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SEC/CORPORATE

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

On November 3, the Securities and Exchange Commission issued proposed rules for implementing the whistleblower provisions added to Section 21F of the Securities Exchange Act of 1934 by the Dodd-Frank Wall Street Reform and Consumer Protection Act. Under the proposed rules, the SEC will pay an award or awards to one or more whistleblowers who voluntarily provide the SEC with original information that leads to the successful enforcement by the SEC of a federal court or administrative action in which the SEC obtains monetary sanctions totaling more than $1 million.

Under the proposed rules, a whistleblower is an individual who, alone or jointly with others, provides information to the SEC relating to a potential violation of the securities laws. A whistleblower must be a natural person. A company or another entity is not eligible to receive a whistleblower award.

Under the proposed rules, whistleblowers are eligible for awards only when they provide original information to the SEC "voluntarily." Proposed Rule 21F-4(a)(1) would define a submission as "voluntary" if a whistleblower provides the SEC with information before receiving any formal or informal request, inquiry or demand from the SEC, Congress, any other federal, state or local authority, any self-regulatory organization or the Public Company Accounting Oversight Board about a matter to which the information in the whistleblower's submission is relevant. Proposed Rule 21F-4(a)(2) provides that submissions from certain individuals who have a pre-existing or contractual duty to report securities violations to the SEC will not be considered "voluntary" for purposes of Section 21F.

Under the proposed rules "original information" means information that is derived from the whistleblower's "independent knowledge" or "independent analysis," is not already known to the SEC from any other source, and is not derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information. Proposed Rule 21F-4(b)(4) provides that information will not be considered to derive from an individual's "independent knowledge" or "independent analysis" in the following circumstances:

- Attorneys who attempt to use information obtained from client engagements to make whistleblower claims for themselves (unless disclosure of the information is permitted under SEC rules or state bar rules).
- Independent public accountants who obtain information through an engagement required under the securities laws.
- People who learn about violations through a company's internal compliance program or who are in positions of responsibility for an entity, and the information is reported to them in the expectation that they will take appropriate steps to respond to the violation. This exclusion ceases to be applicable if the company does not disclose the information to the SEC within a reasonable time or acts in bad faith. In these circumstances, such persons can become whistleblowers.
- By a means or in a manner that violates applicable federal or state criminal law.

The SEC also would not pay culpable whistleblowers awards that are based upon either the monetary sanctions that such people themselves pay in the resulting SEC action, or on sanctions paid by entities whose liability is based substantially on conduct that the whistleblower directed, planned or initiated.

Under the proposed rules, a whistleblower's information can be deemed to have led to successful enforcement if (1) the information results in a new examination or investigation being reopened and significantly contributes to the success of a resulting enforcement action, or (2) the conduct was already under investigation when the information was submitted, but the information is essential to the success of the action and would not have otherwise been obtained.

The proposed rules provide that awards will range between 10% and 30% of monetary sanctions imposed, where such sanctions exceed $1 million. According to the SEC's Annual Report to Congress on the Whistleblower Program, the Securities and Exchange Commission Investor Protection Fund, established by the Dodd-Frank Act to provide funding for the whistleblower programs, including the payment of awards, had a balance of approximately $452 million as of September 30.

The proposed rules also provide the procedures for submitting "original information" to the SEC (under penalty of perjury) and making a claim for an award.

At the SEC open meeting on November 3, there was discussion about the potential negative impact the proposed rules may have on internal corporate compliance functions, with Commissioner Troy Paredes stating that he was "concerned that the Commission's proposal might not do enough to preserve the important role that corporate compliance programs serve" and that "It would be unfortunate if, as result of the Dodd-Frank whistleblower program, effective corporate compliance programs were thwarted."

In an attempt to address this concern, the proposed rules include provisions designed to discourage employees from bypassing their own company's internal compliance programs. The proposed rules would treat an employee as a whistleblower under the SEC program as of the date that employee first reports the information internally as long as the employee provides the same information to the SEC within 90 days. Thus, employees will be able to report their information internally first while still preserving their "place in line" for a possible award from the SEC. The proposed rules also permit the SEC to consider higher percentage awards for whistleblowers who first report their information through effective company compliance programs.

