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Corporate and Financial Weekly Digest

MARCH 12, 2010

LITIGATION

Group Pleading Improper in CFTC Enforcement Action

The Commodity Futures Trading Commission brought an enforcement action against several investment firms and affiliated individuals for the fraudulent operation of a foreign currency trading firm. The CFTC's complaint grouped defendants together when discussing the alleged fraudulent scheme and did not link specific defendants to the fraudulent acts alleged in the complaint.

Defendants filed a motion for a more definite statement under Rule 12(e) of the Federal Rules of Civil Procedure, arguing that the CFTC's fraud claim was subject to the strictures of Federal Rule of Civil Procedure 9(b), which requires, among other things, that a party plead fraud with particularity. The CFTC argued that it was entitled to use group pleading because it alleged that the individual defendants were controlling persons responsible for the fraud committed by the companies.

The district court granted defendants' motion, holding that while the CFTC could use group pleading to attribute statements to business entities through principles of agency or corporate law, the CFTC's complaint exceeded this allowance by combining all of the defendants and occasionally combining unspecified representatives as well. Furthermore, the allegations as a whole did not adequately connect the particular defendants with knowing or reckless conduct necessary to establish scienter—an essential element of fraud. (*United States Commodity Futures Trading Comm'n v. M25 Inv., Inc.* No. 3:09-CV-1831-M, 2010 WL 769367 (N.D. Tex. Mar. 6, 2010))

Summary Judgment on Fiduciary Duty of Disclosure Claim Vacated

The U.S. Court of Appeals for the Fifth Circuit vacated and remanded the U.S. District Court for the Western District of Louisiana's grant of summary judgment in favor of defendants in an action brought by a minority shareholder of an entity-defendant for breach of fiduciary duty arising out of the individual defendant's failure to disclose to plaintiff that the entity-defendant was in talks to be acquired by another entity.

The individual defendant, Chief Financial Officer of the entity-defendant, acted as plaintiff's agent for the purposes of redeeming plaintiff's shares. Plaintiff argued that individual defendant thus had a duty to disclose to plaintiff facts that were material to the stock redemption by virtue of their relationship. Plaintiff further argued that the entity-defendant's ongoing merger acquisition discussions with a third party were material to plaintiff's stock redemption. Plaintiff claimed that by failing to disclose this fact, the individual defendant breached his fiduciary duty of disclosure.

The district court granted summary judgment in favor of defendants on statute of limitations grounds, holding that Louisiana's two-year limit for bringing claims for breach of fiduciary duties against officers and directors had lapsed. The Fifth Circuit vacated the order and remanded the action, directing the district court to explore the scope of plaintiff's relationship with the individual defendant, as the 10-year statute of limitations relating to agency relationships may apply. (*D&J Tire, Inc. v. Hercules Tire & Rubber Co.*, No. 09-30275, 2010 WL 670634 (5th Cir. Feb. 26, 2010))

BROKER DEALER

Historic TRACE Data to Become Available March 31

Effective March 31, transaction-level data for transactions in all Trade Reporting and Compliance Engine (TRACE) Eligible Securities reported to TRACE since July 1, 2002, will be publicly available as Historic TRACE Data (except with respect to Rule 144A transactions). Historic TRACE Data will include transactions that, at the time of

reporting, were not subject to dissemination, such as Non-Investment Grade corporate bond transactions. Historic TRACE Data will also include certain transaction-level information, such as actual trade volume or size, which is currently not publicly available for larger transactions. The Financial Industry Regulatory Authority will charge a fee per data set for the use of Historic TRACE Data, as will be set forth in FINRA Rule 7730(d)(1) following the effective date.

Click here to read FINRA Regulatory Notice 10-14.

SEC to Make Mid-Year Rate Adjustment for Exchange Act Section 31 Fees

The Financial Industry Regulatory Authority has released an Information Notice describing the upcoming mid-year increase to the fee rates paid under Section 31 of the Securities Exchange Act of 1934. Effective April 1, the Section 31 fee rate on the aggregate dollar amount of sales in specified securities transactions on the exchanges and in the over-the-counter markets will increase from $12.70 per $1 million to $16.90 per $1 million. Fee rates for fiscal year 2011 will be announced no later than April 30 and will become effective October 1, or 30 days after the Securities and Exchange Commission's fiscal year 2011 appropriation is enacted, whichever is later.

Click here to read the FINRA Information Notice.

Please see "FinCEN Issues Guidance Requiring Financial Institutions to Obtain Beneficial Ownership Information in Certain Cases" in **Banking** below.

