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BROKER DEALER

SEC Seeks Public Comment on Proposed Rules for Clearly Erroneous Trades

On June 17, the Securities and Exchange Commission announced that the exchanges and the Financial Industry Regulatory Authority filed proposed rules to implement a series of thresholds for breaking erroneous trades. Currently, the exchanges and Electronic Communications Networks all treat clearly erroneous trades differently with respect to thresholds and timing for reporting such trades. The current proposal comes in response to the May 6 market disruption and complements the SEC's recent approval of stock-by-stock circuit breakers. "Establishing clear and transparent standards for breaking trades helps provide certainty in advance as to which trades will be broken, and allows market participants to better manage their risks," said SEC Chairman Mary Schapiro.

Under the proposed rules for stocks in the S&P 500 Index, stock trades would be broken if the transaction price falls too far below the last sale price:

- For stocks priced $25 or less, trades would be broken if the trades are at least 10% away from the circuit breaker trigger price.
- For stocks priced $25 to $50, trades would be broken if the trades are 5% away from the circuit breaker trigger price.
- For stocks priced more than $50, trades would be broken if the trades are 3% away from the circuit breaker trigger price.

For all stocks not included in the S&P 500 Index, stock trades would be broken at specified levels for events involving multiple stocks depending on how many stocks are involved:

- For events involving between 5 and 20 stocks, trades would be broken that are at least 10% away from the last sale price.
- For events involving more than 20 stocks, trades would be broken that are at least 30% away from the last sale price.

The proposed rules, which are proposed to be in effect on a pilot basis until December 10, will be published in the *Federal Register* for a 21-day public comment period.

To read the SEC's order addressed to FINRA requesting comment, click here.

See also the June 11 edition of *Corporate and Financial Weekly Digest* discussing the SEC's approval of rules requiring the exchanges and FINRA to implement stock-by-stock circuit breakers.

CFTC

CFTC Provides Clarification on Regulation 1.25 with Respect to Suspension of Money-Market Mutual Fund Redemptions

In a letter to the Chicago Mercantile Exchange dated June 3, the Commodity Futures Trading Commission has provided guidance on the potential impact of newly adopted Securities and Exchange Commission Rule 22e-3 on the investment of customer segregated funds, by futures commission merchants (FCMs) and derivatives clearing organizations (DCOs), in money-market mutual funds (MMMFs) under CFTC Rule 1.25. SEC Rule 22e-3 authorizes MMMFs to suspend redemptions if necessary to facilitate an orderly liquidation of the fund.

Rule 1.25 generally permits customer segregated funds to be invested in an MMMF, subject to the requirement that any such MMMF be "legally obligated to redeem an interest and to make payment in satisfaction thereof by the business day following a redemption request." Among the exceptions to this next-day redemption requirement is the existence of "emergency conditions," as "set forth in Section 22(e) of the Investment Company Act of 1940." Section 22(e) allows the SEC to "by rule or regulation determine the conditions under which (i) trading shall be deemed to be restricted and (ii) an emergency shall be deemed to exist.…"

The CFTC has determined that SEC Rule 22e-3 qualifies as a "rule or regulation" under Section 22(e) describing when an emergency condition will be deemed to exist. Consequently, FCMs and DCOs may continue to invest customer funds in an MMMF that otherwise qualifies as a permitted investment under Rule 1.25, notwithstanding the right of the MMMF to suspend redemptions to facilitate an orderly liquidation of the fund.

The CFTC Staff Letter providing the interpretation can be found here.

CFTC Grants Exemption from Foreign Futures and Options Regulations to Member Firms Designated by Bursa Malaysia

The Commodity Futures Trading Commission, acting pursuant to CFTC Regulation 30.10, has granted an exemption from certain of the CFTC's foreign futures and options regulations to firms designated by Bursa Malaysia Derivatives Berhad (Bursa Derivatives) who offer and sell foreign futures and options on futures contracts to customers located in the United States.

