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SEC/CORPORATE

SEC to Hold Roundtable to Discuss Conflict Mineral Rulemaking

On September 29, the Securities and Exchange Commission announced that it will host a public roundtable on October 18 to discuss the SEC's rulemaking under Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. As described in the December 17, 2010, edition of *Corporate & Financial Weekly Digest*, on December 15, 2010 the SEC issued proposed rules implementing disclosure and reporting requirements regarding the use by issuers of conflict minerals in the Democratic Republic of the Congo (DRC).

The proposed rules would apply to issuers who file reports with the SEC under Sections 13(a) or 15(d) of the Securities Exchange Act of 1934 for whom conflict minerals are "necessary to the functionality or production of a product manufactured" or contracted to be manufactured by such issuers, and would require such issuers to determine, after a reasonable country of origin inquiry, whether their conflict minerals originated in the DRC countries. The original comment period for the proposed rulemaking expired on January 31, and an extension of such comment period expired on March 3. On July 29, the SEC announced it intends to implement the "conflict mineral" rules sometime between August and December.

The SEC believes that roundtable will provide a forum for stakeholders to exchange views and provide input on issues related to the SEC's required rulemaking, including reporting approaches for the final rule, challenges in tracking conflict minerals through the supply chain and workable other due diligence requirements related to the rulemaking. While it is unusual for the SEC to hold a roundtable for rulemaking after the rule has been proposed and the comment period has expired, the SEC may be responding to the controversy surrounding the proposed rules as well as to heightened rule adoption standards resulting from the recent decision of the U.S. Court of Appeals for the District of Columbia Circuit vacating the SEC's "proxy access" rule.

To read the SEC's announcement, click here.

BROKER DEALER

SEC Staff Issues Risk Alert on Master/Sub-account Risks

A master/sub-account arrangement exists where the same beneficial owner maintains multiple sub-accounts; the beneficial ownership interests in the various sub-accounts may or may not be identified to a broker-dealer. On September 29, the Securities and Exchange Commission's Office of Compliance Inspections and Examinations released a National Exam Risk Alert (the Alert) on risks associated with master/sub-account arrangements. In the Alert, the SEC's National Exam Program (NEP) identified a number of potential risks associated with master/sub-account arrangements. Specifically, NEP identified the following potential risks:

- **Money Laundering, Terrorist Financing, and Other Illicit Activity** – NEP noted that a broker-dealer's Anti-Money Laundering program should evaluate the risks potentially presented by master/sub-accounts. For example, the master/sub-account arrangement could affect a broker-dealer's ability to comply with the

requirement to monitor, detect, and file reports of suspicious activity, or its ability to meet obligations under the Customer Identification Program rule.

- **Insider Trading** – NEP expressed a concern that master/sub-account arrangements could be used as vehicles for insider trading schemes, and it offered suggestions to address potential weaknesses.

- **Market Manipulation** – NEP noted that a sub-account trader may open multiple accounts under a single master account or accounts under different master accounts and at different broker-dealers and use them to create the false appearance of activity or volume, thereby fraudulently influencing the price of a security. NEP stated that broker-dealers should apply their market manipulation surveillance parameters to trading activity at both the master account and sub-account levels.

- **Information Security** – NEP observed that master/sub-account arrangements pose a greater risk of hacking based on the risk that a larger population of persons with access to a broker-dealer's trading systems is more likely to include either bad actors or persons who are careless about information security. NEP stated that broker-dealers must take reasonable measures to address risks to information security.

- **Unregistered Broker-Dealer Activity** – NEP noted that many master/sub-account arrangements may permit the master account owner, and possibly a sub-account owner, to act as unregistered broker-dealers in violation of Section 15(a) of the Securities Exchange Act of 1934.

- **Excessive Leverage and Other Risks** – In addition to unregistered broker-dealer activity, the SEC is concerned that master/sub-account arrangements can be inappropriately used to offer excessive leverage to pattern day-traders who may have inadequate equity balances for such leverage.

With respect to each risk identified above, the Alert includes further suggestions for broker-dealers to address concerns arising from trading in sub-accounts.

Additionally, the Alert addresses the obligation that broker-dealers—including broker-dealers that offer master/sub-accounts—have under the Market Access Rule, *i.e.*, the obligation to establish, document and maintain a system of risk management controls and supervisory procedures associated with offering market access to customers. In particular, NEP stated that, in examining for compliance with the Market Access Rule, the staff intends to "scrutinize" (i) the system of risk management controls and supervisory procedures that addresses master account customers to which a broker-dealer offers market access, and (ii) whether, in accordance with such controls and procedures, a subject broker-dealer is appropriately vetting the master account customer and sub-accounts identified as customers engaged in the trading business, or proprietary accounts, and individual traders with access to the broker-dealer's Market Participant ID (or MPID), trading system and technology providing market access.