PRIVATE INVESTMENT FUNDS

CFTC Chairman Testifies on OTC Derivatives Reform

Commodity Futures Trading Commission Chairman Gary Gensler spoke on March 9 before the Senate Committee on Energy and Natural Resources regarding the regulation of over-the-counter (OTC) derivatives, particularly with respect to energy markets. Chairman Gensler stated that to promote transparency and reduce risk, OTC derivative reform should include the following components:

- establish an explicit regulatory framework for swap dealers and major swap participants, including requirements relating to capital, margin, business conduct standards, recordkeeping and reporting;
- bring transparency by requiring standardized OTC derivatives be traded on regulated transparent exchanges or trade execution facilities, including requiring public reporting of key trading data; and
- require financial institutions that are "too big to fail" and "too interconnected to fail" to bring all of their standardized derivatives transactions to central clearinghouses.

Chairman Gensler stated that if Congress determines certain commercial end-users should be exempt from any clearing requirements, hedge funds should not be among those exempt entities with respect to their OTC transactions. Further, Chairman Gensler stated that any commercial end-user exempt from clearing should not be granted an exemption from a transparency requirement.

Chairman Gensler's speech can be found here.
Click here to read a summary of previous remarks made by Chairman Gensler regarding OTC derivatives reform in the January 29, 2009, edition of *Corporate and Financial Weekly Digest*.

Senators Introduce PROP Trading Act Similar to "Volcker Rule" Proposal

Senators Jeff Merkley (D-Ore.), Carl Levin (D-Mich.), Ted Kaufman (D-Del.), Sherrod Brown (D-Ohio), and Jeanne Shaheen (D-N.H.) have introduced a bill to limit banks and certain financial institutions from investing in or sponsoring a hedge fund or private equity fund. The Protect our Recovery through Oversight of Proprietary Trading Act (PROP Trading Act) also: (1) bars banks, bank holding companies, and their affiliates and subsidiaries from engaging in high-risk speculation involving any stock, bond, option, commodity, derivative, or other security or financial instrument; (2) requires certain large non-bank financial institutions to set aside additional capital to discourage them from engaging in high-risk speculation and investing or sponsoring hedge funds or private equity funds, and puts strict limits on the amount of such speculation; and (3) addresses conflicts of interest associated with asset-backed securities by prohibiting securities brokers from betting against the same packages of loans they are promoting to their clients. Although unofficial copies of the bill have been posted online, the official text has not yet been published.

The PROP Trading Act is similar in many respects to proposed legislative language reportedly sent by the Obama administration to Congress on March 3 to implement the "Volcker Rule" that was initially proposed by President Obama in remarks on financial reform on January 21. The proposed legislative language has not been officially released, but news outlets have published the purported text of the proposal. Among other things, the legislative text proposed by the Administration (1) directs appropriate federal banking agencies to prohibit banks from engaging in proprietary trading or sponsoring or investing in private equity or hedge funds and (2) directs the Federal Reserve Board to adopt rules applying capital and quantitative limits to any non-bank financial company under the Federal Reserve Board's supervision that engages in proprietary trading or that sponsors or invests in private equity or hedge funds.

To read Senator Merkley's press release on the PROP Trading Act click here.
To read Senator Levin's floor statement on the PROP Trading Act click here.
To read the administration's reported proposed legislative text implementing the "Volcker Rule" click here.
Click here for more information on the "Volcker Rule" in the January 22 edition of *Corporate and Financial Weekly Digest*.

OTC DERIVATIVES

Please see "CFTC Chairman Testifies on OTC Derivatives Reform" in **Private Investment Funds** above.

CFTC

Supreme Court Rejects Appeal of Ruling That Manager of a Feeder Fund is a Commodity Pool Operator

On March 8, the Supreme Court declined to hear an appeal of a decision of the Third Circuit Court of Appeals to the effect that the manager of a feeder fund investing in a master fund that trades futures was a commodity pool operator (CPO) under Section 1(a)(5) of the Commodity Exchange Act (CEA).

Defendant was the manager of a feeder fund, and solicited investors for the feeder fund, which then invested in master fund entities that were actively engaged in trading futures contracts. Neither the manager nor the feeder fund was registered with the Commodity Futures Trading Commission. The manager argued that because the feeder fund was not itself engaged in trading futures, the feeder fund was not a "commodity pool" under the CEA and, therefore, that the manager was not a "commodity pool operator." The Third Circuit Court of Appeals disagreed, ruling that an entity need not be actually engaged in the trading of futures contracts to be a "commodity pool" under the CEA, but instead need only be "engaged in a business in the nature of an investment trust, syndicate, or similar form of enterprise" that solicits, accepts or receives funds for the purpose of futures trading.

The opinion of the Third Circuit Court of Appeals can be found here.
The Supreme Court's denial of certiorari can be found here.

CFTC Allows Funds Managed by Commonly Controlled Entities to "Designate" CPO

The Commodity Futures Trading Commission has granted no-action relief from commodity pool operator (CPO) registration requirements to three managers of related commodity pools where a fourth commonly owned and controlled entity acted as the "designated" CPO for all of the commodity pools managed by those managers and registered as a CPO with the CFTC.

