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SEC/Corporate

Commission on the Regulation of U.S. Capital Markets in the 21st Century Calls for Reform

On March 12, the U.S. Chamber of Commerce's Commission on the Regulation of U.S. Capital Markets in the 21st Century issued its Report and Recommendations assessing the current state of the securities industry and making several recommendations for improving the competitive position of the U.S. markets.

The Chamber Commission Report highlighted six principal recommendations:

- reform and modernize the government's regulatory approach to financial markets and market participants; including realigning its organizational structure to improve its efficiency and mirror the contours of the current capital markets;
- give the Securities and Exchange Commission the flexibility to address issues relating to the implementation of the Sarbanes-Oxley Act of 2002 by making it part of the Securities Exchange Act of 1934, as amended;
- convince public companies to stop issuing earnings guidance or, alternatively, move away from quarterly earnings guidance reports with a single earnings per share number to annual guidance with a range of projected earnings per share numbers;
- call on domestic and international policymakers to consider proposals to reduce the significant risks faced by auditors raised by litigation and criminal prosecution and consider allowing auditors to raise capital from private shareholders rather than just audit partners;
- increase retirement savings plans by connecting all employers with 21 or more employees without any retirement plan to a financial institution that will provide such a plan to those employees; and
- encourage employers to sponsor retirement plans and enhance the portability of retirement accounts through the introduction of a simpler, consolidated 401(k)-like program.

The Commission makes a number of additional interesting recommendations with respect to U.S. capital markets in the global marketplace, accumulated savings and investor education, issuers and auditors, and financial services. For example, in the accounting area, the Commission encourages continued convergence of international and U.S. accounting and auditing standards and recommends a change to the SEC's existing approach to reconciliation. The

SEC/CORPORATE

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Commission also recommends that the SEC's Chief Accountant conduct rulemaking about when a restatement of financials is required.

In the enforcement area, the Commission states that there is a "strong need to investigate the accuracy of the widely held global perception that the U.S. securities litigation and regulatory environment makes it dangerous to participate in our capital markets." The Commission urges the SEC to study whether its enforcement program is effective, as well as the impact of the Private Securities Litigation Reform Act of 1995 on the effectiveness of federal securities laws.

The Commission recommends that the Department of Justice and the SEC should not consider the waiver of privilege as a factor in determining whether there was cooperation in an investigation and that Congress adopt legislation "establishing a selective waiver that would permit corporations to share privileged information with the SEC and continue to assert the privilege against other parties." The Commission also recommends that Congress establish a selective waiver that would "permit a private party to share privileged information or documents with external audit firms or government appointed corporate compliance monitors without waiving the attorney-client privilege to other third parties."

The release of the Chamber Commission Report was followed this week by the Treasury's Conference on U.S. Capital Market Competitiveness hosted by Treasury Secretary Paulsen and the U.S. Chamber of Commerce's First Annual Capital Markets Summit featuring keynote addresses by the Chairmen of the SEC, PCAOB, House Financial Services Committee and Senate Banking Committee and the formal release and discussion of the Chamber Commission Report.

All of this serious hand-wringing over the state of the U.S. capital markets (General Electric Chairman and CEO Jeffrey Immelt's observation that the regulatory system is: "just too gosh-darn complex.") was counterpointed by one particularly upbeat observation by Warren Buffet that corporate profits have never been higher as a percentage of gross domestic product. "That cannot be regarded as a broken capitalistic system."

The full Report is located at:
http://www.uschamber.com/NR/rdonlyres/eozwwssfrqzdm3hd5siogqhp6h2ngxwdpr77qw2bogptzvi5weu6mmi4plfq6xic7kjonfpg4q2bpks6ryog5wwh5sc/0703capmarkets_full.pdf

The Executive Summary of the Report is located at:
http://www.uschamber.com/NR/rdonlyres/ex4nk2agcvtretp2osaiperiqoczkvhtq6w5f5vwsh6mef4snh3atd7n4b256hexty4wcc7i3eq4thca4vdnoqovurg/0703capmarkets_summ.pdf

Broker Dealer

SEC Staff Outlines How Foreign Brokers and Exchanges Can Access U.S.

