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Corporate and Financial Weekly Digest

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SEC/Corporate

SEC Releases Updated Compliance and Disclosure Interpretations for Section 16, Form 8-K and Regulation S-K

On June 26, the Securities and Exchange Commission issued updated compliance and disclosure interpretations for Section 16 of the Securities Exchange Act of 1934 and Form 8-K. Additionally, on July 3, the SEC issued updated compliance and disclosure interpretations for Regulation S-K.

The updated interpretations for Section 16 of the Exchange Act, Form 8-K and Regulation S-K supersede previously issued telephone interpretations, frequently asked questions, compliance and disclosure interpretations and current issues and projects outlines on the same subjects.

http://www.sec.gov/divisions/corpfin/guidance/sec16interp.htm
http://www.sec.gov/divisions/corpfin/guidance/8-kinterp.htm
http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm

SEC and FRB Sign Memorandum of Understanding

On July 7, the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System signed a memorandum of understanding which will result in the two agencies sharing information and cooperating in a number of important areas of common interest including anti-money laundering, bank brokerage activities under the Gramm-Leach-Bliley Act, clearance and settlement in the banking and securities industries, and the regulation of transfer agents.

SEC Chairman Christopher Cox stated, "This agreement represents a valuable coordination of the roles of the SEC and the Fed in our capital markets... [T]he interconnectedness of mortgage and lending markets, credit derivatives, securitizations, and counterparty relationships requires the U.S. government to adopt a more coherent and coordinated approach... This is smart government."

This cooperative effort was stimulated by the recent stress in the financial markets affecting commercial and investment banks as well as many other market participants, and will give the Federal Reserve access to critical information with respect to such banks. The SEC recently entered into a similar memorandum of understanding with the Commodity Futures Trading Commission. An agreement between the SEC and the Department of Labor is anticipated later this summer.

http://www.sec.gov/news/digest/2008/dig070708.htm

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Corporate "Outsider" Could Be Held Liable for Insider Trading Under Misappropriation Theory

Defendant J. Thomas Talbot sat on the Board of Directors of Fidelity National Financial, Inc., which owned a 10 percent interest in LendingTree, Inc. In April 2003, LendingTree's CEO informed Fidelity's Vice President that LendingTree was proceeding with negotiations for a third party to acquire LendingTree. Several days thereafter, at a Fidelity Board of Directors meeting, Fidelity's CEO informed the Board (including Talbot) of the LendingTree negotiations, including that Fidelity's stock in LendingTree would be acquired at "a very attractive price." Two days after the Board meeting Talbot purchased 5000 shares of LendingTree, and, six days later, he purchased an additional 5000 shares.

The Securities and Exchange Commission brought a civil action against Talbot alleging he had engaged in insider trading in violation of Section 10(b) of the Securities Exchange Act. Talbot moved for summary judgment, which the district court granted. The district court held that Talbot could not be liable under the SEC's misappropriation theory because the SEC failed to prove that either Talbot or Fidelity owed a fiduciary duty to LendingTree and, thus, could not show a "continuous chain of fiduciary relationships" linking Talbot to LendingTree, which the district court characterized as the "originating source" of the information on which Talbot traded. The Ninth Circuit reversed.

The Ninth Circuit explained that under the misappropriation theory the recipient of material, non-public information violates Section 10(b) if he breaches a fiduciary duty that he owes to his source of the information by using the information in an undisclosed and self-serving manner. The court ruled that the district court had erred, however, in ruling that a continuous chain of fiduciary duties that goes beyond the trader's source of information is required for liability under the misappropriation theory. To the contrary, the Ninth Circuit held that to prove insider trading it was sufficient for the SEC to prove that Talbot knowingly breached a fiduciary duty he owed to Fidelity, *i.e.*, his source of the information on which he traded. Based on this holding, the Court had little trouble finding that Talbot could be liable under the misappropriation theory because, as a member of Fidelity's Board, he owed a fiduciary duty to Fidelity. (*S.E.C. v. Talbot*, 2008 WL 2574513 (9th Cir. June 30, 2008))

Court Affirms Insider Trading Conviction

Defendant James Anderson was the founder and an executive officer of Zomax, a publicly traded company. After receiving two internal, nonpublic company reports indicating that Zomax's third quarter sales would fall significantly short of projections, Anderson liquidated every share of Zomax stock that he and his wife owned over an 8-week period. The day after their final shares were sold, Anderson approved the issuance of a press release announcing that Zomax would not meet its third quarter sales projections.

