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Corporate and Financial Weekly Digest

JULY 31, 2009

## SEC/CORPORATE

**House Committee Approves "Say on Pay" Legislation**

On July 28, the House of Representatives Financial Services Committee approved legislation that would give shareholders of publicly traded companies a non-binding advisory vote on the compensation of such companies' named executive officers at annual meetings of shareholders to elect directors. Additionally, the legislation would require, in connection with a merger or acquisition of the issuer, a separate non-binding stockholder vote on "golden parachute" payments provided to executives in connection with such merger or acquisition. Issuers would be required to include and clearly disclose in tabular form in their soliciting materials the exact amounts senior executive officers would receive (whether present, deferred or contingent) if the merger or acquisition is completed. In its current form, the legislation would permit the Securities and Exchange Commission to exempt certain categories of companies, including smaller reporting companies, from such "say on pay" requirements. The draft legislation also provides that institutional investors must annually disclose their "say on pay" votes and that compensation approved by a majority vote of shareholders would not be subject to any clawback, except as provided by contract or due to fraud. (Note that this provision may conflict with the clawback provisions of Section 304 of the Sarbanes-Oxley Act of 2002 which do not require fraud, only a restatement "due to the material noncompliance of the issuer as a result of misconduct.")

The legislation would also place stringent new requirements on the compensation committees of publicly traded companies. Compensation committee members would be prohibited from accepting any consulting, advisory or other compensatory fee from the company. Compensation committees would additionally be authorized to engage outside advisors, with such committees having the direct responsibility for the appointment, compensation and oversight of such advisors. Such advisors would be required to meet standards of independence established by the SEC.

Finally, the draft legislation would require certain "covered financial institutions" (which would include registered broker-dealers, investment advisors, as well as depository institutions and credit unions, in each case with $1 billion or more in assets) to disclose to the appropriate federal regulator their incentive-based compensation arrangements for a determination of whether such incentive-based compensation arrangements are aligned with sound risk management, are structured to account for the time horizon of risks and meet such other criteria as the regulators may deem appropriate to reduce unreasonable incentives for officers and employees to take "undue risks." Regulators reviewing such incentive-based compensation arrangements would have authority to prohibit such incentive-based plans at covered financial institutions.

According to published reports, the full House may consider this legislation today.

Read more.

**NASDAQ Extends Suspension of Continued Listing Requirements for Third and Final Time**

On July 23, the Securities and Exchange Commission approved a proposed rule change by NASDAQ Stock Market LLC to extend until today the temporary suspension of continued listing requirements related to bid price and market value of publicly held shares for listing on the NASDAQ Stock Market, effective as of NASDAQ's filing with the SEC on July 13. As previously reported in the March 27 edition of *Corporate and Financial Weekly Digest*, the prior suspension was set to expire on July 19.

In its filing, NASDAQ asserted that the extension is appropriate to allow additional time for market conditions to return to normal and for deficient companies to develop plans to regain compliance with the continued listing requirements.

NASDAQ has stated that it does not expect a further extension of the suspension beyond July 31.

Under the extended suspension, companies would not be cited for new bid price or market value of publicly held shares deficiencies during the suspension period, and the time allowed to companies already in a compliance period or in the hearings process for such deficiencies would remain suspended with respect to those requirements. Following the temporary suspension, any new deficiencies with the bid price or market value of publicly held shares requirements would be determined using data starting on August 3. When the suspension expires, companies that were in a compliance period as of October 16, 2008, when the suspension first began, would resume in that process at the same stage they were in on such date.

While the SEC's rules provide that a self-regulatory organization's proposed rule change does not become operative until 30 days after the date of its filing with the SEC, the SEC waived this requirement for the proposed rule change.

Click here to read the SEC's notice regarding the NASDAQ rule change.

## LITIGATION

**Statute of Frauds Bars Claim for Recommending Investment in Ponzi Scheme**

The Second Circuit Court of Appeals affirmed the Southern District of New York's dismissal of a complaint by South Cherry Street, LLC, alleging that Hennessee Group LLC breached an oral contract to provide investment advisory services. Hennessee, an investment advisor, had recommended that South Cherry invest with Bayou Accredited Fund L.L.C. South Cherry alleged that Hennessee's failure to learn of and disclose that Bayou was operated as a Ponzi scheme was a breach of its contractual duty to perform due diligence with respect to the investments it recommended.

