



March 14, 2008

SEC/Corporate

SEC to Allow Debt Buybacks by Agencies and Municipalities in Auctions

On March 12, Erik Sirri, Director of the Division of Trading and Markets of the Securities and Exchange Commission testified before the Committee on Financial Services of the United States House of Representatives that the SEC will allow state agencies and municipalities to buy back their own auction rate bonds as a measure to ease the distress in the credit markets which has made borrowing more expensive for state agencies and municipalities. Mr. Sirri noted that certain municipal issuers in the \$325-\$360 billion auction rate securities market have been forced to pay "penalty" interest rates as high as 20% due to the failure to obtain sufficient bids in auctions to establish a "clearing rate". In addition, investors holding auction rate securities cannot sell their holdings until the next successful auction.

Mr. Sirri stated that the SEC is developing guidance which would be designed to clarify that, with appropriate disclosures and compliance with certain other conditions, municipal issuers can provide liquidity to investors and repurchase their auction rate bonds by participating in auctions for their own securities without triggering market manipulation rules.

Mr. Sirri did not indicate when the guidance would be released.

<http://www.sec.gov/news/testimony/2008/ts031208ers.htm>

SEC Suspends Trading of 26 Companies to Combat "Corporate Hijacking"

On March 13, the Securities and Exchange Commission announced that it had suspended trading in the securities of 26 companies that had apparently usurped the identity of defunct or inactive publicly-traded corporations using a tactic known as corporate hijacking. The SEC ordered the suspensions because of questions regarding the adequacy and accuracy of information pertaining to their status as publicly-traded companies. The trading suspensions will last for 10 business days. This suspension is the first action resulting from the formation of the microcap fraud working group of the SEC's Enforcement Division.

In conducting the corporate hijacking, certain persons appear to have incorporated each of the 26 companies using the same name as a then defunct or inactive publicly-traded corporation. For identification purposes, each class of an issuer's publicly-traded securities is assigned a ticker symbol by Nasdaq Reorganization and a CUSIP number by the Standard & Poor's CUSIP Bureau. These same persons appear to have usurped the CUSIP numbers and ticker symbols assigned to the defunct or inactive corporations' publicly-traded securities for use by the newly-incorporated entities. They then appear to have obtained new CUSIP numbers and ticker symbols in lieu of the

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old ones, also for use of the newly incorporated entities, by apparently representing falsely that they were duly authorized officers, directors, or agents of the original publicly-traded corporation.

<http://www.sec.gov/news/press/2008/2008-41.htm>

Litigation

Confidential Sources Can Establish Scienter Post-Tellabs

A California District Court denied a motion to dismiss a complaint asserting claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, holding, among other things, that the complaint satisfied the PSLRA's standards for pleading scienter even though the allegations were based on information obtained from confidential sources. Plaintiff alleged that defendants, a corporation and its officers, made material misstatements by stating in a May 2006 press release and an accompanying conference call that the company had successfully integrated a competitor acquired earlier in 2006 when "the integration was in fact facing significant problems." In order to establish scienter, plaintiff relied upon five different confidential sources that it described with the particularity required under the 9th Circuit standard announced in *In re Daou Systems, Inc.*

Relying on a 7th Circuit case, defendants argued that the use of confidential sources, by definition, could not give rise to "a cogent and compelling inference of scienter," as required by Supreme Court's recent holding in *Tellabs, Inc. v. Makor Issues & Rights, LTD.* The Court noted that the 9th Circuit had not yet considered whether reliance on confidential sources was permissible under the *Tellabs* standard. The Court refused to follow the 7th Circuit decision cited by defendants and instead, relying on a 5th Circuit opinion, found that *Daou*, which permitted reliance on confidential sources as long as they are described with sufficient particularity and there are "adequate corroborating details" provided in the complaint, was not overruled by *Tellabs*. (*Rosenbaum Capital, LLC v. McNulty*, No. 07-0392 (SC), 2008 WL 619001 (N.D. Cal. Mar. 4, 2008))

Issuer Had Standing to Bring 10b-5 Claim for Injunction

A Utah District Court denied defendants' motion to dismiss plaintiff's claims for injunctive relief brought under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Plaintiff, a company that develops and markets nutritional products alleged, among other things, that the defendants, Fraud Discovery Institute and one of its co-founders, had engaged in illegal market manipulation. According to plaintiff's allegations, defendants first short sold plaintiff's stock and then published uncomplimentary reports about plaintiff's products and business practices.

