Katten Muchin Rosenman LLP

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SEC/Corporate

Final Report of the Advisory Committee on Smaller Public Companies

On February 27, the Securities and Exchange Commission's Advisory Committee on Smaller Public Companies released its draft final report for public comment. Katten Muchin Rosenman LLP partner Herbert S. Wander is Co-Chair of the Advisory Committee.

The Advisory Committee made 32 recommendations, specifying a first tier of primary recommendations for priority consideration by the SEC.

The first primary recommendation calls for the establishment of a new system of scaled or proportional securities regulation for smaller public companies which divides smaller public companies into two groups, microcap companies and smallcap companies. Microcap companies would consist of companies whose common stock (or equivalent) in the aggregate comprises the lowest 1% of total U.S. equity market capitalization (a cut off of approximately $128 million of market capitalization), and smallcap companies would consist of companies whose common stock (or equivalent) in the aggregate comprises the next lowest 5% of total U.S. equity market capitalization (a cut off of approximately $787 million of market capitalization). This framework would provide the basis for determining the application of individual securities regulations.

Another primary recommendation would exempt microcap companies with less than $125 million in annual revenue and smallcap companies with less than $10 million in annual revenue from the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, provided that such companies adhere to standards relating to audit committees in conformity with Rule 10A-3 under the Securities Exchange Act of 1934; have adopted a code of ethics within the meaning of Item 406 of Regulation S-K; and have complied with the further obligations under Item 406(c) relating to the disclosure of the code of ethics. In addition, the final report also proposes exemptive relief from the external auditor involvement in the Section 404 process to smallcap companies with less than $250 million but greater than $10 million in annual revenues, subject to their compliance with the same corporate governance standards detailed in the preceding sentence. The exemptions would apply until an acceptable framework for assessing internal control over financial reporting for microcap or smallcap companies is developed. The Advisory Committee recommended that if the SEC concludes that an audit of internal controls is required, the standards for implementing such audit be changed to a more cost-effective standard.

After receiving public comments, the Advisory Committee will present its final report to the SEC commissioners in April 2006.
http://www.sec.gov/info/smallbus/acspc/acspc-finalreport_d.pdf

SEC Warns About "Paid Autosurf" Scams

On February 27, the Securities and Exchange Commission issued an investor alert warning the public about scams involving so-called "paid autosurf" programs that promise to pay people for looking at online ads, as it announced that it had filed securities fraud charges against one of the largest operators of such Web sites, 12dailyPro. According to the SEC, 12dailyPro was actually "a massive Ponzi scheme" that bilked some 300,000 investors worldwide of more than $50 million by offering a 44% return in 12 days. In a tentative settlement with the SEC, the operator agreed to stop soliciting investors, the operator's assets were frozen and a receiver was appointed to take over company operations.

The SEC urged the public to be aware that paid memberships in such schemes may be a form of investment, and to exercise caution before investing.
http://www.sec.gov/investor/pubs/autosurf.htm

Cox Scolds SEC Staff for Subpoenas Issued to Journalists

Securities and Exchange Commission Chairman Christopher Cox publicly scolded the Commission staff for failing to notify the commissioners, the Commission general counsel or the public affairs office before issuing subpoenas to several journalists. Criticism of the subpoenas emerged last weekend when the journalists voiced objections to subpoenas issued by the Commission in connection with an ongoing investigation into alleged market manipulation by stock-research company Gradient Analytics, Inc. and hedge fund Rocker Partners LP, run by well known short-seller David Rocker. Chairman Cox did not rule out journalist subpoenas in all circumstances, but made it clear that such a move would be an "extraordinary step that should, and will be, considered and decided by the Commission before this matter proceeds further."

