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CORPORATE & FINANCIAL
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BROKER DEALER

SEC Approves FINRA's Consolidated Financial Responsibility and Related Operational Rules

The Securities and Exchange Commission approved the Financial Industry Regulatory Authority's proposed consolidated rules regarding financial responsibility and related operational rules. FINRA Rules 4150, 4311, 4522 and 4523 (Consolidated Rules) are partially derived from and replace certain provisions in the New York Stock Exchange and National Association of Securities Dealers Rules. The Consolidated Rules, together with those consolidated financial responsibility rules that the SEC approved in late 2009, were adopted to permit FINRA to better effectuate "its financial and operational surveillance and examination programs." The Consolidated Rules are effective as of August 1.

A summary of each of the Consolidated Rules follows:

FINRA Rule 4150 (Guarantees by, or Flow Through Benefits for, Members)—Requires members to provide FINRA prior written notice before a member guarantees, endorses or assumes, directly or indirectly, a third party's obligations or liabilities. The rule also requires members to obtain FINRA's prior written approval before a member receives flow through capital benefits under SEC Rule 15c3-1.

FINRA Rule 4311 (Carrying Agreements)—Sets forth the requirements for members entering into agreements for the carrying of any customer accounts in which a securities transaction can be effected (each, a Carrying Agreement). Generally, the rule prohibits a member from entering into a Carrying Agreement, on an omnibus or fully disclosed basis, unless the Carrying Agreement meets certain financial responsibility and other requirements (such as allocation of a variety of obligations between the parties) and is with a carrying firm that is a FINRA member.

FINRA Rule 4522 (Periodic Security Counts, Verifications and Comparisons)—Requires members subject to SEC Rule 17a-13 to make the counts, examinations, verifications, comparisons and entries set forth therein. Carrying or clearing members subject to the SEC rule are required to make such counts, examinations, verifications, comparisons and entries more frequently where prudent business practice so requires.

FINRA Rule 4523 (Assignment of Responsibility for General Ledger Accounts and Identification of Suspense Accounts)—Intended to ensure the accuracy of members' books and records and includes supervisory measures for their implementation. The new rule mandates that members designate an associated person (1) to be responsible for each general ledger bookkeeping account, (2) control and supervise entries into each such account, and (3) ensure that the account is current and accurate. A supervisor must review each account for accuracy at least once per month. The rule also requires that carrying or clearing members maintain records of the names of each individual assigned primary or supervisory responsibility for each account. Lastly, the rule requires members to maintain a suspense account in which money charges or credits and receipts or deliveries of securities whose disposition is pending determination are recorded.

Click here to read FINRA Regulatory Notice 11-26.

LITIGATION

Department of Labor Panel Adopts Liberal Pleading Standard for SOX Whistleblower Cases

The U.S. Department of Labor's Administrative Review Board (ARB) adopted a liberal pleading standard for whistleblower retaliation cases under the Sarbanes-Oxley Act (SOX).

Two former employees of Parexel International LLC filed whistleblower complaints alleging that Parexel terminated their employment in violation of SOX's anti-retaliation provisions. Both former employees had complained to their superiors after discovering that other company employees were falsifying drug-testing data in violation of Food and Drug Administration rules. Parexel allegedly failed to investigate the falsification, and over the next several months both complainants were allegedly subjected to various forms of retaliation and finally terminated.

The lawsuits were first dismissed by the Occupational Safety and Health Administration, a determination that was affirmed by an Administrative Law Judge (ALJ). The ALJ dismissed the retaliation claims for lack of subject matter jurisdiction. In reaching that conclusion, the ALJ determined that the former employees' complaints: (1) did not relate "definitively and specifically" to a violation of any laws covered by the whistleblower provisions of SOX Section 806; (2) did not involve an actual violation by Parexel of any of the laws enumerated in SOX Section 806; and (3) did not plead the elements of either a securities fraud claim or common law fraud claim.

The ARB reversed the ALJ's dismissal order on the ground that subject matter jurisdiction "clearly existed." The ARB held that the burden of establishing subject matter jurisdiction in a SOX retaliation case was "not particularly onerous" and that claimants met the jurisdiction test simply by filing a complaint that alleged that Parexel terminated their employment in retaliation for reporting on potentially fraudulent misconduct.

