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Corporate and Financial Weekly Digest

May 30, 2008

SEC/Corporate

SEC Signs Protocols for Sharing Information on IFRS

On May 23, the Securities and Exchange Commission announced that it had signed protocols to share information on the application of International Financial Reporting Standards (IFRS) with financial regulators in Belgium, Bulgaria, Norway and Portugal. The arrangements with regulators in the four European countries are in line with the work plan previously agreed to between the SEC and the EU Committee of European Securities Regulators (CESR) and follow the recently signed protocols with the UK Financial Reporting Council and the UK Financial Service Authority. The protocols also follow the final rules published by the SEC on December 21, 2007, regarding the acceptance in SEC filings by foreign private issuers of financial statements prepared in accordance with IFRS as issued by the International Accounting Standards Board without reconciliation to U.S. Generally Accepted Accounting Principles. The protocols are based on a model protocol developed between the SEC and CESR and provide for the confidential exchange of issuer-specific information.

http://www.sec.gov/news/press/2008/2008-95.htm

SEC Revises Rules to Reflect Structural Reorganization

On May 28, the Securities and Exchange Commission released final rule amendments reflecting the reorganization of its former five regional and six district offices into eleven regional offices, each of which reports directly to SEC headquarters.

The rule amendments were created following the April 1, 2007, restructuring of the SEC's regional and district offices and changes to the designation of the offices and their chief supervisory personnel. Prior to the reorganization, the SEC had six district offices reporting to five regional offices, which in turn reported to SEC headquarters. Each regional office is now designated by the name of the city in which it is located. The rule amendments also reflect the elimination of the title "District Administrator," and the heads of all of the regional offices are now referred to as "Regional Directors."

Finally, because of a number of SEC offices have relocated, the rule amendments update the addresses that appear in SEC rules.

http://www.sec.gov/rules/final/2008/34-57877.pdf

SEC/CORPORATE

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Court Holds That Multi-Level Marketing Plan Constitutes a "Security"

Defendant, Essentially Yours Industries, Inc. (EYI), sold its Code Blue water filtration system through a multi-level, pyramid-type marketing scheme in which EYI recruited Independent Business Associations (IBAs) to sell products and recruit additional IBAs. In order to become an IBA an individual invested a specified amount and, in return, received a specified number of filtration systems to sell and was enrolled in EYI's Code Blue Profit Sharing Plan (the Plan). Under the Plan, IBAs received a share of profits, which could amount to nearly five times the amount of their original investment, based on the number of Code Blue systems sold worldwide.

Plaintiffs, who were themselves IBAs, alleged that defendants failed to register the Plan in accordance with Section 5 of the Securities Act of 1933. Defendants sought the summary judgment dismissal of the claims, arguing that registration was not required because the Plan did not constitute a "security" under the Securities Act.

The court, after applying the three factors established by the Supreme Court in *SEC v. W.J. Howey Co.*, *i.e.*, was there (i) an investment of money; (ii) in a common enterprise; and (iii) with the expectation of profits produced solely by the efforts of others, ruled that the Plan did constitute an "investment contract" and thus was a "security" under the Securities Act.

With respect to the first factor, although defendants argued that an IBA's initial payment should be deemed an agreement to simply purchase EYI filtration systems, the court ruled that the "true motivation" for the payment was to invest in the possibility of a substantial payout from the profit-sharing element of the Plan. The court next ruled that the "common enterprise" requirement was satisfied because the success of the Plan depended upon the efforts of each IBA to maximize the size of the profit-sharing pool. Finally, the court ruled that the third "Howey" element—expectation of profits derived "solely" from the efforts of others—was to be construed liberally in order to best give effect to the remedial purpose of the Securities Act. While recognizing that the plaintiffs contributed some effort in connection with the money that went into the profit-sharing pool, the court found that the third element was satisfied because "defendants' efforts were the truly significant efforts required to produce the profits that defendants held out to plaintiffs." (*French v. Essentially Yours Industries, Inc.*, 2008 WL 2065223 (W.D. Mich. May 13, 2008))

Disgorgement Order Credited Defendant With Money Returned to Investors

The Securities and Exchange Commission charged defendants with operating an investment fund in violation of the Securities Act of 1933, by (i) failing to file a registration statement as required by Section 5 of the Securities Act in connection with its sale of secured debt obligations (SDOs), and (ii) knowingly making material misrepresentations in connection with the offer or sale of the SDOs in violation of Section 17(a) of the Securities Act. After defendants failed to respond, the court entered a default judgment requiring disgorgement of an amount equal to the funds they had illegally obtained.

