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Corporate and Financial Weekly Digest

July 20, 2007

SEC/Corporate

SEC to Approve AS No. 5 and Propose Rules for Shareholder Access to Proxy Statements

On July 18, the Securities and Exchange Commission announced the agenda for its open meeting to be held on July 25. At the meeting, the SEC will consider whether to:

- approve the Public Company Accounting Oversight Board's *Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements*, a Related Independence Rule 3525, and Conforming Amendments;
- adopt rule amendments to Rule 12b-2 of the Securities Exchange Act of 1934 and Rule 1-02 of Regulation S-X to define the term "significant deficiency;"
- publish a Concept Release to solicit public comment on allowing U.S. issuers, including investment companies subject to the Investment Company Act of 1940, to prepare financial statements in accordance with International Financial Reporting Standards as published in English by the International Accounting Standards Board for purposes of complying with the SEC's rules and regulations; and
- propose amendments to the proxy rules under the Securities Exchange Act of 1934, for operating and investment companies regarding shareholder proposals, disclosure about shareholder proponents, shareholder communications, and related matters.

www.sec.gov/news/openmeetings/2007/ssamtg072407.htm.

"Scheme Liability" Theory Advocated Before U.S. Supreme Court

Three former commissioners of the Securities and Exchange Commission, William Donaldson, Harvey Goldschmid and Arthur Levitt filed an amicus brief with the U.S. Supreme Court in the matter of *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc., et al.*, case number 06-43, advocating a theory of "scheme liability" for companies that engage in transactions that facilitate securities fraud by another issuer, in this case a cable television company, Charter Communications, Inc. that paid additional fees to cable box vendors in exchange for agreements by such vendors to buy advertising from the company, allegedly permitting it to overstate revenues and defraud shareholders. The brief argued that "a party commits a primary securities fraud violation for which it may be held liable in a private action by actively engaging in fraudulent conduct as part of a scheme to defraud investors, even if it does

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not make a public statement."

The brief was not filed timely, but the filers asked the Supreme Court to accept it in light of the Solicitor General's failure to file such a brief despite having been requested by the SEC to do so, which plaintiff's counsel Stanley M. Grossman of Pomerantz Haudek Block Grossman & Gross LLP described as "unprecedented". The Charter case was granted a writ of certiorari in March 2007 and will be heard by the Supreme Court during its 2007-2008 term. (*Securities Law 360,* 7/18/07)

Broker Dealer

Policy on Foreign Issue Book Entry Deposits and Deliveries Proposed

Depository Trust Company (DTC) has proposed a policy statement on the ability to use DTC's book entry system for securities issued by foreign governments and foreign private issuers. Foreign securities registered under the Securities Act of 1933 and those that are exempt from registration under the Securities Act where there are no restrictions on resale are eligible. Securities offered and sold in reliance on Regulation S would be eligible if the issuer gave a supplemental letter to DTC with representations as to a CUSIP or CINS identification number separate from any registered issues of that issuer.

Rule 144A securities of foreign issuers would be eligible if the issuer had a CUSIP or CINS number different from any registered issues of that issuer and the security was listed on PORTAL (Private Offerings, Resales and Trading through Automated Linkages) operated by the NASD. Securities of a foreign issuer not relying on any of the foregoing would be eligible for DTC book entry if they had a separate CUSIP or CINS number and could be resold without Securities Act registration either under Rule 144 or pursuant to any other Securities Act exemption. DTC participants wishing to deposit, deliver and receive foreign issues would have to submit a one time blanket letter of representation that, among other things, they would not deposit unregistered foreign securities unless they are eligible for resale without registration under the Securities Act, and that they would not engage in any transaction in foreign securities in violation of DTC rules, including violation of the Securities Act.

http://www.sec.gov/rules/sro/dtc/2007/34-55940.pdf

NASD Applies Manning Rule to Canadian Issues

The National Association of Securities Dealers, Inc. has modified Rule 2320(g) (the Manning Rule) requiring a broker to obtain three quotes for a transaction in a non-exchange listed security to apply to Canadian issues. A non-exchange listed security that is listed on a Canadian exchange will be exempt from the requirement if the customer order is executed by the NASD member or a person associated with the member on a Canadian exchange in an agency or riskless principal capacity, and the member periodically conducts reviews of the quality of the execution of such orders pursuant to the NASD's best execution rules.