Erik R. Sirri, the Director of the Division of Market Regulation of the Securities and Exchange Commission, recently proposed a "cooperative approach" to easing the registration requirements applicable to the activities of foreign broker-dealers and foreign exchanges in the U.S.

Under the "cooperative approach," U.S. brokers could join foreign exchanges in jurisdictions with exchange regulation and oversight standards comparable to those in the U.S. and market securities that trade on those foreign exchanges in the U.S., and the foreign exchanges would not have to register

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with the SEC. In addition, the SEC would ease the requirements of SEC Rule 15a-6 to allow foreign brokers to deal directly with U.S. Qualified Institutional Buyers in the U.S. (but only in foreign securities and U.S. government bonds) without registering as broker-dealers.

Mr. Sirri's proposal conditioned the recognition of foreign regulators and registration status as the substantive equivalent to the U.S. standards on: (i) the existence of a supervisory cooperation, investigative and financial memorandum of understanding between the SEC and the foreign regulatory authority; (ii) compliance by foreign broker-dealers with specific U.S. regulatory requirements, including notice and record access requirements; and (iii) reciprocal treatment of U.S. broker-dealers by the home jurisdiction of the foreign broker-dealer.

With respect to foreign exchanges accepting U.S. members, Mr. Sirri proposed the following additional conditions: (i) notice to U.S. investors that their trading is effected in a foreign marketplace; (ii) U.S. persons can only trade foreign securities that do not have an ADR program on foreign exchanges; (iii) U.S. persons could trade through registered U.S. broker-dealers that have access to the foreign exchange; (iv) no discrimination by the foreign exchange in granting access to services.

http://www.sec.gov/news/speech/2007/spch030107ers.htm

SEC Proposes Amendments to Broker-Dealer Financial Responsibility and Related Rules

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The Securities and Exchange Commission has proposed amendments to the financial responsibility rules under the Securities Exchange Act of 1934. The proposed amendments would affect the net capital rule (Rule 15c3-1), the customer protection rule (Rule 15c3-3), the books and records rules (Rule 17a-3 and Rule 17a-4), and the notification rule (Rule 17a-11).

The proposed changes include the following:

- Broker-dealers would be required to perform a reserve computation, segregate the cash balances in a proprietary account of an introducing broker-dealer and obtain certain agreements and notices related to such accounts. The introducing broker would be able to carry this account balance as a good asset for its net capital computation.

- Broker-dealers would have to obtain the affirmative consent of or give notice to a customer before changing the terms under which the customer's free credit balances are maintained.

- Broker-dealers with customer credit balances over $1 million or $20 million in capital would have to make and maintain records documenting internal controls for analyzing and managing risks.

- Broker-dealers would have to provide the SEC with notice upon the occurrence of certain insolvency events.

- Broker-dealers would have to notify the SEC if their securities borrowed, loaned, or reverse repurchased reached 25 times tentative net capital, excluding government securities.

- Broker-dealers would have to include as a capital deduction expenses paid by a third party, e.g., parent holding company, unless they could demonstrate that the third party had sufficient assets or income, excluding that attributable to the broker-dealer, to make such payments.

The SEC has requested comments on these rule proposals on or before May 18.

http://www.sec.gov/rules/proposed/2007/34-55431.pdf

SEC Staff Issues Report on Options Order Routing and Execution

The Securities and Exchange Commission Staff recently released a report relative to the retail option execution practices of eight major brokers. The report concluded that there has been improvement over the last six years in order routing firms' processes to obtain best execution for their retail customers' options orders. However, two impediments to best execution for retail customers exist: (i) payment for order flow and other inducements continue to play a substantial role in broker-dealers' order routing decisions; and (ii) the negative impact of the lack of standardized, widely available execution quality data.

