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SEC/Corporate

SEC Focuses on "Free Lunch" Seminars

On September 10, the Securities and Exchange Commission released a joint report summarizing the results of regulatory examinations of "free lunch" investment seminars for senior citizens.

The SEC, together with the North American Securities Administrators Association and the Financial Industry Regulatory Authority conducted a fourteen month long investigation of these seminars held in seven states with large numbers of retirees. It found widespread misrepresentation, weak supervisory practices and, in some cases, fraud in the presentations of 110 securities firms and branch offices that sponsor such seminars. More specifically, the regulatory agencies found that all such "seminars," no matter how advertised, were in fact sales presentations and that 59% of such presentations reflected ineffective supervisory practices, including the failure to review seminar presentations or materials in advance. Fully half the "seminars," featured exaggerated or misleading advertising claims and in 25 of the 110 examinations, examiners found indications that unsuitable recommendations were made. Finally, in 13% of the examinations, the examiners found fraud and have made referrals to the appropriate regulator for possible enforcement or disciplinary action. In these 14 examinations, the regulators found serious misrepresentations of risk and return, possible liquidation of accounts without the customer's knowledge or consent, and possible sales of fictitious investments.

These investigations are part of a focus, under the current SEC Chairman, Christopher Cox, on frauds targeting retirees and other older investors. During the past two years, the SEC has brought more than 40 enforcement actions in this area, and has sponsored, along with others, educational programs focused on senior citizens. According to *Business Week*, people 60 and older make up 15% of the country's population but account for an estimated 30% of fraud victims, and three-quarters of the nation's consumer financial assets are held by households headed by people 50 or older.

http://www.sec.gov/news/press/2007/2007-179.htm
http://www.businessweek.com/ap/financialnews/D8RITPOO0.htm

Broker Dealer

SEC Declines to Issue No-Action Letter to Finder/Consultant

The Securities and Exchange Commission recently declined to issue a no-action letter to Hallmark Capital Corporation (Hallcap) in respect of certain private placement and acquisition/disposition activities and, instead,

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recommended registration as a broker-dealer pursuant to the Securities Exchange Act of 1934.

Hallcap limits its business to serving companies with annual sales of $25 million or less and is paid with a success fee. In raising capital Hallcap prepares a confidential business summary, identifies broker-dealers that might act as placement agents and arranges meetings with the broker-dealer. Once the broker-dealer is engaged, it controls the offering. In case of bank debt, Hallcap identifies potential bank lenders, prepares a confidential business summary and assists with the loan application process, including arranging meetings between the client and the lender. In representing potential sellers of businesses, Hallcap prepares a confidential information summary, identifies and qualifies the interest, and ability to pay, of potential buyers and arranges exploratory meetings. In representing potential acquirers, Hallcap identifies potential targets, conducts preliminary information gathering interviews, including discussions of price and terms, and prepares a profile of the target company.

In denying the no-action request the SEC staff referred to Country Business Inc., p.a. November 8, 2006. In Country Business no-action relief was granted for a finder that acted similarly to Hallcap in representing business sellers that were "small business companies" when the advertising presented the transaction as an asset sale of a going concern.

http://www.sec.gov/divisions/marketreg/mr-noaction/2007/hcc061107-15b.pdf
http://www.sec.gov/divisions/marketreg/mr-noaction/cbi110806.htm

NYSE Adds Sub-Penny Trading Halt to Message Alerts

On September 7, the New York Stock Exchange announced that it will halt trading in any security that may fall below $1.05, which will result in the publication of an automated trade halt message to all NYSE Alert subscribers. The NYSE's alert system is a push system that publishes regular ongoing alerts on various issues, and automatically sends notice of those alerts to subscribers. The message for a trading halt is classified as Message Type 131 – Opening Delays and Trading Halts. In contrast to other trading halts described in NYSE Rule 123D, a "Sub-penny Trading" halt is automatic and does not require the approval of any NYSE floor officials.

http://www.nysedata.com/nysedata/default.aspx?tabid=155&id=284

Public to Access Historic TRACE Data and Amendment of NASD Rule 7030

The Financial Industry Regulatory Authority (FINRA) has proposed the adoption of a policy to provide for public access to historic transaction-level TRACE data, and the amendment of NASD Rule 7030 to establish fees to offset the costs of developing and maintaining the Historic TRACE database.

