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Corporate and Financial Weekly Digest

March 9, 2007

SEC/Corporate

SEC Suspends Trading in Thirty-Five Pink Sheets Companies

On March 8, the Securities and Exchange Commission announced that it has suspended trading in the securities of 35 companies quoted on the Pink Sheets quotations service that have been the subject of recent and repeated spam email campaigns. The trading suspensions – the most ever aimed at spammed companies – were ordered because of questions regarding the adequacy and accuracy of information about the companies, none of which are subject to the reporting requirements of the Securities Exchange Act of 1934.

The trading suspensions are part of a stepped-up SEC effort - code named "Operation Spamalot" - to protect investors from potentially fraudulent spam email hyping small company stocks with phrases like, "Ready to Explode," "Ride the Bull," and "Fast Money." It's estimated that 100 million of these spam messages are sent every week, triggering dramatic spikes in share price and trading volume before the spamming stops and investors lose their money.

The trading suspensions will last for ten business days. The trading suspensions commenced March 8 at 9:30 a.m., EDT, and will terminate at 11:59 p.m., EDT, on March 21, 2007.

http://www.sec.gov/news/press/2007/2007-34.htm

Shareholder Votes on Executive Compensation Considered

In three recent no-action letter responses, the staff of the Division of Corporation Finance of the Securities and Exchange Commission advised AT&T Inc. and two other companies that they may not exclude from their proxy statements a shareholder proposal to adopt a policy that included, as a voting item in the proxy statement for each annual meeting, a non-binding advisory management resolution to approve the compensation of the named executive officers set forth in the Summary Compensation Table in the company's proxy statement and the accompanying narrative disclosure of material factors provided to understand the Summary Compensation Table. (The SEC's response in the AT&T letter is subject to proof of stock ownership by the proponent of the proposal.)

In addition, on March 1, United States House of Representatives Financial Services Committee Chairman Barney Frank (D-Mass.) introduced legislation to require public companies to include in their annual proxy statements a non-binding advisory shareholder vote on their executive pay plans. The bill also contains a separate advisory vote if a company gives a new, not yet disclosed, "golden parachute"

SEC/CORPORATE

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while simultaneously negotiating to buy or sell a company.

AT&T Inc., SEC No-Action Letter, available 2/16/07.

http://www.house.gov/apps/list/press/financialsvcs_dem/press030107.shtml

Broker Dealer

CBOE Rule Regarding Establishment of CBOE Stock Exchange

On December 26, 2006, the Chicago Board Options Exchange, Incorporated (CBOE) filed with the Securities and Exchange Commission a proposed rule change relating to the establishment of the CBOE Stock Exchange (CBSX), which will be operated by CBOE Stock Exchange, LLC (CBSX LLC). CBOE filed Amendment No. 1 to the proposed rule change on January 10 (the SEC received no comments), Amendment No. 2 and Amendment No. 3 on March 1 and March 2, respectively. On March 2, the SEC granted approval of the proposed rule change, granted accelerated approval to Amendment Nos. 2 and 3 and solicited comments on Amendment Nos. 2 and 3.

CBOE proposes to establish CBSX as a "facility" (as that term is defined in Section 3(a)(2) of the Securities Exchange Act of 1934) of CBOE. CBOE will have regulatory responsibility for the activities of CBSX. CBSX will be a fully automated marketplace for the trading of securities other than options by CBOE members. In prior releases, the SEC approved the CBSX rules for listing, trading and membership permits.

CBSX will be owned 50% by the CBOE, 20% by VDM Chicago, LLC, 10% by Labranche & Co., Inc., 10% by an affiliate of Interactive Brokers and 10% by Susquehanna International Group. In the current proposed rule change, CBOE seeks the SEC's approval of the proposed governance structure of CBSX LLC as reflected in its Operating Agreement.