Anderson was convicted of, among other things, insider trading. On appeal, he argued that the government did not produce sufficient evidence to prove that he committed insider trading in violation of Section 10(b) of the Securities Exchange Act. The Eighth Circuit disagreed.

The Eighth Circuit rejected Anderson's argument that the Zomax sales reports did not contain material information. Although there was testimony at trial that the sales projection reports at Zomax were often unreliable or inaccurate, the court concluded, on the basis of evidence introduced at trial, that the reports were important to the company and to institutional investors and that a jury could reasonably conclude that the reports constituted "material" information,

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i.e., information that a reasonable investor would consider important in making investment decisions concerning Zomax stock. The Eighth Circuit also rejected Anderson's argument that he did not trade "on the basis of" material, nonpublic information because his sales were made pursuant to a preexisting plan to sell stock rather than on any information in the internal reports. Based upon, among other things, the sparsity of evidence supporting Anderson's claimed preexisting stock sale plan and Anderson's failure to comply with Zomax's policy requiring insiders to pre-clear stock sales with the company's CFO and outside counsel, the Court ruled that the evidence was sufficient for a jury to find that the defendant traded on the basis of nonpublic, material information. (*U.S. v. Anderson*, 2008 WL 2609206 (8th Cir. July 3, 2008))

Broker Dealer

CBOE Receives Approval for Rule Changes Related to Sponsored Users

The Chicago Board Options Exchange (CBOE) received approval from the Securities and Exchange Commission for its rule proposal to allow "Sponsored Users" to access all products traded on CBOE. Currently, Sponsored Users, i.e., non-CBOE member firms that have entered into a sponsorship arrangement with a CBOE member for purposes of receiving direct electronic access to CBOE, are only allowed access to CBOE's FLEX Hybrid Trading System (FLEX) and the CBOE Stock Exchange (CBSX) facility. Although the approved rules will not change the requirements currently applicable to sponsored access to FLEX and CBSX, the new rules will limit the number of Sponsored Users with access to all CBOE products to a total of 15 persons or entities. These "Sponsored User Slots" will be allotted on a first-come, first-served basis.

http://www.sec.gov/rules/sro/cboe/2008/34-58051.pdf

NYSE Arca Amends Minor Rule Plan

NYSE Arca, Inc. received approval from the Securities and Exchange Commission for its proposal to amend its Minor Rule Plan (MRP) and make other related changes to its rulebook. The MRP-related amendments will make several new trading and recordkeeping rules eligible for MRP disposition and will modify the existing Recommended Fine Schedule (in Rule 10.12(k)). The amendments will, among other things, also modify NYSE Arca Rule 11.1 so that options trading permit holders (OTP Holders) will now be under an obligation to at all times comply with "fair and equitable principles of trade". This is a departure from the current "just and equitable principles of trade" standard in Rule 11.1. Further, the amendments will expand the scope of Rule 11.18 (regarding supervision) to require all OTP Holders, and not just those for whom NYSE Arca acts as Designated Examining Authority, to be subject to the supervisory requirements in the NYSE Arca rules.

http://www.sec.gov/rules/sro/nysearca/2008/34-58034.pdf

ISE Files Amendments to Proposed Rule Change to Reduce Order Handling and Exposure Periods

The International Securities Exchange, LLC (ISE) has filed with the Securities and Exchange Commission a third amendment to a proposed rule change to reduce the order handling and exposure periods contained in ISE Rules 716 (Block Trades), 717 (Limitations on Orders), 723 (Price Improvement Mechanism for Crossing Transactions) and 811 (Directed Orders) from three seconds to one second.