The issue brings to the fore simmering complaints from some conservatives and business groups that the division, which has aggressively investigated allegations of wrongdoing and become bigger and more powerful in the wake of corporate scandals, has too much autonomy and needs closer supervision by the commissioners. Unlike the Department of Justice, the SEC doesn't have a formal policy governing when or how to subpoena journalists. In a further statement on March 2, Mr. Cox told reporters that the SEC would move quickly to write a policy on the issuance of subpoenas to journalists.
http://www.nytimes.com/2006/03/03/politics/03sec.html?_r=1&pagewanted=all&oref=slogin
http://sec.gov/news/press/2006-24.htm

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Banking

Kevin M. Warsh Newest Member of Board of Governors

Kevin M. Warsh took the oath of office on February 24 as a member of the Board of Governors of the Federal Reserve System. The oath was administered by Vice President Cheney in the Vice President's Ceremonial Office in the Eisenhower Executive Office Building.

President Bush announced his intention to nominate Mr. Warsh on January 27 and the Senate confirmed him on February 17. Mr. Warsh was nominated to a vacant seat. The term expires January 31, 2018. Mr. Warsh had previously served on the President's National Economic Committee. He is a graduate of Stanford University and Harvard Law School.

Banking Agencies Issue Final Community Reinvestment Guidance

The federal banking agencies on March 2 announced final guidance implementing the recent changes to the Community Reinvestment Act (CRA) regulations. The guidance clarifies, among other things, the availability of CRA consideration for bank activities that revitalize or stabilize designated disaster areas.

The guidance indicates that a bank's loans, investments, and services in support of disaster recovery that help to attract new, or retain existing, businesses or residents to a designated disaster area will receive CRA "community development" consideration for a 36-month period following designation of the area. The guidance allows for extensions of this period in unusual cases, and the agencies plan to substantially extend the time periods in the Gulf Coast areas hit by hurricanes Rita and Katrina.

The guidance also addresses the availability of CRA "community development" consideration for bank activities that revitalize or stabilize underserved or distressed middle-income rural areas. The other major issue it addresses is implementation of the new community development test for banks with assets between $250 million and $1 billion.

The guidance, which takes the form of questions and answers, will be effective upon publication in the Federal Register, which is expected shortly.
http://www.fdic.gov/news/news/press/2006/pr06023a.pdf

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Broker Dealer

NASD Proposes Principal Review of Retail Correspondence

The Securities and Exchange Commission has published for comment (Release No. 34-53333) a proposal by the National Association of Securities Dealers, Inc. to require that all correspondence sent to 25 or more retail customers by a member firm within any 30-day calendar period be approved in advance by a principal of the firm. This would include e-mails and instant messages. A Securities Sales Supervisor (Series 9/10) would be sufficient for pre-use approval. Clerical or ministerial correspondence would be excluded from this requirement. The correspondence subject to pre-approval would not be required to be filed with the NASD's advertising department. The NASD will issue a Notice to Members at least 30 days in advance of the rule change's effectiveness.
http://www.sec.gov/rules/sro/nasd/34-53333.pdf

