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Corporate and Financial Weekly Digest

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SEC/Corporate

SEC Staff Critiques 2007 Executive Compensation Disclosure

The Staff of the Division of Corporation Finance of the Securities and Exchange Commission published a report this week discussing the principal themes and comment areas that emerged from its review of compliance by 350 public companies with the SEC's new executive compensation disclosure rules.

Two principal themes emerged from the Staff review. First, the Staff stated that companies should provide more focused disclosure of the *how* and *why* of specific executive compensation decisions and policies. The Staff found that while there was much discussion, there was a lack of *analysis*, particularly, in the Compensation Discussion and Analysis (CD&A) disclosures reviewed. Disclosure does not need to be longer or more technical, but crisper and clearer. Second, the Staff urged companies to present compensation information in a manner that will provide clear information to investors.

In a speech delivered shortly after publication of the Staff's report, John White, Director of the SEC's Division of Corporation Finance, stated that in his view the "biggest shortcoming" of the first-year disclosures is that "far too often, meaningful analysis is missing....stated simply, where's the analysis?" He went on to emphasize that what was generally lacking was a discussion of the *how* and *why* compensation philosophies and processes resulted in the specific compensation amounts disclosed. He also stated that while there was "a great deal of detail on individual compensation components" there was little discussion of "how the amounts paid or awarded under each compensation element – and how the total compensation delivered from all these elements...affected the decisions...regarding amounts paid or awarded under other compensation elements."

In most cases, even where disclosure changes were required, the Staff comments were directed at correcting future disclosures. In a significant number of the filings reviewed, the Staff suggested making certain items disclosed more prominent by providing an emphasis on material information using plain English principles.

In many of the Staff's comment letters, companies were asked to enhance their CD&A disclosure by including *how* the amounts and the elements of specific compensation were determined. The emphasis should be on the substance of compensation decisions and why the companies analyses resulted in the compensation actually paid rather than the philosophies and decision mechanics behind such compensation. The Staff also commented that the CD&A should always precede the tabular disclosure.
The report summarized Staff comments relating to other specific disclosure elements:

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Performance Targets

Performance targets drew the greatest number of comments issued by the Staff. While most companies disclosed that executive compensation was conditioned on individual performance, they rarely disclosed how they analyzed such individual performance. Where companies omitted performance target amounts, the Staff sought more specific disclosure of the difficulty of meeting targets and/or that the company demonstrate why disclosure of specific targets would cause competitive harm. Where a company presented a non-GAAP financial figure as a performance target, the Staff required that the company disclose how such figure is calculated.

Benchmarks

As to benchmarks, companies were asked to provide a more detailed explanation of how they used comparative compensation information and how that comparison affected compensation decisions. If a company can use its discretion to benchmark to different ranges or for that matter not to benchmark at all, the nature and extent of that discretion and how it is exercised must be disclosed.

Change-in Control-and Termination Arrangements

The Staff required more detailed analysis of disclosure of change-in-control and termination arrangements, including a discussion of why companies structured the material terms and payment provisions in their change-in-control and termination arrangements as they did.

http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm

http://www.sec.gov/news/speech/2007/spch100907jww.htm

Banking

FinCEN Provides SAR Compliance Tips

The Financial Crimes Enforcement Network (FinCEN), a department within the US Treasury, issued on October 10, additional guidance with respect to the filing of Suspicious Activity Reports (SARs). The guidance sets forth the 10 most common errors with respect to the filing of such reports and the means by which many of them can be mitigated.

Notably, FinCEN identified three distinct areas where financial institutions should concentrate their efforts to ensure the information in any SAR is complete: (i) SAR narratives, (ii) certain critical fields that allow users to analyze quickly where activity has occurred, and (iii) fields that identify type, category and character of the suspicious activity. Within those three areas, the guidance addresses issues such as inadequate or empty narrative fields, invalid subject social security number or employer identification number, and missing characterizations of suspicious activity.

The errors were noted by FinCEN in its review of SARs filed by money services businesses, but the agency stated in its release that this guidance has applicability to all institutions required to file SARs.

http://www.FinCEN.gov/SAR_Common_Errors-PR.html

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SEC Adopts Regulation R Gramm-Leach-Bliley Bank Broker Exceptions

The adoption of Regulation R by the Securities and Exchange Commission implements the Gramm-Leach-Bliley bank broker exceptions in Section 3(a)(4) of the Securities Exchange Act of 1934, as amended (Exchange Act). The SEC and Federal Reserve Board were mandated with jointly adopting a single set of rules to implement the bank broker exceptions as part of the Financial Services Relief Act of 2006. In this release, the SEC and the Federal Reserve Board adopted an identical set of rules.