In granting the exemption, the CFTC determined that the regulatory framework established by Malaysian law and the rules of Bursa Derivatives is comparable to that imposed by the Commodity Exchange Act and CFTC regulations. The exemption is limited to brokerage activities undertaken on behalf of customers located in the United States with respect to transactions on or subject to the rules of Bursa Derivatives for products that customers located in the United States may trade, and is conditioned on an eligible firm making and maintaining certain representations to the National Futures Association relating to compliance with applicable provisions of Malaysian law and the rules of Bursa Derivatives.

The *Federal Register* notice of the order can be found here.

LITIGATION

Securities Brokers Required to Disclose Bonus Commissions

Hampton Porter Investment Bankers, LLC, was a registered securities broker-dealer whose owners and top-level managers were found to have engaged in a "pump and dump" scheme. According to the U.S. Court of Appeals for the Ninth Circuit, certain publicly traded companies granted Hampton Porter (or its owners) large blocks of free, or deeply discounted, stock. In return, Hampton Porter drove up the price of these thinly traded stocks by pressuring clients into purchasing shares, by discouraging clients from selling shares, and by refusing in some instances to execute clients' sales orders. In the meantime, Hampton Porter sold its shares at artificially inflated prices.

The government indicted Hampton Porter's owners, managers and senior brokers, alleging that each participated in a securities fraud conspiracy. Hampton Porter's owners and managers pleaded guilty, but the senior brokers, including defendants Bryan Laurienti, Curtiss Parker, Donald Samaria, David Montesano, and Michael Losse, pleaded not guilty. The senior brokers conceded that a fraudulent scheme existed but argued that they had not

joined the conspiracy. The jury acquitted Mr. Losse, but found the remaining brokers guilty on all counts. The Ninth Circuit affirmed defendants' convictions but vacated their sentences and remanded for further proceedings due to technical errors in the trial court's application of applicable sentencing guidelines.

While the Ninth Circuit addressed a number of defenses to the government's claims, the court's discussion on the duties of brokers to disclose bonus commissions to their clients is particularly noteworthy.

Count One of the indictment alleged that defendants conspired to commit securities fraud in violation of 18 U.S.C. Section 371, by individually acting, or aiding and abetting an act, in furtherance of the fraudulent scheme in connection with client purchases of "house stocks." Specifically, the government alleged that Hampton Porter failed to disclose to its customers that company brokers received "bonus commissions" when a client purchased shares of four targeted stocks, referred to by defendants as "house stocks." These bonus commissions were potentially many times larger than the ordinary commission (which was disclosed to customers) that the brokers would be paid for the sale of "non-house stocks." Further, the brokers could lose those their bonus commissions if clients sold their "house stocks."

To prove the conspiracy count, the government had to show that a conspiracy existed, that a particular defendant knew the purposes of the conspiracy and joined the conspiracy, and that some member of the conspiracy (including the owners and managers) performed an overt act in furtherance of the conspiracy. The court found that the undisclosed bonus commissions—even if not independent criminal conduct—were nevertheless sufficient circumstantial evidence of defendants' agreement to join the conspiracy.

In affirming the convictions, the court held that a broker has a duty to disclose *material* information about a stock purchase if the broker and client have a fiduciary relationship or a similar relationship of trust and confidence. Notably, the court strongly suggested that it might uphold criminal liability even in the absence of a trust relationship where a defendant fails to disclose material information about bonus commissions (e.g., where, as here, a defendant discloses the ordinary commission applicable to most stocks, but not the bonus commission applicable to four "house stocks"). (*U.S. v. Laurienti*, 2010 WL 2473573 (C.A.9 (Cal.) June 16, 2010))

Allegations of Corporate "Hijacking" State Fraud Claim Against Corporate Attorney

The U.S. District Court for the Southern District of New York recently denied defendant Nicolette Loisel's motion to dismiss a Securities and Exchange Commission complaint against her and four co-defendants, which alleged, among other things, violations of Section 10(b) of the Securities Exchange Act and Rule 10(b)(5), promulgated thereunder.