Many firms have begun to utilize order routing technology to ensure that marketable retail customer options orders are sent to the market displaying the best price. But because multiple market centers often display the same best price, firms rely on other competitive factors to determine to which market center, among those displaying the best price, to route customer orders. These include payment for order flow and situations in which the firm has an ownership interest in the exchange or in the specialist on the exchange to which the order is routed. The Staff noted that because most options prices continue to be quoted in 5¢ and 10¢ increments, spreads remain artificially wide and the excess dealer profits often are shared with order flow providers through payment arrangements.

The SEC's efforts to encourage the options markets to quote in penny increments and support the need for standardized execution quality data in best execution analyses for the options market includes the sixth month long "penny pilot program," which began on January 26. As part of the penny pilot program options exchanges are quoting certain series of 13 options classes in pennies.

http://www.sec.gov/news/studies/2007/optionsroutingreport.pdf

Banking

FinCEN and Banking Regulators Announce Availability of New SAR Form

In December 2006, the Financial Crimes Enforcement Network (FinCEN) and the federal banking agencies announced that the format for the Suspicious Activity Report by Depository Institutions (SAR-DI) was to be revised. The revisions are the result of their continuing efforts to reduce paperwork and respondent burden. The form was revised and reformatted to standardize suspicious activity reports, enhance the clarity of instructions, allow for joint filing of Suspicious Activity Reports, and to improve the usefulness of the Suspicious Activity Report to law enforcement.
The revised SAR-DI format, which should not be used until June 30, was released to allow depository institutions subject to SAR filing requirements to begin initial planning for the effective implementation date. On June 30, depository institutions will have the option of using either the existing or the revised SAR-DI formats. Use of the revised format for filing will become mandatory December 31. A link to the revised format follows:

http://www.fincen.gov/fincen_form111.pdf

BANKING

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United Kingdom Developments

FSA Clarifies Approach to Alternative Investment Regulation

In a speech delivered to an industry conference on March 12, Dan Waters, Head of Retail Policy at the Financial Services Authority (FSA), outlined the FSA's approach to the regulation of hedge funds and private equity funds.

Waters reiterated that the FSA's view remains that properly run alternative investment funds contribute to the overall efficiency and liquidity of global capital markets.

The key risks identified include potential market disruption, loss of confidence, market abuse and operational deficiencies. To address these, the FSA has implemented periodic surveys to better understand the risks, enhanced the role of its alternative investments monitoring team (created in 2005) and increased its co-operation with other international regulators such as the US Securities and Exchange Commission and the US Federal Reserve.

To reduce the threat of market abuse and the risk of fraud, the FSA is working with the International Organization of Securities Commissions (IOSCO) to establish good practice for the valuation of complex assets. FSA will continue to use both prevention and enforcement where necessary to ensure that potential market abuse is minimized. This includes monitoring "hot-spots", the creation of a modern transaction analysis system and industry co-operation.

The FSA is also exploring how the market for alternative investment funds may be opened up to a wider group of investors by relaxing its listing rules and creating an on-shore retail fund of hedge funds vehicle.

http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0313_dw.shtml

http://www.iosco.org/library/pubdocs/pdf/IOSCOPD240.pdf

FSA Sets Out Suspicious Transaction Scenarios

In the March 14 issue of its regular Market Watch newsletter, the Financial Services Authority (FSA) gave firms some assistance in understanding their market abuse suspicious transaction reporting obligations.

The requirement to report transactions suspected of constituting market abuse to the FSA is one of the major obligations introduced by the European Union's Market Abuse Directive in July, 2005. The FSA implemented this requirement by rules to be found at SUP 15.10 of its rule book.

In deciding what transactions to report, the key test is whether there are reasonable grounds for suspecting the transaction involves market abuse. The Market Watch examples clarify the FSA's view of when there are reasonable grounds for a regulated firm to suspect market abuse.

http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter19.pdf

UK Treasury Committee to Hear Evidence on Private Equity Funds

On March 6, the Treasury Select Committee of the UK House of Commons announced its plans to hold new hearings on Private Equity Funds. Further information about the terms of reference and timing of these hearings is expected shortly. This will supplement the Financial Services Authority's work in the area. The FSA published a discussion paper (DP06/6) entitled *Private equity: a discussion of risk and regulatory engagement'* in November 2006.

