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SEC/CORPORATE

House Approves Dodd-Frank Wall Street Reform Bill

Earlier this week, the House of Representatives approved the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Senate vote has been delayed until mid-July with signing by President Obama expected thereafter. The bill includes significant changes to corporate governance and executive compensation and disclosure applicable to publicly traded issuers. Provisions address say on pay, proxy access, compensation clawbacks, compensation committee independence and further restrictions on broker discretionary voting. Of note is that the majority voting requirement that would have required directors in uncontested elections to be approved by a majority of the votes cast was dropped from the Senate version of the bill.

An upcoming Katten *Client Advisory* will provide a more detailed discussion of the Dodd-Frank provisions.

BROKER DEALER

NYSE Arca Proposes Changes to the Handling of Order Flow during Regulatory Halts on Another Primary Listing Market

NYSE Arca, Inc. (the Exchange) has issued a rule proposal to revert back to how it handled order flow during a regulatory halt for a security listed on another primary listing market. Earlier this past June, NYSE Arca Equities Rule 7.11(f) was amended to require the Exchange, upon receiving a trading pause or regulatory halt message for a security from another primary listing market, to reject all orders for the stock until the stock has reopened, to accept and process all cancellations and to take certain other actions. As noted in its rule proposal, the Exchange believes there are times that trading should continue despite another market invoking a regulatory halt. It now proposes to revert back to how it handled order flow prior to the Rule 7.11(f) amendment, which means that it will reject and cancel orders or take other actions under Rule 7.11(f) for a trading pause on another primary listing market, but will not do so for a regulatory halt. Comments to the proposal should be submitted to the Securities and Exchange Commission on or before July 21.

Click here to read Securities and Exchange Commission Release No. 34-62368.

PRIVATE INVESTMENT FUNDS

Please see “SEC Adopts ‘Pay to Play’ Rule for Investment Advisers” in **Investment Companies and Investment Advisers** below.

CFTC

NFA Petitions CFTC for Amendments to CFTC Rule 4.5

National Futures Association (NFA) has submitted a petition for rulemaking to the Commodity Futures Trading Commission that would reinstate certain limitations on the marketing and trading activities of investment vehicles operated pursuant to CFTC Rule 4.5 (Rule 4.5 Entities), which the CFTC had removed from the rule in 2003. Rule 4.5 excludes from the definition of a "commodity pool operator" certain otherwise regulated persons and entities, including registered investment companies. NFA's proposal would require that a Rule 4.5 Entity (1) not be marketed as a method for obtaining exposure to commodity futures or options, and (2) limit its commodity futures and options positions (other than positions held for bona fide hedging purposes) to no more than 5% of the liquidation value of the portfolio. In its petition, NFA cites its concerns regarding the recent establishment of several registered investment companies that are marketed to retail investors and engage in significant futures trading, but which are not subject to the registration and disclosure requirements set out in the CFTC's Part 4 Rules due to the exclusion set out in Rule 4.5.

The NFA petition is available here.

INVESTMENT COMPANIES AND INVESTMENT ADVISERS

SEC Adopts "Pay to Play" Rule for Investment Advisers

On July 1, the Securities and Exchange Commission adopted Rule 206(4)-5 under the Investment Advisers Act of 1940 to protect public pension plans and other government investors by deterring advisers from participating in "pay to play" practices. The new rule applies to investment advisers that are registered (or required to be registered) with the SEC or are exempt from registration under Section 203(b)(3) of the Advisers Act, including investment advisers to any "covered investment pool" in which a "government entity" (including public pension plans and other government investors) invests or is solicited to invest. Most, if not all, advisers that provide discretionary management with respect to public pension fund assets would fall under the scope of the new rule. "Covered investment pools" include entities that would be investment companies but for the exceptions provided by Sections 3(c)(1), 3(c)(7) or 3(c)(11) of the Investment Company Act of 1940, and any registered investment company that is an investment option under a government plan or program.

