CORPORATE & FINANCIAL

WEEKLY DIGEST

June 17, 2011

BROKER DEALER

SEC Seeks Public Comment on Proposed Amendments to Broker-Dealer Financial Reporting Rule 17a-5

On June 15, the Securities and Exchange Commission proposed amendments to the broker-dealer financial reporting rule in order to strengthen the audits of broker-dealers as well as the SEC's oversight of the way broker-dealers handle their customers' securities and cash.

The first set of amendments relates to the requirement that a broker-dealer file annual financial reports with the SEC, and is designed to, among other things: (1) update the existing requirements of Rule 17a-5; (2) facilitate the ability of the Public Company Accounting Oversight Board to implement oversight of independent public accountants of broker-dealers as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act; and (3) eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually registered as, investment advisers.

The second set of amendments would require broker-dealers that either clear transactions or carry customer accounts to consent to allowing the SEC and their designated examining authorities access to independent public accountants to discuss their findings with respect to annual audits of the broker-dealers and to review related audit documentation, or work papers.

The third set of amendments would enhance the ability of the SEC and examiners of a designated examining authority to oversee broker-dealers' custody practices by requiring broker-dealers to file on a quarterly basis a new Form Custody, which would elicit information as to whether and how a broker-dealer maintains custody of cash and securities of customers and others.

The proposed rules will be published in the *Federal Register* for a 60-day public comment period.

To read the proposed amendments to Rule 17a-5, click here.
To read SEC Chairman Mary Schapiro's opening statement at the SEC Open Meeting: Proposals to Amend Rule 17a-5, click here.

DERIVATIVES

SEC Issues Final Rule on Beneficial Ownership of Securities via Security-Based Swaps

In March, the Securities and Exchange Commission issued a proposed rule that was intended to meet the SEC's obligations under Section 766 of the Dodd-Frank Wall Street Reform and Consumer Protection Act to determine the extent to which a security-based swap will be deemed to involve the acquisition of beneficial ownership of underlying equity securities for the purposes of Sections 13 and 16 of the Securities Exchange Act of 1934. The proposed rule was noncontroversial because in the SEC's view existing Exchange Act Rules 13d-3 and 16a-1 already provide sufficient guidance on this topic, so the rule was technically just a "re-adoption" of those rules without change. The proposed rule has now been reissued without change as a final rule that will take effect on July 16.

The final rule can be found here.

CFTC

CFTC Proposes Order Providing Exemptive Relief from Certain Dodd-Frank Provisions

The Commodity Futures Trading Commission has proposed to issue an order (the Proposed Order) providing temporary relief from certain swap-related provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act that would otherwise take effect on July 16, 2011. The CFTC proposal, which describes the scope of the proposed exemptive relief but does not include the actual text of the Proposed Order, groups the provisions of Title VII as to which the CFTC has regulatory responsibility into four broad categories:

1) provisions that, by their terms, do not take effect without the adoption of implementing rules;
2) self-effectuating provisions that include references to terms that require further definition;
3) self-effectuating provisions that do not reference terms requiring further definition and that repeal current provisions of the Commodity Exchange Act (CEA); and
4) other self-effectuating provisions.

The Proposed Order would provide relief for categories 2 and 3 above. The remaining provisions will take effect either on (1) July 16 (in the case of category 4 above), or (2) upon the effective date of the applicable final implementing rules, which can be no earlier than 60 days following their adoption (in the case of category 1 above).

With respect to "category 2" provisions, the Proposed Order would temporarily exempt persons from complying with many provisions of the CEA that reference the terms "swap," "swap dealer," "major swap participant," or "eligible contract participant," each of which is subject to further rulemaking by the CFTC.

With respect to "category 3" provisions, the Proposed Order would temporarily exempt specified over-the-counter transactions in exempt and excluded commodities, effectively preserving the current regulatory safe harbors applicable to such transactions.