Hennessee asserted that the breach of contract claim was barred by New York's Statute of Frauds, which voids any agreement that is not evidenced by a signed writing and which cannot be performed in one year. Although it was entitled to a fee for the investments it recommended as long as they were held by South Cherry, Hennessee had no ability to terminate the contract at will (or at any time within one year from its making). Relying on language from a 1984 New York Court of Appeals decision that stated that a contract "is not within the Statute of Frauds '[w]here *one or both* parties have... an explicit option to terminate their agreement within one year,'" South Cherry asserted that since it had the option to terminate the contract at any time, the contract was not covered by the Statute of Frauds.

The Second Circuit affirmed the District Court's finding that, despite the language relied upon by South Cherry, the contract at issue was within the Statute of Frauds and unenforceable. The Court held that to fall outside the statute, the possibility of performance within one year must be within the control of the party to be charged, not solely with the plaintiff. Thus, the Court ruled that "because the possibility of performance of the alleged oral agreement within one year depended solely on the will and actions of South Cherry, the party seeking to enforce the agreement," the oral agreement was barred by the Statute of Frauds. (*South Cherry Street, LLC v. Hennessee Group LLC*, No. 07-3658-cv, 2009 WL 2032133 (2d Cir. July 14, 2009))

**Third Tier Civil Penalty Imposed for Violations of Securities Laws**

The U.S. District Court for the District of Minnesota imposed a third tier civil penalty against defendants Sherwin Brown and Jamerica Financial, Inc., who were found to have violated Section 17(a) of the Securities Act of 1933, Section 10(b)(5) of the Securities Exchange Act of 1934, and the Investment Advisors Act of 1940. Mr. Brown, acting through his companies, including Jamerica, misappropriated several hundred thousand dollars in client funds for his own benefit and attempted to conceal his actions. Mr. Brown and Jamerica had sought a reduced penalty, arguing that the Court should consider his weakened financial condition in determining the appropriate amount.

In imposing penalties of $80,000 against Mr. Brown and $400,000 against Jamerica, the Court noted that civil penalties are designed to punish the violator as well as to deter future violations. The Court explained that these goals cannot be accomplished through disgorgement, which "merely requires the return of illegal profits." There are three tiers of civil penalties for violations of the applicable securities statutes: the first tier applies to basic violations; the second tier applies to violations involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement"; and the third tier applies to violations that meet the second tier and additionally "resulted in substantial losses or created significant risk of substantial losses."

Here, the Court imposed a third tier civil penalty because there was overwhelming evidence that defendants acted with reckless disregard to the regulatory requirements. In particular, the Court determined that a third tier penalty was appropriate because defendants misappropriated more than $800,000 of the $1.62 million in funds received from investors, the conduct was recurring, and defendants did not fully cooperate with authorities during the course of the lawsuit. The Court also rejected the argument that the penalty should be reduced because the SEC had introduced evidence that Mr. Brown had made substantial deposits into his own bank accounts and he and Jamerica did not come forward with any evidence of their financial condition. (*United States Securities and Exchange Commission v. Brown,* Civil No. 06-1213, 2009 WL 2163505 (D. Minn. July 20, 2009))

## BROKER DEALER

**CBOE Proposes to Extend Delta Hedging Exemption to Customers**

The Chicago Board Options Exchange (CBOE) filed a rule proposal that would extend the current delta hedging exemption from equity option position limits to customers. The delta hedging exemption currently only applies to members or non-member affiliates that use a “permitted pricing model”. The filing would extend the existing exemption to customers of members who use the pricing model maintained and operated by the Options Clearing Corporation. The CBOE determined that extending the exemption to customers at this time was appropriate given that customers had expressed an interest in using it and that it had not encountered any problems with the delta hedging exemption since it initially adopted it for members and non-member affiliates 18 months ago.

Read more.

