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Corporate and Financial Weekly Digest

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## SEC/Corporate

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### SEC, District Court Approve Company's Exclusion of Shareholder Policy Proposal

On April 22, the United States District Court for the Southern District of Texas ruled that Apache Corporation could, pursuant to Rule 14a-8 of the Securities Exchange Act of 1934, reject the inclusion in its proxy statement of a shareholder proposal prohibiting the company from discriminating on the basis of sexual orientation or gender identity. The Court's ruling followed a Securities and Exchange Commission no-action letter on March 5 supporting the company's position in excluding the proposal. In response to the SEC's no-action letter, the New York City Employees' Retirement System, which had originally submitted the proposal, sued the company. The company then went to the Court, seeking declaratory relief that such exclusion was appropriate.

The Court ruled that even though the Employees' Retirement System attempted to change company policy, Rule 14a-8(i)(7)'s "Management Function" exception appropriately excluded the proposal, which would have prohibited discrimination on the basis of sexual orientation or gender identity not only in hiring decisions, but also in sales and purchasing decisions, because it "seeks to micromanage the company to an unacceptable degree... [i]t would be imprudent to effectively cede control over such day-to-day decisions, traditionally within the purview of the company's executives and officers, to the shareholders." Thus, the Court has formally endorsed the Commission's view that shareholder policy proposals may be excluded under Rule 14a-8(i)(7) to the extent such proposals deal with ordinary business matters. (*Apache Corp. v. New York City Employees' Ret. Sys.*, 2008 WL 1821728 (S.D. Tex. Apr. 22, 2008))

### SEC Makes Recommendations on U.S. Investors' Rights in Overseas Mergers and Acquisitions

On April 29, the Securities and Exchange Commission's Division of Corporation Finance announced that it had completed its review of the SEC's cross-border tender, exchange offer and business combination rules and prepared recommendations concerning such rules for consideration by the Commission. The cross-border tender offer rules apply to offers for the securities of foreign companies that have U.S. security holders. The goal in reviewing the current rules, which were adopted by the SEC in 1999, was to determine whether changes could be made that would further facilitate the ability of U.S. investors to exercise their rights in connection with cross-border mergers and acquisitions. This review included looking at areas of conflict and inconsistency with foreign regulations and practices that are frequently encountered in cross-border business combinations and that result in U.S. investors being excluded from these transactions.

In a January 2008 speech, John White, Director of the Division of Corporation Finance, indicated that one of the proposed amendments to the cross-border rules may be with respect to the way U.S. ownership of a subject company's securities is calculated.

The Division of Corporation Finance recommended Commission consideration as soon as possible. Issuance of a rule proposal by the SEC based on the Division of Corporation Finance's recommendations requires a vote of the Commissioners, followed by a public comment period.

http://www.sec.gov/news/press/2008/2008-66.htm

## Litigation

### Parallel SEC/DOJ Proceedings Did Not Violate Defendants' Rights

The Ninth Circuit held that the United States did not violate defendants' due process or Fifth Amendment rights by failing to inform them during the course of a Securities and Exchange Commission enforcement action that the U.S. Attorney's Office (USAO) had opened a criminal investigation involving the same subject matter.

Defendants argued that: (i) the USAO's use of evidence obtained by the SEC would violate their Fifth Amendment privilege against self-incrimination; (ii) the government's use of the SEC investigation was "solely" for the purpose of obtaining evidence for the subsequent criminal prosecution and, therefore, violated the due process clause; and (iii) the SEC engaged in acts of "trickery and deceit," such as giving evasive answers to defendants' inquiry about whether there was a USAO investigation and instructing court reporters not to mention the USAO's involvement in the presence of defense counsel.

