Katten Muchin Rosenman LLP

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SEC/Corporate

California LLC Fee Held Unconstitutional

In *Northwest Energetic Services, LLC v. California Franchise Tax Board*, a California Superior Court recently declared the California LLC Fee (which applies to both LLCs formed in California and other LLCs registered or doing business in California) unconstitutional, at least as applied to the plaintiff. The scope of the case (if ultimately upheld on appeal) is unclear, but entities that have paid this LLC Fee may wish to file a "Protective Claim for Refund" of the Fee for years 2001 and forward, as discussed further below.

The California Superior Court held that the annual fee that is based on world-wide gross income violates the fair apportionment requirement of the Due Process and Commerce Clauses of the U.S. Constitution. The plaintiff (Northwest) stated that other than registering to do business in California, it did not conduct any business activity in the state. By registering to do business in the state, Northwest became subject to California's LLC Fee. The fee is based on annual total income from all sources of $250,000 or more, with an annual maximum fee per LLC of $11,790 for 2005.

The proposed Statement of Decision, dated March 2, is reportedly subject to a fifteen day period for comments before it becomes a final Decision. The case is likely to be appealed because of its revenue impact on the state, and may take several years to decide.

A separate LLC tax of $800 per year applies to all LLCs in California; that tax is not the subject of the case. Only the LLC Fee was declared unconstitutional.

LLC's should check with their accountants about filing timely protective return claims for refunds. The statute of limitations in California is four years from the later of (i) the original due date for the return (which for most LLCs is April 15th) or (ii) the date the return was filed. Therefore, LLCs which have paid taxes for 2001 and forward may still be able to file a timely protective claim for refund for 2001 (if filed by April 15, 2006) and subsequent years.

Chief Counsel of SEC's Division of Corporation Finance Clarifies Form S-3 Issue

On March 3 and 4, 2006, the Practising Law Institute held its annual SEC Speaks program, during which the Staff of the Securities and Exchange Commission addressed current issues in securities regulation. During the March 4 session, David Lynn, Chief Counsel of the Commission's Division of Corporation Finance, warned S-3 filers that if their Form 10-K

incorporated proxy statement information in Part III (e.g., beneficial ownership table, certain relationships and related transactions, directors and executive officers, executive compensation and accountant fees and services) by reference, and they have not yet filed their proxy statement, and they incorporate their Form 10-K by reference into the S-3, they need to include the incorporated proxy information in the S-3 prospectus. As an alternative a company could file a Form 10-K/A, before filing the S-3, to include the proxy information that it did not want to put in the prospectus. Lynn also stated that for Well Known Seasoned Issuers, while an automatic shelf registration statement would go immediately effective, proxy information would need to be filed before the filing of a prospectus to take down the shelf. This position will apparently not apply to a company with an already effective Form S-3 that files a Form 10-K which incorporates by reference information from its proxy statement, as long as the proxy statement is filed within 120 days of year-end.

SEC'S Advisory Committee on Smaller Public Companies Solicits Comments on Draft Final Report

On March 3, the Securities and Exchange Commission's Advisory Committee on Smaller Public Companies, which was established by the Commission to examine the impact of the Sarbanes-Oxley Act and other federal securities laws on smaller companies, published for public comment an exposure draft of its final report and proposed recommendations to the Commission. The Committee will consider comments, which are due by April 3, before finalizing the recommendations in the report. The report will be submitted to the Commission by April 23, 2006.
http://www.sec.gov/news/press/2006-32.htm

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Banking

OTS Preempts Local Lending Law

On March 7, the Office of Thrift Supervision, pursuant to its preemption authority, found that certain provisions of the Montgomery County, Maryland, lending laws were not applicable to federal savings associations and their operating subsidiaries. The relevant provisions of the Montgomery County Code in question prohibited the making of a mortgage loan that (1) includes the financing of a single premium credit life insurances, (2) provides for excessive upfront points, excessive fees, or excessive prepayment penalties; or (3) provides compensation paid directly or indirectly to a person from any source.