http://www.sec.gov/rules/sro/nasd/2007/34-56004.pdf

NASD Revises Rules to Accommodate Removal of Tick Test for Short Sales

The National Association of Securities Dealers, Inc. responded to the Securities and Exchange Commission's removal of the tick test in connection with short sales of equity securities effective as of the July 6, 2007 effective

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date for the removal of the tick test. Rule 5100 prohibiting short sales in over-the-counter securities at prices below the national best bid when that was below the previous national best bid was deleted. Various transaction reporting rules that required classification of a short sale as either a short sale or exempt short sale were amended to delete all references to short exempt sales.

http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_019381.pdf

United Kingdom Developments

Reform of FSA's Procedures for Regulatory Guidance

Following a consultation issued in May 2006, HM Treasury has amended the way in which the UK Financial Services Authority (FSA) consults on and makes guidance. A Regulatory Reform Order (RRO) was laid before Parliament in May 2007 to pass the changes and the RRO took effect on July 12.

The RRO has abolished the requirements contained in the Financial Services and Markets Act 2000 for the FSA, as part of any consultation on proposed guidance, to publish: (i) a cost benefit analysis, (ii) an explanation of the guidance's purpose, (iii) an explanation of why FSA believes the proposed guidance is compatible with their general duties, (iv) an account of representations made and any responses and (v) an account of any difference between the proposed guidance and the actual guidance made. Until the RRO, only the FSA Board could exercise the legislative function of issuing general guidance. The RRO now allows a committee or sub-committee of the FSA Board to issue general guidance.

Taken together these procedures should simplify the process of consulting on guidance and facilitate its issuance.

http://www.fsa.gov.uk/pubs/policy/ps07_10.pdf

LSE Launches Specialist Fund Market

On July 13, the London Stock Exchange (LSE) announced the launch of a new Specialist Fund Market (SFM) for alternative investment funds which target non-retail investors. The SFM will be subject to a "light touch" regulatory regime and is targeted at specialist funds that are seeking a quotation on a regulated market. The SFM will be a "regulated market" for the purposes of EU law. Funds admitted to the SFM will therefore be required to prepare a prospectus meeting the requirements of the EU Prospectus Directive – the so-called directive minimum requirement.

This development dovetails with the Financial Services Authority's revised proposals for the listing of investment entities covered in the July 20, 2007 edition of the *Corporate and Financial Weekly Digest*. The requirements of the SFM regime will be similar to the Listing Rules chapter 14 proposal withdrawn by the Financial Services Authority. The FSA's withdrawn proposal would have applied to funds directed at retail investors unlike the SFM which will target professional investor funds only.

The SFM regime will be lighter touch than the chapter 15 Listing Rules regime which will apply to funds aimed at retail investors.

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http://www.londonstockexchange.com/NR/exeres/CAF85279-3285-47B4-A5A6-E66269A0E8E2.htm

BVCA Working Group Publishes Private Equity Consultation

On July 17, a British Private Equity and Venture Capital Association (BVCA) high-level industry working group issued a consultative document that makes recommendations about the need for self-regulation by the private equity industry. The working group, chaired by Sir David Walker, Senior Advisor at Morgan Stanley International (and a former Executive Director of the Bank of England and former Chairman of the Financial Services Authority's predecessor regulator the Securities and Investments Board) was established in March 2007.

The document proposes that private equity firms should provide: (i) identification of the management company's leadership team, (ii) a commitment to conform to proposed guidelines, (iii) conflicts of interest and corporate social responsibility policies; (iv) indications of funds' performance, and (v) disclosure of the limited partners in their funds, including banks and private individuals.

The document also included disclosure proposals for portfolio companies and guidelines for the collection of fund data.

The consultation period for comments on the proposals runs until October 9.

http://walkerworkinggroup.com/sites/10051/files/walker_consultation_document.pdf

FSA Publishes Further Consultation on Implementing MiFID

On July 18, the Financial Services Authority published consultation paper CP07/16 *Consequential Handbook Amendments (arising from implementation of MiFID and creation of NEWCOB*). The paper seeks views on proposed consequential amendments to the Handbook to reflect changes FSA has made in implementing the Markets in Financial Instruments Directive (MiFID) and in the new Conduct of Business Sourcebook (COBS).