The "Networking Exception" in Section 3(a)(4)(B)(i) of the Exchange Act permits a bank to avoid being considered a broker if it enters into a contractual arrangement with a registered broker-dealer under which the broker-dealer offers brokerage services to bank customers, subject to limitations on incentive compensation paid to bank employees for referring bank customers to the broker-dealer. Regulation R defines the different levels of "nominal" incentive compensation bank employees can receive for referring typical bank customers, institutional customers and high net worth customers to the broker-dealer.

The "Trust and Fiduciary Exception" in Section 3(a)(4)(B)(ii) of the Exchange Act permits banks to effect securities transactions in a fiduciary or trustee capacity without being registered as a broker, provided the bank executes the transaction in its trust department or another department regularly examined by bank examiners and the bank is "chiefly compensated" for the transaction by: (i) an administration or annual fee; or (ii) a percentage of assets under management; or (iii) a flat or capped order processing fee; or (iv) any combination thereof. Rule 722 under Regulation R will permit banks to meet the "chiefly compensated' test if their relationship-based income from the fiduciary or trust account exceeded 50% percent of the total compensation attributable to that account, or if the bank-wide aggregate relationship-based compensation attributable to its trust or fiduciary business exceeded 70% of the total compensation attributable to its trust or fiduciary business.

The "Sweep Exception" in Section 3(a)(4)(B)(v) of the Exchange Act exempts a bank from the definition of a broker for transactions effected as part of a program of investment or reinvestment of deposit funds into a no-load, open-end money market fund registered under the Investment Company Act. Rule 741 of Regulation R will permit banks to utilize this exception so long as the bank provides to the customer in question services such as escrow, trust, fiduciary or custody accounts, deposit accounts, loans or other extensions of credit that would not in and of themselves require broker-dealer registration by the bank.

The "Custody and Safekeeping Exception" in Section 3(a)(4)(B)(viii) of the Exchange Act exempts banks from the definition of broker for services such as safekeeping or custody of securities, facilitating the transfer of funds or securities, effecting securities lending transactions with or on behalf of a customer as part of their custodial services, holding securities pledged by a customer or facilitating pledging transactions, or providing custodial or administrative services to individual or group retirement plans. Rule 760 under Regulation R will continue to permit banks to effect securities transactions for employee benefit, individual retirement and other account types for which the bank acts as custodian, subject to restrictions on employee compensation and advertising imposed to prevent the banks from utilizing their custody operation to run a full-fledged brokerage business.

Regulation R also includes rules which will permit banks to engage in certain securities lending transactions and with a conditional exemption from the

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definition of broker, to effect transactions involving mutual funds, variable annuities or variable life insurance policies through the National Securities Clearing Corporation or a transfer agent rather than through a registered broker-dealer, and to permit banks to conduct employee benefit transactions in employer securities directly with a transfer agent subject to certain restrictions.

http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/07-4769.pdf

SEC to Permit U.S. Banks to Effect Regulation S Transactions, Act as Conduit Lenders

Concurrent with its adoption of Regulation R, the Securities and Exchange Commission has adopted two rules to permit securities activities of U.S. banks to fall within an exemption from the definition of "dealer" under the Exchange Act. Rule 3a5-2 will permit U.S. banks to engage in transactions involving securities exempt from registration under Regulation S, allowing U.S. banks to sell overseas securities that foreign banks sell and thereby help to eliminate a competitive disadvantage. Rule 3a5-3 will permit banks to continue to act as conduit lenders, an activity previously authorized under the now withdrawn Rule 15a-11 adopted in 2003.

Under Rule 3a5-2, U.S. banks will be allowed to purchase and sell any eligible Regulation S security, defined as a Regulation S security that is neither in the inventory of the bank or an affiliate nor underwritten by the bank or any affiliate on a firm commitment basis, on a riskless principal basis. The exemption applies in three situations: (i) when a U.S. bank purchases an eligible new-issue security from an issuer or broker-dealer and sells the security under Rule 903 of Regulation S to a purchaser who is not in the U.S.; or (ii) when a U.S. bank purchases an eligible security after its initial sale from a person who is not a U.S. Person under Rule 902(k) of Regulation S with a reasonable belief that the security was initially sold outside the U.S., and resells to a purchaser who is not in the U.S.; or (iii) when a U.S. bank purchases an eligible security from a registered broker-dealer after its initial sale with a reasonable belief that the security was initially sold outside the U.S., and resells the security to a purchaser who is not in the U.S.

