Katten
Katten Muchin Rosenman LLP
Corporate and Financial Weekly Digest

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SPECIAL BULLETIN: TREASURY DEPARTMENT PUBLISHES FINANCIAL REGULATORY REFORM PLAN

Overview

On June 17, the United States Department of the Treasury (UST) released a white paper (the Plan) outlining the Obama administration's blueprint for financial regulatory reform (available here). The Plan touches on a range of topics covered in sections of the *Corporate and Financial Weekly Digest*, including reform of regulations regarding banking, financial markets, securitization and structured finance, private investment funds, and derivatives.

Revised Supervision of Bank and Non-Bank Financial Firms

The Plan would require all financial firms that are found to pose a systemic threat to the economy's financial stability, whether or not they own banks, to be subject to consolidated supervision and regulation by the Federal Reserve Board, including higher standards on capital, liquidity and risk management. A new regime to resolve nonbank financial institutions whose failure could have serious systemic effects would be developed, and the Federal Reserve's emergency lending authority would be revised to improve accountability.

A new Financial Services Oversight Council, to be chaired by the UST, would be created to facilitate coordination of policy and identify emerging risks in firms and market activities among financial regulatory agencies. The Council would have broad authority to collect information about financial firms and activities in financial markets that may pose a threat to financial stability.

The Plan would also create a new Consumer Financial Protection Agency, which would be an independent entity dedicated to consumer protection in credit, savings, and payments markets, and a new National Bank Supervisor, which would be a single agency with separate status in UST with responsibility for federally chartered depository institutions. This would entail a merger of the Office of the Comptroller of the Currency with the Office of Thrift Supervision. To promote national coordination in the insurance sector, the Plan also would create an Office of National Insurance within UST. However, the Plan would maintain the respective roles of the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) in the supervision and regulation of state chartered banks, and would maintain the authority of the National Credit Union Administration (NCUA) with regard to credit unions.

Regulation of Fund Advisors and Private Funds

The Plan provides that all advisors to hedge funds and other private pools of capital, including private equity funds and venture capital funds, whose assets under management exceed "some modest threshold" should be required to register with the Securities and Exchange Commission under the Investment Advisers Act of 1940. It then proposes that all investment funds advised by an SEC-registered investment adviser should be subject to requirements relating to disclosure to investors, creditors, and counterparties; recordkeeping and regulatory reporting. Although the Plan contemplates that reporting requirements may differ across fund types, it suggests that minimum reporting to regulators, which would be confidential, should cover the amount of assets under management, borrowings, off-balance sheet exposures and such other information necessary to assess whether any fund or fund family is so large, interconnected to other financial market participants or highly leveraged that it poses a threat to financial stability. The SEC would also be granted authority to conduct regular, periodic examinations of such funds to monitor compliance with the proposed requirements, and to share information it receives from the funds with the Federal Reserve. If the Federal Reserve determined that a fund posed a threat to financial stability due to a combination of its size, leverage, and interconnectedness, the Federal Reserve would have the authority to supervise and regulate such fund in the same manner as other institutions that are found to present systemic risk.

The Plan notes that many hedge funds are also registered with the Commodity Futures Trading Commission as commodity pool operators and calls for harmonization of the CFTC's "principles based" approach to regulation with the SEC's "rules based" approach.

Money Market Funds

The Plan calls for the SEC to strengthen the regulatory framework for money market funds (MMFs) to prevent runs on these funds similar to those in September 2008 and tasked the President's Working Group on Financial Markets (PWG) with preparing a report by September 15 considering what changes would be useful in addressing systemic risk. The Plan suggests the SEC consider liquidity buffers, reducing maximum weighted average to maturity of MMF assets, making credit concentration limits stricter, improving credit risk analysis and management of MMFs and giving MMFs the abilty to suspend redemptions in extraordinary circumstances. Although the Plan contained several suggestions on what changes should be considered by the SEC and the PWG, it appeared that the administration has not yet fully determined its recommendations for strengthening regulation of MMFs.