The Proposed Order includes a "sunset" provision, which provides that the exemptive relief will expire upon the earlier of either (1) December 31, 2011, or (2) the effective date of the applicable final rules. If necessary, the CFTC may extend the period beyond December 31. The details of the relief provided by the Proposed Order will be the subject of a forthcoming Katten *Client Advisory*.

The Proposed Order will be open to public comment for a period of 14 days after its publication in the *Federal Register*.

A copy of the Proposed Order and documents identifying the provisions of the Dodd-Frank Act that fall within category 1 and category 4 may be found here.

LITIGATION

Supreme Court Creates Bright Line Test Under Rule 10b-5

The U.S. Supreme Court has found that a party that assists in the drafting and dissemination of a misleading statement related to the sale of a security—but that is not the legal entity ultimately responsible for the statement—will not be subject to liability for securities fraud under Securities and Exchange Commission Rule 10b-5.

Janus Capital Management LLC (JCM) is the investment adviser for a trust of mutual funds known as the Janus Investment Fund (JIF) and assisted with the drafting of JIF prospectuses which stated that JIF funds did not engage in the controversial practice of "market-timing." When allegations surfaced in a lawsuit that certain JIF funds did engage in market-timing, the shares of JIF's corporate parent Janus Capital Group, Inc. (JCG) fell, and investors in JCG sued JCM for securities fraud under SEC Rule 10b-5.

Rule 10b-5 states that it is unlawful for any person to "make" a misleading statement in the sale of a security. Investors argued that JCM, which is a separate legal entity from JIF, had made the misleading statement for purposes of Rule 10b-5 liability by participating in the writing and dissemination of the misleading JIF prospectuses. The district court granted the motion to dismiss and the U.S. Court of Appeals for the Fourth Circuit reversed.

The Supreme Court in a 5-4 decision reversed the Fourth Circuit, holding that, in order for liability to attach under Rule 10b-5, the defendant must have ultimate authority over the content of the statement, including "whether and how to communicate it." Because JIF was the entity that filed the prospectuses with the SEC, JCM could not be subject to liability under Rule 10b-5. A detailed discussion of the case will be the subject of an upcoming Katten *Client Advisory*. (*Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525, 2011 WL 2297762 (U.S.) (June 13, 2011))

Absence of "Hard Numbers" Scuttles Securities Fraud Claims

The U.S. District Court for the Northern District of California dismissed securities fraud claims against a dental device maker based on the plaintiffs' failure to allege sufficient "hard numbers" showing that that the defendants knew their public statements were false when made.

Align Technology, Inc., a medical device company, had settled a lawsuit with a competitor and had—as part of the settlement—agreed to provide dental devices for the competitor's customers free of charge. In public statements issued after the settlement, Align asserted that its business prospects were positive and that the company was "positioned to generate significant top line growth." The company's stock price fell sharply when it later announced that it was shifting its priorities from generating new business to handling a backlog of orders related to the settlement. Investors sued Align for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b–5, alleging that the company and its officers had knowingly made material misrepresentations and omissions in public statements regarding the company's performance.

The U.S. District Court for the Northern District of California granted defendants' motion to dismiss, holding that the investors failed to meet the specificity requirements of Rule 9(b) of the Federal Rules of Civil Procedure and the Private Securities Litigation Reform Act of 1995. Specifically, the court ruled that the investors' allegation that the defendants knew their optimistic appraisals of the company's performance were false was unsupported by "hard numbers" or other "specific information" that demonstrated defendants' scienter with the requisite specificity. The court also held that the company's public statements, such as the statement that the company was "positioned to generate significant top line growth," constituted mere expressions of optimism that did not support a securities fraud claim. (*Wozniak v. Align Technology, Inc.*, No. C-09-3671 MMC, 2011 WL 2269418 (N.D. Cal. June 8, 2011))

EXECUTIVE COMPENSATION AND ERISA

Department of Labor Extends Specified Applicability Dates

The U.S. Department of Labor's Employee Benefit Security Administration (EBSA) published a notice in the *Federal Register* on June 1 that proposed to extend the applicability dates for fiduciary-level fee disclosure regulations (29 CFR 2550.408(b)-2(c)) and related participant-level disclosures (29 CFR 2550.404a-5) under the Employee Retirement Income Security Act to January 1, 2012, and April 30, 2012, respectively.

