May 27, 2011

SEC/CORPORATE

SEC Proposes Rules for Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings

On May 25, the Securities and Exchange Commission issued proposed rule amendments that disqualify securities offerings involving certain "felons and other 'bad actors'" from reliance on the safe harbor from registration under Section 4(2) of the Securities Act of 1933 provided by Rule 506 of Regulation D to reflect the requirements of Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 926 of the Dodd-Frank Act requires that that the SEC issue disqualification rules for Rule 506 offerings that are "substantially similar" to the disqualification rules provided by Rule 262 of the Securities Act, which apply to securities offerings under Regulation A.

The proposed rules would apply to the following "covered persons":

- the issuer and any predecessor of the issuer or affiliated issuer;
- any director, officer, general partner or managing member of the issuer;
- any beneficial owner of 10% or more of any class of the issuer's equity securities;
- any promoter connected with the issuer in any capacity at the time of the sale;
- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering; and
- any director, officer, general partner or managing member of any such compensated solicitor.

The SEC notes that while a significant percentage of issuers in Rule 506 offerings are funds, the proposed rules do not apply to investment advisers of issuers, or the directors, officers, general partners or managing members of such investment advisers, as those persons are not currently covered by Rule 262. The SEC also notes that disqualifying events that pre-date the affiliation with the issuer of an affiliated issuer, with certain exceptions, would not be deemed disqualifying. The SEC is also specifically soliciting comments on whether "officer" should be "executive officer."

The proposed rules include the following types of disqualifying events:

- criminal convictions;
- court injunctions and restraining orders;
- final orders of certain state regulators (such as state securities, banking and insurance regulators) and federal regulators;
- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers and investment companies and their associated persons;
- suspension or expulsion from membership in, or suspension or bar from associating with a member of, a securities self-regulatory organization;
- SEC stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.

The proposed rules also provide for a "reasonable care" exception under which an issuer would not lose the benefit of the Rule 506 safe harbor, despite the existence of a disqualifying event, if it can show that it did not know and, in the exercise of reasonable care (which must include a "factual inquiry"), could not have known of the disqualification of another covered person.

Similar to Rule 262, the proposed rules also permit issuers to seek waivers from disqualification under Rule 506 from the SEC.

The proposed rules would apply to all sales made under Rule 506 after the effective date of the new provisions for all disqualifying events that occurred within the relevant look-back periods, regardless of whether the events occurred before the enactment of the Dodd-Frank Act, or the proposal or the effectiveness of the amendments to Rule 506. Sales of securities made before the effective date of the amendments to Rule 506 would not be affected by any disqualification that arises as a result of the adoption of the amendments, even if such sales were part of an offering that was intended to continue after the effective date.

The proposed rules also seek public comment on whether the proposed disqualification standards under Rule 506 should apply uniformly to all offerings under Regulation A, Regulation D and Regulation E.

Comments on the proposed rules should be received on or before July 14.

Read more.

SEC Issues Final Rules for Whistleblower Program under Dodd-Frank Act

On May 25, the Securities and Exchange Commission issued final rules creating a whistleblower program under Section 21F of the Securities Exchange Act of 1934 as required by Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The new program authorizes the SEC to pay rewards to individuals who voluntarily provide the SEC with original information that leads to successful SEC enforcement actions that result in monetary sanctions totaling more than $1 million. The total amount of the award is between 10% and 30% of the monetary sanctions.

An individual is deemed to have voluntarily provided original information to the SEC if such individual has provided the information before the government, a self-regulatory organization or the Public Company Accounting Oversight Board requests it from the whistleblower. Information will be considered "original" if it is based upon the whistleblower's "independent knowledge" or "independent analysis," is not already known to the SEC from any other source, and is not derived exclusively from certain public sources. A whistleblower's voluntary provision of original information will be deemed to have led to a successful enforcement action if:

- the information was sufficiently specific, credible and timely to cause the SEC to open or reopen an examination or investigation and the SEC brought a successful action based in whole or in part on conduct that was the subject of the whistleblower's original information;
- the information significantly contributed to the success of an ongoing investigation; or
- the whistleblower's information is reported under the whistleblower employer's whistleblower, legal or compliance procedures for reporting allegations of possible violations of law before or at the same time reported to the SEC, and the employer then passes such information on to the SEC and either of the criteria above are met. In any event, the whistleblower must report this information to the SEC within 120 days of reporting to the employer.