In support of their request for no-action relief, each of the managers executed and submitted to the CFTC a written undertaking pursuant to which they agreed to be jointly and severally liable for the violation by any of them of the Commodity Exchange Act (CEA) or CFTC regulations in connection with the performance of the CPO function for any of the commodity pools. The managers also represented in connection with the no-action request that (1) none of the managers is subject to a statutory disqualification under Section 8a(2) or 8a(3) of the CEA and (2) all management authority over each of the commodity pools had been delegated to the registered CPO entity.

A copy of the no-action letter can be found here.

INVESTMENT COMPANIES AND INVESTMENT ADVISERS

SEC Updates Custody Rule FAQ

On March 5, the Securities and Exchange Commission updated its list of frequently asked questions and answers (FAQs) regarding Rule 206(4)-2, the custody rule under the Investment Advisers Act of 1940. The updates are in response to questions arising as a result of the SEC's adoption of recent amendments to the custody rule. (For a summary of the custody rule amendments, click here.) The FAQs have been updated to reflect guidance on the following topics: compliance dates, definition of custody and scope of the rule, account statements and surprise exams, pooled investment vehicles, privately offered securities, auditing non-pool accounts and trustees.

The full text of the FAQs may be found here.

Please see "FinCEN Issues Guidance Requiring Financial Institutions to Obtain Beneficial Ownership Information in Certain Cases" in **Banking** below.

BANKING

FinCEN Issues Guidance Requiring Financial Institutions to Obtain Beneficial Ownership Information in Certain Cases

On March 5, the primary agencies responsible for anti-money laundering (AML) regulation issued guidance to clarify the regulatory expectations for obtaining beneficial ownership information for certain accounts and customer relationships in connection with a financial institution's AML compliance program. The guidance is being issued jointly by the Securities and Exchange Commission, the Financial Crimes Enforcement Network (FinCEN), the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the National Credit Union Administration, in consultation with the Commodity Futures Trading Commission.

Under FinCEN rules, financial institutions, including banks, broker-dealers, futures commission merchants and investment companies, are required to adopt and implement a customer identification program. The guidance issued recently notes that a financial institution's customer due diligence (CDD) should include procedures reasonably designed to identify and verify the identity of beneficial owners of an account (i.e., the individual(s) who have a level of control over, or entitlement to, the funds or assets in the account that enables such individual(s), directly or indirectly, to control, manage or direct the account), as appropriate, based on an evaluation of the risk pertaining to the account. CDD procedures may include:

- determining whether the customer is acting as an agent, and if so, obtaining information regarding the capacity in which and on whose behalf the customer is acting;
- obtaining information about the structure or ownership of accounts opened by a customer organized as a legal entity not publicly traded in the United States, such as an unincorporated association, a private investment company, trust or foundation; and
- obtaining information about trust structures, where applicable, to determine the provider of funds and any persons or entities with control over the funds or the power to remove the trustees.

Where a financial institution's CDD identifies an account posing heightened risk, the account should be subjected to enhanced due diligence (EDD). EDD procedures may include steps to:

- identify and verify beneficial owners;
- determine the sources and uses of account funds; and
- understand the relationship between the nominal customer and the beneficial owner.

The guidance identified private investment companies, certain trusts, corporate entities and shell entities as examples of customers that may pose heightened risk requiring EDD. The guidance also suggests enterprise-wide implementation of beneficial ownership procedures, including sharing of such information across businesses within an enterprise and cross-checking of beneficial ownership information with data held for other purposes (e.g., marketing).

The guidance does not alter existing FinCEN regulations requiring financial institutions to take reasonable steps, including EDD where appropriate, e.g., to identify accounts opened on behalf of senior foreign political figures, to identify nominal and beneficial owners of private banking and foreign correspondent accounts.

The full text of the guidance may be found here.

Please see "Senators Introduce PROP Trading Act Similar to 'Volcker Rule' Proposal" in **Private Investment Funds** above.

EXECUTIVE COMPENSATION AND ERISA

DOL Issues Proposed Rule Relating to Investment Advice in Individual Account Plans

On February 26, the Department of Labor's Employee Benefits Security Administration released a proposed rule relating to the provision of investment advice to participants and beneficiaries in individual account plans and retirement accounts (i.e., 401(k) plans). The proposed rule is intended to replace a final rule issued on January 21, 2009, but withdrawn later in the year after extensive criticism by commentators that it was inadequate to address issues of conflicts of interests and self-dealing by investment advisers. This new proposed rule has attempted to deal with these concerns by excluding an administrative class exemption that was the main reason for concern under the old regulation. The remainder of the new proposed rule addresses the requirements for satisfying the statutory investment advice exemption, which was adopted as part of the Pension Protection Act of 2006.