In setting the amount to be disgorged, the court first noted that disgorgement is an equitable remedy that is meant to prevent the wrongdoer from enriching himself by his wrongs, but which is not meant to punish the wrongdoer. Applying this rule, the court held that defendants should disgorge the total proceeds received from their sale of the SDOs less a credit for any monies returned to the investors during the course of their fraudulent scheme or after its conclusion. Although the SEC argued that no credit should be given for

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monies received after the scheme, the court disagreed, reasoning that such amounts could not be characterized as defendants' gain or profit from wrongdoing. Accordingly, because the purview of a disgorgement order is to "wrest" ill-gotten gains from the wrongdoer, but not to punish, the court ruled that the failure to credit amounts returned to investors after the scheme would constitute an unenforceable penalty. (*S.E.C. v. AmeriFirst Funding, Inc*., 2008 WL 1959843 (N.D. Tex. May 5, 2008))

Broker Dealer

FINRA Guidance on Examination Priorities and Results

The Financial Industry Regulatory Authority (FINRA) has issued "Improving Examination Results," listing its examination priorities and frequently found deficiencies. FINRA examination priorities include: senior investors, sales of deferred variable annuities, anti-money laundering rule compliance, protection of customer information, supervision and supervisory controls, sales of new or non-conventional products, transaction reporting, business continuity plans, data integrity, bank sweep programs, agency lending disclosure, inventory valuations, outsourcing, Order Audit Trail System (OATS) reporting, and Regulation NMS.

Frequently found deficiencies were:

- Supervisory Controls: firms incorrectly interpreting the applicability of supervisory control rules to their businesses and failing to meet some or all of the requirements to implement supervisory control procedures.

- Written Supervisory Procedures: procedures failing to include a description of the controls and procedures used to reasonably detect and prevent misconduct, but instead merely repeating the rule requirements or firm policies.

- Anti-Money Laundering: failing to conduct a test, failing to conduct an adequate test, failing to ensure the test is conducted by an independent party, or failing to have any procedures or adequate procedures addressing testing, follow up on independent test results and findings.

- Business Continuity: failing to prepare an adequate business continuity plan and to update the plan as necessary or to designate qualified emergency contact persons.

- Regulation S-P: lacking procedures addressing Regulation S-P requirements and the review of outsourcing arrangements involving customer information, failing to evidence that the firm provided initial and annual privacy notices to customers, lacking procedures that ensure the proper disposal of consumer report information, failing to obtain required confidentiality agreements from third parties, failing to ensure that outsourcing entities maintained the confidentiality of customer information, and failing to include a required "opt out" clause in privacy policies.

- Changes in Account Name or Designation: not properly evidencing approval of changes in account designation, as well as failing to document the essential facts relied upon by the person approving the change.

- Time and Price Discretion: extension of time and price discretion beyond the business day on which the customer grants it not being

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authorized by signed and dated customer instructions.

- Net Capital: firms either inaccurately valuing proprietary trading positions or failing to maintain adequate controls over inventory mark-to-markets performed by traders.

- Customer Protection: inaccurately treating stock record allocation positions, non-bona fide reserve bank deposits and creating segregation deficits by deliveries, securities loaned and securities borrowed returns.

- Operations: inaccurate books and records resulting from member firms' inability to accurately process and reconcile transactions.

- Order Data Transmission Requirements: OATS data not being properly submitted with accurate order information, terms and conditions, and/or special handling codes.

