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SEC/Corporate

Delaware Supreme Court Affirms Ovitz Decision, Provides Guidance on Duty of Good Faith

On June 8, the Delaware Supreme Court issued its opinion in the Disney/Ovitz compensation case, affirming the trial court's decision that the Disney directors did not violate their fiduciary duties when they hired and fired Ovitz more than 10 years ago. The Court declined to provide a categorical definition of "good faith," but endorsed a non-exclusive definition of lack of good faith as "intentional dereliction of duty, a conscious disregard for one's responsibilities." The Court also approved the three different examples of bad faith identified by the Chancellor:

- where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation;
- where the fiduciary acts with the intent to violate applicable positive law; or
- where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.

The Supreme Court's decision and the earlier cases include ample discussion of best practices for corporate governance and the exercise of fiduciary duties. While the Supreme Court did not modify the traditional Delaware fiduciary duty analysis (the business judgment rule is alive and well) or impose emerging best practices as a standard of conduct for directors, it did imply that by following best practices, particularly in distributing important board materials prior to the meeting and documenting board action, it should be possible to reduce litigation over detailed factual matters such as what board members knew and the procedures followed.
(*In re The Walt Disney Company Derivative Litigation*, No. 411, 2005 (Del. June 8, 2006))

SEC Chairman Cox Again Addresses Backdating of Stock Options

Last week we reported that Securities and Exchange Commission Chairman Christopher Cox has said that backdating of stock option grants was of "serious concern" to the SEC. On June 14, the *Wall Street Journal* reported that Chairman Cox said in an interview that the SEC's new executive compensation rules would "almost certainly address options backdating explicitly" and that he expects the rule-making process to be completed before the end of summer.
(*Wall Street Journal*, 6/14/06, p.A3)

SEC Close to Naming New Chairman of Public Company Accounting Oversight Board

Following a speech last week, Securities and Exchange Commission Chairman Christopher Cox said he expected to appoint a new chairman of the Public Company Accounting Oversight Board in the coming weeks. The PCAOB has been without a chairman since the resignation of William McDonough late last year. The Wall Street Journal reported on June 14 that the candidates for the position are William Gradison, who has served as acting chairman since December 2005, Jerome H. Powell, a former Treasury Department official, and Mark W. Olson, a Federal Reserve Board governor.
(*Wall Street Journal*, 6/14/06, p.A3)

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Broker Dealer

SEC Issues No-Action Letter on Principal Trading by Investment Adviser

Gardner Russo & Gardner (GRG), an SEC registered investment adviser, filed with the Securities and Exchange Commission a letter requesting that the SEC concur with its view that, in compliance with Section 206(3) of the Investment Advisers Act of 1940, GRG could cross a trade between two private funds of which its controlling person was the general partner. Section 206(3), in relevant part, makes it unlawful for any investment adviser, directly or indirectly, acting as principal for its own account, knowingly to sell any security to, or purchase any security from, a client without disclosing to such client in writing, before the completion of the transaction, the capacity in which the adviser is acting and obtaining the client's consent to the transaction. GRG stated that, pursuant to discretionary investment management agreements, GRG acts as investment manager to various client accounts including two private funds, of which a general partner of GRG is the sole general partner and portfolio manager. GRG wanted to cross trades between these two private funds. GRG was concerned that because of the partner's ownership interest in each private fund, GRG may be acting as principal for its own account, thereby subjecting the proposed transactions to the transaction-by-transaction notice and consent requirements of Section 206(3). The SEC staff's reply stated that Section 206(3) would apply to a cross transaction between a client account and an account of which the investment adviser and/or a controlling person, in the aggregate, own(s) more than 25%, but that Section 206(3) would not apply to a cross transaction between a client account and an account, of which the investment adviser and/or its controlling persons, in the aggregate, own 25% or less. GRG's partner owned 6.237% and 1.4405% ownership interests in the private funds. The staff went on to say that the anti-fraud provisions of the Advisers Act, Sections 206(1) and 206(2), would apply to the crosses and suggested, that, (1) these "cross" transactions and ownership interests of the adviser and its affiliates in the private funds be monitored as part of the firm's written supervisory procedure under Advisers Act Rule 206(4) – 7, and (ii) consideration be given to disclosure of these cross transactions to investors in the private funds.
http://www.sec.gov/divisions/investment/noaction/gardner060706.htm