SEC Approves NYSE Rule Changes to Effect Merger with Archipelago

The Securities and Exchange Commission has approved rule changes submitted by the New York Stock Exchange, Inc. in anticipation of its merger with Archipelago to form NYSE Group, Inc. (NYSE GROUP), to be a publicly held, for profit corporation that will be listed on the NYSE. These rule proposals were summarized in the January 13, 2006 issue of the *Corporate and Financial Weekly Digest*. The registration of the NYSE as a national securities exchange will be held by New York Stock Exchange LLC, a wholly owned subsidiary of NYSE Group (Stock Exchange). NYSE Market, Inc., a wholly owned subsidiary of Stock Exchange, will operate the trading floor and listing requirements (NYSE Market), and NYSE Regulation, Inc., a Type A New York not-for-profit corporation (NYSE Regulation), will conduct enforcement and regulatory activities. The major changes in the approved rules are: (a) the NYSE Group directors on NYSE Regulation's board will be a minority, and the majority must be independent directors not affiliated with NYSE Group; (b) the NYSE Group directors on the NYSE Regulation nominating and governance committee will constitute a minority of the directors; (c) NYSE Regulation will have a compensation committee composed of a majority of independent directors that are not NYSE Group directors, setting compensation for the head of NYSE Regulation and others; and (d) NYSE Group and its subsidiaries will enter into an explicit agreement and adopt a rule to provide adequate funding for NYSE Regulation. NYSE Group will not be able to remove directors from Stock Exchange other than for cause. Stock Exchange will not be able to remove directors on NYSE Market's board selected by members and non-affiliated regulation directors other than for cause. Members of the Stock Exchange will be firms that have purchased trading permits and other broker-dealers that submit to its jurisdiction. The NYSE undertook to conduct a review of its rules that are inconsistent with the rules of the NASD. This review will be conducted with the National Association of Securities Dealers and industry representatives, and the NYSE will submit a report to the SEC within one year of proposed rule changes reconciling inconsistent rules and a report of those rules that have not been reconciled.
http://www.sec.gov/rules/sro/nyse/34-53382.pdf
http://www.sec.gov/news/press/2006-29.htm

SEC Approves CBOE's Automated Improvement Mechanism

In Release No. 34-53222, the Securities and Exchange Commission approved a rule proposal by the Chicago Board of Options Exchange (CBOE) to establish the Automated Improvement Mechanism (AIM). AIM will only be available for option classes with at least three market makers quoting at the time of an initiating agency order. In AIM an initiating member submits an agency order and a second order on the other side either for itself or a solicited order other than for the account of a market maker in that option class. In the case of an order for less than 50 contracts, the second order must be either (a) at one cent over the then national best bid or offer (NBBO) or at the limit order price if the agency order is a limit order, or (b) "auto match", as described below. In the case of orders for 50 or more contracts, the second order must be either (a) at the NBBO or limit order price, or (b) an auto match order. The CBOE will commence an auction by issuing a request for responses. The auction will last 3 to 5 seconds. Other CBOE members may reply to the request, but no one member will know what the replies are of the other members. Generally, the auction will be stopped if another order in the same series is received that would fill or could be matched against the agency order. Otherwise, at the end of the auction, the CBOE will either execute the order against the initiating broker's order if its price is the best price. In the case of an auto match order, the CBOE will execute the agency order against the prices submitted by the other members, and the initiating broker will, in most cases, be allocated an amount equal to 40% of those priced orders from the other members until the agency order is filled. Where one market maker matches the initiating order, the initiating broker may be allocated 50%. Where there is more than one response to the auction at the same price, the CBOE will allocate the orders according to its established algorithms for allocating order executions. During a pilot period ending July 18, 2006, the CBOE will furnish specified information to the SEC regarding the operation of the AIM.
http://www.sec.gov/rules/sro/cboe/34-53222.pdf

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Not for Profit

IRS Takes Action - Report Determines Nearly 75% of Not for Profits are Violating Tax Code Prohibitions Concerning Political Activity

Internal Revenue Service officials reported this week on the agency's examination of political activity by tax-exempt organizations during the 2004 election campaign. They report some level of prohibited political activity by section 501(c)(3) organizations in nearly three-quarters of the cases reviewed. 132 cases were referred to the field for investigation and of 82 cases already examined and closed, the IRS claims to have substantiated that prohibited political campaign activity occurred and, further, has proposed the revocation of the organizations' exempt status. In 55 of the cases, the IRS issued written advisories indicating the Service's view that prohibited campaign activity had occurred, yet did not recommend revocation.

With the enactment of the Revenue Act of 1954, Congress barred all section 501(c)(3) tax-exempt organizations (not just religious institutions like churches, synagogues and mosques) from political campaign intervention by adding language to the Internal Revenue Code that disqualifies them from exemption if they "participate in, or intervene in (including the publicizing or distributing of statements), any political campaign on behalf of any candidate for political office." In 1987, Congress amended section 501(c)(3) to clarify that the prohibition on political campaign intervention applies to activities "in opposition to," as well as on behalf of, any candidate for public office.

