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Corporate and Financial Weekly Digest

MAY 29, 2009

SEC/CORPORATE

New Rules Governing Securities Trading by SEC Personnel

Following disclosure of inappropriate trading in public company securities by two veteran Securities and Exchange Commission staff members, on May 22 the SEC announced a series of measures to strengthen its rules relating to securities trading by SEC employees.

Under the new initiative, the SEC will (i) require SEC employees to obtain preclearance on all securities trades (currently preclearance is recommended but not mandatory), among other things to be sure the company whose stock is traded is neither being investigated nor the subject of a pending registration statement; (ii) hire an outside vendor to develop a computer system to track and audit employee securities transactions in real time; and (iii) consolidate compliance and reporting responsibility within the SEC's Ethics Office and hire a new chief compliance officer.

Current agency rules prohibit SEC employees from short-selling, carrying securities on margin, engaging in options or futures transactions in instruments whose value is derived from an underlying security and holding a security interest in broker dealers and registered investment advisors. The current rules also mandate that employees hold stock for at least six months and require the reporting of trades within five days of confirmation. The new rules will add to the prohibited ownership list publicly traded exchanges and transfer agents, require employees to authorize their brokers to provide the SEC with duplicate trade confirmation sheets and require employees to certify they do not possess non-public information about the company being traded.

Read more.

LITIGATION

Court Denies Motion to Dismiss Claims Against "Winners" of Ponzi Scheme

The receiver of a collapsed Ponzi scheme orchestrated and maintained by Val Edmund Southwick brought an action for fraudulent transfer and unjust enrichment against two consultants to Mr. Southwick's organizations who allegedly received millions of dollars in consulting fees during the period in which he operated the Ponzi scheme. Further, one of the consultants was an early investor with Mr. Southwick's organizations, and "received significantly more money than he invested."

Denying defendants' motion to dismiss the action, the court held that both claims were sufficiently pleaded. First, the receiver's claim for fraudulent transfer was sufficient because "fraudulent intent," as required under the Utah Fraudulent Transfer Act, "may be inferred from the mere fact that a debtor is managing a Ponzi scheme," and therefore "the inference of fraudulent intent applies to transfers made by Mr. Southwick during the course of carrying out his scheme." Although the receiver could not differentiate between legitimate business payments and otherwise, the receiver was not required to allege more to survive a motion to dismiss.

Next, the receiver's alternative claim for unjust enrichment was sufficiently pleaded despite the fact "that unjust enrichment claims can only be asserted under Utah law when there is no contract between the parties." Although the payments were made pursuant to consulting agreements and investment contracts, the receiver's allegation "that these contracts were in fact illegal instruments used to carry out Mr. Southwick's fraudulent scheme" rendered the validity of those contracts a question of fact to be decided at trial. (*Wing v. Wharton*, 2009 WL 1392679 (D. Utah May 15, 2009))

Investors in Municipal Bonds Sufficiently Pleaded Scienter

The U.S. District Court for the Northern District of California held that scienter was sufficiently pleaded in a proposed counterclaim set forth by investors in municipal bond notes against the issuing city and its underwriter. The city commenced the action seeking a declaration of the respective rights and duties of the city and the note holders. The proposed counterclaim sought, among other things, damages under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The plaintiffs had previously moved to dismiss the counterclaim and, after the motion was submitted, the investors sought leave to amend the counterclaim with new allegations based upon documents produced by plaintiffs specifically demonstrating that the city "fraudulently inflate[d]" revenues in its projections.