Harmonization of Regulation of Investment Advisors and Broker-Dealers

In the same spirit as the proposals regarding creation and function of a Consumer Financial Protection Agency, the Plan recommends that the SEC be given expanded authority to improve timing and content of disclosure to investors regarding financial products and to align duties for financial intermediaries across financial products. It proposes to establish a fiduciary duty of broker-dealers when they are providing investment advice and otherwise harmonizing regulation of broker-dealers and investment advisors to achieve consistent regulation of persons providing similar products and services. The Plan includes suggestions that (i) both broker-dealers and investment advisors would be required to provide simple and clear disclosure to investors regarding the scope of the terms of their relationships; (ii) certain conflicts of interest and sales practices that are contrary to the interests of investors would be prohibited; and (iii) the fiduciary duties of broker-dealers who provide investment advice about securities to retail investors would be aligned with the fiduciary standard of investment advisors. The SEC would also be authorized to examine and ban forms of compensation that encourage both broker-dealers and investment advisors to put investors into products that are profitable to the intermediary but are not in the investors' best interest.

Enhanced Supervision and Regulation of Securitization Markets

The Plan proposes a number of reforms to address what it calls the "breakdown in market discipline" in the securitization markets. First, originators or sponsors would be required to retain a five percent economic interest in the credit risk of securitized assets to ensure that securitizers have more "skin in the game".

Second, to align the compensation of market participants with the longer term performance of the underlying receivables, the Plan proposes changes such as (i) eliminating the immediate recognition of gain on sale by originators under generally accepted accounting principles (GAAP) and instead require originators to recognize income over time, and (ii) requiring many securitizations to be consolidated on the originators' balance sheets.

Third, the SEC would be given clear authority to require robust ongoing reporting by issuers of asset backed securities (ABS), and to improve and standardize disclosure practices, including requiring ABS issuers to disclose loan-level data, the nature and extent of broker, originator and sponsor compensation, and risk retention for each securitization. The Plan encourages completion of industry initiatives to standardize legal documentation and proposed that the Trade Reporting and Compliance Engine (TRACE) of the SEC and the Financial Industry Regulatory Authority (FINRA) be expanded to include ABS.

Fourth, the SEC would continue its efforts to strengthen the regulation of credit rating agencies, including measures to require that firms have robust policies and procedures that manage and disclose conflicts of interest, differentiate between structured and other products, and otherwise promote the integrity of the ratings process.

Finally, regulators would be required to reduce their use of credit ratings in regulations and supervisory practices, wherever possible.

Comprehensive Regulation of OTC Derivatives Including Credit Default Swaps

OTC derivatives, including credit default swap (CDS) markets, would be subject to a regulatory framework that would (i) impose recordkeeping and reporting requirements on all OTC derivatives; (ii) impose a prudential regulatory structure on all OTC derivative dealers; and (iii) require standardized OTC derivatives to be centrally cleared through regulated clearinghouses and executed on regulated and transparent trading venues.

The CFTC and SEC would have clear authority to police and prevent fraud, market manipulation and other market abuses involving all OTC derivatives and, further, the Plan would give the CFTC authority to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets.

CFTC-SEC Harmonization

To eliminate regulatory gaps and inconsistencies in the regulation of derivatives products, the Plan would require the CFTC and the SEC to submit a report to Congress by September 30 with recommendations to eliminate differences in statutes and regulations with respect to similar types of financial instruments that are not essential to achieving investor protection, market integrity, or price transparency.

Oversight of Payment, Clearing and Settlement Systems

The Federal Reserve Board would be assigned oversight of all systemically important payment, clearing, and settlement systems. In the case of clearing and settlement systems for regulated markets, the Federal Reserve Board would be required to coordinate its oversight with the CFTC or the SEC, as appropriate, which will remain the primary regulators of such systems.

Oversight of the Insurance Sector

The Plan indicates that the Obama administration will introduce legislation to create and Office of National Insurance (ONI) within UST to coordinate the fragmented state regulation of insurance and improve the ability of U.S. insurance companies to participate in the international insurance markets. ONI would be tasked with gathering information, recommending to the Federal Reserve insurance companies that should be supervised as posing a systemic risk, suggesting changes to the insurance regulatory system and increasing national uniformity, among other duties. The Plan also contemplates the possibility of federally chartered insurance companies and more effective and uniform action by the states.

