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Corporate and Financial Weekly Digest

September 12, 2008

Litigation

"Architects" of Securities Fraud Scheme Were "Primary Violators"

The SEC alleged that defendants Simpson Capital Management Inc., its Chief Investment Officer and its head trader violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 by designing and implementing a fraudulent scheme whereby they engaged five separate broker-dealers to place more than 10,700 trades in over 375 mutual funds after the 4:00 p.m. Eastern Time market close and falsely represented the trades to have been made prior to the close. By concealing the true nature of the trades, defendants were able to gain important information not available prior to the close of trading.

The defendants moved to dismiss the complaint, arguing that only the broker-dealers who actually placed the late trades and violated the applicable rules could be primary violators and that, at most, "the complaint supported an inference that the defendants had knowledge of the regulatory violations of others, obtained an economic advantage from those violations, and did nothing to reveal or prevent those violations." Defendants claimed that the complaint must be dismissed because they were not charged with aiding and abetting liability and could not be held liable as "primary violators."

Although acknowledging that the Second Circuit has not definitively described the bounds of primary liability, the court noted that the Second Circuit has recognized that merely participating in a fraudulent scheme, even without directly performing the violating actions, is enough to establish primary liability. With that background, the court ruled that defendants could be charged as primary violators of Section 10(b) and Rule 10b-5 if they participated in the alleged fraud and, in doing so, employed a deceptive device or engaged in a fraudulent practice. Based upon the SEC's allegations that the defendants devised the late trading scheme and identified and worked exclusively with broker-dealers who agreed to participate in the scheme, the court held that the SEC had sufficiently pled defendants' primary liability. (*S.E.C. v. Simpson Management, Inc., et al.*, 2008 WL 4093046 (S.D.N.Y. Sept. 3, 2008))

Employee Had No Protectable Privacy Interest in Personal Files Stored on Company Computer

Defendant, the former bookkeeper of Certified Data Products (CDP), pled guilty to embezzling over $650,000 from his former employer during the course of his employment. Defendant's plea was conditioned on his right to appeal the denial of his motion to suppress evidence obtained from the warrantless search of two CDP computers that defendant regularly used. Although acknowledging that CDP had consented to the computer search, defendant argued that its consent was ineffective and any information obtained from the search was inadmissible because he had a reasonable expectation of privacy in the personal information he stored on the computers.

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The court stated that in order to establish that a defendant had a "reasonable expectation" of privacy, "[the defendant] must establish that he had both 'an actual (subjective) expectation of privacy,' and 'one that society is prepared to recognize.'" After finding no controlling precedent in New Jersey, the court, drawing upon federal court rulings, held that, because the computers were owned by, stored at and used by CDP, defendant had no reasonable expectation of privacy of the files stored on the computers. Although finding that defendant may have had a "subjective" expectation of privacy because he had installed a confidential password on the computer, the court ruled that such an expectation was not "reasonable," stating that "neither the law nor society recognizes as legitimate defendant's subjective expectation of privacy in a workplace computer he used to commit a crime." (*State of New Jersey v. M.A.*, 2008 WL 4057305 (N.J. Super. Ct. App. Div. Aug. 29, 2008))

Broker Dealer

FINRA Notice on Clearing Deposits Requires Amendment of Clearing Agreements

The Financial Industry Regulatory Authority (FINRA) has issued Regulatory Notice 08-46 to provide interpretive guidance with respect to clearing deposits. Current Securities and Exchange Commission interpretation of Securities Exchange Act Rule 15c3-1 provides that a clearing deposit may be treated as an allowable asset in the computation of the introducing firm's net capital, provided that the clearing agreement explicitly states that the deposit will be returned to the introducing firm within 30 calendar days after cancellation of the agreement, and the clearing agreement contains the language in the SEC No-Action letter on Proprietary Accounts of Introducing Brokers. Effective immediately, the interpretation of Rule 15c3-1 is amended to reflect that the 30 calendar day period shall commence five business days after the date of the initial transfer out of customer accounts. The amount of any clearing deposit that is not returned to the introducing firm within 30 calendar days after the five business day grace period shall be treated as a non-allowable asset in the computation of the introducing firm's net capital commencing on the 31st day.