Defendants argued that plaintiff did not have standing to bring the claim under Rule 10b-5 because it was neither the purchaser nor seller of the securities as required by the Supreme Court's decision in *Blue Chip Stamps v. Manor Drug Stores*. The Court rejected Defendants' argument, holding that *Blue Chip Stamps*, which involved a claim for damages, did not directly overrule prior case law that permitted a 10b-5 claim for injunctive relief by an issuer if there was a "causal connection between the fraudulent sale of a security" and the "injury to the plaintiff." Because the plaintiff had alleged that it suffered damages both directly and proximately caused by defendants' market manipulation and sought injunctive relief rather than monetary damages, the Court denied defendants' motion to dismiss the 10b-5 claim. (*USANA Health Sciences, Inc. v. Minkow*, No. 2:07-CV-159 (TC), 2008 WL 619287 (D. Utah March 4, 2008))

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Broker Dealer

MSRB Reminds Dealers of Rules in Auction Rate Securities Transactions

In a February 19 Notice, the Municipal Securities Rulemaking Board reminded dealers of their disclosure and suitability obligations applicable to transactions in Auction Rate Securities. The recent volatility in the market for municipal Auction Rate Securities, including failed auctions, the downgrades of municipal bond insurers and other short term liquidity concerns, prompted the Notice. In a failed auction, investors who chose to liquidate their positions through the auction process could not do so.

MSRB Rule G-17 requires dealers to deal fairly with all persons and prohibits deceptive, dishonest, or unfair practices. This rule has been interpreted to require that a dealer inform the customer of all material facts of the transaction, a potentially wide array of disclosures given the variety and complexity of Auction Rate Securities. MSRB Rule G-19 provides that a dealer must consider the nature of the security as well as the customer's financial status, tax status and investment objectives, based upon facts disclosed by or otherwise known about the customer, when making recommendations. The dealer must consider both the liquidity characteristics of an Auction Rate Security and the customer's need for liquidity in making its suitability determination.

<http://www.msrb.org/msrb1/whatsnew/2008-09.asp>

FINRA Publishes FAQs on Rule 3012 Supervisory Reports

NASD Rule 3012 requires members to designate and specifically identify to the Financial Industry Regulatory Agency (FINRA) one or more principals to establish, maintain and enforce a system of supervisory control policies reasonably designed to comply with applicable securities laws and regulations and applicable NASD rules and to report, at least annually, to senior management on the testing of the efficacy of such system. FINRA has published a set of frequently asked questions about the Rule 3012 Report, including clarification that Rule 3012 Reports detailing the firm's system of supervisory controls is due to management on at least an annual basis.

Rule 3012 Reports differ from Rule 3013 Reports. Rule 3013 Reports identify the processes a firm follows to establish, maintain, review, test and modify its written compliance policies and written supervisory procedures.

The Rule 3012 Report:

- Details the manner, method and review for testing and verifying that the firm's system of supervisory policies and procedures are designed to achieve compliance with applicable rules and laws;
- Provides a summary of the test results and any deficiencies or gaps identified; and
- Identifies the changes a firm made or will need to make to its supervisory procedures based thereon.

Rule 3012 Reports may be combined with Rule 3013 Reports.

The FAQ also discusses the applications of Rule 3012 to various scenarios involving a producing manager.

<http://www.finra.org/RulesRegulation/IssueCenter/SupervisoryControl/p037999>

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NASDAQ to Trade Options Beginning March 31

The NASDAQ Stock Market LLC announced approval by the Securities and Exchange Commission of the NASDAQ Option Market rules; the market will begin operations on March 31. Options initially listed for trading are on QQQQ and AMAT. Market makers can register or de-register for a particular option series by calling or e-mailing NASDAQ.

<http://www.nasdaqtrader.com/TraderNews.aspx?id=OTA2008-001>

CFTC

CFTC and SEC Sign Collaboration Agreement

On March 11, the Commodity Futures Trading Commission and the Securities and Exchange Commission signed an agreement of mutual cooperation. The agreement establishes a framework for increased communication between the two agencies, including information sharing, joint consideration of new financial products, and cooperation in areas of joint regulatory interest such as portfolio margining, foreign security index products, and the oversight of firms registered with both agencies.

<http://cftc.gov/newsroom/generalpressreleases/2008/pr5468-08.html>

CFTC Allows U.S. Trading of Eurex Futures Contract on a Security Index

On March 6, the Commodity Futures Trading Commission's Office of General Counsel issued a no-action letter allowing the offer and sale in the United States of Eurex Deutschland's futures contract based on the RDXxt USD-RDX Extended Index (Index). In analyzing Eurex's request for relief, the CFTC used the same criteria as those applicable to the offer and sale of security index futures contracts on designated contract markets or derivatives transaction execution facilities, and concluded that the Index lacks any of the elements of a narrow-based security index.