Denying the motion to dismiss as to the Section 10(b) and Rule 10b-5 claims in the proposed counterclaim, the court held that the new allegations satisfied the *Tellabs* standard for pleading scienter in Private Securities Litigation Reform Act cases because they contained "a number of specific facts in support of the claim" including "facts taken from numerous surveys, feasibility studies, reports, budgets, and other documents showing that [the city] and [its underwriter] knew about all of the material problems" when they made statements to the contrary. Further, although some of these documents and information were available on the city's website during the relevant time period, the court held that "there is a question about whether this information was reasonably available to investors." (*Alameda v. Nuveen Municipal High Income Opportunity Fund*, 2009 WL 1424529 (N.D. Cal. May 20, 2009))

BROKER DEALER

FINRA Proposes New Customer Account Statement Rule for the Consolidated Rulebook

The Financial Industry Regulatory Authority has proposed to adopt new FINRA Rule 2231, regarding the obligation to send customer account statements, in the consolidated FINRA rulebook. New FINRA Rule 2231 would incorporate much of existing National Association of Securities Dealers Rule 2340 (Customer Account Statements) and certain select provisions and interpretations from existing New York Stock Exchange Rule 409 (Statements of Accounts to Customers). Current NASD Rule 2340 generally requires members to send customers at least once each calendar quarter account statements containing a description of any securities positions, money balances or account activity in the accounts since the prior account statements were sent. NYSE Rule 409(a) similarly requires member organizations to send customer account statements at least once each calendar quarter. FINRA Rule 2231 as proposed would require each "general securities member" to send account statements at least once every calendar month to each customer whose account had activity during the period since the last statement was sent to the customer. FINRA believes this requirement better reflects current industry practice given that a significant number of member firms already send customers monthly account statements through their clearing firms.

Read more.

Amendment to Rule Governing Trading Differentials and Expansion of Penny Pilot

NYSE Arca, Inc. has proposed to amend its option trading rules to (i) extend the Penny Pilot in options classes in certain issues (Pilot Program) previously approved by the Securities and Exchange Commission through December 31, 2010; (ii) provide for additional classes to quote and trade all contracts in one-cent increments; and (iii) expand the number of issues included in the Pilot Program.

NYSE Arca also proposes to (i) expand the number of issues included in the Pilot Program to add the top 300 most actively traded multiply listed option classes that are not yet included in the Pilot Program; (ii) phase in the additional classes to the Pilot Program over four successive quarters; (iii) designate two Pilot Program issues as eligible to quote and trade all options contracts in one-cent increments, regardless of premium value; and (iv) allow for any Pilot Program issues that have been delisted to be replaced on a semi-annual basis by the next most actively traded multiply listed options classes that are not yet included in the Pilot Program. NYSE Arca has agreed to submit semi-annual reports to the SEC that will include sample data and analysis of information collected from April 1 through September 30, and from October 1 through March 31, for each year, for the 10 most active and 20 least active options classes added to the Pilot Program.

Read more.

PRIVATE INVESTMENT FUNDS

Connecticut Senate Approves Disclosure Requirements

The Connecticut Senate has approved a bill titled "An Act Concerning Hedge Funds," that would require all investment advisors, registered and unregistered, of private investment funds that offer or sell securities in Connecticut or that are located in Connecticut to comply with the disclosure requirements of Rule 204-3 of the federal Investment Advisers Act of 1940, but only to the extent the disclosures relate to material conflicts of interest of the investment advisor. Rule 204-3 requires registered investment advisors to provide each advisory client and prospective advisory client with a written disclosure statement containing at least the information prescribed by Part II of Form ADV. The bill, if finally adopted in its current form, would nominally become effective January 1, 2010, but would not be enforced until the state banking commissioner adopts regulations implementing the law. The bill allows the state banking commissioner to adopt such regulations only if similar federal regulations to regulate investment advisors of private investment funds are not adopted by December 31, 2009. The bill now moves to the state House of Representatives for consideration.

To view the text of the bill click here.

See also the February 27, 2009, edition of *Corporate and Financial Weekly Digest*, discussing separate bills concerning investment funds proposed in the Connecticut General Assembly.