The new SEC rule has three key elements:

- It prohibits an investment adviser from providing investment advisory services for compensation to a government entity within two years after the investment adviser or any of its "covered associates" has made a contribution to an official of the government entity that is in a position to influence the selection of the investment adviser for its advisory services. This prohibition does not apply to certain de minimis contributions made by a covered associate who is a natural person (limited in the aggregate to $150 or $350 per election per candidate depending upon the circumstances).
- It prohibits an investment adviser or any of its covered associates from directly or indirectly paying any person to solicit a government entity for investment advisory services on its behalf, including soliciting investments to a covered investment pool advised by the investment adviser. This prohibition on paying third party marketers does not apply to "regulated persons," such as registered investment advisers that have met certain preconditions and registered brokers who are subject to similar prohibitions on "pay to play" by the self-regulatory organization overseeing such broker.
- It prohibits an investment adviser or any of its covered associates from coordinating or soliciting any person or political action committee to make any (1) contribution to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services, or (2) payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.

The SEC also adopted amendments to the books and records maintenance obligations in Rule 204-2 under the Advisers Act to require registered investment advisers that provide investment advisory services to government entities to make and keep additional records related to political contributions made by such advisers and their covered associates.

Rule 206(4)-5 and the recordkeeping requirements in the amendment to Rule 204-2 become effective 60 days after their publication in the *Federal Register*, and compliance will generally be required within six months of the effective date. However, the SEC has allowed one year for compliance with the prohibition on paying third-party marketers who do not meet the new requirements and for all of the requirements (under both Rule 206(4)-5 and Rule 204-2) for advisers to registered investment companies that are covered investment pools.

To read the SEC's press release on Rule 206(4)-5 click here.
To read the Adopting Release click here.
Click here for more information on the Proposing Release in the July 24, 2009, edition of *Corporate and Financial Weekly Digest*.

LITIGATION

Commodities Exchange Act Claim Dismissed for Failing to Plead Scienter

The U.S. Court of Appeals for the Fifth Circuit affirmed a district court's dismissal of a putative class action brought by a group of natural gas futures and options contract traders under the Commodities Exchange Act (CEA).

Plaintiffs alleged that defendants manipulated the natural gas futures and options prices in violation of the CEA by selling large quantities of natural gas for delivery at one delivery hub, the Houston Ship Channel, in order to depress the price of the natural gas at that hub to an artificial level. The defendants allegedly intended to profit from the difference in price at that hub and the Henry Hub, the hub where delivery was to be made for all natural gas contracts on the New York Mercantile Exchange (NYMEX). Plaintiffs further alleged that the defendants' price manipulation caused the NYMEX price to decrease, resulting in a loss to plaintiffs, who traded futures and options on NYMEX.

Defendants moved to dismiss plaintiff's securities fraud claim before the district court. In granting the motion to dismiss, the district court reasoned that plaintiffs failed to allege that defendants specifically intended to manipulate the price of natural gas at Henry Hub, as required for a private right of action under the CEA. The plaintiffs argued that they had sufficiently alleged a CEA claim by alleging that the defendants intended to manipulate the price of the underlying commodity, natural gas, knowing that their manipulation would result in a decrease in the price at the Henry Hub and thereby affect the commodity contracts traded on NYMEX. In affirming the district court's dismissal, the Fifth Circuit rejected plaintiffs' contention that defendants' purported knowledge that their actions would ultimately affect prices on the Henry Hub was sufficient to state a claim under the CEA. In so holding, the court noted that the "effect on the Henry Hub, and NYMEX futures contracts, was merely an unintended consequence of the defendants' manipulative trading" and, as a result, the defendants lacked the requisite specific intent. (*Hershey v. Energy Transfer Partners, L.P.,* No. 09-20651, 2010 WL 2510122 (5th Cir. June 23, 2010))

Whistleblower's Claim Dismissed for Lack of Subjective Belief

The U.S. Court of Appeals for the Eleventh Circuit upheld the U.S. Department of Labor's review of a summary dismissal of a whistleblower complaint filed by petitioner Michael Gale, the Chief Operations Officer and a director of World Securities Group (WSG), the affiliated broker-dealer of World Financial Group (WFG). Gale's complaint alleges that he was discharged because he (1) provided information and opposed decisions made by company officers relating to waste and misuse of corporate monies that resulted in loss of shareholder equity and (2) raised concerns that the operation of WSG by WFG violated certain Securities and Exchange Commission rules and regulations.