The filing discusses in detail various provisions of the Operating Agreement of CBSX LLC, which relate to: (i) CBSX being a "facility" of CBOE; (ii) changes in control of CBSX LLC; (iii) regulatory jurisdiction over CBSX LLC owners; and (iv) ownership and voting restrictions on CBSX LLC owners.

http://www.sec.gov/rules/sro/cboe/2007/34-55389.pdf

Frequency of Short Interest Reporting Rule Change Approved

On December 4, 2006, December 7, 2006, and January 10, respectively, the National Association of Securities Dealers, Inc., the New York Stock Exchange LLC and the American Stock Exchange LLC filed with the Securities and Exchange Commission proposed rule changes to increase the frequency of the short interest reporting requirements from monthly to twice per month. The proposed rule changes were previously discussed in the February 9 edition of the *Corporate and Financial Weekly Digest*.

The NASD, NYSE and AMEX proposed an implementation date of 180 days following the SEC's approval of the filing in order to allow firms sufficient time to make any systems changes necessary to comply with the new requirements. In its request for comments, the SEC specifically asked whether the proposed 180 day implementation period should be shortened. On March 6, the SEC approved the proposed

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rule changes and found that the 180 day implementation period will provide members adequate time to make any necessary changes.

http://www.sec.gov/rules/sro/nasd/2007/34-55406.pdf

Private Investment Funds

Amendment Requiring Advisers Act Registration Thwarted

On March 7, Senator Chuck Grassley of the US Senate Committee on Finance attempted to offer an amendment to Section 203(b)(3) of the Investment Advisers Act of 1940. The amendment would have narrowed an existing exemption from registration that is applicable to advisers who have had fewer than 15 clients during the preceding 12 months and neither hold themselves out to the public as advisers nor act as advisers to registered investment companies. This exemption is frequently relied on by managers of hedge funds and other private investment pools.

Citing a backlog of amendments, the Senate bill manager objected to the introduction of Senator Grassley's amendment at this time. Senator Grassley sought to introduce the amendment as part of the 9-11 homeland security legislation now being debated by the full Senate.

Senator Grassley's amendment would have authorized the Securities and Exchange Commission to require an investment adviser to register with the SEC as such unless such investment adviser: (i) had $50 million or less in assets under management; (ii) had fewer than fifteen clients; (iii) did not hold himself out to the public as an investment adviser; and (iv) managed the assets of fewer than fifteen investors, *regardless of whether the investors were direct clients of the investment adviser or participated in a pooled investment vehicle managed by the investment adviser*.

If passed, this amendment would have provided the SEC with the statutory authority to enact rules similar to those struck down by the D.C. Circuit Court of Appeals last June in *Goldstein v. Securities and Exchange Commission*.

Senator Grassley's attempt to introduce the amendment comes after a recent pronouncement by the President's Working Group on Financial Markets that there is no need to impose new regulations on the hedge fund industry. It also follows statements by the Bush Administration last month that market discipline and risk awareness are the best ways to protect investors from any problems associated with the growing hedge fund industry.

It is unclear whether the amendment might be reintroduced in the future.

http://finance.senate.gov/press/Gpress/2007/prg030707b.pdf

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Banking

Public Comment Sought for Subprime Mortgage Lending

On March 2, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency and the Office of Thrift Supervision (collectively, the Banking Agencies) issued for comment a proposed *Statement on Subprime Mortgage Lending*

BANKING

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(the Statement) intended to address "certain risks and emerging issues relating to subprime mortgage lending practices, specifically, particular adjustable-rate mortgage (ARM) lending products."