The Court rejected all of the defendants' arguments. First, the Court ruled that defendants knowingly waived their Fifth Amendment privilege by failing to assert it during the SEC investigation. The Court supported this ruling by noting, among other things, that the SEC disclosed in writing when it subpoenaed defendants that information the SEC obtained in its investigation was often made available to, among others, the USAO. Second, while acknowledging that due process concerns would be raised if the SEC investigation had been "solely" for the purpose of obtaining evidence for a criminal prosecution, the Court ruled that this was not the case because the SEC began its investigation first and imposed SEC sanctions on the defendants. Finally, the Court held that the government engaged in no "trickery" or "deceit" because, while not volunteering information, it made no affirmative misrepresentations in responding to defendants' inquiries about any USAO investigation. (*U.S. v. Stringer,* 2008 WL 901563 (9th Cir. Apr. 4, 2008))

### Securities Fraud Claim Dismissed

A United States District Court entered judgment in favor of a company's chairman and CEO and dismissed a shareholder's claims under Section 10(b) of the Securities Exchange Act and Rule 10b-5. Plaintiff alleged that the defendant committed securities fraud by making false and misleading statements and omissions regarding the status of the company's negotiations with potential investors, which had the alleged effect of depressing the value of the company's stock and inducing plaintiff to sell its shares at an artificially low price.

In granting summary judgment, the Court noted, among other things, that defendant's denials of ongoing negotiations were not material misstatements because the defendant had submitted evidence, uncontradicted by plaintiff, that at the relevant time the company had engaged only in preliminary

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discussions. The Court also held that plaintiff failed to satisfy the scienter requirement of his securities fraud claims because, among other things, they failed to show that defendant acted with recklessness or had a motive for his alleged wrongdoing, such as a personal benefit. As a further ground for dismissal, the Court rejected the plaintiff's argument that defendant, as Chairman and CEO, had an affirmative duty to disclose to the company's shareholders the state of every discussion or negotiation in which he engaged. After noting that the defendant was not trading with plaintiff and that there was no evidence that he had made any prior misleading statements that he was under a duty to clarify, the court ruled that it would be "inimical" to corporations, which "often negotiate secretly," to impose on their officers a duty to inform shareholders of "every discussion or negotiation." (*Pennmont Securities v. Wallace*, 2008 WL 834379 (E.D. Pa. March 26, 2008)

## Broker Dealer

### FINRA Proposes OTC Trade Reporting Changes

The Financial Industry Regulatory Authority (FINRA) has proposed for Securities and Exchange Commission approval an amendment of its trade reporting rules applicable to OTC equity transactions. The first part of the proposal would replace the current market maker-based trade reporting framework with a requirement that the "executing party" reports the trade. An executing party would be defined as the member that receives an order for handling or execution or is presented an order against its quote, does not subsequently re-route the order, and executes the transaction. For transactions between members, where both members would be the "executing party," the sell-side reports the trade unless the parties agree otherwise, and for a transaction between a member and a non-member or customer, the member would report the trade. In any event, Electronic Communication Networks and Alternative Trading Systems would have the reporting obligation unless they forward the order onward. FINRA's rationale for this is that the proposed rule change would result in more accurate and timely trade reporting and make the trade reporting process less cumbersome for members.

In electronic trade reporting, the executing party identifies itself and the contra-party. However, in riskless principal transactions or when a member acts as agent of one or more members there will be more than two members as parties to the trade. In these cases FINRA is proposing that in addition to the electronic reporting, the executing party submits a non-tape report identifying the other members. These non-tape reports would be due by the end of the trade date, even though the electronic report is due within 90 seconds. These reporting proposals would not apply to trades executed on and reported through an exchange.

http://edocket.access.gpo.gov/2008/pdf/E8-8872.pdf

### FINRA Requests Comments on Proposed Changes to Forms U4 and U5

The Financial Industry Regulatory Authority (FINRA) has proposed for comment changes to registration Forms U4 and U5. One part of the proposal would add questions to Forms U4 and U5 to require reporting when the person is the subject of an investment-related, consumer-initiated complaint, arbitration claim or civil litigation when the registered representative was not named as a respondent or a defendant or where a claim is settled and the registered representative, while not a defendant or respondent, is described in the complaint or claim as being responsible for the alleged sales practice violation. A second part would raise the level for reporting settlements from $10,000 to $15,000. A third part would allow firms to amend a filed Form U5 to