The proposals include (i) the application of the 'customer principles' in the Principles for Businesses Sourcebook (PRIN) to non-designated investment business, (ii) amendments to the rules in the Senior Management Arrangements, Systems and Controls sourcebook (SYSC) relating to apportionment and oversight and senior management responsibility, (iii) amending the approved persons regime, (iv) amending MiFID transaction reporting requirements to take into account CESR guidance relating to transaction reporting and (v) revisions to the arrangements for Trade Data Monitors (TDMs).

This CP covers changes relevant to both MiFID and non-MiFID firms and business within and outside the scope of MiFID.

The consultation period closes on September 14, except for comments on Chapter 6 (Post-trade transparency and trade data monitors) which closes on August 15.

http://www.fsa.gov.uk/pubs/cp/cp07_16.pdf

EU Developments

CESR Gives Guidance on Implementing MAD

On July 16, the Committee of European Securities Regulators (CESR) published more guidance on the EU Market Abuse Directive (MAD). The guidance includes clarifications on what constitutes inside information, where delays to disclosure of inside information are permissible, insider lists and in what circumstances information relating to a pending orders may constitute inside information.

http://www.cesr-eu.org/index.php?page=home_details&id=225

Litigation

Plaintiff Failed to Adequately Plead Securities Fraud Claims

The plaintiff corporation alleged that defendant investors made material misrepresentations in connection with their purchase of convertible preferred stock from plaintiff in violation of Rule 10b-5 and, thereafter, engaged in illegal market manipulation. Due to its troubled condition, in order to attract investors, the convertible preferred stock issued by the plaintiff could be converted into common stock at a discount to market value.

Plaintiff claimed that despite defendants having represented when purchasing the convertible preferred stock that they would be long-term investors and would not undertake activities to depress the stock, defendants thereafter engaged in a wrongful scheme to drive down plaintiff's stock price by first shorting the stock to reduce the price and then converting their preferred stock at below market rates to cover their short position at a substantial profit. Defendants successfully moved to dismiss, contending, among other things, that plaintiffs failed to plead the alleged manipulation with the particularity required by the PSLRA and F. R. Civ. P. 9(b).

The Second Circuit affirmed the dismissal. The court ruled that the plaintiff's allegations that the defendants' fraudulent intent could be inferred from (i) the high volume of selling coinciding with large drops in stock price, (ii) the stock's negative reaction to positive news, and (iii) the high volume of trades in excess of "settlements" during the 10 day period before AMEX suspended trading in plaintiff's stock were, at best, speculative and did not constitute a "strong inference" of scienter as required by the PSLRA.

The Court, expressly found that there were more plausible, non-culpable explanations for defendants "trading activities and that the fact that the attributes of the convertible preferred stock "create[d] an opportunity for profit through manipulation" fell short of establishing the requisite "strong inference" of scienter. (*ATSI Communications, Inc. v. The Shaar Fund, Ltd.,* 2007 WL 1989336 (2nd Cir. July 11, 2007))

Plaintiff Sufficiently Pleaded Securities Fraud Claims

The former Vice President of Finance and CFO of a publicly traded company unsuccessfully moved to dismiss claims asserted against him by the Securities and Exchange Commission for, among other things, violations of Rule 10b-5 based upon the inclusion of allegedly false and misleading statements in the company's Form 10-K and Form 10-Q.

The SEC alleged that the company falsely represented in its annual report and SEC filings that a $9.8 million write-off was attributable entirely to activities of a limited segment of the company occurring in 2001. As asserted in the

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complaint, the defendant knew at the time he signed the SEC filings in issue that the write-offs concerned activities spanning at least a three year period and involving activities of many of the company's business units. Rejecting the defendant's challenge to the adequacy of these allegations under Rule 9(b), the court determined that the "fraud with particularity" pleading requirements were met because the SEC identified contemporaneous statements and information that were available to the defendant at the time he signed the SEC filings that contradicted representations contained in the filings.

The Court also ruled that the SEC's allegations that defendant's execution of documents filed with the SEC and of "representation letters" sent to the company's auditors without disclosing "alarming information" concerning the company's financial condition of which he was aware (e.g., the existence of significant unsubstantiated account balances and significant internal accounting discrepancies) sufficiently established scienter for pleading purposes. (*SEC v. Baxter*, 2007 WL 2013958 (N.D.Cal. July 11, 2007))

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