The ARB proceeded to examine and reject the ALJ's substantive determination that the allegations of the consolidated complaints failed to demonstrate that the former employees engaged in SOX-protected whistleblower activity. The ARB first determined that the stricter pleadings standards governing ordinary federal complaints do not apply to SOX retaliation cases. The ARB emphasized that motions to dismiss SOX complaints on insufficient pleading grounds should only be granted as "a last resort."

The ARB further concluded that SOX complainants need only allege a "reasonable belief" that the complained of conduct constituted mail fraud, wire fraud, bank fraud, securities fraud, or violated any federal law relating to fraud against stockholders. A whistleblower need not allege that one of the applicable laws was violated; he or she will be protected for reporting a violation "about to be committed" as long as he or she "reasonably believes that the violation is likely to happen." Moreover, the ARB rejected the ALJ's requirement that claimants plead that the misconduct at issue "definitively and specifically" related to the statutes and rules covered by SOX.

The ARB also made clear that the misconduct need not be related to fraud against stockholders and that mail, wire or bank fraud not involving stockholders would be sufficient.

Finally, the ARB held that the complainant is not required to plead or establish each of the elements of a securities fraud claim. (*Sylvester v. Parexel Int'l LLC,* ARB No. 07-123, ALJ Nos 2007-SOX-39,042 (Dep't of Labor ARB May 25, 2011))

Eleventh Circuit Affirms Dismissal of Securities Fraud Complaint Against Mortgage Lender

Stockholder plaintiffs brought a purported class action against HomeBanc Corporation and certain of its officers and directors alleging that the mortgage and lending company committed securities fraud by improperly concealing numerous purchases of subprime mortgage securities, which allegedly caused substantial losses when the company collapsed during the housing and subprime market crash.

The district court granted the defendants' motion to dismiss the complaint because, among other things, plaintiffs' complaint failed to adequately plead scienter.

On appeal, the U.S. Court of Appeals for the Eleventh Circuit affirmed the district court's dismissal ruling. Significantly, the court noted that while the complaint alleged that the defendants expressed "mistaken confidence in the company's financial well-being" and "engaged in business practices that contributed to HomeBanc's demise," the facts alleged do not give rise to a strong inference that defendants knew that their public statements were fraudulent or were reckless in light of their actual knowledge.

The Eleventh Circuit expressed agreement with the district court's assessment that rather than suggesting that the defendants knew their statements were fraudulent, the stronger inference arising from the complaint's allegations was that the defendants "simply failed to predict the eventual collapse of the housing and subprime mortgage market, and, as a result, were ill-prepared to respond when those markets crashed." (*Kadel v. Flood,* 2011 WL 2015379 (11th Cir. May 24, 2011))

BANKING

Notice Requirement Implements Dodd-Frank Act Provision on Unlimited FDIC Coverage for Noninterest-Bearing Transaction Accounts

On November 9, 2010, the Federal Deposit Insurance Corporation's Board of Directors issued a final rule implementing Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 343 of the Dodd-Frank Act provides unlimited insurance coverage for noninterest-bearing transaction accounts at all insured depository institutions (IDIs) from December 31, 2010, through December 31, 2012. The final rule imposes certain notice requirements, including the requirement that if an IDI modifies the terms of a deposit account so that the account no longer will be eligible for unlimited deposit insurance coverage, the institution "must notify affected customers and clearly advise them, in writing, that such actions will affect their deposit insurance coverage." As explained in the preamble to the final rule, this notice requirement is intended primarily to apply when IDIs begin paying interest on a demand deposit accounts (DDA), permitted beginning July 21, 2011, under Section 627 of the Dodd-Frank Act.

Therefore, if on or after July 21, an IDI modifies the terms of a DDA so that the account may pay interest, the IDI must notify affected customers that the account no longer will be eligible for unlimited deposit insurance coverage as a noninterest-bearing transaction account. The FDIC has not imposed specific requirements as to the form of the notice. Rather, the FDIC expects IDIs to act in a commercially reasonable manner and to comply with applicable state and federal laws and regulations in informing depositors of changes to their account agreements.

The notice requirement for noninterest-bearing transaction accounts that convert to interest-bearing accounts does not apply to DDAs modified after December 31, 2012. As of January 1, 2013, all transaction accounts, whether they pay interest or not, will be insured up to the standard maximum deposit insurance amount, which currently is $250,000.

Read more.