Finally, in order to meet the monetary sanctions totaling in excess of $1 million, the rules permit the aggregation of multiple SEC cases that arise out of a common nucleus of operative facts as a single action.

The final rules prohibit the following individuals from receiving awards (subject to certain exceptions):

- people who have a pre-existing legal or contractual obligation to report the information to the SEC;
- public accountants working on SEC engagements and attorneys who attempt to use information from client engagements;
- people who attempt to use information obtained in a manner that violates federal or state criminal laws;
- foreign government officials;

- officers, directors, trustees or partners of an entity who learn such information from another person such as an employee or who learn such information in connection with conducting the entity's internal compliance review; and
- individuals whose actions led to all or part of the sanctions.

The final rules also protect potential whistleblowers by prohibiting retaliation against the whistleblower or interference with a whistleblower's efforts to communicate with the SEC. The final rules will be discussed further in an upcoming *Client Advisory*.

Click here to read the Opening Statement of the SEC Chairman on these rules.
Click here to read the press release from the SEC.
Click here to read the final rules.

LITIGATION

Federal Circuit Addresses Duty to Preserve

The U.S. Court of Appeals for the Federal Circuit recently reviewed the decisions in *Micron Tech., Inc. v. Rambus, Inc.*, 225 F.R.D. 135, (D. Del. 2009) (*Micron I)*, and *Hynix Semiconductor, Inc. v. Rambus, Inc.*, 591 F.Supp.2d 1038 (N.D.Cal. 2006) (*Hynix I)*, two cases that analyzed substantially identical facts but reached widely disparate conclusions. In each case, the plaintiff alleged that Rambus, Inc. committed spoliation by destroying potentially relevant documents pursuant to a document destruction policy at two company-sponsored "shred days." In both cases, the question of spoliation turned on the point at which litigation was reasonably foreseeable. The U.S. District Court for the District of Delaware determined that Rambus had committed spoliation because litigation was reasonably foreseeable prior to the destruction of documents, and issued sanctions against Rambus. Conversely, the U.S. District Court for the Northern District of California concluded that litigation was not reasonably foreseeable until after certain documents had already been destroyed, and did not sanction Rambus.

On appeal, the Federal Circuit explained that the issue of when litigation is "reasonably foreseeable" "is a fact-specific standard" that "does not trigger the duty to preserve documents from the mere existence of a potential claim or the distant possibility of a claim." Yet, the standard "is not so inflexible as to require that litigation be 'imminent or probable without significant contingencies.'" The Federal Circuit concluded in both cases that litigation was "reasonably foreseeable," and thus the duty to preserve arose, at some time prior to the second "shred day." (*Micron Tech., Inc. v. Rambus, Inc.*, 2011 WL 1815975 (C.A.Fed. (Del.) May 13, 2011)); (*Hynix Semiconductor, Inc. v. Rambus, Inc.*, 2011 WL 1815978 (C.A.Fed. (Cal.) May 13, 2011))

UK DEVELOPMENTS

£1.1m Fine and First High Court Injunction Against Market Abuse

On May 24, the UK Financial Services Authority (FSA) announced that it had fined Samuel Kahn £1,094,900 (approximately $1,790,000) and obtained a High Court injunction restraining him from committing market abuse. This was the first time the FSA had secured such a final injunction from the High Court.

The FSA stated that in March and April 2010, Mr. Kahn carried out a scheme to deliberately inflate the share price of Global Brands Licensing plc (GBL), a company quoted on PLUS Stock Exchange, a UK Recognized Investment Exchange. In that period he controlled the vast majority of the trading in GBL's shares and disguised this by impersonating others when placing orders. Mr. Kahn's false trading moved GBL's share price from 2 pence to 5.25 pence.

Mr. Kahn had previously been the subject of FSA enforcement action (in 2007). The FSA made Mr. Kahn bankrupt after he admitted liability with respect to his involvement in overseas boiler-room activities in relation to some 800 investors.