In addition to supplying its examination focus with respect to master/sub-account arrangements, NEP highlighted effective practices that it believes could be helpful to firms in meeting their obligations under the Market Access Rule.

While the alert does not have the same impact as an official SEC pronouncement, broker-dealers should be aware that regulators will look to it in analyzing broker-dealer compliance with applicable rules. Click here to read the Alert.

LITIGATION

Fraudulent Statements That Maintain Inflated Price Can Support Securities Fraud Claims

The U.S. Court of Appeals for the Eleventh Circuit vacated a District Court's entry of summary judgment on plaintiff shareholders' claims against an internet commerce company, finding that the defendants could be held liable for knowingly reinforcing false information and thereby preventing already existing stock price inflation from dissipating.

Defendant Miva, Inc. is an online advertising company that provides "pay-per-click" services. Advertisers pay Miva based on the number of times internet users click on their advertising. A group of investors brought this

action in 2005, claiming that the company committed fraud by not disclosing that a large part of its revenue was from companies that engaged in "click fraud." Click fraud artificially inflates the number of clicks registered on advertisements through the use of spyware and other software, rather than by attracting potential consumers. The plaintiffs claimed that the stock price dropped and that they suffered losses after the company revealed that click fraud had been contributing to its revenue.

The District Court dismissed several of the plaintiffs' claims for, among other things, failing to allege scienter adequately and granted summary judgment to the defendants on claims arising out of two alleged misrepresentations. Plaintiffs appealed and the Eleventh Circuit affirmed the dismissal of the claims for failing to plead a securities fraud claim adequately.

However, the Eleventh Circuit vacated the District Court's order granting summary judgment with respect to claims arising out of two misrepresentations that helped to maintain the inflated stock price. The District Court had granted summary judgment based on the testimony of plaintiffs' expert that the inflation of the stock price predated the statements at issue, reasoning that since the inflation already existed, the misrepresentations at issue could not have caused it. The Eleventh Circuit held that this was erroneous, pointing out that whether a misrepresentation caused the initial inflation of the stock price or merely helped maintain that inflation is analytically irrelevant. As a result, the Eleventh Circuit vacated the decision, noting that "fraudulent misstatements that prolong inflation can be just as harmful to subsequent investors as statements that create inflation in the first instance."

Findwhat Investor Group v. Findwhat.com, No. 10-10107 (11th Cir. Sept. 30, 2011).

Provision of Credit Card Receipt Is Not A "Publication" That Triggers Duty To Defend

The U.S. Court of Appeals for the Eleventh Circuit affirmed a District Court's grant of summary judgment to an insurer, agreeing that the alleged violations of the Fair and Accurate Credit Card Transaction Act (FACTA) did not constitute a "publication" under the insurance policy in question and, therefore, did not trigger a duty to defend.

E.T. Limited (ETL), a restaurant operator in Miami, was covered under an insurance policy with the defendant, Essex Insurance Company (Essex), for personal and advertising injury. Essex denied coverage and refused to defend ETL when ETL was sued in state court for allegedly violating FACTA by printing more than the last five digits of customers' credit card account numbers and/or expiration dates on consumer receipts. Essex argued that a receipt is not a "publication" and that, therefore, the claims for violation of FACTA were not covered under the policy. The District Court granted summary judgment to Essex, noting the Florida Supreme Court had recently defined "publication" to mean a "communication . . . to the public," that is, a "public announcement."

On appeal, ETL emphasized that the policy under consideration in this case included the phrase "publication, in any manner" as opposed to simply the term "publication" as was the case when the Florida Supreme Court addressed the issue. ETL also argued that the term "publication" was not defined in the policy and is ambiguous and, therefore, must be construed against Essex. The Eleventh Circuit rejected ETL's argument, holding that the policy should be construed according to its plain meaning and applied the dictionary definition employed by the Florida Supreme Court. Thus, the Court concluded that "publication" did not include the consumer receipts at issue, rejecting ETL's argument that the phrase "in any manner" expanded the definition of "publication" wide enough to include the receipts.

E.T. Limited, Inc. v. Essex Insurance Co., No. 11-11781 (11th Cir. Sept. 30, 2011).

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