Rule 716 contains the requirements with respect to the execution of orders using the Block Order Mechanism, Facilitation Mechanism and Solicited Order

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Mechanism. Rule 723 contains the requirements with respect to the execution of orders using the Price Improvement Mechanism. Under the proposal, the exposure period for all four mechanisms would be reduced to one second. Rule 717 requires members to expose agency orders to the marketplace before executing them as principal or executing them against orders solicited from other members. The proposal aims to reduce the exposure period for orders entered onto the ISE to one second. Rule 811 contains the requirements applicable to the handling and execution of Directed Orders. Under the proposal, this time period would be reduced to one second.

The ISE believes that it is in the best interests of all market participants to minimize the exposure period to a time frame that continues to allow ample time for market participants to electronically respond, as both the order being exposed and the participants responding to the order are subject to market risk during the exposure period.

http://www.sec.gov/rules/sro/ise/2008/34-58041.pdf

NYSE Proposes to Amend Rules to Redefine Specialist Operations

The New York Stock Exchange LLC (NYSE) has filed with the Securities and Exchange Commission a proposed rule change to amend NYSE Rule 98 and related rules to redefine specialist operations. Under the proposal, Rule 98 would be amended to reduce the regulatory burdens imposed under the rule and to provide flexibility to member organizations with respect to how they structure their specialist operations and manage their risks. The NYSE intends to provide a framework for specialist operations that meets both the regulatory concerns of the current rule while also addressing the reality of today's marketplace. The proposal includes conforming changes to other NYSE rules that rely on Rule 98 exemptions for approved persons. Rule 98 would also be amended to shift from an assumption that the approved persons of each specialist member organization are subject to certain NYSE rules (unless an exemption is provided) to a more case-by-case basis whereby NYSE Regulation, Inc. reviews whether a particular trading unit that proposes to engage in specialist operations is sufficiently walled off from either its approved persons or parent member organization.

http://www.sec.gov/rules/sro/nyse/2008/34-58052.pdf

New Methodology for Adjusting Options Contracts

On June 2, the Options Clearing Corporation (OCC) filed with the Securities and Exchange Commission the proposed rule change which would adopt interpretive guidance relating to the new adjustment method for adjusting options contracts for cash dividends or distributions (New Methodology). Generally, options are not adjusted to reflect "ordinary" cash dividends or distributions. Under the OCC's existing By-Laws, which remain operative until the New Methodology becomes effective, a cash dividend is considered ordinary unless it is greater than 10% of the value of the underlying security on the dividend declaration date. Dividends greater than 10% under this definition usually trigger an options contract adjustment, with the criterion for adjustment being the size of the cash dividend. Under the New Methodology, a cash dividend or distribution will be deemed to be ordinary (regardless of size) if it is declared pursuant to a policy or practice of paying such dividends on a quarterly or other regular basis. Dividends paid outside such practice would be considered extraordinary.

http://sec.gov/rules/sro/occ/2008/34-58059.pdf

Structured Finance and Securitization

California Legislature Passes Mortgage Foreclosure Bill

On July 2, the California State Senate passed a mortgage foreclosure-related bill, SB 1137 (which was passed by the California State Assembly on June 30). The legislation would require lenders to attempt to contact a borrower prior to beginning foreclosure proceedings in order to discuss workout or loan modification options. Lenders would not be allowed to file a notice of default until after 30 days from the later of the date of contact with the borrower and the exhaustion of required diligence procedures. The legislation would also (i) require owners of foreclosed property to maintain the property or face daily fines of up to $1,000, (ii) provide tenants with a 60-day notice period prior to eviction from a rental property that has been subject to foreclosure and (iii) provide a safe harbor regarding contract interpretation to servicers making loan modifications in accordance with the provisions of the statute.

http://info.sen.ca.gov/pub/07-08/bill/sen/sb_1101-1150/sb_1137_bill_20080707_enrolled.html

SEC Publishes Summary Report Regarding Credit Reporting Agencies and Third Set of Proposed Rules Regarding Credit Ratings

On July 8, the Securities and Exchange Commission published a summary report of issues identified in the SEC's examination of nationally recognized statistical rating organizations (NRSROs) in light of the subprime mortgage crisis and subsequent credit crunch. The examination upon which the report is based included a review of internal records, including more than two million emails and instant messages. Many of these communications are quoted in the report and in the judgment of the SEC, among other things, "appear to reflect struggles [by the NRSROs] to adapt to the increase in the volume and complexity of the deals".