Frannie Mae, Freddie Mac and the FHLB

While discussing briefly these housing finance government sponsored entities, the Plan does not make any specific recommendations and instead indicates that UST will report on government sponsored entities at the time of the President's 2011 budget release.

International Cooperation

Finally, the Plan would focus on reaching international consensus on four core issues: (i) regulatory capital standards; (ii) oversight of global financial markets; (iii) supervision of internationally active financial firms; and (iv) crisis prevention and management. Foreign firms whose U.S. operations are deemed to pose risks to the U.S. financial system would be subject to the same prudential regulation and oversight as U.S. firms that pose risks to the U.S. financial system.

SEC/CORPORATE

Congressman Peters Introduces Corporate Governance Legislation

On June 12, Congressman Gary Peters (D-MI), a member of the House Financial Services Committee, introduced the Shareholder Empowerment Act of 2009, which would require the Securities and Exchange Commission to adopt new rules governing the nomination and election of directors, executive compensation, and related corporate governance matters.

The proposed legislation echoes several of the initiatives set forth in Senator Charles Schumer's (D-NY) Shareholder Bill of Rights Act of 2009, including majority voting requirements for the election of uncontested director nominees, increased shareholder access to issuer proxy materials, heightened independence requirements for board chairpersons and "say on pay" provisions. The Shareholder Empowerment Act also corresponds in several respects with the SEC's recent proposal to permit broader shareholder access to issuer's proxy materials and legislative proposals initiated by the Obama administration in support of "say on pay" and similar regulation of executive compensation.

In several respects, the Shareholder Empowerment Act is more expansive than Sen. Schumer's proposed legislation. In addition to the governance changes noted above, if enacted, the Shareholder Empowerment Act would eliminate broker discretionary voting in uncontested director elections, impose an independence requirement for compensation advisors and consultants engaged in connection with executive compensation arrangements, require issuers to adopt and disclose policies allowing them to claw-back executive compensation in circumstances involving fraud or restatement of financial statements, eliminate severance for executives terminated for “poor performance,” and enhance disclosure of performance targets tied to executive compensation.

For additional information regarding recent proposals related to shareholder access to issuer proxy materials and executive compensation, please see the June 12 edition of *Corporate and Financial Weekly Digest* and Katten's June 19 *Client Advisory*.

To view the text of the Shareholder Empowerment Act of 2009, click here.

LITIGATION

Court Holds Employee Stock Option Plan Not a Security

Plaintiff brought an action against Coty Inc., his former employer, alleging violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, based on Coty's purported misrepresentations regarding stock options granted to plaintiff under an employee benefit program. Defendants moved to dismiss, arguing that neither the benefit plan itself nor the options granted to plaintiff were “securities” as defined in the Exchange Act.

The District Court began its analysis by noting that an element of plaintiff's securities law claims required that the alleged fraud occur in connection with the purchase or sale of a security. The Court first ruled that the employee benefit plan was not a “security” because it did not constitute an “investment contract” under the federal securities law. The plan in question was “noncontributory” and, under established precedent, the Court ruled that only voluntary, contributory plans have the characteristics required to be deemed “securities.”

The Court next concluded that the plaintiff's claim of fraud in connection with the options themselves was also flawed. The Court recognized that the options were “cognizable securities” under the Exchange Act. However, the Court ruled that there was never a purchase or sale of the options and that the alleged fraud did not concern their issuance, but rather their decrease in value based upon an interpretation of the plan document that the plaintiff challenged. Accordingly, and after noting the Second Circuit's reluctance to transform what are fundamentally breach of contract claims into securities claims, the Court dismissed plaintiff's federal securities law claim. (*Fishoff v.Coty Inc.*, 2009 WL 1585769 (S.D.N.Y.))

