarifies elements of existing guidance and describes interest rate risk-management techniques used by effective risk managers. In addition to the Federal Reserve, the financial regulators include the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Financial Institutions Examination Council State Liaison Committee.

The financial regulators remind depository institutions that an effective interest rate risk-management system does not involve only the identification and measurement of interest rate risk, but also addresses appropriate actions to control this risk. If an institution determines that its core earnings and capital are insufficient to support its level of interest rate risk, it should take steps to mitigate its exposure, increase its capital, or both.

In an accompanying Supervision and Regulation letter to Reserve Bank heads of supervision, the Federal Reserve noted that although the advisory is targeted at depository institutions, the advice provided is also directly pertinent to bank holding companies. Bank holding companies are reminded of supervisory expectations that they should manage and control aggregate risk exposures, including interest rate risk, on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries.

Read more.

Financial Regulators Propose Guidance on Reverse Mortgage Products

The Federal Financial Institutions Examination Council (FFIEC), on behalf of its members, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve, the Office of Thrift Supervision and the National Credit Union Administration, released proposed guidance on December 17 relating to reverse mortgage products. The guidance is designed to help financial institutions ensure that their risk management and consumer protection practices adequately address the compliance and reputation risks raised by reverse mortgage lending.

The proposed guidance addresses the general features of reverse mortgage products, relevant legal requirements and consumer protection concerns raised by reverse mortgages. The proposed guidance focuses on the need for banks, thrifts and credit unions to provide clear and balanced information to consumers about the risks and benefits of these products. According to the FFIEC, such information should be provided while consumers are making decisions about these products and should address the specific matters listed in the guidance, including informing consumers of available alternatives to reverse mortgages. The proposed guidance also states that institutions should require that consumers receive qualified independent counseling and take steps to avoid any appearance of a conflict of interest. The proposed guidance addresses related policies, procedures, internal controls and third-party risk management.

Read more.

CDFIs Now Permitted to Become Members of FHLBs

On December 29, the Federal Housing Finance Agency, which regulates Freddie-Mac, Fannie-Mae and the 12 Federal Home Loan Banks, issued a final rule implementing portions of the Housing and Economic Recovery Act of 2008, which authorizes community development financial institutions (CDFIs) that have been certified by the U.S. Treasury Department's CDFI Fund to become members of Federal Home Loan Banks (FHLBs). The final rule sets forth eligibility and procedural requirements for CDFIs to become members of FHLBs.

Eligible CDFIs include: (1) federally regulated insured depository institutions and their holding companies; (2) credit unions, whether federally or state-chartered; (3) community development loan funds, which are unregulated institutions specializing in financing of housing, businesses or community facilities that provide health care, child care, educational, cultural or social services; and (4) community development venture capital funds, which are unregulated institutions that provide equity and debt-with-equity features to small and medium-sized businesses in distressed communities. CDFIs can be either for-profit or nonprofit entities.

The rule is effective February 4.

Read more.

EXECUTIVE COMPENSATION AND ERISA

IRS Issues Correction Guidance for 409A Document Failures

Earlier this week, the Internal Revenue Service issued Notice 2010-6, which sets forth the method for correcting certain documentary failures that occur under Internal Revenue Code Section 409A. Documentary compliance with Section 409A was required on and after January 1, 2009. However, until issuance of Notice 2010-6, minor plan document violations could subject income recipients to harsh tax consequences.

Section 409A contains strict rules related to the timing and form of payment of deferred compensation. Section 409A provides that payments of deferred compensation are only permissible upon certain events (including, but not limited to, a separation from service, change in control and a specified future date). If these rules are violated, the recipient of the deferred compensation is subject to immediate income inclusion of the deferred amounts (even if they have not been paid), as well as an additional 20% tax. Penalties and interest can also apply. An employer usually has a corresponding withholding and reporting obligation related to its promise to pay non-compliant deferred compensation.

One of the more frustrating issues arising under Section 409A was the idea that an unintentional technical violation in the plan document that continued to exist on and after January 1, 2009, would result in all amounts deferred under the plan being subject to adverse tax consequences. Fortunately, with the release of Notice 2010-6, many of these violations are now correctable. In addition, if the corrections are made on a timely basis, there is often little or no penalty involved with correction.

Over 15 types of violations may be corrected under Notice 2010-6. The notice contains detailed procedural requirements for each type of violation in order to ensure that full correction is made. Many of the correction procedures require the payment of penalty amounts by the income recipient (particularly in situations where correction is made less than one year prior to payment). As an example of one correction available under Notice 2010-6, Section 409A requires that amounts be paid within 90 days following a permissible payment event. If a deferred compensation plan permits payment within 180 days following an otherwise permissible payment event, Notice 2010-6 allows amendment of the plan to shorten the period to 90 days. In connection with such correction, no penalty payment would be required.

To be eligible to correct a Section 409A document failure under Notice 2010-6, certain eligibility criteria must be satisfied. For example, neither the payor (e.g., the company) nor the payee (e.g., the employee) may be under audit with respect to the relevant deferred compensation plan at the time correction is made. In addition, both the payor and the payee will be required to include certain information with the filing of their respective tax returns for the year in which correction occurs.

Finally, Notice 2010-6 contains transition provisions that allow even more favorable correction treatment for corrections made prior to 2011. The IRS stated that the transition period is intended to allow employers an opportunity to voluntarily reexamine their deferred compensation plans and ensure that each of them is in full compliance with Section 409A.

Notice 2010-6 can be found here.

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