Under Rule 3a5-3, banks acting as conduit lenders will continue to be permitted to engage in or effect certain securities lending transactions and securities lending services in connection with conduit loan transactions. The exemption will only apply to transactions by or on behalf of a person the bank believes to be a qualified investor as defined by Section 3(a)(54) of the Exchange Act or an employee benefit plan that owns and invests more than $25 million in investments on a discretionary basis.

http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/E7-19093.pdf

Anti-Money Laundering

Guidance Issued Regarding Due Diligence Obligations of OTC Executing Dealers

The Financial Crimes Enforcement Network (FinCEN) has issued interpretive guidance clarifying the due diligence obligations of executing dealers under the correspondent account rule with respect to prime brokerage clients in over-the-counter foreign exchange and derivatives markets (OTC Markets). The rule requires a covered financial institution to establish a due diligence program that is designed to detect and report known or suspected money laundering activity in such correspondent accounts.

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Noting that both the prime brokerage client and the executing dealer enter into opposing transactions with the prime broker, rather than effecting transactions directly with one another in the OTC Markets, FinCEN has concluded that the correspondent account rule does not impose a due diligence obligation upon the executing dealer with respect to prime brokerage clients. FinCEN cautioned, however, that executing brokers that are subject to anti-money laundering obligations are nonetheless expected to establish and implement risk-based policies, procedures, and controls for assessing the money laundering risk posed by their operations, including the execution of over-the-counter foreign exchange and derivatives transactions; for monitoring and mitigating that risk; and for detecting and reporting suspicious activity.

http://www.fincen.gov/312ForexOTCPrimeBrokerage.pdf

Financial Markets

Comments Requested on Financial Industry Regulatory Framework

In connection with several ongoing initiatives concerning the international competitiveness of US capital markets, the Treasury Department has published a release requesting comments on a number of issues of significance to the financial services industry, including the securities and futures markets. Among other issues, the Treasury Department release requests comments on whether there is a continued rationale for having separate securities and futures regulators and regulatory frameworks and whether it would be useful to apply some of the principles of the Commodity Futures Modernization Act of 2000 to the securities regulatory regime. More broadly, the release asks whether a move towards a single financial market regulator (comparable to the United Kingdom's Financial Services Authority) would prove beneficial in the United States.

The comment period for the Treasury Department's release closes on November 21.

http://www.treas.gov/press/releases/reports/federalregisternoticehp602.pdf

United Kingdom Developments

LSE Makes Final MiFID Handbook Changes

On October 4, the London Stock Exchange (LSE) confirmed detailed changes to its dealing rules in preparation of the November 1 implementation of the EU Markets and Financial Instruments Directive.

The key changes include: (i) clarification of the requirements for the reporting of client-side legs of risk-less principal transactions, (ii) the use of negotiated and large trade waivers, (iii) the LSE's deferred publication regime, (iv) European Trade Reporting, (v) the removal of rules relating to the Traditional Options Market, and (vi) clarifications on the use of the terms "customer" and "counterparty".

www.londonstockexchange.com/NR/rdonlyres/224320A5-3B7D-411E-B768-7A2F6045CBBF/0/N6707.pdf

FSA Publishes Latest Quarterly Consultation

On October 5, the UK Financial Services Authority (FSA) published its latest quarterly consultation paper, which sets out proposals to amend various sections of its handbook including:

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- Amendments to the FSA's Collective Investment Schemes handbook that include changes as a result of the EU Eligible Assets Directive clarifying the types of instruments and techniques that may be eligible for use in an undertakings for collective investment in transferable securities fund, such as transferable securities, money market instruments, derivatives, efficient portfolio management, indices and other collective investment schemes.

- Amendments to the General Prudential sourcebook to allow substitution into directly issued preferential non-cumulative preference shares with a step-up as well as directly issued non-innovative tier one capital instruments and clarifications on the rules for coupon payments.

- Various amendments and clarifications in respect of mortgage and insurance business including the treatment of lifetime mortgages for the calculation of capital adequacy requirements, the use of intermediaries for mortgage and home finance firms, and the FSA's permitted links rules.

- Consequential amendments as a result of the Regulatory Reform (Financial Services and Markets Act 2000) Order 2007 which came into effect on July 12, as described in the July 20, 2007 edition of *Corporate and Financial Weekly Digest*.