The Statement is essentially divided into three parts. The first part discusses "criteria and factors, including payment shock, that an institution should assess in determining a borrower's ability to repay a subprime loan." The second part of the Statement examines issues related to consumer protection, including reminders about existing laws and regulations and concepts related to unfair and deceptive trade practices. Finally, the third part of the statement discusses the need for "policies, procedures and systems to assure that institutions' subprime mortgage lending is conducted in a safe and sound manner."
It should be noted that the ARM products the Banking Agencies are most concerned with include those that contain the following characteristics:

- offering low initial payments based on fixed introductory or "teaser" rates that expire after a short initial period;
- approving borrowers without considering appropriate documentation of their income;
- setting very high or no limits on how much the payment amount or the interest rate may increase at reset periods;
- containing product features likely to result in frequent refinancing to maintain an affordable monthly payment;
- including substantial prepayment penalties and/or prepayment penalties that extend beyond the initial interest rate adjustment period; and/or
- providing borrowers with inadequate information relative to product features, material terms and product risks, prepayment penalties, and the borrower's obligations for property taxes and insurance.

Comments are due sixty days after publication in the *Federal Register*.

http://www.occ.treas.gov/ftp/release/2007-19a.pdf

United Kingdom Developments

UK Financial Services Authority (FSA) Uses Wind Up Power

In a decision handed down on February 23, the High Court granted a winding-up petition brought by the Financial Services Authority under section 367 of the Financial Services and Markets Act 2000 (FSMA).

The Inertia Partnership LLP (Inertia) introduced companies that wanted to raise capital to a British Virgin Islands company, which engaged brokers as "boiler rooms". Inertia entered into agreements with two of the companies whereby it issued application forms, was named as the receiving agent, collected money and distributed it to the companies. The brokers cold-called consumers in the UK and offered them the opportunity to buy shares in the companies. Inertia later went into creditors' voluntary liquidation.

The Court held that petitions could be brought by public officials and that the Court had a power to make a winding up order in the public interest on the just and equitable ground. The power should be

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exercised with a view to protecting the public interest and in so doing the Court needed to balance all relevant interests against each other to ascertain the just and equitable result.

The FSA's petition was on the basis that Inertia had carried on a regulated activity in contravention of the general prohibition in section 19 of FSMA, it was insolvent and it was just and equitable that it be wound up.

http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/028.shtml

FSA Publishes Updated Measure of UK Market Cleanliness

On March 7, the Financial Services Authority published *OP25: Updated Measurement of Market Cleanliness* with the results of its work to measure the cleanliness of the UK financial markets. The exercise examined the period of trading from 2004/2005. Although the results show that a decrease in the level of possible informed trading ahead of FTSE 350 companies' trading announcements, the level of suspicious trading remains high.

There had been possible insider trading ahead of a takeover announcement in almost one in four cases in 2005. The figure - 23.7% - is down from the 2004 figure of 32.4%, but is little changed since the introduction of FSMA (standing at 24% in 2000). There had been a significant decrease in the level of possible insider trading ahead of trading announcements - such as financial results and updates - by companies in the FTSE 350. In only 2% of those cases were announcements preceded by informed price movements in 2004/5, against 11.1% in 2002/3, and 19.6% in 1998-2000.

The FSA analyzed the potential for insider trading by, in the case of takeover announcements, looking at abnormal price movements around the time of disclosure. The study only looks at cash equities, not derivatives or other trading instruments.

http://www.fsa.gov.uk/pubs/occpapers/op25.pdf

Litigation

Securities Fraud Claims Asserted Against Accountants Sustained

Plaintiffs, investors in a now defunct broker-dealer, sued the company's accountants under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 for failing to correct mistakes in its certified opinion of the company's financial statements. Plaintiffs alleged that they relied on the erroneous statements in making a substantial investment in the broker-dealer subsequent to the time that the defendant accountants had learned of the errors in their certified statements.

The District Court dismissed plaintiffs' claim, citing the United States Supreme Court's decision in *Central Bank* for the proposition that aider and abettor claims are not actionable under § 10(b) and ruling that an accountant's failure to correct its certified opinion could amount to no more than aider and abettor liability. The Second Circuit, disagreed, noting that the *Central Bank* decision contemplated that secondary actors such as accountants could incur primary liability based on their misrepresentations or omissions. The Court also cited its own post-*Central Bank* decisions providing that an accountant has a duty to correct its certified opinions that it discovers to be mistaken and on which it knows the public is relying.