The Administrative Law Judge (ALJ) granted WFG's motion for summary dismissal on the ground that Mr. Gale's complaint failed to plead that he reasonably believed WFG's activities were illegal or fraudulent in nature, an essential element in a whistleblower action under the Sarbanes-Oxley Act (SOX). The ALJ found that none of Mr. Gale's expressed concerns regarding WFG's activities contained any factual basis for finding that WFG committed illegal or fraudulent acts prohibited by SOX. On appeal, the Department of Labor's Administrative Review Board agreed with the ALJ's finding that Mr. Gale had not presented sufficient evidence to create a genuine issue of fact that he engaged in activity protected by SOX.

On appeal to the Eleventh Circuit, Mr. Gale argued that to state a whistleblower claim it is not necessary for an employee to subjectively believe that his employer engaged in unlawful conduct, but rather asserted that it was

sufficient for him to voice "sufficient concerns" about his employer's practices. The Eleventh Circuit rejected Mr. Gale's arguments and affirmed the dismissal of his claim, reasoning that to be protected by SOX, a whistleblower must reasonably believe that the information he is disclosing to a supervisory authority constitutes a violation of federal laws relating to fraud against shareholders. The court determined that while Mr. Gale had reservations about WFG's practices, he did not know whether those practices were illegal, relying on the fact that Mr. Gale admitted during his deposition that he did not actually believe that WFG was engaging in illegal or fraudulent activities. (*Gale v. U.S. Dep't of Labor,* No. 08-14232, 2010 WL 2543138 (11th Cir. 2010))

BANKING

Banking Agencies Issue Host State Loan-to-Deposit Ratios

On June 24, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency issued the host state loan-to-deposit ratios they will use to determine compliance with Section 109 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Section 109). Section 109 generally prohibits a bank from establishing or acquiring a branch or branches outside of its home state primarily for the purpose of deposit production. Such ratios are published on an annual basis.

Section 109 specifically prescribes a two-step process to test compliance with the statutory requirements. The first step involves a loan-to-deposit ratio screen that compares a bank's statewide loan-to-deposit ratio to the host state loan-to-deposit ratio for banks in a particular state. The second step is required if a bank's statewide loan-to-deposit ratio is less than one-half of the published ratio for the state or if the data are not available at the bank to conduct the first step. (A statewide loan-to-deposit ratio relates to an individual bank and is the ratio of a bank's loans to its deposits in a particular state where the bank has interstate branches.) The second step requires the appropriate banking agency to determine whether the bank is reasonably helping to meet the credit needs of the communities served by the bank's interstate branches. If a bank fails both steps, it is in violation of Section 109.

For more information, click here.

UK DEVELOPMENTS

UK Regulators Focus on Role of Auditors

The UK Financial Services Authority (FSA) and the UK Financial Reporting Council (FRC) issued a discussion paper on June 24 which considers ways of enhancing auditors' contribution to regulation.

The paper FSA DP 10/3 is entitled "Enhancing the auditor's contribution to prudential regulation" and covers the following areas:

- questions aspects of the quality of audit work relevant to prudential regulation—in particular, whether the auditor has always been sufficiently skeptical and has paid sufficient attention to indicators of management bias when examining key areas of financial accounting and disclosure that depend critically on management judgement;
- outlines the FSA's concerns about auditors' work on client assets and how auditors fulfill their legal obligation to report to the FSA;
- explores a variety of ways in which changes are being made and further changes could be made by the FSA, FRC and auditors to increase the effectiveness with which auditors undertake their work; and
- examines the regulatory environment in which auditors operate more widely and suggests measures to enhance how auditors contribute to prudential supervision.