In its complaint, the Securities and Exchange Commission alleged that Ms. Loisel and co-defendant, Roger Shoss, were part of a "complex securities fraud ring" that carried out a scheme between 2003 and 2007, in which nearly two dozen defunct public corporations were "hijacked." The scheme included a series of maneuvers to bring void or inactive corporations back into existence, such as changing the corporate names and obtaining new Committee on Uniform Securities Identification Procedures (CUSIP) numbers and ticker symbols for the corporations. The SEC alleged that defendants made fraudulent statements to various secretaries of state, the Nasdaq Corporate Data Operations and the Standard & Poors CUSIP Bureau, and improperly utilized certain exemptions from securities registration requirements. The defendants allegedly caused the "hijacked" corporations to offer and improperly sell unregistered shares into the market.

In moving to dismiss the SEC's complaint, Ms. Loisel argued that the SEC had not pled its claim of securities fraud with the heightened level of particularity required under Federal Rule of Civil Procedure 9(b), which requires that a complaint (1) specify the statements that the plaintiff contends were fraudulent; (2) identify the speaker; (3) state where and when the statements were made; and (4) explain why the statements were fraudulent.

The court found that the complaint "amply complies" with the heightened pleading standard required for fraud claims. Specifically, the court found that the following allegations sufficiently particularized the SEC's fraud charges: (1) Ms. Loisel took part in a fraudulent scheme in which her role included making false and fraudulent statements in Transfer Agent Verification forms, in opinion letters, and in documents sent to the CUSIP Bureau and Nasdaq Reorganization; (2) Ms. Loisel opined that corporations were exempt from registration requirements of the securities laws based on information that she knew to be false; (3) Ms. Loisel sought to change CUSIP identification numbers and stock tickers in order to pass off private corporations as reactivated public corporations in an effort to allow the sale of unregistered stock; and (4) Ms. Loisel knew that a representation in "Rule 504

opinion letters"—that all investors of the relevant securities resided in Texas—was false at the time she made the representation.

The court rejected the argument that the SEC's allegations were insufficient for failing to identify the date of the alleged misrepresentations, instead finding that the above allegations provided "detailed notice of the charges leveled against [Ms. Loisel]." (*S.E.C. v. Boock*, 2010 WL 2398915 (S.D.N.Y. June 15, 2010))

BANKING

Banking Agencies Issue Final Guidance on Executive Compensation

On June 21, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation (collectively, the Banking Agencies) issued final guidance regarding incentive compensation arrangements at financial organizations that are intended to be consistent with safe and sound practices (Guidance). The Guidance applies to all the banking organizations supervised by the Banking Agencies, including national banks; state member banks; state nonmember banks; savings associations; U.S. bank holding companies; savings and loan holding companies; the U.S. operations of foreign banks with a branch, agency or commercial lending company in the United States; and Edge and agreement corporations (each, a Covered Institution). With regard to scope within each Covered Institution, the Guidance applies to senior executives as well as employees who, either individually or as part of a group, have the ability to expose the banking organization to material amounts of risk.

The Guidance is the result of the Federal Reserve's analysis of incentive compensation practices at large, complex banking organizations. In conducting this review, the Federal Reserve noted the following deficient areas: (1) many firms need better ways to identify employees that expose banking organizations to material risk; (2) many firms are not fully capturing the risks involved in incentive compensation; (3) many firms are using deferral arrangements to adjust for risk, but are not tailoring such deferrals according to the type and duration of the risk; and (4) many firms do not have adequate mechanisms to evaluate whether established practices are successful in balancing risk.

Three key principles are identified in the Guidance: (1) incentive compensation arrangements at a banking organization should provide employees incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk; (2) these arrangements should be compatible with effective controls and risk management; and (3) these arrangements should be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

The Guidance also states that the Federal Reserve will prepare a report in consultation with the other Banking Agencies at the conclusion of 2010 on trends and developments in compensation practices at banking organizations.