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The Second Circuit held that that an accountant can be primarily liable under § 10(b) and Rule 10b-5 if it (i) makes a statement in its certified opinion that is false and misleading when made; (ii) subsequently learns or was reckless in not learning of the error; (iii) knows or should know that potential investors are relying on its opinion and financial statements; (iv) fails to take reasonable steps to correct the error or withdraw its opinion; and (v) all other requirements for § 10(b) and Rule 10b-5 liability are satisfied. Because it found all of the foregoing elements sufficiently pleaded, the Second Circuit reversed and reinstated the plaintiffs' securities fraud claim. (*Overton v. Todman & Co., CPAS, P.C.*, 2007 WL 574623 (2d Cir. Feb. 26, 2007))

Breach of Fiduciary Duty Claim for Excessive Investment Advisory Fees Dismissed

The District Court dismissed plaintiffs' derivative action on behalf of three open-ended mutual funds, alleging that defendant, an investment advisor, violated § 36 of the Investment Company Act of 1940 by receiving excessive fees for the advisory services it provided to the Funds. The fees were approved on a yearly basis by the Funds' board of trustees.

Applying the standard established by the Second Circuit in *Gartenberg*, the District Court determined that the fees charged by defendant were not so disproportionately large that they could not have been a result of arm's-length bargaining between defendant and the Funds' board of trustees. The Court found that the fees charged by defendant were within the range paid by institutional clients and defendant's other mutual fund clients. Plaintiffs' allegations of potential conflicts of interest through the board members' social and professional relationships with defendant, without any evidence that the defendant attempted to exercise influence through those relationships, were insufficient to show that the fee negotiations were not conducted in good faith. The District Court declined to consider whether the Funds could have gotten more for their money from defendant ruling that "[s]ection 36(b) does not create a duty that advisers receive the lowest possible fee amount of compensation for the services they provide." (*Jones v. Harris Associates L.P.*, 2007 WL 627640 (N.D. Ill. Feb. 27, 2007))

CFTC

No-Action Letter Allows Direct Access to TFX Trading System

On March 6, the Commodity Futures Trading Commission's Division of Market Oversight issued a no-action letter to the Tokyo Financial Exchange, Inc. (TFX) allowing TFX to grant direct access to its electronic trading and order matching system (LIFFE CONNECT®) to TFX members in the U.S. without TFX first being designated as a contract market or derivative transaction execution facility by the CFTC.

The no-action relief allows TFX to grant direct access to TFX members in the U.S. that: (i) trade for their own account; (ii) are registered futures commission merchants (FCMs), or are exempt from registration pursuant to CFTC Rule 30.10 (Rule 30.10 Firms), and submit orders for U.S. customers to the trading system for execution; (iii) are registered commodity pool operators (CPOs) or commodity trading advisors (CTAs), or are exempt from such registration under CFTC Rules 4.13 or 4.14, and submit orders on behalf of pools they operate or for U.S. customer accounts over which they have discretionary authority (respectively), provided that an FCM or Rule 30.10 Firm acts as

CFTC

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clearing firm and guarantees all such trades of the CPO or CTA through the trading system; or (iv) are registered FCMs or Rule 30.10 Firms that accept orders through the automated order routing system from U.S. customers for transmission to the trading system.

http://www.cftc.gov/files/tm/letters/07letters/tm07-02.pdf

No-Action Relief Extended to FTSEurofirst 80 and 100 Futures Traded on Euronext Paris

The Commodity Futures Trading Commission's Office of the General Counsel confirmed, in a no-action letter dated March 5, that the no-action relief previously granted to the London International Financial Futures Exchange, permitting the offer and sale in the U.S. of futures contracts based on the FTSEurofirst 80 and FTSEurofirst 100 Indices, will be extended to futures contracts based on the same indices that are listed and traded on Euronext Paris.

http://www.cftc.gov/files/tm/letters/07letters/tm07-03.pdf

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