The deadline for comments on the proposals is FSA December 5.

www.fsa.gov.uk/pubs/cp/cp07_18.pdf

UK Chancellor Announces Amendments to Investment Management Exemption

On October 9, the UK Chancellor of the Exchequer, Alistair Darling, announced changes to the Investment Management Exemption (IME) in his Pre-Budget Report to the House of Commons. These changes complement the HM Revenue & Customs' revised Statement of Practice on the IME published in July 2007, as described in the July 27, 2007 edition of *Corporate and Financial Weekly Digest*. They are seen as a helpful simplification of the IME regime.

The changes include: (i) broadly aligning the list of transactions to those transactions and activities that are regulated by the FSA in order to clarify the scope of "investment transactions"; and (ii) providing for a more proportionate tax effect on non-qualifying transactions, and will be enacted in the Finance Bill 2008.

www.hmrc.gov.uk/pbr2007/pbrn7.pdf

UK Hedge Fund Working Group Publishes Proposals for Voluntary Code

On October 11, the UK Hedge Fund Working Group announced a consultation on its proposals for a voluntary code for the UK hedge fund industry. The proposals include improved transparency in respect of risk, asset valuations and trading strategies.

The proposed code also asks hedge fund managers to stress-test their holdings and to provide information on risk controls to investors and lenders.

The Working Group was established in June by 13 hedge funds, as described in the June 22, 2007 edition of *Corporate and Financial Weekly Digest*, and is chaired by Sir Andrew Large. Sir Andrew is a former Deputy Governor of the

Bank of England (2002-2006) and former Chairman of the precursor of the FSA, the Securities and Investments Board (1992-1997).

The deadline for responses is December 14.

www.hfwg.co.uk/?section=10365

EU Developments

CEBS Consults on Commodities Risks

On October 10, the Committee of European Banking Supervisors (CEBS) published its report on prudential risks that may arise from the conduct of commodities business and the activities of firms carrying out commodities business.

CEBS concludes that the risks present in commodities business is broadly in line with the risks present in other financial markets and that they are generally the same across all types of underlying assets. As the majority of transactions are carried out OTC, significant risks still remain in commodities business and those risks need to be appropriately managed. The report highlights that interconnections between firms carrying on commodities business has increased the perception of systemic risk. The exact extent of any systemic risk will depend on the size of the respective markets for commodities relative to the wider financial market and may vary widely across different markets.

www.c-ebs.org/Advice/advice.htm

Litigation

Ninth Circuit Affirms Dismissal of Securities Fraud Complaint

The plaintiffs asserted claims under Section 10(b) of Securities Exchange Act of 1934 following their acquisition of shares in a car rental company pursuant to the defendant's recommendation and representation that he would not let them lose money on the investment. The plaintiffs provided defendant with money to acquire shares in their name which the defendant allegedly used to acquire shares in his own name.

The Court held, among other things, that the complaint failed to allege any theory upon which the plaintiffs' federal securities fraud claim could prevail. Although plaintiffs alleged that the defendant wrongfully failed to carry out his commitment to purchase stock in their names, the court ruled that this claim was, at most, one for breach of contract. In support of its ruling, the Court noted that in contrast to plaintiffs' state law claim, which asserted that the defendant fraudulently intended not to purchase the shares in plaintiffs' names when he accepted their money, the federal claim did not contain a comparable allegation. (*Foster v. Wilson*, 2007 WL 2893608 (9th Cir. October 5, 2007))

Class Action Securities Fraud Complaint Dismissed

The District Court granted the defendants' motion to dismiss a class action complaint alleging violations of Section 10(b) of the Securities Exchange Act of 1934, ruling, in part, that plaintiffs failed to adequately plead loss causation. The plaintiffs based their claim on defendants' alleged misrepresentation and concealment of material negative information concerning Mattel's new release of a competing product line and problems with the corporation's supply chain and product distribution system.

Plaintiffs alleged that the failure to disclose material information regarding

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Mattel during the class period caused a decline in the corporation's stock price. However, defendant argued that the drop in the stock price was due to an "operating climate" that was "tougher" than anticipated due to "unanticipated increases in costs of commodities and an industry-wide decline in toy sales," and not to new competition from Mattel. The Court found that plaintiffs had failed to allege any facts which would support a conclusion that the drop in the stock price was due to competition from Mattel rather than the factors that the defendant raised. Based on that ruling, the Court held that none of the disclosures provided a casual link between the decline in defendant's stock price and the allegedly misleading statements or omissions regarding competition from Mattel and that, as a result, loss causation could not be established. (*In re Leapfrog Enterprises, Inc. Securities Litigation*, 2007 WL 2900566 (N.D.Cal. Sept. 30, 2007))

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