Short Swing Profits Claim Barred by Statute of Limitations

Plaintiff, a shareholder of Brocade Communications System, Inc. (Brocade), brought an action on behalf of Brocade to recover “short swing profits.” Plaintiff alleged that four of Brocade's top officers received these profits in violation of Section 16(b) of the Securities Exchange Act of 1934 because defendants sold shares of Brocade stock within six months of their receipt of options for those shares from the company. The United States District Court for the Northern District of California dismissed the action for failure to state a claim, without resolving defendant's alternative argument that the claim was time barred.

On appeal, after questioning whether the basis of the District Court's ruling was correct, the Ninth Circuit considered the statute of limitations issue. Defendants argued that the dismissal should be upheld because plaintiff failed to bring the action within the applicable two year time period. Plaintiff argued that the statute of limitations should be tolled because defendants, who as insiders were required to publicly disclose their sales under Section 16(a), falsely reported that their sales were exempt from Section 16(b) because they had been approved by Brocade's board of directors. Plaintiff challenged defendant's position, claiming that because the options had been “backdated,” they were not approved “in advance” by the Board, which according to plaintiff, was required in order for the exemption to apply.

In upholding the dismissal of plaintiff's action, the Ninth Circuit rejected the argument that the public filing of the allegedly erroneous Section 16(a) reports tolled the period of limitations. The Court reasoned that granting a toll would essentially eliminate the period of limitations in any Section 16(b) action in which an exemption to Section 16(b) was implicated. If a toll were permitted whenever the legitimacy of the claimed exemption was questioned, a full lawsuit would be required to determine if the exemption was validly claimed in order to determine whether a toll was permitted. Recognizing that permitting a lawsuit to proceed in these circumstances would “nullify” the limitations period whenever an exemption was challenged, the Court held that the limitations period begins to run when the transaction in question is disclosed regardless of whether the disclosure erroneously claims an exemption. (*Roth v. Reyes*, No. 07-16805, 2009 WL 1564228 (9th Cir. 2009))

BROKER DEALER

FINRA Proposes to Adopt Certain NASD Rules as Part of Consolidated FINRA Rulebook

In a May 1 filing with the Securities and Exchange Commission, the Financial Industry Regulatory Authority proposed rule changes to adopt certain National Association of Securities Dealers, Inc. (NASD) rules, without substantive changes, as FINRA rules in the consolidated FINRA rulebook. The proposed rule change would renumber NASD Rule 2220 (Options Communications) as FINRA Rule 2220, NASD Rule 2441 (Net Transactions with Customers) as FINRA Rule 2124, and NASD Rule 2460 (Payments for Market Making) as FINRA Rule 5250. In addition, the proposed rule change would combine NASD Rules 3510 (Business Continuity Plans) and 3520 (Emergency Contact Information) into FINRA Rule 4370. The SEC is accepting comments through July 6 on these proposed rule changes.

Read more.

Options Exchanges File Rules for New Options Linkage Plan

A number of options exchanges made filings in a step toward replacing the current, stand-alone intermarket options linkage plan. The new plan effectively applies the Regulation NMS price-protection provisions to the options markets. Under the plan, each participating exchange will be required to adopt new rules that are "reasonably designed to prevent trade-throughs." These rules will replace the linage rules currently in effect on the various exchanges. The proposed rules provide for a number of exceptions to the prohibition on trade-throughs, including an intermarket sweep order.

Click for press releases concerning:
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NYSE Arca, Inc.
NYSE Amex LLC

Establishment of Fees for Orders Utilizing NASDAQ "Flash" Functionality

The NASDAQ Stock Market LLC (NASDAQ) proposed a rule change to establish the fees it will charge NASDAQ members that trade equities in the NASDAQ Market Center using the "Flash" functionality set forth in NASDAQ Rule 4758(a)(1)(A). The Flash functionality provides an optional pre-routing display period for orders using NASDAQ's DOT, SCAN or STGY routing strategies. When voluntarily employed by a member, the Flash-enabled routing strategies will first execute to the maximum extent possible in NASDAQ's book, before displaying the remaining share amounts and prices to NASDAQ market participants and market data vendors for not more than one half of one second. If at the end of the Flash period the order is not executed or is partially executed, NASDAQ will route the order automatically to the appropriate venue selected by the chosen routing strategy. This proposed rule change, which is effective upon filing, will become operative when the Flash functionality becomes available.