For more information, click here.

INSURANCE CAPITAL MARKETS

House-Senate Conferees on Financial Reform Agree to Scope of Insurance Regulation

Last week, through negotiations among the House of Representatives and Senate conferees on the financial services reform legislation, agreement was reached on the scope of a proposed insurance office within the U.S. Treasury Department to be led by a newly appointed Director.

The Senate Banking Committee, in its press release on progress on the draft legislation, reported that the new office would be called the Federal Insurance Office, the name selected in the House version of the measure. This office would monitor the insurance industry, undertake a study on ways to modernize insurance regulation and provide recommendations to Congress. The office would also examine the extent to which traditionally underserved communities, minorities, and low- and moderate-income persons have access to affordable insurance products. The office would have no authority over health insurance.

In the international arena, the new Federal Insurance Office would have the power to pre-empt state insurance measures that are found to discriminate against non-U.S. insurers subject to certain bilateral or multilateral agreements between the U.S. and foreign governments or regulatory authorities regarding prudential matters. Such a finding would be reported to certain House and Senate Committees, and the relevant state would also be notified of the potential pre-emption and offered the opportunity to comment.

One of the most controversial sections of the original bill, which has been opposed by state insurance regulators, authorized the new Federal Insurance Office to recommend that an insurer and its affiliates be designated an entity that could pose a systemic risk and, accordingly, subject to regulation as a non-bank financial company by the Federal Reserve. It is unclear at this time whether that section will undergo further amendment in the negotiations among the congressional conferees.

For additional information and updates on the financial reform bill conference process, click here.

EXECUTIVE COMPENSATION AND ERISA

Health Care Reform: Guidance Issued Regarding “Grandfathered” Plan Status

Certain provisions of the Patient Protection and Affordable Care Act (PPACA), as amended by the Health Care and Education Reconciliation Act of 2010, do not apply to “grandfathered” group health plans, or have a delayed effective date for such plans. A grandfathered group plan is generally a plan in which an individual was enrolled on March 23, 2010 (the date of PPACA’s enactment). However, PPACA did not offer any insight on what would cause a plan to lose its grandfathered status, leading many employers to be hesitant to make any changes to their plans for fear of losing such status.

On June 14, the federal government issued guidance (Guidance) on grandfathered plan status, which, among other things, provides the reasons a plan in existence on March 23, 2010, will nonetheless lose its grandfathered status. Specifically, this status may be lost if:

- the plan eliminates all or substantially all benefits to diagnose or treat a particular condition;
- the plan increases a percentage cost-sharing requirement (e.g., coinsurance requirement);
- the plan increases a fixed-amount cost sharing requirement (e.g., deductible, out-of-pocket limit) other than a co-pay more than 15 percentage points over the medical inflation rate (e.g., a 36% deductible increase if medical inflation is 20%);
- the plan increases a fixed-amount co-pay more than certain thresholds over the medical inflation rate;
- the employer decreases its contribution rate more than five percentage points below its contribution rate as of March 23, 2010;
- the plan adds or decreases certain annual or lifetime limits; or
- the plan is not a collectively-bargained plan and enters into a new insurance policy, even if the new policy provides the same coverage and cost-sharing as the old insurance policy (policy renewal is not considered entering into a new policy).

Because the changes above are the only changes that may cause a plan to lose its grandfathered status, a grandfathered plan may generally modify its provisions to comply with federal/state law or voluntarily comply with PPACA, or change its third-party administrator.

In addition, the Guidance imposes disclosure and recordkeeping requirements on a plan in order to maintain its grandfathered status. All plan materials provided to plan participants describing the plan’s benefits must include a statement that the plan is grandfathered and list contact information for questions and complaints (the Guidance provides model language). To comply with the recordkeeping requirement, the plan must maintain records documenting the terms of the plan’s coverage as of March 23, 2010 (as well as any other supporting documentation) and make those records available for examination upon request.

The Guidance can be found here.

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