Comments on the proposed rules should be submitted to the SEC on or before December 17.

Read more.

SEC Letter to Public Company CFOs Regarding Mortgage and Foreclosure-Related Activities or Exposures

The Securities and Exchange Commission has released a letter sent in late October by its Division of Corporation Finance to the chief financial officers of certain public companies to remind them of disclosure obligations in their upcoming Form 10-Qs and subsequent filings in light of continued concerns about potential risks and costs associated with mortgage- and foreclosure-related activities or exposures. The letter instructs companies to review their various mortgage-related representations and warranties made in sale agreements with purchasers of the mortgages or mortgage-backed securities and consider the implications on their accounting and disclosures. In addition, companies undertaking reviews of their loan documentation and foreclosure practices and which have suspended foreclosures pending completion of such reviews should consider their treatment of loss contingencies and disclosures.

Item 103 (Legal Proceedings) and Item 303 (Management's Discussion and Analysis of Financial Condition and Results of Operations) of Regulation S-K, as well as accounting rules regarding contingencies set forth in Accounting Standards Codification Subtopic 450-20 (SFAS 5), require public companies to provide clear and transparent disclosure regarding their obligations relating to representations and warranties made in connection with securitization activities and whole loan sales, including a roll forward of related reserves. In addition, companies are encouraged to discuss implications of any foreclosure review, including potential delays in completing foreclosures, if applicable. These disclosures may include increased risks and uncertainties, including litigation risks, potential defects in securitizations, impairments and liquidity, and should address the company's role as an originator, securitizer, servicer or investor, as applicable. The letter notes that some of these disclosure issues are not limited to financial institutions that sold or securitized mortgages or mortgage-backed securities, and instructs companies that engage in mortgage servicing, title insurance, mortgage insurance and other activities relating to residential mortgages to consider the impact of these and similar issues for their disclosures.

Click here for a copy of the SEC letter.

SEC Publishes Staff Review of Public Company Interactive Data Financial Statements

On November 1, the staff of the Securities and Exchange Commission's Division of Risk, Strategy and Financial Innovation released a report of its review of the Interactive Data Financial Statement submissions during June–August. The submissions reviewed included the first group of mandated detailed tagged public company filings and the initial filings of the second phase-in group of public companies. The staff expects these deficiencies to be addressed by filers in their November Form 10-Q filings and future filings.

The most common deficiencies identified in the review included incorrect tagging of data with negative values, unnecessary use of custom elements where existing U.S. Generally Accepted Accounting Principles taxonomy is appropriate, incorrect tagging of classes of stock, and improper designations by consolidated entities of parent company and subsidiary information, and incorrect tagging of parenthetical line item data.

Click here to read the staff report.

BROKER DEALER

FINRA Requests Comment on Proposal to Require Disclosure Statement to Retail Investors

The Financial Industry Regulatory Authority released a notice requesting comment on its proposal that would require member firms at or prior to commencing a business relationship with a retail customer to provide a written statement to such customer describing the types of accounts and services it provides, potential conflicts associated with such services and any limitations on the duties the firm otherwise owes to retail customers.

Before the Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted, FINRA was already considering whether to implement a heightened standard of care with respect to broker-dealers. FINRA's staff concluded that retail customers would benefit from an up-front disclosure document that sets forth in plain English a firm's accounts and services, its associated conflicts of interest and any limitation on duties owed to its customers. FINRA's disclosure statement would serve a purpose similar to that of a Form ADV, which is required under the Investment Advisers Act to be provided to each advisory client.

With the enactment of the Dodd-Frank Act, FINRA believes its disclosure concept is even more appropriate, if not a necessity. The Dodd-Frank Act requires the Securities and Exchange Commission to conduct a study of broker-dealers' and investment advisers' obligations with respect to disclosure of conflicts of interest and authorizes the SEC to establish a fiduciary standard of care for broker-dealers. FINRA, in anticipation of any rulemaking mandates from the SEC resulting from such studies and to enhance retail investors' understanding of the business, relationships and conflicts of their brokers, is seeking comment on its proposal.