The new proposed regulation provides that investment advice to plan participants is appropriate if either (1) a certified, non-biased computer model is used, such that the model is designed and operated to avoid investment recommendations that inappropriately distinguish among investment alternatives, or (2) the advice is provided by an investment adviser who is compensated on a "level-fee" basis (i.e., the fees do not vary based on investments selected by the participant).

The proposed rule contains many administrative and procedural requirements that must be satisfied in connection with the implementation and operation of an investment advice program under a 401(k) plan. The proposed regulations are expected to go into effect 60 days following the publication of final regulations. While the timing of such publication is unclear, comments on the proposed rule must be submitted on or before May 5.

The proposed rule may be found here.

UK DEVELOPMENTS

Retired Senior Trader Jailed for Insider Dealing

On March 11, Malcolm Calvert was sentenced to 21 months in prison, having been found guilty on five counts of insider dealing the previous day. Mr. Calvert, who retired as a market maker and partner of Cazenove (a leading City of London firm) in 2000, was charged with insider dealing based on the receipt of confidential price-sensitive information about planned takeovers from an unnamed primary insider at Cazenove. The guilty verdict related to purchases of shares in three issuers out of a total of six relating to which allegations were made concerning purchases between April 2003 and April 2005.

Mr. Calvert's friend, Bertie Hatcher, agreed to place orders on Mr. Calvert's behalf in return for a one-third share of the profits. Purchases were made of shares of a total value of about £500,000 (approximately $750,000) in Vernalis Group plc, Johnston Group plc and South Staffordshire plc, and a profit of about £104,000 (approximately $157,000) was made by selling the shares after takeover announcements were made shortly after each purchase. Mr. Calvert was found not guilty of alleged insider dealing relating to Mr. Hatcher's purchases of shares of three other issuers. In each case Cazenove had acted as an advisor to the issuer.

Mr. Hatcher cooperated with the UK Financial Services Authority (FSA) and agreed to give evidence against Mr. Calvert. Ultimately, he did not give evidence in court for health reasons. He accepted a fine of £56,098 (approximately $85,000) representing disgorgement of his share of the profits made with respect to all six issuers. The FSA proceeded against him under its civil powers rather than making him the subject of criminal proceedings. The FSA issued a Final Notice with respect to Mr. Hatcher after the Calvert verdict was announced.

The FSA has had powers to proceed against insider dealing in 2001. It brought its first two criminal prosecutions in 2009; the Calvert case was its third successful criminal prosecution. The FSA has emphasized that it will not hesitate to use its criminal enforcement powers. In connection with the Calvert verdict, Margaret Cole, Director of

Enforcement and Financial Crime at the FSA, said: "The guilty verdict is a shot across the bow for any city workers who may be tempted to trade using insider knowledge. Our message is simple: if you take part in such activity, you run a very real risk of the FSA taking criminal action against you."

Mr. Calvert will return to court on April 23 for a confiscation and costs hearing.

No charges have been brought against Cazenove or any of its current employees, and in a statement the firm pointed out that no breach of its systems or controls was identified by the FSA during its four-year investigation of the insider trading allegations.

To read more about the Calvert verdict and sentence click here and here.
To read the Hatcher FSA Final Notice, click here.

FSA Publishes New Financial Penalties Framework

In early March, the UK Financial Services Authority (FSA) issued policy statement PS10/04 entitled *Enforcement Financial Penalties*. PS10/04 confirms the creation of a new framework for calculating financial penalties in enforcement cases. The new regime has been brought into force with immediate effect.

Financial penalties are to be based on three principles: disgorgement, discipline and deterrence, under a five-step framework:

- removing any profits made from the misconduct;
- setting a figure to reflect the seriousness of the misconduct;
- considering any aggravating or mitigating factors;
- achieving the appropriate deterrent effect; and
- applying any settlement discount.

Under the new framework, fines will be linked more closely to firms' revenues and individuals' incomes and will be based on the following amounts:

- up to 20% of a firm's revenue over the period during which the misconduct took place from the business area linked to the misconduct;
- up to 40% of an individual's salary and benefits (including bonuses) from their job relating to the misconduct (except in serious market abuse cases); and
- for individuals in serious market abuse cases: the starting point for fines to be £100,000 (approximately $150,000).

Margaret Cole, the FSA Director of Enforcement and Financial Crime, noted that there had been industry opposition to the FSA's proposals and said that the FSA had nonetheless decided to implement them as the FSA believed that the proposed enforcement penalty framework could serve as a powerful tool to help change behavior. Ms. Cole said, "We imposed record fines in 2009, but this new approach further amplifies the deterrent effect of our penalties and sends a powerful message to firms which makes it clear that non-compliant behaviour will not be tolerated."

To read PS10/04, click here.

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