In its opinion, the OTS reiterated its position found in prior preemption determinations that concluded that state laws that prohibit the financing of single premium credit life insurance or that restrict points, fees and prepayment penalties or other forms of compensation are preempted. The OTS further stated that the Home Owners' Loan Act and its implementing regulations "together occupy the field of lending regulation for federal savings associations to the exclusion of state laws."

The opinion also touched upon the OTS's congressional mandate, stating that "Congress gave OTS, not the States or local governments, the task of determining the best practices for federal savings associations."
http://www.ots.treas.gov/docs/4/480031.pdf

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Broker Dealer

Nasdaq Petitions to Include National Capital Market Stocks as Covered Securities

The Nasdaq Stock Market Inc., in a February 28 letter, petitioned the Securities and Exchange Commission to amend Securities Act Rule 146(b) to include stocks listed on the Nasdaq Capital Market (NCM) as covered securities under Section 18 of the Securities Act of 1933. Section 18 of the Securities Act prohibits any state from requiring covered securities to qualify or register in the state. Section 18 defines a covered security to include a security listed on the New York and American Stock Exchanges and the National Market System of Nasdaq, and authorizes SEC actions to identify other markets with similar listing standards. Rule 146(b) identifies other stock exchanges with listing standards that meet the requirements of Section 18—substantially similar to the listing requirements of the New York or American Stock Exchange. In its letter, Nasdaq compared the listing requirements for NCM, formerly known as The Nasdaq SmallCap Market, with the listing standards for the American Stock Exchange. They argued that NCM's listing standards were as stringent as, and in some cases more stringent than, the American Stock Exchange listing standards. Nasdaq argued that it was unfair not to grant the requested relief for several reasons. Among these were that some 39% of NCM issuers had been on the National Market System where they were covered securities, and the SEC's Advisory Committee on Smaller Public Companies has included in its preliminary recommendations designating NCM securities as covered securities.
http://www.sec.gov/rules/petitions/petn4-513.pdf

SEC Studying Retail Customer Protections under Exchange Act and Advisers Act

In Release No. 34-53406, Chairman Christopher Cox of the Securities and Exchange Commission announced that a study will be commenced comparing the levels of protection afforded retail investors under the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. In Release No. IA-2376 (April 12, 2005) the SEC adopted Advisers Act Rule 202(a)(11)-1. This rule excludes broker-dealers offering flat fee services that include research reports from the definition of investment adviser under the Advisers Act and includes, within the definition, broker-dealers offering financial planning or exercising discretionary authority. In the adopting release the SEC said it would study the existing regulatory schemes applicable to broker-dealers and investment advisers servicing retail customers to see whether the sales practice standards and advertising rules applicable to investment advisers should apply to broker-dealers, whether broker-dealers providing investment advice but excluded from investment adviser registration should be subject to a fiduciary duty to their clients, and whether Adviser Act obligations applicable to dually registered broker-dealers/investment advisers should be streamlined. The announcement did not disclose the composition of this study group, its timetable and whether it would cover any other issues beside those listed in Release No. IA-2376.
http://www.sec.gov/rules/other/34-53406.pdf
http://www.sec.gov/rules/final/34-51523.pdf

March 16 Cutoff For Limited Size and Resources Exception to NASD Rule 3012

Under National Association of Securities Dealers, Inc. Rule 3012 broker-dealers are required to review and supervise the customer account activity conducted by branch office managers, sales managers, regional or district sales managers and others performing similar functions. A designated principal of the firm, senior to those being reviewed, is to conduct the review and to report a summary of the review of the

designated sales personnel and the results of a review of the firm's system of supervisory controls annually to senior management. The first such report is due no later than April 1, 2006. The rule provides an exception for the independent review in cases where the broker-dealer is so limited in size and resources that there is no qualified person senior to those being reviewed to conduct the review. NASD member firms wishing to take advantage of this exception must file an electronic notice with the NASD on the form and in the manner prescribed by the NASD in Notice to Members 06-04 no later than March 16.
http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_015854.pdf