Specifically, FINRA's new rule would require a firm, at or prior to commencing a business relationship with a retail customer, to provide a written statement that sets forth the following information:

- types of brokerage accounts and services the firm provides;
- disclosures designed to permit existing and prospective retail customers to evaluate (a) the scope of services provided by the firm, (b) the scope of products offered, (c) if applicable, that the firm may not offer all products of a certain class or type and that it may be the sponsor or originator of certain products and may determine in some cases to act as a distributor or placement or sales agent for a fee from the issuer or sponsor of the product, and (d) all fees associated with each brokerage account and service offered to retail customer;
- disclosure as to the financial or other incentives that a firm or its registered representatives have to recommend certain products;
- disclosure of conflicts that may arise between a firm and its customers; and
- limitations on the duties a firm owes to its customers.

The comment period expires on December 27.

Click here to read the full text of FINRA Regulatory Notice 10-54.

SEC Adopts New Rule Preventing Unfiltered Market Access

On November 3, the Securities and Exchange Commission announced the adoption of Rule 15c3-5, which prohibits broker-dealers from providing customers with "unfiltered" or "naked" access to an exchange or alternative trading system (i.e., where broker-dealers allow customers to trade in those markets electronically using the broker-dealers' market participant identifiers). The rule also requires broker-dealers to have better risk controls when they access the market on behalf of their customers or themselves. For example, broker-dealers must put in place risk management controls and supervisory procedures to help prevent erroneous orders, ensure compliance with regulatory requirements and enforce preset credit or capital thresholds.

The final rule includes certain limited exceptions to these requirements. For example, a broker-dealer providing market access is permitted to reasonably allocate control over specific regulatory risk management controls and supervisory procedures to a customer that is a broker-dealer, so long as such broker-dealer customer has better access to that ultimate customer and its trading information such that it can more effectively implement the specified controls and procedures.

According to the SEC, the new rule aims to bring greater standardization, accountability and transparency to market behaviors. "I have previously likened unfiltered access to giving your car keys to a friend who doesn't have a license and letting him drive unaccompanied," said SEC Chairman Mary Schapiro. "This rule requires that broker-dealers not only remain in the car, but also maintain control of it so we can all be assured the rules of the road will be observed before the car is ever put into drive."

The new rule will be effective 60 days from the date of its publication in the *Federal Register*. Once effective, broker-dealers subject to the rule will have six months to comply with the requirements.

Click here to read the SEC press release regarding adoption of Rule 15c3-5, issued on November 3.
SEC Release No. 34-63241 is available here.

SEC Proposes Rule Prohibiting Fraud, Manipulation and Deception in Connection with Security-Based Swaps

On November 3, the Securities and Exchange Commission proposed a new rule under the Securities Exchange Act of 1934 (Exchange Act) that is intended to prevent fraud, manipulation and deception in connection with the offer, purchase or sale of any security-based swap, the exercise of any right or performance of any obligations under a security based-swap, or the avoidance of such exercise or performance.

Section 761(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act defines a "security-based swap" as "any agreement, contract, or transaction that is a swap, as defined in Section 1(a) of the Commodity Exchange Act, that is based on a narrow-based security index, or a single security or loan, or any interest therein or on the value thereof, or the occurrence or non-occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statement, financial condition or financial obligations of the issuer."

A key characteristic of most security-based swaps, as compared to other securities, is the obligation for and right to ongoing payments or deliveries between the parties throughout the life of the security-based swap. The exercise of such rights or performance of such obligations under a security-based swap presents opportunities and incentives for fraudulent conduct. Parties to a security-based swap may engage in misconduct to trigger, avoid or affect the value of such ongoing payments or deliveries. To address the increased exposure to fraudulent conduct related to security-based swaps, the SEC is proposing Exchange Act Rule 9j-1.

The proposed rule would subject security-based swaps, as securities, to the general antifraud and anti-manipulation provisions of the federal securities laws (e.g., Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 17(a) of the Securities Act of 1933), but would also explicitly reach misconduct that is in connection with the "exercise of any right or performance of any obligation under" a security-based swap.

Therefore, the proposed rule would explicitly reach misconduct in connection with the ongoing payments or deliveries characteristic of security-based swaps. Misconduct to trigger, avoid or affect the value of such ongoing payments or deliveries would be explicitly prohibited.