The fine is the first calculated under the FSA's new penalties regime introduced on March 6, 2010. It consists of disgorgement of £210,563 (approximately $344,500) and a financial penalty of £884,365 (approximately

$1,447,000). Mr. Kahn qualified for a Stage 1 (30%) discount on the penalty amount under the FSA's settlement discount scheme, without which the fine would have been £1,263,379 (approximately $2,068,000).

Tracey McDermott, the FSA's acting Director of Enforcement and Financial Crime, said: "Kahn undertook a month-long campaign of market abuse, manipulating 85% of the buy trades and 91% of the sell trades of GBL for his own financial benefit as well as to facilitate tax relief fraud and boiler room activities... In imposing a significant fine under our new penalties regime and obtaining an injunction against Kahn, we want to send a clear message to the market. The FSA will not tolerate this type of repeat behaviour and will use all of our powers to ensure credible deterrence."

Read more.

Prudential Regulation Authority's Approach to Banking Supervision Announced

On May 19, the Bank of England and the UK Financial Services Authority (FSA) published a joint paper, "The Bank of England, Prudential Regulation Authority - Our approach to banking supervision," setting out the current thinking on how the future Prudential Regulation Authority (PRA) will approach the supervision of banks, building societies, credit unions and investment firms.

The paper outlines: (1) the principles underlying the PRA's approach; (2)the scope of the PRA; (3) the PRA's risk assessment framework; (4) the PRA's forward looking, judgment-led approach to supervision; (5) the approach to policy-making that will support the judgment-led model; and (6) the approach to authorizing firms and approving individuals.

The PRA will be also responsible for supervising both insurance companies and deposit-takers. A companion paper will be published in June 2011 to cover the PRA's approach to supervising insurance companies.

This paper follows on from the government's July 2010 consultation document on proposed changes to the UK regulatory framework (see the July 30, 2010, edition of *Corporate and Financial Weekly Digest*), which provides details of the government's proposals to disband the FSA and establish replacement-focused financial services regulators.

Hector Sants, FSA Chief Executive and PRA Chief Executive Designate, said: "The PRA's purpose is fundamentally different from that of previous regulatory regimes and will lead to a significantly different model of supervision to that which was in use pre-2007. In designing this new model we have incorporated both the lessons learned from the last financial crisis and those from firm failures of the past.

"The new regulatory model will be based on forward looking judgments and will be underpinned by the fact that the PRA has a single objective to promote the stability of the UK financial system and in consequence will be a very focused organisation. The new supervisory approach will build on the more intensive approach adopted by the FSA since the crisis."

Read more.

EU DEVELOPMENTS

European Parliament's Economic and Monetary Affairs Committee Votes on EMIR

On May 24, the European Parliament announced the result of the vote of the Parliament's Economic and Monetary Affairs Committee (ECON) on the proposed European Market Infrastructure Regulation (EMIR).

The draft regulation (which covers over-the-counter (OTC) derivatives, central clearing parties (CCPs) and trade repositories) "aims to bring greater safety, transparency and stability to the OTC derivatives market."

Under the proposal, many OTC derivative contracts will need to be cleared through central counterparties (CCPs), market participants will be required to report information on OTC derivative contracts to trade repositories (these reports will be accessible to supervisory authorities) and a key supervisory role is envisaged for the new European Securities and Markets Authority (ESMA).

ECON has rejected proposals by some member states that all derivatives should fall within the scope of EMIR. Reporting obligations will apply to all derivatives; the majority of EMIR's requirements will apply only to OTC derivatives.

Cooperation arrangements between clearing houses, known as "interoperability," under which traders would be allowed to choose where their trades are cleared, are limited to cash securities. Before a CCP can apply for authorization for interoperability, it will be required to have complied with the standards set out in the Regulation for not less than three years.

Consideration was given to applying clearing obligations retroactively, to OTC contracts entered into prior to the Regulation coming into force. ECON has accepted that this would be impracticable. ESMA has been asked to assess whether reporting obligations could be introduced with retrospective effect.

The draft version of EMIR, which has been approved by ECON, will be voted on by the European Parliament at its plenary sitting on July 5. Thereafter, under a "trialogue" process, the final text will be resolved by three-way negotiations among the European Commission, the Council of Ministers and the Parliament.

Read more.

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