NYSE Proposes to Change Who Must Be an Approved Person

The New York Stock Exchange, Inc. has filed a rule proposal with the Securities and Exchange Commission (File No. SR-NYSE-2006-10) to change the persons who must be approved persons under NYSE Rules 2, 98, 304 and 346. Presently, any person controlling a member firm, and under common control with or controlled by a member firm that is engaged in the securities business, must be an approved person. As proposed, persons controlling a member firm, those associated with a member firm possessing privileged information concerning the specialist activity of the member firm and "related persons" - persons controlled by or under common control with the member firm that engage in securities or financial arrangements with the member firm - would have to be approved by the NYSE. The NYSE noted that in the nearly 30 years the approved person requirement has been in effect no one has been denied approval or has been referred for enforcement action.
http://apps.nyse.com/commdata/pub19b4.nsf/docs/E3F0334B2BBD88558525711D0068DFF6/$FILE/NYSE-2006-10.pdf

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United Kingdom Developments

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FSA Fines Hedge Fund and Senior Trader $1.3 Million Each for Market Abuse

Although a final notice has yet to be issued by the Financial Services Authority (FSA), it has been widely publicized that the FSA has imposed fines of £750,000 each ($1.3 million) on GLG Partners LP (GLG), one of Europe's largest alternative investment managers and Philippe Jabre, one of GLG's former senior managers and traders for market abuse. There has so far been no public comment by the FSA, GLG or Mr Jabre.

The case against GLG and Jabre is reported to have centered on an allegation of improper trading relying on the use of non-public information concerning Sumitomo Matsui Bank received by Jabre from a Goldman Sachs employee ahead of a Sumitomo Matsui Bank stock sale.

This is the first major FSA disciplinary proceeding against a hedge fund manager.

FSA to Simplify Training and Competence Rules

The Financial Services Authority (FSA) has confirmed that its detailed rules on training and competence, and in particular the requirements to pass an "appropriate examination," will be disapplied in relation to registered individuals who deal only with or for institutions and corporate customers and who do not deal with or for private customers.

In relation to the "appropriate examination" requirement, the FSA stated that although it will limit the requirement to individuals carrying out activities with or for private customers, it will continue to expect all firms to ensure that their employees have an adequate understanding of the United Kingdom regulatory system. At present, this is demonstrated by an individual sitting and passing the relevant regulatory module of an appropriate examination. Firms who decide that their employees will no longer take an appropriate examination will be expected to put in place internal procedures to ensure that their employees have the requisite adequate understanding of the UK regulatory system.

The FSA also announced that it will conduct a wider review of its training and competence regime which will take account of the impact of the Markets in Financial Instruments Directive (MiFID) due to be implemented in the UK in November 2007. The removal of detailed training and competence rules for wholesale business, together with any further changes resulting from the wider review, will be made when the FSA introduces the rule changes which will be required for the implementation of MiFID in 2007.

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Litigation

Ninth Circuit Affirms Dismissal of Complaint for Failure to Plead Scienter

On appeal from a judgment dismissing its third amended federal securities law class action complaint with prejudice, lead plaintiff argued that the allegations of its pleading were sufficient to raise a strong inference that defendants had acted with deliberate or conscious recklessness. Among other things, it alleged that defendants knew of various GAAP violations as well as the inadequacies of the company's internal accounting controls, and that they had created various obstacles to the effectiveness of the audit process. Affirming the dismissal, the Ninth Circuit held that absent specific allegations of defendants' direct involvement in actions to manipulate financial data and mislead investors, references to their "day to day" involvement in management were insufficient to meet the heightened pleading standards of the PSLRA. It also noted that the restatement of certain financials did not constitute an admission that defendants knew those financials had been false when issued. In addition, the Court observed that the purchase of stock by the company's CEO during the time that defendants allegedly were inflating its revenue indicated his belief that its financials were accurate. (*In re Aspeon, Inc. Securities Litigation*, 2006 WL 448793 (9th Cir. Feb. 23, 2006))