CFTC

CFTC Requests Comment on Changes to Regulations on Investment of Customer Funds

On May 22, the Commodity Futures Trading Commission issued an advance notice of proposed rulemaking with respect to CFTC Regulation 1.25, governing the investment of customer funds held by a derivatives clearing organization (DCO) or a futures commission merchant (FCM) and segregated pursuant to Section 4d of the Commodity Exchange Act (customer segregated funds). The CFTC is considering significant revisions to the scope and character of permitted investments for customer segregated funds and is seeking public comment before issuing any proposed amendments to Regulation 1.25. The CFTC is also requesting comment on whether customer funds held by an FCM in an account subject to CFTC Regulation 30.7 in connection with foreign futures and options positions should explicitly be made subject to the same investment limitations that currently apply to customer segregated funds. The deadline for comments is July 21.

Read more.

NFA Seeks CFTC Approval on Prohibition of Pool Loans to Commodity Pool Operators

On May 27, the National Futures Association submitted to the Commodity Futures Trading Commission for approval proposed Compliance Rule 2-45, which would prohibit direct or indirect loans or any advance of assets by commodity pools to commodity pool operators and affiliated persons or entities.

Read more.

BANKING

OTS Releases Letter Regarding Allowance for Loan and Lease Losses

On May 22, the Office of Thrift Supervision (OTS) released a letter to the chief executive officers of OTS-regulated institutions related to the agency's findings after a "horizontal review" it performed with respect to allowance for loan and lease losses (ALLL) at some of the larger thrift institutions (savings banks and savings and loan associations) regulated by the OTS.

According to the letter, the purpose of such horizontal review was to "identify industry practices, including sound practices, in the ALLL estimation process." Sound practices identified by the OTS with respect to estimating an appropriate ALLL included the following: (i) the use of an ALLL methodology at inflection points (periods of increasing or decreasing losses) that utilizes lagging data supplemented and validated with other methods that rely upon leading data (such as a migration analysis); (ii) the segmenting of sophisticated portfolio products, such as option adjustable-rate mortgages, into multiple risk levels when forecasting delinquency and default; (iii) the application of qualitative factors to specific loan portfolio segments; and (iv) the stress-testing of loss rates and delinquency rates.

Noting that "no single successful method has emerged for predicting losses on loans" and that ALLL methodology is not an exact science but instead relies "heavily on management expertise and judgment", OTS nonetheless identified ALLL practices that are considered weak and do not appear to be in accordance with generally accepted accounting principles and/or supervisory guidance. Such practices included the following: (i) the charge-off of losses only at foreclosure or when deemed uncollectible; (ii) the placement of loans on nonaccrual status when deemed "uncollectible" and the failure to reverse accrued but uncollected interest through current earnings; (iii) the use of varying look-back periods and simple averages to calculate charge-off or delinquency rates; and (iv) the failure to validate ALLL methodology.

For more information, click here.

STRUCTURED FINANCE AND SECURITIZATION

President Obama Signs PPIP Improvement and Oversight Act of 2009

On May 20, President Obama signed into law the Public-Private Investment Program Improvement And Oversight Act of 2009, which is contained within the Helping Families Save Their Homes Act of 2009 (the Act). The Act imposes additional statutory restrictions on the operation of the planned Public-Private Investment Program (PPIP) that is intended to encourage private investors to purchase "legacy" assets that are clogging bank balance sheets. Many of the new requirements respond to concerns voiced by the Office of the Special Inspector General of the Troubled Asset Relief Program (SIGTARP), but may have the effect of limiting the interest of potential PPIP participants.

Section 402 of the Act requires each Public-Private Investment Fund (PPIF) formed pursuant to any federal government program to:

- give the SIGTARP access to all books and records of any PPIF;
- acknowledge, in writing, a fiduciary duty on the part of the PPIF's manager to both the public and private investors in the PPIF;
- identify for the Secretary of the Treasury (Secretary), on a periodic basis, each investor that, individually or together with affiliates, directly or indirectly, holds equity interests equal to at least 10% of the equity interest of the PPIF;
- make a quarterly report to the Secretary that discloses the 10 largest positions of the PPIF (to be disclosed publicly by the Secretary at such time it determines will not harm the ongoing business operations of the PPIF);
- comply with strict investor screening procedures;
- retain all books, documents and records relating to the PPIF, including electronic messages;
- develop a robust ethics policy that includes methods to ensure compliance with such policy; and
- comply with strict conflict of interest rules developed in consultation with the SIGTARP to ensure securities are purchased by PPIFs in arms-length transactions, without violating fiduciary duties to public and private investors, and with full disclosure of "relevant facts and financial interests".