Chicago Board Options Exchange Proposes to List and Trade Options on Corporate Debt Securities

The Securities and Exchange Commission recently noticed for comment a proposal by the Chicago Board Options Exchange to trade a new type of option, called "Corporate Debt Security Options" (CDSOs), which are options based on corporate bonds. Over-the-counter transactions in corporate debt securities recently have become subject to enhanced transparency and now are reported publicly through the NASD's Trade Reporting and Compliance Engine (TRACE) system. CBOE believes that an exchange-traded alternative may provide a useful risk management and trading vehicle for member firms and their customers. CBOE understands that products similar to the CDSOs proposed in this rule filing are currently traded in the OTC market by hedge funds, proprietary trading firms, and certain large fixed income funds. CBOE believes that CDSOs listed on the Exchange would have three important advantages over the contracts that are traded in the OTC market. First, as a result of greater standardization of contract terms, exchange-listed contracts should develop more liquidity. Second, counterparty credit risk would be mitigated by the fact that the contracts are issued and guaranteed by The Options Clearing Corporation. Finally, the price discovery and dissemination provided by CBOE and its members would lead to more transparent markets. The CBOE proposed comprehensive listing and margin maintenance requirements. CDSOs could be listed for companies whose equity securities are listed on a national securities exchange and whose stock is eligible to be the basis for option trading on the CBOE. Also, the debt underlying a CDSO must be rated not less than Caa by Moody, and CC by S&P, and there must be at least $250 million of the bonds outstanding. Position limits will be based on the float outstanding, excluding amounts held by holders of 10% or more of the debt. Margin and maintenance margin will generally be 100% of current market value of the option plus 10% of contract value minus the amount by which the option is out of the money. Required maintenance calls are based on whether the underlying debt is rated investment grade or is a convertible bond.
http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/E6-9154.pdf

NYSE Announces Trading in New Product – Ipath Exchange-Traded Notes

On June 7, the division of Market Surveillance of the New York Stock Exchange released an information memorandum regarding the trading in a new product – the IPath Exchange Traded Notes (Notes) and simultaneously adopted new Rules 1300B and 1301B applicable to trading in the Notes. The memorandum outlined various rules and policies applicable to trading in the new product, including certain exemptive, interpretive and no-action responses of the Securities and Exchange Commission, as well as highlighting the characteristics and risks of the Notes. The Notes are Index-linked debt securities of Barclays Bank PLC linked to the performance of the GSCI Total Return Index (Index). The Index is a proprietary index on a production-weighted basket of futures contracts on physical commodities traded on trading facilities in major industrialized countries. The Notes provide for a cash payment at maturity or upon earlier exchange at the holder's option, based on the performance of the Index subject to certain adjustments and will trade on the NYSE's equity trading floor. The NYSE's existing equity trading rules will apply to trading in the Notes. Due to the fact that Notes are unsecured debt of Barclays, the Notes are riskier than ordinary unsecured debt securities. The risks of investing in the Notes include, without limitation: noteholders will not benefit from any increase in the value of the Index if such increase is not reflected in the value of the Index on the applicable valuation date; there are restrictions on the minimum number of Notes a noteholder may redeem and on the dates on which redemption may occur; the market value of the Notes may be influenced by many unpredictable factors, including volatile commodities prices, suspension or disruptions of market trading in commodities and related futures may adversely affect the value of the Notes; and there may not be an active trading market in the Notes. The Notes will

be considered securities for purposes of NYSE Rule 3 and are therefore subject to all applicable trading rules.
http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256FCB005E19E88525718600521D3F/$FILE/Microsoft%20Word%20-%20Document%20in%2006-41.pdf