Click here to read the full text of the SEC release.

SEC Extends New Short Sale Rule Compliance Date

On November 4, the Securities and Exchange Commission announced it will extend the date for compliance with the SEC's new short sale rule to February 28, 2011. The extension was granted to give certain exchanges additional time to modify their market opening, reopening and closing procedures for individual securities covered by the rule, and in order to provide additional time to market participants for programming and testing of systems for implementation.

The new short sale rule will, in part, restrict the prices at which a stock can be sold short if the stock's price drops 10% or more in one day.

SEC Release No. 34-63247 is available here.
Click here for the text of the final short sale rule.

CFTC

CFTC to Hold Open Meeting on Proposed Rules under Dodd-Frank Act

The Commodity Futures Trading Commission announced that it will hold a public meeting to propose rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act regarding: (1) registration of foreign boards of trade; (2) registration of swap dealers and major swap participants; (3) implementation of the new whistleblower provisions of the Commodity Exchange Act; (4) conflict of interest policies and procedures for futures commission merchants (FCMs), introducing brokers, swap dealers and major swap participants; and (5) FCM, swap dealer and major swap participant compliance policies.

The meeting will take place at 1:00 p.m. Eastern on November 10.

The CFTC's press release, which includes information on viewing a webcast of the meeting, can be found here.

LITIGATION

Civil RICO Complaint Based on Alleged Diamond Scheme Dismissed

The U.S. District Court for the Southern District of Florida dismissed a civil Racketeer Influenced and Corrupt Organizations Act complaint based on a series of investments made with a group of India-based companies.

Plaintiffs made 35 investments with two corporations related to the defendants between May 2007 and March 2009. According to the plaintiffs, the corporate defendants were created to hide money originally stolen from them through a series of sham transactions. Plaintiffs alleged that the companies pretended to purchase diamonds from Indian diamond merchants, reflected in fake invoices, as part of a complicated scheme to legitimize the stolen funds. Plaintiffs included invoices, details about specific wire transfers and a flow chart to support their allegations. The court held that the plaintiffs' allegations that the diamond sales and related paperwork were "fake" and that the transferred funds were "embezzled" and "converted" were "conclusory" because "[t]hey are simply unsupported statements of plaintiffs' belief as to the origin of the funds" rather than actual facts supporting their claims. Accordingly, the case was dismissed. (*Rajput v. City Trading, LLC et al.*, 10-Civ.-21654, 2010 WL 4259955 (S.D.Fla. Oct. 25, 2010))

Veil Piercing Allegations Insufficient in Breach of Contract Case

The U.S. District Court for the District of Massachusetts granted a motion to dismiss in a breach of contract and promissory estoppel case, ruling that plaintiff failed to plead the requisite justification for piercing the corporate veil of the defendants.

Plaintiff, TechTarget Inc., provided advertising services pursuant to a contract with one of the defendants, Spark Design, LLC. Spark Design fell behind on payments owing under the contract almost immediately. Thereafter, defendant WW Capital Partners, LLC, a wholly owned subsidiary of defendant Black Mountain Enterprises, LLC, acquired a controlling interest in Spark Design. After that acquisition, WW Capital made representations to TechTarget that past-due invoices would be paid. WW Capital issued checks to TechTarget, but one check was returned for insufficient funds and another had a stop payment order placed on it. After TechTarget filed suit on the contract, Spark Design filed for Chapter 11 Bankruptcy, staying the proceeding against it, and WW Capital and Black Mountain moved to dismiss. Although TechTarget alleged that the three corporate defendants shared common ownership, that WW Capital and Black Mountain may have exercised pervasive control over Spark, and that business assets were intermingled between the three companies, TechTarget failed to include any allegations of fraudulent or improper use of Spark Design's corporate form in a manner related to the contract. Accordingly, the court could not find that Spark Design was the alter ego of WW Capital and Black Mountain, and the claims against those entities were dismissed. (*TechTarget, Inc. v. Spark Design, LLC, Black Mountain Enterprises, LLC, WW Capital Partners, LLC,* No. 10-Civ.-11266 (WGY), 2010 WL 4269602 (D. Mass. Oct. 27, 2010))

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