**MSRB Proposes Guidance on Disclosure and Other Sales Practice Obligations**

The Municipal Securities Rulemaking Board (MSRB) filed a proposal which provides guidance to brokers, dealers and municipal securities dealers of their sales practice obligations under the MSRB rules as applied specifically to individual and other retail investors. Among other things, the proposed rule change updates guidance to dealers on their (i) obligations to disclose material information about issuers, their securities and credit/liquidity support for such securities in connection with the fulfillment of their disclosure obligations, (ii) obligations to use such material information in fulfilling their suitability obligations, and (iii) fair pricing obligations. The proposed rule change also applies previous guidance on bond insurance rating downgrades and wide-scale auction failures for municipal auction rate securities to municipal securities transactions in general and specifically to transactions with individual and other retail investors in variable rate demand obligations. The proposed rule change became effective upon filing with the Securities and Exchange Commission.

Read more.

## FINANCIAL MARKETS

**Congressmen Peterson and Frank Issue Concept Release on OTC Derivatives Legislation**

Congressman Collin Peterson, Chairman of the House Agriculture Committee, and Congressman Barney Frank, Chairman of the House Financial Services Committee, have issued a “concept release” outlining certain agreed principles for the development of legislation to enhance regulation of over-the-counter (OTC) derivatives markets. Principles identified in the concept release include:

- Harmonization of Securities and Exchange Commission and Commodity Futures Trading Commission regulation of OTC derivatives markets, including joint regulation of certain derivative products and the formation of a Financial Services Oversight Council to resolve disputes between the SEC and CFTC as to regulatory authority over new products

- Trade reporting requirements for all OTC derivatives trades

- Mandatory clearing of OTC derivatives by an approved clearinghouse (subject to exceptions for non-standardized contracts and counterparties that are not “major market participants”)

- Adoption of “significantly higher” capital and margin charges for non-standardized OTC contracts that are not exchange-traded or centrally cleared

- Limitations on and/or increased oversight of speculative positions in credit default swaps

- Coordination with foreign regulators to harmonize OTC derivative market regulation, together with authority to restrict access to the U.S. banking system for institutions in countries with lower capital standards than those of the United States.

The concept release is available here.

**SEC Grants Temporary Exemptions for ICE Clear Europe and Eurex AG CDS Clearinghouses**

The Securities and Exchange Commission recently issued two separate conditional exemptions that are designed to permit ICE Clear Europe Limited and Eurex AG to operate clearinghouses for credit default swaps without registering as clearing agencies under the Exchange Act. The orders largely mirror the temporary and conditional exemptive orders issued by the SEC with respect to the Chicago Mercantile Exchange, ICE US Trust LLC and LIFFE A&M and LCH.Clearnet for the same purposes. (See the January 16 Katten *Client Advisory*.) The conditional exemptions for ICE Clear Europe Limited and Eurex AG expire on April 23, 2010.

The SEC's exemptive orders are available here and here.

## CFTC

**CFTC Designates ICE Natural Gas Contract as "Significant Price Discovery Contract"**

The Commodity Futures Trading Commission has issued an order finding that the Henry Financial LD1 Fixed Price natural gas contract traded on the IntercontinentalExchange, Inc. (ICE) performs a "significant price discovery function." As an exempt commercial market (ECM) under CFTC rules, ICE and contracts traded on ICE generally are subject to minimal regulation by the CFTC. However, ECM-listed contracts that the CFTC determines perform a significant price discovery function (significant price discovery contracts, or SPDCs) subject the listing ECM to many of the obligations that apply to designated contract markets, such as large trader reporting, publication of daily trading information, and the establishment of position limits or position accountability levels for SPDCs.

In finding that the ICE contract was an SPDC, the CFTC considered the contract's (i) high daily trading volume, (ii) price linkage with a contract listed on the New York Mercantile Exchange (NYMEX), and (iii) use by traders for pricing purposes. Because the ICE contract is ICE's first SPDC, ICE will have a grace period of 90 days to come into compliance with applicable CFTC regulations.

The CFTC press release announcing the order is available here.

**ICE WTI Contract to Be Included in Commitments of Traders Reports**

The Commodity Futures Trading Commission has announced that positions in the West Texas Intermediate Crude Oil (WTI) contract listed on ICE Futures Europe will be reported in the CFTC's weekly Commitments of Traders (COT) reports, beginning with the COT report published on July 31. The ICE WTI contract settles based upon the settlement price of the WTI futures contract listed on the New York Mercantile Exchange (NYMEX), and is being included in the COT reports due to this price linkage with the NYMEX contract.