UK DEVELOPMENTS

FSA Revises Guidance on Reporting of Exchange Platform Derivative Transactions

The UK Financial Services Authority (FSA) recently announced proposed revised guidance on reporting on-exchange derivatives transactions conducted through exchange platforms. Under current FSA guidance, if a transaction conducted through an exchange platform is in a instrument whose characteristics differ from an exchange standardized derivative, the transaction must be reported as an OTC derivative transaction. If the instrument is fungible with an exchange standardized derivative, the reporting firm may report it as an on-exchange or OTC derivative transaction.

The FSA proposes to revise its guidance to: (1) remove the need to distinguish between transactions for fungible and non-fungible derivative instruments conducted through exchange platforms; (2) more accurately reflect the status of the transactions and make it easier for firms to integrate their transaction reporting systems; and (3) extend the guidance from Aii derivative transactions to all derivative transactions (ISIN and Aii) conducted through European Economic Area derivative exchange platforms.

Read more.

FSA Fines and Bans Former Compliance Officer

The UK Financial Services Authority (FSA) recently announced that is had fined David McGrath, the former compliance officer of ActivTrades Plc, £3,000 (approximately $4,900) and prohibited him from performing the compliance oversight CF10 controlled function for any regulated entity because he lacked competence and capability to perform that function.

The FSA found that Mr. McGrath had breached Principle 7 of the FSA's Statements of Principle for Approved Persons. Principal 7 requires reasonable steps to ensure that the business of the firm for which the relevant approved person is responsible in his controlled function complies with relevant requirements and standards of the regulatory system.

Mr. McGrath was found to have: (1) failed to ensure that ActivTrades accounted for and treated client money in accordance with the FSA client money and assets rules—in particular, failing to ensure that ActivTrades segregated client money appropriately and performed client money calculations and reconciliations correctly, and failing to make clear the circumstance in which it would retain interest received on client money or cease to treat interest received as client money; (2) failed to implement adequate risk management systems to ensure the protection of client money; and (3) failed to demonstrate an appropriate knowledge of the FSA client money and assets rules.

The FSA said that it would have imposed a penalty of £20,000 (approximately $33,000) but reduced it because of verifiable evidence of hardship to Mr. McGrath.

Read more.

FSA Censures BDO LLP for Failings as a Sponsor

On June 1, the UK Financial Services Authority (FSA) announced that it had censured BDO LLP for failings while acting as a sponsor during the takeover by Shore Capital Group PLC of Puma Brandenburg Limited. This is the FSA's first public censure of a sponsor in relation to the Listing Rules.

In May 2009, BDO was approached by Shore Capital to provide advice as a sponsor on its proposed merger with Puma. BDO was made aware that the transaction might constitute a reverse takeover due to the size of the target company.

The Listing Rules state that a suspension of a listed company's shares will often be appropriate when a reverse takeover is announced, unless the FSA (in its capacity as UK Listing Authority (UKLA)) is satisfied that there is sufficient information already in the market about the proposed transaction. These requirements are designed to ensure the smooth operation of the market as well as investor protection and market confidence.

The UKLA relies on sponsors to ensure that issuers meet their obligations under the Listing Rules, and in its view, it is crucial that sponsors deal with the FSA in an open and cooperative manner, and perform sponsor services with due care and skill.

The FSA found that despite these requirements, BDO failed to liaise with the UKLA in advance of the announcement of the Puma transaction to ascertain whether Shore Capital's shares should be suspended. Instead BDO agreed with Shore Capital from the outset that it would delay contacting the UKLA until after the announcement and attempted to avoid classifying the transaction as a reverse takeover, despite recognizing at the time that this strategy was highly unlikely to succeed.

Marc Teasdale, head of department at UKLA, said: "BDO failed in its responsibilities as a sponsor on this transaction and we are sending a clear message with this public censure about the importance we attach to the sponsor role."

Read more.

EU DEVELOPMENTS

EU Council Formally Adopts Alternative Investment Fund Managers Directive

On May 27, it was announced that the EU Council of Ministers had adopted the final text of the Alternative Investment Fund Managers Directive (AIFMD).

The Directive was adopted by the European Parliament on November 11, 2010 (see the November 19, 2010, edition of *Corporate and Financial Weekly Digest*).

The Directive will enter into force on the 20th day following its publication in the EU Official Journal (expected to be some time in June). After that member states will have two years to transpose the AIFMD provisions into national law. Accordingly the provisions of the AIFMD will begin to come into force in mid-2013.

Read more.

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