Many clearing agreements contain a penalty clause that is triggered if the agreement is terminated before a certain date. During this period, the introducing firm must treat the amount of its clearing deposit up to the penalty amount as a non-allowable asset for net capital purposes. FINRA advised that if language specified in the Regulatory Notice subordinating the claim for the penalty amount to the claims of the introducing firm's customers is added to the clearing agreement by January 2, 2009 the penalty amount in the clearing deposit may be treated as an allowable asset.

http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p039159.pdf

CBOE Revises Rule on Foreign Member Organization Qualifications

The Chicago Board Options Exchange (CBOE) has revised its Rule 3.4 regarding qualifications of foreign member organizations. Under the revised rule, a CBOE member that does not maintain an office in the United States responsible for preparing and maintaining financial and other reports required to be filed with the Securities and Exchange Commission and the CBOE would be required to:

- Prepare all such reports, and maintain a general ledger chart of account and any description thereof, in English and U.S. dollars;
- Reimburse the CBOE for any expense incurred in connection with examination of the member to the extent that such expenses exceed the cost of examining a member located within the continental United

BROKER DEALER

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States; and

- Ensure the availability of an individual fluent in English knowledgeable in securities and financial matters to assist representatives of the CBOE during examinations.

The CBOE believes that it will continue to have adequate regulatory jurisdiction over foreign members by virtue of rule provisions that are generally applicable to all CBOE members, e.g., consent to jurisdiction, agreements to abide by the constitution and rules of the CBOE and all circulars, notices, etc., and does not believe that the additional requirements in previous Rule 3.4 for foreign member organizations are necessary.

http://edocket.access.gpo.gov/2008/pdf/E8-20229.pdf

Structured Finance and Securitization

STRUCTURED FINANCE AND SECURITIZATION

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Fannie Mae and Freddie Mac Placed in Conservatorship by U.S. Treasury and FHFA

On September 7, the U.S. Treasury Department and the Federal Housing Finance Authority (FHFA) placed Fannie Mae and Freddie Mac into conservatorship, and announced (i) Treasury's entry into a Senior Preferred Stock Purchase Agreement with each Government Sponsored Entity (GSE), (ii) the creation of a Government Sponsored Entity Credit Facility (GSECF), and (iii) the adoption of a GSE Mortgage Backed Securities (MBS) Purchase Program.

The senior preferred stock purchase agreements are indefinite contracts between the Treasury Department and both Fannie Mae and Freddie Mac, and ensure that both companies maintain a positive net worth by allowing the Treasury to contribute up to $100 billion to either company if the FHFA determines that the company's liabilities exceed its assets. In exchange for entering into the agreements the Treasury (i) will receive immediate compensation in the form of $1 billion of senior preferred stock in each company that will accrue dividends at a minimum of 10% per year, and warrants to purchase common stock at a nominal price, (ii) will begin receiving in 2010 a periodic compensation fee that may be paid in cash or stock, and (iii) will receive broad approval power over all major decisions made by either company.

The GSECF, which was authorized by the Housing and Economic Recovery Act of 2008, is a lending facility that will ensure credit availability to the companies, providing secured funding on an as-needed basis under terms and conditions established by the Treasury to protect taxpayers. Funding will be provided directly by the Treasury in exchange for eligible collateral from the companies, which is limited to guaranteed MBS issued by the GSEs and Federal Home Loan Bank advances.

Finally, the Treasury will purchase MBS issued by the GSEs on the open market to promote the stability of the mortgage market and broaden access to mortgage funding for current and prospective homeowners. The scale of the program will be based on developments in the capital and housing markets, and the Treasury will designate independent asset managers as financial agents to undertake the purchase and management of MBS portfolios.

http://www.treasury.gov/press/releases/reports/pspa_factsheet_090708%20hp1128.pdf
http://www.treasury.gov/press/releases/reports/gsecf_factsheet_090708.pdf
http://www.treasury.gov/press/releases/reports/mbs_factsheet_090708hp1128.pdf

CFTC

NFA Proposes Amendments to Enhanced Supervisory Requirements

On September 5, the National Futures Association (NFA) submitted to the Commodity Futures Trading Commission two proposed amendments to its Interpretive Notice regarding Compliance Rule 2-9: Enhanced Supervisory Requirements. The first amendment raises the adjusted net capital requirement for Forex Dealer Members that are subject to enhanced supervision under the Notice from $2,000,000 to the early warning level required under CFTC Regulation 1.12. The second amendment limits to 10 years the look-back for determining whether associated persons have been employed by an NFA Member that has been subject to regulatory action involving fraud.

http://www.nfa.futures.org/news/PDF/CFTC/CR2_9IntNotc_EnhancSupervRequire82208.pdf

Banking

Federal Reserve Board Issues Small Entity Compliance Guide for Regulation R

On August 29, the Board of Governors of the Federal Reserve System (the Federal Reserve) released its *Small Entity Compliance Guide for Regulation R*. Adopted jointly by the Federal Reserve and the Securities and Exchange Commission in September 2007, Regulation R implements certain exceptions for banks from the definition of "broker" under Securities Exchange Act of 1934 (SEA) Section 3(a)(4).