In addition, on July 1, the SEC published the third set of its proposed rules regarding NRSROs. As reported in the June 27, 2008 edition of *Corporate and Financial Weekly Digest*, these proposed rules focus on reducing the reliance upon and reference to credit ratings in the SEC's own rules. An example of one of the important proposed changes is a rule replacing the Securities Act requirement that only investment grade asset-backed securities are eligible for Form S-3 shelf-registrations with a rule that an asset-backed securities offering would be Form S-3 eligible, regardless of credit rating, if initial and subsequent sales of the securities are made in minimum denominations of $250,000 and initial sales are made only to "qualified institutional buyers", as defined in Rule 144A.

http://www.sec.gov/news/studies/2008/craexamination070808.pdf
http://www.sec.gov/rules/proposed/2008/34-58070.pdf
http://www.sec.gov/rules/proposed/2008/33-8940.pdf
http://www.sec.gov/rules/proposed/2008/ic-28327.pdf

IRS Issues New Revenue Procedure Regarding Subprime Loan Modifications

On July 8, the Internal Revenue Service published Revenue Procedure 2008-4 which states that the IRS will not challenge the tax status of Real Estate Mortgage Investment Conduits that modify certain subprime adjustable rate loans in accordance with the provisions of the newly issued framework for fast-track loan modifications published by the American Securitization Forum on the same date.

http://www.americansecuritization.com/uploadedFiles/RevProc200847.pdf

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CFTC

CFTC Seeks Public Comment on Clearing of Agricultural Swaps

The Commodity Futures Trading Commission is seeking public comment on a petition by the Chicago Mercantile Exchange Inc. (CME) and the Board of Trade of the City of Chicago, Inc. (CBOT) for an exemptive order that would permit the CME Clearing House to clear certain agricultural swaps (Contracts) without having to comply with the requirements of CFTC Regulation 35.2, which would otherwise prohibit standardized material economic terms and require that the creditworthiness of the parties to the Contracts be a material consideration in negotiating the Contracts. The CME and CBOT are also requesting the CFTC to issue an order permitting the CME Clearing House and clearing members to commingle customer funds associated with the Contracts in customer-segregated accounts. The CFTC is requesting comment on whether it should exempt the Contracts based on the power granted to it by Section 4(c)(1) of the Commodity Exchange Act (CEA) to "promote responsible economic or financial innovation and fair competition" by exempting any transaction or class of transactions from most provisions of the CEA. The deadline for comments is August 21.

http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5515-08.html

CFTC Comments on Federal Trade Commission Market Manipulation Rulemaking

On June 23, the Commodity Futures Trading Commission filed comments with the Federal Trade Commission (FTC) in response to an FTC Advance Notice of Proposed Rulemaking on the implementation of Section 811 of the Energy Independence and Security Act of 2007. In general, Section 811 makes it unlawful for any person to employ any "manipulative or deceptive device or contrivance" in connection with the wholesale purchase or sale of crude oil, gasoline or petroleum distillates. The CFTC commended the FTC for its prompt response to the authority granted by Congress but urged the FTC not to propose regulations that may be inconsistent with or duplicative of the Commodity Exchange Act (CEA) or that would apply to registered entities that are subject to the CFTC's exclusive jurisdiction under the CEA.

http://www.ftc.gov/os/comments/marketmanipulation/535819-00151.pdf

Private Investment Funds

IRS Issues Revenue Ruling Addressing Deductibility of Management Fees

In recently issued Rev. Rul. 2008-39, the Internal Revenue Service ruled that a management fee charged by a partnership (or other entity taxed as a partnership) that invests in other partnerships (i.e., a fund-of-funds) cannot be treated as a trade or business expense. Instead, the management fee must be reported to the individual partners in the partnership as an investment expense, which is deductible for regular income tax purposes only to the extent in excess of 2% of the investor's adjusted gross income and is not deductible at all for alternative minimum tax purposes.