- Transaction Reporting Rules: firms incorrectly reporting riskless principal transactions or incorrectly reporting transactions with the long/short-sale indicator.

http://www.finra.org/RulesRegulation/ComplianceTools/ImprovingExamResults/p038526

FINRA Eliminates Senior Registered Options Principal and Compliance Registered Option Principal

Effective June 23, the Financial Industry Regulatory Authority (FINRA) has eliminated two principal categories—Senior Registered Options Principal (SROP) and Compliance Registered Options Principal (CROP). All options principals will be Registered Options and Security Futures Principals (ROSFPs). ROSFPs designated by the firm will be authorized now to approve all advertisements, sales literature and educational materials issued by a firm pertaining to options. ROSFPs designated by the firm must approve new accounts to write uncovered options by persons not meeting specified criteria and review discretionary accounts' trading of options. If a firm has computerized surveillance tools, discretionary account trading in options may be reviewed in accordance with the firm's written supervisory procedures, otherwise discretionary options orders must be reviewed and approved on the day of order entry.

http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p038539.pdf

FINRA Addresses Supervision of Registered Representatives' Use of Marketing Material to Establish Expertise

The Financial Industry Regulatory Authority's (FINRA) Regulatory Notice 08-27 addresses the obligation of firms supervising registered representatives' use of marketing materials to establish their expertise. Specifically, the notice addresses the practice of registered representatives affixing their name to publications purchased from third party vendors and implying that the representatives authored the publication. Registered representatives may not suggest, or encourage others to suggest, that they authored investment-related books, articles or similar publications if they did not write them, and any ghostwritten publication must disclose that it was prepared either by the third party or for the representatives' use. If the firm or representative has paid for the publication, production or distribution of any communication that appears to be a magazine, article, interview, or webcast, then it must be clearly identified as an advertisement. The Notice also states that the use of any title or

designation that conveys an expertise in senior investments or retirement planning where such expertise does not exist may violate FINRA rules.

http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p038522.pdf

CFTC

Congress Adopts CFTC Reauthorization Bill

Congress recently adopted legislation to reauthorize the Commodity Futures Trading Commission through 2013 and to provide the CFTC with expanded authority over exempt commercial markets (ECMs) and off-exchange retail foreign currency (F/X) transactions. Among other things, the CFTC Reauthorization Act of 2008 gives the CFTC enhanced regulatory authority with respect to certain contracts traded on ECMs that are deemed to be significant price discovery contracts (SPDCs), including the authority to require large trader position reporting and to exercise emergency authority, as well as to require an ECM to adopt position limits and assume other self-regulatory responsibilities with respect to SPDCs. The reauthorization bill also expressly extends CFTC anti-fraud authority over all F/X transactions, creates a new registration category for F/X dealers and establishes a $20 million minimum capital requirement for F/X dealers and futures commission merchants that act as counterparties to F/X transactions. The Reauthorization Act became effective on May 22.

http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5501-08.html

CFTC Announces Energy Market Initiatives and Investigation

The Commodity Futures Trading Commission has announced several initiatives to enhance its surveillance of energy futures markets. Among the initiatives announced, the CFTC, the UK Financial Services Authority (FSA) and London-based ICE Futures Europe (IFE) have agreed to expanded information sharing with respect to the West Texas Intermediate (WTI) crude oil futures contracts traded on both IFE and the New York Mercantile Exchange (NYMEX). Under the new agreement, which enhances the existing information-sharing pact between the CFTC and FSA, the CFTC will receive, among other things, daily large trader position information for the IFE WTI contract and will be notified by IFE when traders exceed the position accountability levels established by U.S. designated contract markets, such as NYMEX, for WTI contracts. The CFTC also announced an initiative to increase the transparency of index trading in U.S. energy markets and to review such trading for any negative impact that it may have upon price discovery. In connection with this initiative, the CFTC will immediately employ its “special call” authority to require monthly reports from energy traders of their index trading activities, while working to develop a proposal that would routinely require more detailed reporting from index traders and swap dealers.

http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5503-08.html

Banking

Federal Financial Regulators Issue Final Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products

The federal financial regulatory agencies, on May 22, issued final illustrations for helping consumers understand certain hybrid adjustable rate mortgage (ARM) products. The agencies' Statement on Subprime Mortgage Lending (Subprime Statement), which became effective July 10, 2007, recommended that institutions provide clear, balanced, and timely information to consumers

CFTC

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about the relative benefits and risks of hybrid ARM products. The illustrations are intended to assist institutions in providing this information. The illustrations consist of (i) an explanation of some key features of products covered by the Subprime Statement, and (ii) three charts with examples of the potential payment shock accompanying these types of loans.