Paul Sharma, the FSA's Director of Prudential Policy, said, "Our experience has indicated that, at times, auditors have focused too much on gathering and accepting evidence to support firms' assertions rather than exercising sufficient professional skepticism in their approach—this falls far short of what the FSA—and society at large—expects from auditors."

Read more.

FSA Fines and Bans Oil Broker for Market Abuse

On June 28, the UK Financial Services Authority (FSA) announced that it had fined Steven Perkins, a former oil broker, £72,000 (approximately $109,000) for market abuse and had banned him from working in the UK financial services industry for a minimum of five years on the grounds that he was not a fit and proper person.

Mr. Perkins was an oil futures broker with PVM Oil Futures Ltd. His job involved trading Brent Crude Futures contracts on an execution-only basis in the ICE Futures Europe Exchange for PVM's clients. PVM did no proprietary trading.

In the early hours of the morning of Tuesday, June 30, 2009, Mr. Perkins traded in the ICE August 2009 Brent contract without any client authorization, and in doing so accumulated a long outright position in Brent in excess of 7,000 lots (representing over 7 million barrels of oil).

As a direct result of Mr. Perkins' trading, the price of Brent increased significantly. His trading manipulated the market in Brent by giving a false and misleading impression as to the supply, demand and price of Brent and caused the price of Brent to increase to an abnormal and artificial level.

The FSA findings state that Mr. Perkins initially lied repeatedly to PVM in order to try and cover up his unauthorized trading. They also stated that Mr. Perkins' relevant trading seems to have been a consequence of extremely heavy drinking resulting from alcoholism, which he now acknowledges. He drank excessively over the weekend prior to and throughout Monday, June 29.

Alexander Justham, the FSA's Director of Markets, said, "The FSA views market manipulation extremely seriously. Perkins' trading caused disruption to the market and has been met with both a fine and prohibition. This reinforces the fact that a severe sanction will apply in cases of market manipulation, even where no profit is made."

The FSA stated that Mr. Perkins' behavior merited a penalty of £150,000 (approximately $228,000). Because such a fine would cause him serious financial hardship, this was reduced to £90,000 (approximately $136,000). Since Mr. Perkins agreed to settle the case, he qualified for a 20% discount on the fine under the FSA's executive settlement procedures, bringing the fine down to £72,000. The ban imposed on Mr. Perkins was limited to a minimum term of five years since Perkins had joined an alcoholics rehabilitation program. Accordingly, the FSA considered that Mr. Perkins may be a fit and proper person for regulatory purposes at some future date.

Read more.

UK Government Announces 2009-10 Budget Tax Changes

The newly-elected UK Government announced its first Budget on June 22. Key provisions include:

1) Capital Gains Tax is increased to a top rate of 28%, from a flat rate of 18%, with effect from midnight on June 22.
2) The introduction of a UK levy on banks (including the UK branches and subsidiaries of foreign banks). The levy will take effect on January 1, 2011, and will initially be charged at a rate of 0.04% on the total liabilities of the bank or branch (subject to certain exclusions). The rate will be increased to 0.07% on January 1, 2012. In order to encourage longer-term borrowings (perceived as less risky), liabilities with longer than a year to maturity will be taxed at half the standard rate.

   There will be the following exceptions to the levy: (i) Tier 1 capital (i.e. equity); (ii) insured retail deposits; (iii) repos secured on sovereign debt; and (iv) policyholder liabilities of retail insurance businesses within banking groups. Banks or branches with relevant liabilities below £20 billion (approximately $30 billion) will also be exempt from the levy.
3) In relation to asset management, the UK Government intends to: (i) implement the UCITS IV rules; (ii) establish tax transparent contractual funds along the lines of those currently offered by Ireland and Luxembourg; and (iii) consult on rules designed to reform the taxation of UK authorized investment trust companies and UK authorized funds investing in offshore funds (the budget gave no details of these reforms).

Read more.

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