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Banking

OTS Preempts the Field with Respect to Gift Cards

In a detailed letter to an undisclosed federal savings and loan association, the Office of Thrift Supervision reaffirmed its long held position and that of its predecessor the Federal Home Loan Bank Board, that it "totally occupies the field of the regulation of the operations of federal savings associations, including their deposit-taking and lending activities," which in this case includes any five categories of state law provisions purporting to regulate the operations of such associations with respect to gift cards. The OTS opined that "[a]ll five categories of state law provisions are preempted under OTS regulation section 545.2 because the state restrictions impermissibly affect the operations of federal savings associations." The OTS indicated that the state regulations in question "add an additional layer of regulation" and "deny federal savings associations flexibility." In staking out its claim that the area has been preempted by its regulation, the OTS also pointed out that the issuance of gift cards "falls within a federal savings association's funds transfer service authority." The OTS also held that the issuance of gift cards "is subsumed within deposit-related powers" encompassed in section 5(b) of the Home Owners' Loan Act, the OTS enabling statute. Finally, OTS stated that the "issuance of gift cards is an incidental power of federal savings associations." In doing so, the OTS noted that the Office of the Comptroller of the Currency has authorized similar activities for national banks.
http://www.ots.treas.gov/docs/5/56218.pdf

Banking Agencies Issue Host State Loan-to-Deposit Ratios

The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency on June 13 issued the host state loan-to-deposit ratios that the banking agencies will use to determine compliance with section 109 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. In general, section 109 prohibits a bank from establishing or acquiring a branch or branches outside of its home state primarily for the purpose of deposit production. Section 109 also prohibits branches of banks controlled by out-of-state bank holding companies from operating primarily for the purpose of deposit production.

Section 109 provides a process to test compliance with the statutory requirements. The first step in the process 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. A second step is conducted if a bank's statewide loan-to-deposit ratio is less than one-half of the published ratio for that state or if data are not available at the bank to conduct the first step. 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. A bank that fails both steps is in violation of section 109 and is subject to sanctions by the appropriate banking agency.

http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060613/default.htm

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Litigation

No Antitrust Liability for Use of Vertical Restraints to Deter Counterfeiting

Plaintiff drug wholesaler brought a Sherman Act action against a pharmaceutical company arising from a "sole-sourcing" policy, instituted by defendant to address problems arising from the marketing of counterfeit drugs. That policy required distributors to purchase defendant's drugs directly from defendant rather than from wholesalers such as plaintiff. Analyzing this vertical non-price restraint under the "rule of reason", the Court noted that because plaintiff could not demonstrate that "competition as a whole" had been harmed, defendant did not violate the antitrust laws and, further, that the restraints imposed were "understandable" in the circumstances. In addition, in dismissing plaintiff's tortious interference claims, the Court held that plaintiff failed to show that defendant had instituted sole-sourcing to prevent plaintiff from competing or for any reason other than to "protect its business and customers from the dangers of counterfeit drugs." Eveready Wholesale Drugs, Ltd. v. Pfizer, Inc., No. 04 CV 6590(RO), 2006 WL 1564654, (S.D.N.Y. June 5, 2006).

Claim Alleging Fraudulent Scheme to Secure Loan May Proceed

Plaintiff alleged that defendants violated the federal securities laws by inducing him to make a loan to defendant company without disclosing its insolvency. According to plaintiff, defendants made false and misleading statements orally, by e-mail and in materials provided to him regarding the company's financial condition and ability to repay. The Court held that the allegations as to the (1) divergence between internal reports and external statements, (2) defendants' "disregard of the most current factual information"; and (3) defendants' "self-interested motivation" were sufficient to support the strong inference of recklessness required by the PSLRA. Hoagland v. Group Infotech, Inc., No. 5:05-CV-156, 2006 WL 1547282 (W.D. Mich. June 5, 2006).

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