In July 2010, EBSA had proposed interim final regulations requiring retirement plan service providers to make significant disclosures regarding fees and potential conflicts of interest to plan fiduciaries. The disclosures as originally promulgated were scheduled to apply to contracts and services subsequent to July 16, 2011. EBSA also had published a final rule on October 20, 2010, concerning the disclosure of fee and expense information by plan administrators to participants and beneficiaries, with an effective date of November 1, 2011, with a 60-day transition period for compliance. This participant-level disclosure would require plan administrators of 401(k)s, for example, to disclose plan and fee information to participants as a prerequisite for an individual employee to direct investments under a plan.

EBSA has received numerous requests by participants to extend the compliance deadlines for both disclosure regulations. In February, EBSA announced that it intended to extend the compliance date for the fiduciary-level fee disclosures from July 16, 2011, to January 1, 2012, the formalization of which it has accomplished with the June 1 notice. Once notified of EBSA's intention, however, commentators argued that the participant-level disclosure regulation should follow the fiduciary-level fee disclosures; the disclosures under the latter include relevant information required to be disclosed on the former. EBSA, by its June 1 notice, agreed with such commentators and extended the transition period from 60 days to 120 days, thus giving calendar year plans until April 30, 2012, to make the initial disclosures required under participant-level disclosures. EBSA believes the additional time for compliance will lead to greater compliance and coordination of the two related requirements.

Full text of the notice can be read here.

UK DEVELOPMENTS

FSA Issues Feedback Statement on Product Intervention

In FS11/3, a feedback statement on product intervention issued on June 14, the UK Financial Services Authority (FSA) announced that it will follow a new product intervention approach. It will actively regulate all aspects of the product life cycle and focus on the design, development and management of products. The FSA will continue its work on the later parts of the product value chain (including point-of-sale standards such as financial promotions, disclosure and advice).

The FSA acknowledges that further thinking and analysis will be required as it takes forward this approach in specific areas, and does not intend to consult on any specific new rules immediately. However, the FSA confirms its intention to move toward a single set of rules and guidance on product governance, building on what is already in place (including the treating customers fairly guidance on responsibilities of product providers and distributors for the fair treatment of customers).

FS11/3 is part of a wider debate about the future of financial regulation in the UK and the regulatory philosophy to be adopted by the Financial Conduct Authority (FCA). The FSA will publish shortly a document on the FCA's philosophy and hold a conference in late June 2011 to encourage further discussion on the FCA and what stakeholders expect from it.

Read more.

FSA Obtains Permanent Injunction and Fines and Bans Trader

On June 14, the UK Financial Services Authority (FSA) published the final notice it had issued to Barnett Alexander, a trader and former private client stockbroker. The FSA fined him £700,000 (approximately $1,128,000) for market abuse and banned him from performing any controlled function in an FSA regulated firm.

Following receipt of a suspicious transaction report from another investment firm, the FSA became aware that Mr. Alexander was manipulating the price of certain shares traded on the London Stock Exchange. The firm identified examples of Mr. Alexander's trading strategy after carrying out an internal investigation, and reported the activity to the FSA. The FSA found that Mr. Alexander entered multiple buy and sell orders for equities using direct market access (DMA) services of a number of brokers, often using contracts for difference and spread betting accounts in third party names to disguise his actions.

The FSA concluded that Mr. Alexander's behavior amounted to market abuse under Section 118(5) (market manipulation) of the Financial Services and Markets Act 2000 in that he followed an abusive trading strategy designed to manipulate prices in his favor.