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change the date of termination or reason for termination. However, filing firms would have to provide a reason for the amendment.

http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p038384.pdf

**FINRA Issues Investor Alert on Catastrophe Bonds and Other Event-Linked Securities**

The Financial Industry Regulatory Authority (FINRA) has issued an investor alert on catastrophe bonds and other event-linked securities. There are bonds issued by a bankruptcy remote entity (SPV) with a term of 3 to 5 years that use the proceeds to buy collateral to generate the stated interest rate and return of principal. The SPV enters into a swap with a third party to pay the interest from the collateral to the third party in return for payments from the third party of the stated interest on the bond. If the catastrophe specified in the bond occurs, the SPV pays the collateral to a third party, e.g., an insurance company; otherwise, it is returned to the bondholders. These funds are sold to institutional investors, such as mutual funds, on the basis of their high yield and diversification of their portfolios. The release highlights several risks associated with catastrophe bonds including: the risk that the bonds can cause the investor rapidly to lose most or all of his or her principal and any unpaid interest if a triggering event occurs; the fact that prices, yields and ratings of the bonds rely almost exclusively on complex but essentially untested computer modeling techniques; the fact that the investments are not registered with the SEC; and counterparty credit risk for the swap agreements entered into by bond issuers.

The alert urges investors to find out whether any of the funds they own invest in catastrophe bonds or other similar event-linked instruments, and suggests questions for investors to ask:

- Does the fund manager have adequate resources and expertise to evaluate the risks of event-linked securities and whether they are a sound investment?
- Does the fund manager have an educational background or work experience, such as in the insurance industry, that would allow him or her to understand the quantitative and forecasting methods used in building computer models for event-linked securities?
- If not, does the fund manager employ a third party consultant who does?

http://www.finra.org/InvestorInformation/InvestorAlerts/Bonds/CatastropheBondsandOtherEvent-LinkedSecurities/P038367

## CFTC

**CFTC Seeks Public Input on "Event Contracts" Regulation**

The Commodity Futures Trading Commission is seeking public comment on the regulation of "event contracts"—financial agreements that are linked to events or measurable outcomes, such as presidential elections or declarations of war, that are not derived from or correlate with market prices or broad economic or commercial measures. In a release that will be published shortly in the Federal Register, the CFTC noted that it has received a substantial number of requests for guidance on the propriety of trading various event contracts under the Commodity Exchange Act (CEA). In order to promote legal certainty, the CFTC is reviewing the applicability of the CEA to event contracts and markets and is issuing the Concept Release to solicit the expertise of interested parties.

http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5493-08.html


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## Banking

**FDIC Issues Policy Statement on Covered Bonds**

The Federal Deposit Insurance Corporation, on April 30, issued a final interim policy statement on the treatment of "covered bonds" in the event that the issuing insured depository institution is placed into FDIC receivership or conservatorship. The policy statement provides regulatory relief by giving expedited access to covered bond collateral if the issuing institution fails or is placed in conservatorship and meets certain criteria. The FDIC guidance is intended to reduce market uncertainty and allow for evaluation of the benefits and questions about covered bonds as the market develops in the United States. Comments on the policy statement are due by June 23. Highlights follow:

- A covered bond is defined as a recourse debt obligation of an insured depository institution (IDI) with a term greater than one year and no more than ten years that is secured directly or indirectly by a pool of mortgage loans or AAA-rated mortgage bonds.

- Generally, a bond holder of a failed IDI could be required to wait up to 90 days to execute on the collateral or for payment from an FDIC receiver, or up to 45 days from an FDIC conservator. The policy statement provides that the covered bond holder may obtain access to the collateral if the FDIC remains in monetary default on the IDI's obligation on the covered bond for ten business days after receiving notice of default, or if the FDIC does not pay statutory damages within ten business days after the effective date of repudiation.