Specific bank broker exceptions covered by Regulation R include those related to third-party networking arrangements, trust and fiduciary activities, deposit "sweep" activities, and custody and safekeeping activities. Notably, there are other broker exceptions for banks in the SEA but such exceptions are not included in Regulation R. Such exceptions include transactions in exempt securities, certain stock purchase plans, affiliate transactions, private securities offerings, identified banking products, municipal securities and a de minimis number of other securities transactions. As stated in the preamble to the guidance, although such exceptions are not included in Regulation R, they remain in effect and are available to banks.

In addition, the guidance states that if more than one broker exception or exemption is available to a bank under the statute or rules for a securities transaction, the bank is permitted to choose the exception or exemption upon which it is relying to effect the transaction without registering as a broker-dealer. The bank must, however, comply with all of the requirements contained in the exemption or exception upon which it is relying.

http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080829a1.pdf

Financial Services

California Budget Impasse Delays Implementation of Life Settlement Industry Regulation

On August 29, the California Senate approved Senate Bill 1543, which had been passed by the California Assembly two days earlier. This legislation provides that trusts, special purpose entities and any related device, scheme or artifice used to apply for and initiate the issuance of life insurance policies for investors violate California's insurable interest laws and the prohibition against wagering on life. In addition to prohibiting the transfer of life insurance

CFTC

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policies through life settlement contracts (except in limited instances) for a two-year period following the issuance of a policy, the legislation also institutes a licensing requirement for viatical settlement brokers.

Although approved by the legislature, Senate Bill 1543 has not been presented to Governor Arnold Schwarzenegger due to his announcement that he would not sign any bill until a state budget bill has been passed. Approximately 850 other bills are also subject to this impasse.

Governor Schwarzenegger's view of his rights under the California Constitution is that any bills received by him after September 29 are automatically dead. As a result, if the California Legislature fails to pass a budget bill and formally present Senate Bill 1543 for signature on or before that date, this legislation may fail to become law in California during the current legislative session. If signed, Senate Bill 1543 will take effect in July 2009.

http://www.leginfo.ca.gov/pub/07-08/bill/sen/sb_1501-1550/sb_1543_bill_20080831_enrolled.html

UK Developments

FSA Sanctions Hedge Fund Manager for Market Abuse

On September 8, the UK Financial Services Authority (FSA) announced that it had reached a settlement with Steven Harrison, a former hedge fund manager, regarding an enforcement action against Mr. Harrison for market abuse.

The action concerned Mr. Harrison's conduct on September 28, 2006 while a portfolio manager for Moore Credit Fund. He received inside information about the refinancing plans of Rhodia SA (Rhodia) and upon receipt of the information, instructed a colleague to buy 2 million Rhodia 10.50% Senior Notes due 2010. He made a profit of £44,000 on that trade.

The FSA found that Mr. Harrison's conduct was not deliberate and that he made no direct personal profit from these activities. Since he co-operated with the FSA's investigation he qualified for an early settlement discount on his fine, which otherwise would have been £75,000. The FSA stated that the very significant impact of the 12-month restrictions to which Mr. Harrison has agreed was taken into account in setting the penalty.

The FSA stated that this was the first case it has brought concerning the credit markets and that this sent a clear message that the FSA is determined to tackle market abuse in all the markets it regulates.

Margaret Cole, the FSA's Director of Enforcement, commented, "This case highlights the importance of city professionals taking care to recognize inside information when they see it and not to misuse it. Hedge fund managers and people in similar roles are often legitimately provided with inside information in the course of their business. The FSA expects people entrusted with such responsibility, in the credit markets as much as in any other regulated markets, to observe high standards of conduct and not to take advantage of their privileged access to inside information. The consequences for Mr. Harrison of not doing so are that he has lost the privileges of carrying on his profession as a fund manager and a trader for a period."

www.fsa.gov.uk/pubs/final/steven_harrison.pdf

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