TRACE data is a complete database of transaction-level pricing information on the over-the-counter U.S. corporate bond market. To date, FINRA has only made available to the public aggregated statistics culled from the disseminated and non-disseminated TRACE transaction information in a manner designed to protect the transaction-level non-disseminated data from being ascertained. FINRA now proposes to provide access to historic transaction-level TRACE data, other than Rule 144A trades.

Historic TRACE data to be made available will include basic transaction information such as price, date and time of execution, will include transactions not previously made available and yield along with actual trade volumes rather than capped volumes previously available. The data will be provided via quarterly files or reports. Any data released will be aged at least 18 months in

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response to commenter concern over the use of current information to identify current trading, positioning or strategies of market participants. FINRA has proposed the amendment of NASD Rule 7030 to impose a fee structure on users of Historic TRACE data to offset the costs of developing and maintaining the database. Fees will vary depending on the user's status as a professional, tax-exempt organization or non-professional.

http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/E7-17683.pdf

NASDAQ Proposes Step-Outs and Transfer of Rule 7002 Sales Fees for Members

NASDAQ proposed to allow step-out capability with respect to any trade to which a NASDAQ member is a party regardless of the market on which the trade was executed. NASDAQ issued a simultaneous proposal to permit a member to transfer the obligation to pay a sales fee in accordance with Exchange Act Section 31 or a similar fee associated with a particular trade to another member either at the time of the step-out or at a later time.

A step-out transaction involves the transfer of a broker's position in a security in a manner that does not constitute a trade, such as the purchase of a security by one party coupled with an arrangement with one or more third parties to shift settlement obligations to them. NASDAQ believes that because these transactions are not trades, they are not an inherent over-the-counter (OTC) activity. Both the New York Stock Exchange and the American Stock Exchange currently offer step-out functionality to their members as a value-added (fee) service.

Under Rule 7002, NASDAQ and other self-regulatory organizations charge sales fees to defray the costs associated with step-out transactions. NASDAQ is proposing to allow members to transfer the obligation to pay a Rule 7002 sales fee to another member either at the time of the trade or at some other time. NASDAQ states in its proposal that it believes that transfers of obligations to pay sales and similar fees may be appropriately conducted pursuant to its rules as an exchange, since they are not an inherently OTC function.

http://www.sec.gov/rules/sro/nasdaq/2007/34-56345.pdf

Banking

FDIC Approves Application for Deposit Insurance by Proposed ILC

As reported in various press accounts, the Federal Deposit Insurance Corporation (the FDIC) granted a "conditional approval" for deposit insurance to permit Wellpoint Inc, a health insurer, to operate an industrial loan company. Such industrial loan company will operate as ARCUS Financial Bank and will have a Utah charter if approved by the Utah Department of Financial Institutions.

Approval of the application came after the Board of Governors of the Federal Reserve System (the Federal Reserve) informed the FDIC that, in its opinion, such approval would be in compliance with the Bank Holding Company Act. According to Reuters News Agency, the Federal Reserve determined that "Wellpoint's disease management and mail-order pharmacy activities were complementary to the financial activity of underwriting and selling health insurance and are therefore permissible for a financial holding company." Currently, the FDIC is operating under a moratorium whereby it is not acting on industrial loan company applications submitted by companies that are engaged in non-banking activities that are not permissible for a financial holding

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company. Notably, the only federal regulator of industrial loan companies is the FDIC.

The FDIC has not issued a press release as of today's publication date in connection with this action.

http://www.federalreserve.gov/newsevents/press/other/other20070907a1.pdf

United Kingdom Developments

Industry Guidance to Play a Key Role in FSA Regulation

On September 4, the UK Financial Services Authority (FSA) issued Policy Statement 07/16 *FSA Confirmation of Industry Guidance* which introduced a new framework for recognizing industry guidance as part of FSA's continued steps towards more Principles-Based Regulation.

Any guidance that is created by trade associations, professional bodies or firms can now be submitted to the FSA for formal recognition provided that such guidance conforms with certain criteria. FSA recognized industry guidance will supplement the FSA's rules and not replace them. There is no obligation on industry bodies to provide guidance and the development of guidance is at their discretion.

The FSA recently confirmed three sets of industry guidance on Outsourcing, Suitability and Appropriateness and Investment Research prepared by the industry group MiFID Connect, which has been preparing guidance on various aspects of the Markets in Financial Instruments Directive (MiFID).