Plaintiffs Fail to Show that Revenue Forecasts Were False When Made

Plaintiffs' federal securities law class action complaint alleged that iPass, a remote access software company, and its senior executives, falsely represented iPass' positive first quarter results and second quarter projections in a press release and conference call with investors. During the second quarter, iPass experienced a revenue shortfall causing a substantial decline in the price of its stock. In dismissing the complaint with leave to replead, the Court held that the statement that "iPass has momentum" was not actionable because it was a vague, generalized and unspecific assertion of corporate optimism not linked

to any financial measure of performance. It further held that plaintiffs' allegations failed to support a strong inference that defendants knew the earnings statement was false when made. (*In re iPass, Inc. Securities Litigation*, 2006 WL 496046 (N.D. Cal. Feb. 28, 2006))

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CFTC

CFTC Permits Chicago Mercantile Exchange and Clearing Members to Commingle Regulated Futures and OTC Margin Deposits

The Commodity Futures Trading Commission has issued an Order authorizing the Chicago Mercantile Exchange (CME) and registered futures merchants (FCMs) that are CME clearing members to hold in the same account funds that are segregated pursuant to Section 4d of the Commodity Exchange Act and CFTC Regulation 1.20 with funds deposited by eligible contract participants to margin OTC contracts on the same products (certain foreign currencies, cross-rates and Eurodollars). The Order requires that the CME and the FCMs apply appropriate risk management procedures, maintain certain records, and provide specified information to the CFTC.
http://www.cftc.gov/files/tm/tmcmeotc4dorder030306.pdf

SGX Seeks Comments Regarding Proposed Listing Rules for Hedge Funds

The Singapore Exchange Ltd (SGX or Exchange) intends to introduce a framework for hedge funds seeking a listing on the Exchange, and seeks comments from market participants and members of the public regarding the proposed framework on or before March 28, 2006. SGX's consultation paper proposes that a hedge fund be admitted to the Official List of the Exchange provided that: (a) it meets minimum asset size requirements of Exchange Rule 404 (S$20 million if denominated in Singapore Dollars; US$20 million if denominated in a foreign currency); (b) it is authorized or recognized under section 286 or 287 of the Securities and Futures Act of Singapore; or (c) its units are offered only to institutions and/or accredited investors. Notably, while a hedge fund eligible for listing would be admitted to the Official List of the Exchange, there will be no trading in its units on the Exchange.
http://info.sgx.com/SGXWeb_RMR.nsf/5b95e151d95e364348256d81002f10c5/48256cb7003f35524825712a00375fe6/$FILE/030806_SGX_Releases_Consultation_Paper_on_HedgeFunds.pdf

Financial Industry Associations Comment on Proposed PATRIOT Act Regulation

Various financial industry associations (the Associations) filed a joint comment letter on March 6 in response to the Notice of Proposed Rulemaking (the NPR) issued by the Department of the Treasury and the Financial Crimes Enforcement Network relating to a proposed regulation (the Proposed Rule) to implement the provisions of Section 312 of the USA PATRIOT Act. Section 312 requires enhanced due diligence for correspondent accounts established, maintained, administered or managed for certain types of foreign banks. The Associations endorse the risk-based approach set forth in the Proposed Rule, which recognizes that "not all correspondent accounts present the same type or level of risk" and that the same enhanced due diligence need not be applied in every case. The letter also supports the risk-based approach to application of the specified enhanced due diligence requirements, as described in the NPR, because it allows a covered financial institution to vary its application of those requirements to a particular account based on its risk assessment.

The Associations expressed two concerns regarding the Proposed Rule, however. First, the Associations objected to the term "nested bank," commenting that it reflects negatively on the common and accepted practice in international banking whereby a foreign correspondent bank provides correspondent banking services to other foreign banks. Second, the Associations stated that the Proposed Rule vastly underestimates the compliance burdens associated with the Proposed Rule, and note that this low estimate may reflect a misunderstanding of the significant resources required to meet the proposed obligations. http://www.futuresindustry.org/downloads/regulatory/Section312CommentLetter.pdf

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