Institutions are not required to use the illustrations. They may use them, provide information based on them, or provide consumers with information described in the guidance in an alternate format.

The agencies will be posting the illustrations on their websites for downloading and printing. In particular, versions of the illustrations will be posted in English and in Spanish together with a template of the illustrations that institutions can modify to reflect the latest market conditions.

http://www.fdic.gov/news/news/press/2008/pr08035a.html

UK Developments

FSA Considers Increasing Regulatory Transparency

On May 27, the UK Financial Services Authority (FSA) published a discussion paper, *DP08/3 Transparency as a Regulatory Tool*, setting out a proposed code of practice to provide guidance as to the circumstances in which the FSA may release information to the public. The discussion paper recognizes that the FSA operates within certain constraints imposed by the UK Freedom of Information Act 2000 and the Financial Services and Markets Act 2000. Under these statutes, the FSA must safeguard confidential information and follow due process before it can publish a statement which amounts to a "public censure" of an FSA authorized firm. However, the FSA believes that it should make information public where it is legally able to do so and where it believes that if it does so this will help it to achieve its statutory objectives.

The discussion paper provides examples of the types of information the FSA may consider publishing and draws a clear distinction between simply making information available, which the FSA concedes could cause confusion and potentially have a negative impact, and publishing information in a way that makes issues and practices clearer and therefore improves how regulated markets function.

The deadline for comments is August 29.

www.fsa.gov.uk/pubs/discussion/dp08_03.pdf

FSA Launches Consultation on Amending Enforcement Procedures

On May 27, the UK Financial Services Authority (FSA) published consultation paper *CP08/10 Decision Procedure and Penalties Manual and Enforcement Guide Review 2008* following the introduction of its new Decision Procedure and Penalties (DEPP) Manual and Enforcement Guide (EG) in July 2007 and as part of its commitment to annually review such materials.

The consultation paper includes a proposed new chapter to the EG which would include the FSA's policy on new enforcement powers particularly with respect to anti-money laundering and covered bonds. The FSA is seeking powers to impose civil penalties for breaches of these regulations and it intends to apply similar investigative procedures to money laundering regulatory breaches as it does to other matters under its jurisdiction.

The consultation paper includes a proposal to provide a greater incentive for suspects to cooperate with the FSA. In circumstances where misconduct is

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carried out by two or more individuals acting together and one cooperates with the FSA, this will be taken into account by the FSA when deciding whether to prosecute or to bring market abuse proceedings. The FSA proposes to amend the non-exhaustive list of factors it will take into account when considering leniency to include cooperation and assistance.

The consultation closes on August 29.

www.fsa.gov.uk/pubs/cp/cp08_10.pdf

EU Developments

CESR Consults Third Set of Market Abuse Guidance

On May 20, the EU Committee of European Securities Regulators (CESR) launched a consultation on its third set of guidance on the operation of the EU Market Abuse Directive (MAD). The draft guidance on MAD set out in the consultation covers issues relating to insider lists and suspicious transaction reporting (STR). The CESR intends to publish a further consultation on guidance covering issues relating to stabilization and the notion of inside information later this year. Guidance related to directors' dealings and the definition of inside information in the context of commodity derivatives will be addressed at a later stage.

The consultation closes on September 30.

www.cesr.eu/popup2.php?id=5054

European Commission Calls for Strengthening of EU Level Three Committees

On May 23, the European Commission launched a consultation on possible amendments to the structure of each of the EU Level Three Committees: the EU Committee of European Securities Regulators, the Committee of European Banking Supervisors and the Committee of European Insurance and Occupational Pensions Supervisors.

The European Commission would like to align, clarify and strengthen the responsibilities of the three committees to improve EU supervisory cooperation and convergence and the safeguarding of financial stability.

The consultation invites comments on a range of issues including information exchange, delegation of tasks and responsibilities among national supervisors, colleges of supervisors, development of an EU-wide "common supervisory culture," cooperation across sectors and whether the committees should make decisions by consensus or by qualified majority voting.

The consultation closes on July 18.

ec.europa.eu/internal_market/finances/docs/committees/consultation_en.pdf

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