Read more.

FINANCIAL MARKETS

SEC Chair Outlines Current Issues Under Consideration by the Commission

In her Keynote Address at the Annual Awards Dinner of the New York Financial Writers' Association in New York on June 18, the Securities and Exchange Commission Chairman Mary Schapiro delivered prepared remarks and responded to audience questions about the regulatory reform proposals and the current focus of the SEC. The Chairman cited four areas in which the SEC is considering the need for reform or additional regulatory oversight. These are (i) disclosure and operation of Target Date Funds; (ii) offering and ongoing reporting relating to municipal securities; (iii) fiduciary duties of broker-dealers that provide investment advice to retail investors; and (iv) the operation and effect on the public trade execution systems of "dark pools," which, she explained, are alternative trading systems that do not display their prices in the public quote stream. In response to audience questions, Schapiro indicated that the SEC and Commodity Futures Trading Commission are prepared to work together on harmonization, where appropriate, of futures and securities regulation and on regulation of OTC derivatives as requested in the Department of the Treasury's financial regulatory reform plan.

Katten partner Marilyn Selby Okoshi was present at Chairman Schapiro's remarks.

CFTC

CFTC Seeks Comment on Whether ICE Contract Performs Significant Price Discovery Function

On June 9, the Commodity Futures Trading Commission issued a Notice of Intent, pursuant to CFTC Rule 36.3(c)(3), to undertake a determination whether the Henry Financial LD1 Fixed Price contract (Contact) traded on Intercontinental Exchange, Inc. (ICE) performs a significant price discovery function. If the CFTC determines that the Contract serves such a function, ICE, an exempt commercial market, would be required to comply with the core principles set out in section 2(h)(7)(c) of the Commodity Exchange Act and Part 36 of the CFTC rules, including position limit and large trader reporting requirements. The comment period closes July 13.

Read more.

INVESTMENT COMPANIES AND INVESTMENT ADVISORS

Senator Reed Introduces Bill to Eliminate Private Advisor Exemption from Registration

On June 16, U.S. Senator Jack Reed introduced the Private Fund Transparency Act of 2009 that proposes to amend the Investment Advisers Act of 1940 by eliminating the "private adviser" exemption from registration. Currently, an investment advisor with fewer than fifteen clients that neither holds itself out generally to the public as an investment advisor nor acts as an investment advisor to any registered investment company is exempt from registration with the Securities and Exchange Commission. If passed in its current form, an investment advisor with a single client, or an investment advisor that manages a single hedge fund, private equity fund or other pooled investment vehicle, would be required to register with the SEC if the investment advisor had more $30 million under management. In place of the private advisor exemption, the bill would create a new exemption for a "foreign private adviser" that (i) has no place of business in the United States; (ii) has fewer than 15 clients in the United States; (iii) has assets under management attributable to clients in the United States of less than $25,000,000; and (iv) neither holds itself out generally to the public in the United States as an investment advisor, nor acts as an investment advisor to any registered investment company. The bill also would give the SEC the authority to require registered investment advisors to maintain records and submit reports to relevant federal agencies, including keeping such records and submitting any required reports with respect to any private funds advised by the registered advisor, to apply different requirements to different classes of persons and to ascribe meanings to terms in the Act (such as the term "client") used in different sections in any manner it sees fit.

To view the text of the bill click here.

FINRA Notes Obligations in Marketing Leveraged and Inverse ETFs

On June 11, the Financial Industry Regulatory Authority issued Regulatory Notice 09-31, reminding firms of their obligations with respect to sales practices relating to leveraged and inverse exchange-traded funds (ETFs). Inverse and leveraged ETFs generally track the leveraged performance or the inverse performance of an index, meaning they aim to produce returns equal to a multiple, inverse or multiple inverse of the target index. Most inverse and leveraged ETFs are structured to accomplish this goal on a daily basis only and they "reset" at the end of each trading session. Over longer periods of time, particularly when markets are volatile, the impact of compounding leads to performance that may differ significantly from the stated daily objective. In other words, despite tracking a multiple or inverse of the target index successfully on a daily basis, the fund performance may vary significantly from that multiple or inverse of the target index over a longer period of time.