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The discussion paper's period for responses closed on March 6.

http://www.parliament.uk/parliamentary_committees/treasury_committee/tc060307pn33.cfm

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Lead Plaintiff Appointment Vacated Under PSLRA

The District Court vacated the Magistrate Judge's lead plaintiff appointment in a securities class action asserting claims under sections 10(b) and 20(a) of the Securities and Exchange Act of 1934 relating to the alleged unlawful grant of backdated stock options to Defendant's senior executives.

The District Court first found that, under the Private Securities Litigation Reform Act, among competing candidates for lead plaintiff status who have timely filed complaints, the class member with the "largest financial loss" is presumptively the lead plaintiff. It then determined that the Magistrate had improperly calculated the loss that the two principal lead plaintiff candidates suffered. Specifically, in determining the losses sustained by the appointed candidate, the Magistrate included losses that the candidate incurred on "in-an-out trading" that occurred prior to any public disclosure of the alleged misconduct.

The Court ruled that such losses were not recoverable because they were not proximately linked to the misconduct alleged. The Court then determined that once those losses were netted out, the objecting class member had, in fact, sustained the greatest loss and, thus should be designated the lead plaintiff. (*In re Comverse Technology, Inc.*, 2007 WL 680779 (March 2, 2007 E.D.N.Y.))

Plaintiff Failed to State Claim Under § 36(b) of Investment Company Act of 1940

Defendant investment advisors moved to dismiss cause of action for disgorgement brought by plaintiff Fund under Section 36(b) of the Investment Company Act of 1940. The Fund alleged that the investment adviser benefited from a redemption fee received by the Fund. According to the Fund, the defendants benefited from the redemption fees because they reduced the Fund's annual operating expenses, which, in turn, reduced the defendant investment advisors' annual reimbursement obligation to the Fund.

After noting that Section 36(b) narrowly limits the class of potential defendants in actions involving investment advisory services to direct recipients of compensation or fees (or to affiliates, if funds in their possession are "directly trace[able]" to such compensation or fees), the Court dismissed the claim, ruling that "indirect approaches to establishing the receipt of compensation [such as the one alleged by the plaintiff Fund] are clearly beyond Section 36(b)'s purview." (*Reaves v. Federated Investors, Inc. et al.*, 2007 WL 709327 (March 5, 2007 W.D. Pa.))

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Interpretive Notice for FCMs Offering Sweep Accounts Approved

On March 12, the Commodity Futures Trading Commission approved the National Futures Association's (NFA) recently-proposed interpretive notice to NFA Compliance Rule 2-4, which requires futures commission merchants (FCMs) that offer or recommend sweep accounts to make certain disclosures to their clients. The notice does not prescribe specific disclosure language, but specifies certain disclosures that FCMs should make at the time a sweep account program is offered to a customer and requires each FCM to obtain the customer's written consent prior to any funds being transferred pursuant to such program.

http://www.cftc.gov/opa/adv07/opawa11-07.htm

http://www.nfa.futures.org/news/newsRuleSubLetter.asp?ArticleID=1771

CFTC Approves NFA Amendments to Compliance Rule 2-10

Also on March 12, the Commodity Futures Trading Commission approved amendments to the National Futures Association Compliance Rule 2-10(b) requiring futures commission merchants (FCMs) to keep their books and records in an office that is under the supervision of an individual resident in that office, who is a principal and is registered as an associated person (AP) of the FCM. Although the existing rule required FCMs to keep such books and records in an office located either in the U.S. or in a Part 30 jurisdiction, there was no requirement that the office be maintained by the FCM or that it be supervised by a principal and registered AP.

http://www.cftc.gov/opa/adv07/opawa11-07.htm

http://www.nfa.futures.org/news/newsRuleSubLetter.asp?ArticleID=1775

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