The CFTC's announcement is available here.

## BANKING

**Federal Reserve Proposes Certain Changes to Truth in Lending Disclosures in Connection with Mortgage Lending**

On July 23, the Board of Governors of the Federal Reserve System (the Federal Reserve) released proposed changes to Regulation Z (Truth in Lending) intended to improve the disclosures consumers receive in connection with closed-end mortgages and home-equity lines of credit (the Proposal).

The Proposal includes the following specific changes to existing regulations: (i) improving the disclosure of the annual percentage rate so it captures most fees and settlement costs paid by consumers; (ii) requiring lenders to show how a consumer's annual percentage rate compares to the average rate offered to borrowers with excellent credit; (iii) requiring lenders to provide final Truth in Lending Act (TILA) disclosures so that consumers receive them at least three business days before the loan closes; (iv) requiring lenders to show consumers how much their

monthly payments might increase for adjustable rate mortgages; (v) prohibiting payments to a mortgage broker or loan officer that are based on the loan's interest rate or other terms; and (vi) prohibiting a mortgage broker or loan officer from "steering" consumers to transactions that are not in their interest in order to increase the mortgage broker's or loan officer's compensation.

In connection with the Proposal, the Federal Reserve also announced that it would work with the Department of Housing and Urban Development (HUD) to make complementary disclosures required under TILA and those required by the Real Estate Settlement Procedures Act, as administered by HUD.

For more information, click here.

Please see "FDIC Announces Test of Funding Mechanism for Legacy Loans Program" in **Structured Finance and Securitization** below.

## STRUCTURED FINANCE AND SECURITIZATION

**FDIC Announces Test of Funding Mechanism for Legacy Loans Program**

On July 31, the Federal Deposit Insurance Corporation (FDIC) announced that it has taken the next step in the development of the Legacy Loans Program (LLP). The LLP is part of the Public-Private Investment Program intended to assist financial institutions in removing troubled assets from their balance sheets. The LLP is meant to help financial institutions sell troubled residential and commercial mortgage loans, while the Legacy Securities Program, recently launched by the U.S. Treasury Department, focuses on securities backed by those loans.

The FDIC is testing the LLP's funding mechanism through the sale of residential mortgage loans owned by a bank in FDIC receivership. If the test is successful, the FDIC will offer the LLP to open banks as needed.

The test transaction will involve a transfer of a portfolio of residential mortgage loans on a servicing released basis to a limited liability company (LLC) in exchange for an ownership interest in the LLC. The LLC also will sell an equity interest to an accredited investor, who will be responsible for managing the portfolio of mortgage loans. Loan servicing must conform to either the Home Affordable Modification Program guidelines or FDIC's loan modification program.

Accredited investors will be offered an equity interest in the LLC under either (i) an all cash basis, with an equity split of 80% (FDIC) and 20% (accredited investor); or (ii) a sale with leverage, under which the equity split will be 50% (FDIC) and 50% (accredited investor).

A leveraged transaction will be financed through an amortizing note guaranteed by the FDIC offered by the bank in receivership to the LLC. Financing will be offered with leverage of either 4-to-1 or 6-to-1, depending upon certain elections made in the bid submitted by the private investor. If the bid incorporates the 6-to-1 leverage alternative, then performance of the underlying assets will be subject to certain performance thresholds including delinquency status, loss severities and principal repayments. If any one of the performance thresholds is triggered over the life of the note, then all of the principal cash flows that would have been distributed to the equity investors would be applied instead to the reduction of the note until the balance is zero. The performance thresholds will not apply if the bid is based on the lower leverage option.

For more information, click here.

## ANTITRUST

**Intel Appeals EU Fine on Human Rights Grounds**

Intel Corp. has formally appealed the record €1.06 billion ($1.5 billion) antitrust fine that the European Commission levied against the U.S.-based company. According to Intel, one of the grounds for its appeal to the European Court of First Instance is that the fine violates European human rights law because a legal action resulting in such a large penalty should be under the jurisdiction of the EU's criminal courts, rather than conducted as an administrative proceeding. Other companies hit with increasingly large fines from the EU's antitrust regulator have raised the same argument, but so far no appeal has been won on this issue.