The Act also amends certain provisions of the Emergency Economic Stabilization Act of 2008 (EESA) in order to provide the Comptroller General with increased authority to access, upon request, a wide range of information, records, reports or emails relating to any entity participating in a program established under the authority of EESA (which would include PPIP and the Term Asset-Backed Securities Loan Facility (TALF), since both programs involve the use of TARP funds), and to the officers, employees, agents and representatives of those entities.

Finally, the Act requires the Secretary to consult with the SIGTARP and issue regulations governing the interaction of the PPIP with the TALF, addressing concerns regarding "the potential for excessive leverage that could result from interactions between such programs."

For a copy of the Act, click here.

ANTITRUST

Supreme Court Extends Antitrust Ruling

The U.S. Supreme Court has extended the pleading standard it set forth in 2007 in *Bell Atlantic Corp. v. Twombly*. *Twombly* involved an antitrust conspiracy claim. The Court required that, in order to survive a motion to dismiss, a complaint must contain “enough facts to state a claim to relief that is plausible on its face.” This retired the previous *Conley v. Gibson* standard whereby a case was allowed to proceed unless it appeared beyond a doubt that the plaintiff could prove “no set of facts” in support of his claim. There has been some uncertainty about whether *Twombly* applies beyond the antitrust context.

The Court’s recent ruling in *Ashcroft v. Iqbal*, No. 07–1015 (May 18, 2009), ends that debate. The Court in *Iqbal* applied *Twombly* and dismissed a Pakistani Muslim’s complaint alleging that he was deprived of various constitutional protections on account of his race, religion, or national origin when he was arrested following the September 11, 2001, terrorist attacks. By extending *Twombly* to a discrimination claim, the Court has now made clear that the *Twombly* standard applies to all civil actions in federal courts. *Twombly* and now *Iqbal* provide substantial support for lower courts to rigorously test factual allegations early in litigation, not just in antitrust conspiracy cases, but also in other types of antitrust cases and across other areas of law.

Read more.

UK DEVELOPMENTS

FSA Bans and Fines Trader for Unauthorized “Pre-Hedging”

The UK Financial Services Authority (FSA) announced on May 26 that it had banned and fined trader Nilesh Shroff for deliberately disadvantaging his customers on seven occasions between June and October 2007 by partially “pre-hedging” program trades without the clients’ consent. Mr. Shroff has been prohibited from performing any regulated function on the grounds that he is not fit and proper and has been fined £140,000 (approximately $223,500).

“Pre-hedging” refers to trading by a broker for his firm’s benefit in advance of carrying out a trade for his customer, using information provided by that customer. When customers instructed Mr. Shroff to buy particular stocks, he bought those stocks for the firm first, causing the price to increase before he executed the customers’ trades. When the customer order was to sell, he first sold on behalf of the firm, decreasing the price. Mr. Shroff knew such unauthorized pre-hedging was expressly prohibited by the FSA and Morgan Stanley’s policies and not in his clients' interests.

The misconduct occurred while Mr. Shroff was a senior trader at Morgan Stanley. Following its own investigation, Morgan Stanley dismissed him for gross misconduct on December 28, 2007. The FSA determined that he was solely responsible in this case and neither Morgan Stanley nor companies related to it, nor any other individuals employed by it, were subject to criticism.

Mr. Shroff agreed to settle at an early stage of the investigation and therefore qualified for a 30% reduction in penalty from £200,000 (approximately $320,000). In a published comment, Margaret Cole, the FSA's director of enforcement, said, “Nilesh Shroff has been banned from trading because he repeatedly abused his position of responsibility as a senior trader and the trust placed in him by clients and by his employer. He was aware of FSA guidance and Morgan Stanley’s rules in relation to pre-hedging but nonetheless he broke them.”

Read more.

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