The Policy Statement confirms that the FSA will not take action against a firm which has complied with FSA recognized guidance.

http://www.fsa.gov.uk/pubs/policy/ps07_16.pdf

FSA Updates MiFID Guidance

On September 10, the FSA published an update to its Markets in Financial Instruments Directive (MiFID) Permissions and Notifications Guide which was first published in May 2007.

The update includes: (i) clarification on the position of financial advisers wishing to opt-out of MiFID's Article 3 exemption so as to obtain EU passporting rights; (ii) updates on the transitional provisions for client categorization and passport notifications relating to firms that wish to passport into the UK; (iii) additional material on tied agents; (iv) client categorization issues relating to Multilateral Trading Facilities; and (v) issues relating to Approved Persons that arise from changes to certain FSA controlled functions.

http://www.fsa.gov.uk/pubs/international/mifid_update.pdf

Litigation

McGraw-Hill Ordered to Turn Over Pricing Documents in Investigation

In connection with its investigation of whether an energy company (Company) had manipulated and attempted to manipulate natural gas prices at various locations in Texas, the Commodities Futures Trading Commission served a subpoena on McGraw-Hill, a major publisher of energy newsletters, seeking documents concerning trading data. The CFTC argued that the production of these documents was necessary to establish both that the Company had the

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ability to manipulate prices and that it did cause such manipulation. McGraw-Hill opposed the subpoena, claiming that the documents were protected from disclosure under the reporter's privilege of the First Amendment.

While recognizing that the reporter's privilege advances First Amendment interests by safeguarding the confidentiality of the news gathering process, thereby fostering a reporter's ability to gather news, the Court ruled that the privilege was not absolute. In order for it to apply, McGraw-Hill was required to show that its First Amendment interests outweighed the CFTC's (i) need for the subpoenaed documents, and (ii) inability to obtain them from reasonably available alternative sources. Applying this balancing test, the Court held that documents that were relevant to core elements of the CFTC's claim that could not be obtained from the Company and also were needed to verify the bona fides of the Company's document production were not shielded by the privilege. In contrast, the Court upheld the privilege against the CFTC's request for documents concerning unsolicited complaints McGraw-Hill had received about Company, characterizing the request as an unlicensed fishing expedition for information that was not probative of the CFTC's claims. (*U.S. Commodity Futures Trading Commission v. McGraw-Hill Companies, Inc.*, 2007 WL 2416109 (D.D.C. Aug. 27, 2007))

S-8 Registration Does Not Apply to Sales of Securities for Raising Capital

The Securities and Exchange Commission brought an action against the CEO of a publicly traded company (the Company) alleging that he violated, inter alia, Section 5 of the Securities Act of 1933 by using stock registered under Form S-8 to raise capital for the Company. The SEC argued that stock registered under Form S-8 could only be used to compensate consultants for bona fide consulting services not connected to raising capital.

The shares in question were issued to a co-defendant who had been engaged to help the Company identify new business opportunities at a time when the Company was having difficulty making payments to its investment partners. Despite the consultant having only limited resources, the CEO caused the Company to issue the shares in exchange for the consultant's execution of a $1.25 million promissory note. Several months later, in response to the CEO's demand that the consultant repay the note, the consultant sold the shares to a purchaser that the CEO identified pursuant to an agreement that the Company's attorney prepared. The Company used the proceeds of the sale to repay amounts due to its investment partners.

The CEO opposed the Section 5 claim by arguing that, at the time the stock was issued to the consultant, it was intended to provide compensation for bona fide consulting services and, thus, was properly registered under Form S-8. While the Ninth Circuit found the question of whether the initial issuance was bona fide under Form S-8 presented a question of fact that prevented the resolution of the SEC's securities fraud claims on summary judgment, it affirmed the District Court's grant of summary judgment to the SEC on the Section 5 claim. The Court held that even if the initial issuance of stock was permitted under Form S-8, because of the significant role the CEO and the Company played in the consultant's resale of the stock – including choosing the date of the sale, choosing the buyer, providing an attorney to prepare the sale agreement, etc. – the S-8 registration ceased to be effective once the Company sought to use the shares for a capital raising purpose. Accordingly, because no additional registration statement was filed, the transaction constituted an unregistered sale of securities in violation of Section 5 of the Securities Act of 1933. (*SEC v. Phan*, 2007 WL 2429365 (9th Cir. Aug. 29, 2007))

CIRCULAR 230 DISCLOSURE: Pursuant to Regulations governing practice before the Internal Revenue Service, any tax advice contained herein is not intended or written to be used and cannot be used by a taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer.

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