An Executive Summary of the IRS report may be accessed at
http://www.irs.gov/pub/irs-tege/exec__summary_paci_final_report.pdf

The Final Report is at http://www.irs.gov/pub/irs-tege/final_paci_report.pdf

Additional Information at http://www.irs.gov/charities/article/0,,id=154622,00.html

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Litigation

Executive Liable for Nondisclosure of Participation in Stock Spinning Scheme

A New York Court has awarded partial summary judgment to the State in an action against the former chief executive officer of a bankrupt telecommunications company arising from his failure to disclose that an investment bank had deposited more than $9 million of "hot" initial public offering stock into "private wealth management" accounts maintained on his behalf in New York as an inducement for him to direct his company's investment banking business to the bank. The Court held that under New York's Martin Act, defendant's admitted failure to disclose receipt of the IPO stock to his company's shareholders and board of directors "clearly tended to deceive or mislead the purchasing public." Further, in rejecting the argument of defendant, an Iowa resident, that the Court lacked personal jurisdiction over him, the Court determined that the claims were substantially related to his transaction of business in New York through the deposit of IPO stock into his New York accounts. (*State of New York v. McLeod* , No. 403855/02, slip op. (N.Y. Sup. Ct. Feb. 9, 2006))

Setting of Identical Prices for Different Brands Sold by Joint Venture not Per Se Illegal

The U.S. Supreme Court has reversed a Ninth Circuit decision in a class action by service stations alleging that setting a single price for gasoline sold under separate brands by a joint venture formed by two oil companies was unlawful. Specifically, plaintiffs alleged that by unifying the prices of two brands of gas sold by the joint venture, defendants had engaged in an unlawful price-fixing scheme, constituting a per se violation of Section 1 of the Sherman Act. In rejecting that claim, the Court held that since the companies' joint venture, consolidating their domestic refining and marketing in the western U.S., was lawful, the "pricing policy challenged here amounts to little more than price setting by a single entity." Thus, "though the [joint venture's] pricing policy might be price fixing in the literal sense, it is not price fixing in the antitrust sense." (*Texaco Inc. v. Fouad N. Dagher*, Nos. 04-805 and 04-814, 2006 WL 461525 (U.S. Feb. 28, 2006))

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CFTC

NFA Proposes Increased Capital, Report Filing and Affirmative Disclosure Requirements

The National Futures Association (NFA) has proposed to increase the minimum capital requirements from \$250,000 to \$500,000 for futures commission merchants that are not forex dealer members, from \$250,000 to \$1,000,000 for forex dealer members, and from \$30,000 to \$45,000 for independent introducing brokers. Separately, the NFA has proposed formally to require forex dealer members to file weekly electronic reports showing liabilities to customers and other financial information. The proposed amendment also would impose an automatic fee on forex dealer members filing late reports and require forex dealer members affirmatively to disclose to customers that their funds may not be protected under bankruptcy law.
http://www.nfa.futures.org/news/newsRuleSubLetter.asp?ArticleID=1549
http://www.nfa.futures.org/news/newsRuleSubLetter.asp?ArticleID=1555

CFTC Approves FDICIA Multilateral Clearing Organization

The Commodity Futures Trading Commission has issued an order pursuant to Section 409(b)(3) of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which provides that the CFTC or other authorized U.S. financial regulators may determine that the supervision by a foreign financial regulator of a multilateral clearing organization (MCO) for over-the-counter (OTC) derivative instruments satisfies appropriate standards. The CFTC has determined that the supervision by the Alberta Securities Commission in Canada of an MCO for OTC derivatives operated by NetThruPut, Inc. satisfies the statutory criteria. The CFTC Order thus permits NetThruPut, Inc. to operate as an MCO with respect to OTC derivatives transactions to be executed on its online trading platform.
http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-1940.pdf

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