Regulatory Notice 09-31 reminds firms that sales practice obligations dictate that they (i) fully understand the product they are recommending; (ii) recommend the product only to customers whose financial situation and goals are in line with such a product; (iii) ensure sales materials fairly and accurately represent the product; and (iv) maintain adequate supervisory procedures to meet these obligations.

Read more.

STRUCTURED FINANCE AND SECURITIZATION

FRBNY Appoints Trepp as Collateral Monitor and Announces No June CMBS Loan Requests

On June 16, the Federal Reserve Bank of New York (FRBNY) announced that there were no loan requests with respect to the initial June 16 CMBS loan subscription date for the Term Asset-Backed Securities Loan Facility (TALF). Separately, the FRBNY issued revised TALF Terms and Conditions and Frequently Answered Questions documents stating that it had selected Trepp, LLC to act as collateral monitor for TALF as it relates to newly issued CMBS. The FRBNY also clarified that Trepp will not establish policies or make decisions for the FRBNY, including decisions whether to reject a CMBS as collateral for a TALF loan or to exclude loans from mortgage pools, and that the FRBNY may use the services of one or more collateral monitors in connection with TALF. There were no other changes to the TALF Terms and Conditions or TALF Frequently Answered Questions.

Read more.

For more information, contact:

SEC/CORPORATE		
Robert L. Kohl	212.940.6380	robert.kohl@kattenlaw.com
Jonathan D. Weiner	212.940.6349	jonathan.weiner@kattenlaw.com
Robert J. Wild	312.902.5567	robert.wild@kattenlaw.com
LITIGATION		
Alan R. Friedman	212.940.8516	alan.friedman@kattenlaw.com
Brian L. Muldrew	212.940.6581	brian.muldrew@kattenlaw.com
FINANCIAL SERVICES		
Janet M. Angstadt	312.902.5494	janet.angstadt@kattenlaw.com
Henry Bregstein	212.940.6615	henry.bregstein@kattenlaw.com
Gary N. Distell	212.940.6490	gary.distell@kattenlaw.com
Daren R. Domina	212.940.6517	daren.domina@kattenlaw.com
Kevin M. Foley	312.902.5372	kevin.foley@kattenlaw.com
Jack P. Governale	212.940.8525	jack.governale@kattenlaw.com
Patricia L. Levy	312.902.5322	patricia.levy@kattenlaw.com
Robert M. McLaughlin	212.940.8510	robert.mclaughlin@kattenlaw.com
Marilyn Selby Okoshi	212.940.8512	marilyn.okoshi@kattenlaw.com
Ross Pazzol	312.902.5554	ross.pazzol@kattenlaw.com
Kenneth M. Rosenzweig	312.902.5381	kenneth.rosenzweig@kattenlaw.com
Fred M. Santo	212.940.8720	fred.santo@kattenlaw.com
James Van De Graaff	312.902.5227	james.vandegraaff@kattenlaw.com
Meryl E. Wiener	212.940.8542	meryl.wiener@kattenlaw.com
Lance A. Zinman	312.902.5212	lance.zinman@kattenlaw.com
Krassimira Zourkova	312.902.5334	krassimira.zourkova@kattenlaw.com
BANKING		
Jeff Werthan	202.625.3569	jeff.werthan@kattenlaw.com
Terra K. Atkinson	704.344.3194	terra.atkinson@kattenlaw.com
Christina J. Grigorian	202.625.3541	christina.grigorian@kattenlaw.com
Adam Bolter	202.625.3665	adam.bolter@kattenlaw.com
STRUCTURED FINANCE AND SECURITIZATION		
Eric S. Adams	212.940.6783	eric.adams@kattenlaw.com
Hays Ellisen	212.940.6669	hays.ellisen@kattenlaw.com
Reid A. Mandel	312.902.5246	reid.mandel@kattenlaw.com

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Katten Muchin Rosenman LLP www.kattenlaw.com

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK PALO ALTO WASHINGTON, DC