Together with the fine and the ban, Mr. Alexander was also ordered by the FSA to pay £322,818 (approximately $522,000) in restitution to the retail derivatives brokers who suffered loss as a result of his actions. Of the £629,130 (approximately $1,015,000) profit Mr. Alexander made through his abusive behavior, £306,312 (approximately $494,290) (held in trading accounts which he had controlled) will be retained by these brokers.

The FSA has also obtained a permanent High Court injunction prohibiting Mr. Alexander from further market manipulation. (This is the second such injunction in recent weeks—see the May 27 edition of *Corporate and Financial Weekly Digest*.)

The FSA also stated that it encouraged DMA providers to be aware of the risks that DMA presents. It emphasized that DMA providers must put have in place adequate systems and controls to monitor for abusive trading strategies and must report any suspicious activity to the FSA in a timely manner.

Mr. Alexander qualified for a 30% discount on his financial penalty (but not the requirement to make restitution) by agreeing to settle at an early stage of the FSA's investigation and consenting to the court order. Without this discount, the financial penalty on Alexander would have been £1 million (approximately $1.6 million).

Read more.

FSA Obtains Boiler Room Fraud Conviction

On June 14, the UK Financial Services Authority (FSA) announced that it had obtained its first criminal conviction for boiler room fraud. David Mason was sentenced to two years' imprisonment, having pleaded guilty at Southwark Crown Court to: counts of carrying on a regulated activity without authorization; making false or misleading statements, promises or forecasts; and money laundering. He was also disqualified for six years from being a director of any UK company.

The FSA referred to a related regulatory action, in which it had published a final notice (dated December 20, 2010) fining David Sinclair of Axiom Capital Limited, a corporate advisory firm, £68,000 (approximately $109,730) and prohibiting him from holding any significant influence functions in the future. Mr. Sinclair was found to have breached Principle 6 of the FSA's Statements of Principle and Code of Practice for Approved Persons.

In late 2008, Mr. Mason approached Mr. Sinclair asking him to help to set up an investment vehicle, EduVest plc. From November 2008 to May 2009, Mr. Mason coordinated the cold calling and sale of shares in EduVest by unauthorized overseas firms. At least 32 people invested £270,000 (approximately $436,500) in the belief that the company would be listing on the PLUS stock exchange. EduVest was never listed on the PLUS exchange and investors' funds were never used for EduVest business. In addition to setting up EduVest and arranging the deals for the boiler room, Mr. Mason also laundered the proceeds of the operation. The FSA concluded that by failing to exercise due skill, care and diligence to check the purposes for which EduVest was to be used, Mr. Sinclair effectively allowed Mr. Mason to use a bank account under his control to transfer investors' money to Mr. Mason and associated boiler room fraudsters. No regulatory action has been taken against by the FSA against Axiom, which voluntarily compensated all known investor losses.

Read more.

Draft UCITS IV Implementation Regulations Published

On June 13, the UK government published in draft the Undertakings for Collective Investment in Transferable Securities Regulations 2011 implementing the UCITS IV Directive (2009/65/EC) into UK legislation and regulation. Assuming that they are approved by Parliament, the Regulations will be made and come into force on July 1. Changes to the FSA rules in relation to UCITS IV will be published in the near future.

Read more.

UK Government Publishes Legislative Bill on New UK Regulatory Structure

On June 16, HM Treasury published "A new approach to financial regulation: the blueprint for reform," which includes a "white paper" consultation document on its proposals for reform of the UK financial services regulatory structure and a draft Financial Services Bill, the primary legislation that would bring the reforms into effect.

The draft Bill sets out the provisions that will implement the government's structural financial services reforms. These include the measures necessary to establish the new regulatory bodies: the Financial Policy Committee, the Prudential Regulation Authority and the Financial Conduct Authority. The Bill makes very extensive changes to the Financial Services and Markets Act 2000 (FSMA), as well as to the Bank of England Act 1998 and the Banking Act 2009. The government intends to publish a consolidated version of FSMA, showing the proposed amendments, "as soon as possible."

The government has announced that it aims to introduce the Bill formally into Parliament before the end of 2011.

Read more.

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