<http://cftc.gov/stellent/groups/public/@lletter08/documents/letter/08-05.pdf>

Banking

International Financial Supervisors Release Report on Risk Management Practices

On March 6, senior financial supervisors from five countries issued a report entitled *Observations on Risk Management Practices during the Recent Market Turbulence* which assesses a range of risk management practices among a sample of major global financial services organizations. The seven supervisory agencies participating in the project were the French Banking Commission, the German Federal Financial Supervisory Authority, the Swiss Federal Banking Commission, the U.K. Financial Services Authority, and, in the United States, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Board of Governors of the Federal Reserve System.

The report was intended to evaluate the effectiveness of current risk management practices during the current market conditions.

<http://www.occ.treas.gov/ftp/release/2008-29.htm>

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FSA Publishes Views on Rogue Trader Risk

On March 11, the UK Financial Services Authority (FSA) published *Market Watch 25*, which highlights measures UK authorized firms should consider to protect themselves against “rogue trader” risk.

Market Watch 25 focuses on prevention, early discovery and remedial action in respect of inappropriate practices that may quickly lead to significant losses. Specific points covered by *Market Watch 25* include: (i) promoting of oversight and governance in front office culture (such as encouraging all traders to take two-week vacations each year), (ii) segregating front office staff from middle and back office functions, (iii) monitoring the use of suspense accounts, and (iv) producing quality management information.

www.fsa.gov.uk/pubs/newsletters/mw_newsletter25.pdf

UK Government Announces 2008 Budget

On March 12, the UK Chancellor of the Exchequer, Alastair Darling, set out the UK Government’s 2008 Budget in the House of Commons including key issues relevant to the UK financial services industry.

The Budget included announcements in respect of the UK Investment Manager Exemption, the introduction of Funds of Alternative Investment Funds, the introduction of a new tax regime for Property Authorized Investment Funds, changes to the offshore funds rules introducing “reporting funds”, reform of the UK’s non-domicile rules and extending the UK VAT exemption for fund management.

The Investment Manager Exemption (IME). A single list of qualifying transactions for the purposes of the IME will be maintained and updated to allow flexibility to adapt to new products and instruments like carbon credits.

Funds of Alternative Investment Funds (FAIFs). In conjunction with changes proposed by the Financial Services Authority outlining a new regulatory framework for FAIFs which will allow UK funds to invest in other alternative investment funds, as described in the February 29, 2008 edition of *Corporate and Financial Weekly Digest*, new tax rules have been introduced to allow UK authorized funds to elect for exemption from the UK’s offshore funds regime. Instead, investors in FAIFs that make the election (Tax FAIFs) will be taxed as if the Tax FAIF was an offshore fund, effectively moving the point of taxation from the fund to its investors.

New Tax Regime for Property Authorized Investment Funds (PAIFs). A new tax regime has been proposed for PAIFs (authorized investment funds which invest mainly in property and shares in UK Real Estate Investment Funds (UK-REITS) and similar foreign companies). The new regime is to come into effect on or after April 6 and will enable certain alternative investment funds to elect for tax treatment that will move the point of taxation from the fund to its investors. It will also enable PAIFs to provide an open-ended fund alternative to the existing closed-ended UK-REITS.

Changes to the UK offshore funds rules. The existing “distributor status” regime will be replaced with a “reporting” regime. Unlike distributing funds, “reporting funds” will not be required to distribute 85% of income in order to qualify for the new tax regime. Instead, 100% of income will have to be “reported” to investors, who will then be subject to income tax on that reported income.

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Reform of the UK non-domicile rules. As previously proposed by the UK Treasury, non-domiciliaries wishing to benefit from the remittance basis of taxation will be levied an annual charge of £30,000 (\$60,000) if they have been a resident of the UK for seven years. It is now anticipated that the £30,000 (\$60,000) will be creditable under double tax agreements (including with the U.S.) as it will be charged as “tax” not some other “levy” or “charge”.

UK VAT exemption for fund management. Exemption from VAT is currently granted to the management of authorized unit trusts, trust-based schemes and open-ended investment companies. This exemption is to be extended to cover UK-listed investment entities (including investment trusts and venture capital trusts), and will have effect for supplies of services made on or after October 1.

www.hm-treasury.gov.uk/budget/budget_08/bud_bud08_index.cfm

EU Developments

CESR Publishes a Consumer’s Guide to MiFID

On March 7, the EU Committee of European Securities Regulators (CESR) published a consumer’s guide to the EU Markets in Financial Instruments Directive (MiFID). The guide explains the basics of MiFID and the key requirements for firms providing investment services in Europe.

It aims to highlight the key principles that EU firms need to fulfill when dealing with consumers including: (i) a duty to act honestly, fairly and professionally and in accordance with the consumer’s best interests, (ii) the provision of appropriate and comprehensive information which is fair, clear and not misleading to the consumer, and (iii) the provision of services that take account of individual circumstances.

www.cesr.eu/popup2.php?id=4984

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