- The policy statement applies only to covered bond issuances that meet the following criteria:

    - The covered bond issuances must be made with the consent of the IDI's primary federal regulator.

    - The IDI's total covered bond obligations at issuance comprise no more than four percent of the IDI's total liabilities.

    - The collateral for the covered bonds is secured by perfected security interests under applicable state and federal law on performing mortgage loans on one- to four-family residential properties, underwritten at the fully indexed rate and relying on documented income in accordance with existing supervisory guidance governing the underwriting of residential mortgages.

    - Up to ten percent of the collateral may consist of AAA-rated mortgage-backed securities backed solely by mortgage loans that are made in compliance with the policy statement. The FDIC is also seeking comments on whether issuances of covered bonds should increase an IDI's assessment rates or be included in its assessment base and, more generally, whether an institution's percentage of secured liabilities to total liabilities should be factored into an institution's insurance assessment rate or whether the total secured liabilities should be included in the assessment base.

http://edocket.access.gpo.gov/2008/pdf/E8-8750.pdf

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### Compliance with Truth in Savings and Electronic Funds Transfer Rules

The Government Accounting Office recently released a report detailing "undercover" visits to banks and thrifts to determine whether consumers are able to receive information about accounts they wish to open. GAO employees, posing as consumers, visited 185 branches of 154 Federal Deposit Insurance Corporation and National Credit Union Administration insured institutions and determined that it is difficult to get accurate information on basic accounts, such as checking and savings accounts, at the time of account opening. In a memorandum dated April 25 to CEOs of all thrift institutions, Montrice G. Yakimov, Managing Director of Compliance and Consumer Protection of the Office of Thrift Supervision, stated that:

"Regulation DD, which implements the Truth in Savings Act (TISA), requires depository institutions to disclose the amount of any fee that may be imposed in connection with an account and the conditions under which such fees are imposed. Regulation E, which implements the Electronic Fund Transfer Act, requires financial institutions to provide consumers with initial disclosures that explain the terms and conditions of EFT services.

Institutions should ensure that:

- Account terms and conditions and fee disclosure information is available to consumers upon request, prior to account opening, regardless of whether they are existing or prospective customers.

- Employees receive training that incorporates the requirements of Regulation DD and Regulation E.

- Account information and fee disclosures, particularly disclosures related to electronic transactions provided to consumers, are:

    - clear and understandable; and
    - available in a written form that the consumer may keep.

Recordkeeping requirements include retention of account disclosures and fee disclosures sufficient to determine compliance with Regulation DD and Regulation E."

http://www.ots.treas.gov/docs/2/25273.pdf

## UK Developments

### FSA Publishes *Market Watch 26*

On April 29, the UK Financial Services Authority (FSA) published *Market Watch 26*, focusing on market conduct and transaction monitoring issues. It provides an overview of the FSA's strategy for tackling market abuse such as insider dealing through the use of "credible deterrence." *Market Watch 26* reiterates the FSA's enforcement approach and in particular warns again that severe sanctions will be imposed by the FSA for market abuse. As part of its anti-market abuse strategy, the FSA will undertake a thematic review of FSA authorized firms' policies in relation to the dissemination of false market rumors.

*Market Watch 26* also highlights that in 2006 and 2007, "informed price movements" preceded significant announcements related to FTSE 350 companies and public takeovers in 28.6 percent and 28.7 percent of cases respectively. This represents an increase from 23.7 percent in 2005. The FSA considers that these statistics do not necessarily correlate to the level of insider dealing as they may also indicate: (i) financial analysts and the media


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correctly assessing which companies are likely takeover targets; (ii) deliberate "strategic" leaks of information by a company to position a deal in the marketplace; or (iii) trades by "informed" traders who picked up or derived information from the trades of insiders.

www.fsa.gov.uk/pubs/newsletters/mw_newsletter26.pdf

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