Up until now, many fund-of-funds have treated their management fees as trade or business expenses to the extent allocable to their investments in other partnerships that are actively trading securities. However, the Revenue Ruling holds that management fees (and other operating expenses) of a fund-of-funds are not business expenses even if the fund-of-funds invests entirely in hedge funds that are themselves actively trading securities. Accordingly, fund-of-

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funds will now be required to report their management fees and other operating expenses as investment expenses rather than as trade or business expenses.

http://nakedshorts.typepad.com/nakedshorts/files/IRS_2008-39.pdf

Banking

OTS Releases First Mortgage Metrics Report

On July 3, the Office of Thrift Supervision (OTS) released its first Mortgage Metrics Report, which describes efforts by OTS-regulated mortgage servicers in assisting qualified borrowers to retain their homes during the quarter ended March 31, 2008.

Data in the report comes from the five largest servicers of residential mortgages among OTS-regulated thrifts and their affiliates. Combined, these five institutions serviced 11.4 million first-lien residential mortgages with an outstanding balance of approximately $2.3 trillion. According to the report, more than "91 percent of the mortgages in the servicing portfolios are held by third parties via securitization by government-sponsored enterprises and other financial institutions."

Findings in the report include the following: (i) 71% of loans involved in loss mitigation actions during March 2008 were loan modifications, which outnumbered new payment plans by 2.5 to one; (ii) loss mitigation actions increased 26% from February to March 2008, outpacing the number of new foreclosures, which increased 8.5% during the same period; and (iii) the proportion of mortgages in the total portfolio that was current and performing remained relatively constant during each month of the first quarter at approximately 92%. The report is intended to provide a basis for assessing the effectiveness of foreclosure prevention initiatives.

The Office of the Comptroller of the Currency has undertaken a similar initiative with respect to the national banks it regulates. According to the press release, the OTS intends to coordinate future efforts to collect and report data with the OCC.

http://www.ots.treas.gov/docs/7/778027.html

UK Developments

FSA Fines IT Employee for Market Abuse

On July 1, the UK Financial Services Authority (FSA) announced that it had fined John Shevlin, an IT technician at Body Shop International plc (The Body Shop), £85,000 ($170,000) for market abuse.

The FSA found that Mr. Shevlin had established a short position on January 10, 2006 equivalent to 80,000 Body Shop shares through a Contract for Difference (CFD) based on inside information. The position was closed out the next day after The Body Shop announced trading results that were below market expectations. The inside information was obtained by improperly accessing confidential e-mails containing details of The Body Shop's Christmas trading results and a draft announcement that The Body Shop had underperformed expectations.

The FSA did not attribute any fault to The Body Shop and Mr. Shevlin has ceased to be an employee.

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

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FSA Announces Disclosure Regime for CFDs

On July 2, the UK Financial Services Authority (FSA) announced its decision to implement a general disclosure regime for long Contract for Difference (CFD) positions. This announcement follows the FSA's CFD Consultation Paper (CP07/20) which closed for comments last February, as reported in the November 16, 2007 edition of *Corporate and Weekly Financial Digest*. The FSA believes that a general disclosure regime is the most effective way of addressing concerns in relation to market failures linked to voting rights and corporate influence.

Under the new regime, any existing share and CFD holdings in the same company over and above 3% must be aggregated for disclosure purposes. The disclosure threshold is in line with the FSA's existing disclosure rules.

Final rules are expected to be implemented by February 2009.

www.fsa.gov.uk/pubs/cp/cp07_20_update.pdf

EU Developments

European Parliament Proposes Enhanced EU Regulatory and Supervisory Framework for Financial Services

On June 25, the European Parliament's Committee on Economic and Monetary Affairs published a draft report including detailed recommendations for measures to improve EU regulatory and supervisory arrangements. The report includes recommendations covering capital adequacy, transparency, corporate governance, financial stability and systemic risk.

The draft report is scheduled for adoption on September 10.

www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE-407.901+01+DOC+PDF+V0//EN&language=EN

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