In May, the Commission found that Intel violated Article 82 of the EC Treaty, known as the "abuse of dominance" rules, by engaging in the following conduct aimed at excluding its rival Advanced Micro Devices Inc. (AMD) from the market: (i) giving hidden rebates to computer manufacturers on the condition that they bought all or the great

majority of their x86 central processing units (CPUs) from Intel; (ii) making payments to a major retailer on the condition that it would carry only computers containing Intel x86 CPUs; and (iii) making direct payments to computer manufacturers to halt or delay the launch of specific products containing AMD CPUs and to limit the sales channels available to these products.

## EXECUTIVE COMPENSATION

**Proposed Legislation Would Change the Amount and Timing of Stock Option Compensation Deductions**

Last week, U.S. Senators Levin and McCain proposed legislation that, if enacted, would change the amount and timing of corporate tax deductions for stock option compensation. The short title of the bill is telling: "Ending Excessive Corporate Deductions for Stock Options Act."

Currently, both the timing and the amount of the book expense and the tax deduction related to options are disconnected. For book purposes, a corporation generally recognizes the expense, which equals the fair value of the options, on the date of grant. For tax purposes, a corporation takes the deduction when the grantee exercises the option and recognizes taxable income. The tax deduction equals the excess of the fair market value of the underlying stock over the option exercise price. Corporations may recognize a tax deduction only for exercises of nonqualified stock options and for disqualifying dispositions of incentive stock options.

The proposed legislation seeks to connect the book expense and the tax deduction. Such change is intended to reduce the amount of the deduction, but also results in an acceleration of the deduction. The bill grandfathers options granted before the date the bill is enacted, so long as such options were vested before June 15, 2005 (or December 15, 2005, for certain corporations). For all other outstanding options, the bill permits a deduction for the year in which the bill becomes law.

The proposed legislation would also reduce the potential compensation deduction to publicly traded companies by including stock option compensation as compensation subject to the $1 million deduction limit under Internal Revenue Code Section 162(m).

While its is unclear whether this particular legislation will be enacted, this bill is another indication that Congress is taking a hard look at executive compensation practices. This legislation assumes an unfairness because of the disconnect between corporate accounting and corporate taxation; if enacted, however, it will create a new disconnect. Currently, the corporate deduction is the same in amount and timing as the option grantee's recognition of taxable income. In other words, as one taxpayer reports taxable income, another taxpayer receives a corresponding deduction. This would no longer be the case if the proposed legislation becomes law.

To see the full text of the legislation, click here.

## UK DEVELOPMENTS

**FSA Announces Changes to Approved Person Registration Requirements**

On July 27, the UK Financial Services Authority (FSA) confirmed an extension of the approved persons registration regime to include any person performing a "significant influence" function at an FSA authorized firm. The FSA also stated that it would place greater emphasis on the role of senior management, including non-executive directors.

In particular, the FSA has:

- extended the scope and application of CF1 (director function) and CF2 (Non-Executive Director) to include those persons employed by an unregulated parent undertaking or holding company, whose decisions or actions are regularly taken into account by the governing body of a regulated firm;
- extended the definition of the significant management controlled function (CF29) to include all proprietary traders who are not senior managers but who are likely to exert significant influence on a firm; and
- amended the way that the approved persons regime applies to UK branches of overseas firms incorporated outside the European Economic Area.

The changes take effect from August 6, with a transitional period of six months. The FSA regulated firms should immediately commence an assessment of which additional individuals require registration with the FSA in order to ensure that the registration process is completed within the transitional period.

The FSA has indicated that it will announce further proposals in relation to non-executive directors after it has had the opportunity to consider the conclusions of the Walker and Financial Reporting Council reviews. The Walker review of corporate governance of UK banks issued a consultation document earlier in July. The conclusions are due to be published in autumn 2009. The Financial Reporting Council review of the impact of the Combined Code on Corporate Governance, with which UK listed companies are required under the Listing Rules to "comply or explain", is due to be published later in 2009.

Read more.


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