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SEC/Corporate

Office of the Chief Accountant Issues Letter Expressing Its Views on the Appropriate Application of the Stock Option Accounting Literature

On September 19, the Office of the Chief Accountant of the Securities and Exchange Commission issued a letter summarizing the staff's views regarding the accounting for stock options in the historical financial statements of public companies. Prior to the adoption of the Financial Accounting Standards Board's Statement No. 123 (revised 2004), "Share-Based Payment," many public companies accounted for stock options under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." Among other things, the letter discusses the accounting consequences under Opinion 25 of the following:

- dating an option award to predate the actual award date – Under Opinion 25, the measurement date for determining the compensation cost of a stock option is the first date on which both of the following are known: (i) the number of options that an individual employee is entitled to receive and (ii) the option or purchase price. As such, dating the underlying stock option grant documents as of a date prior to the date on which the terms of the award and its recipient are determined does not change the appropriate measurement date for accounting purposes.

- option grants with administrative delays – Because of administrative delays, some companies have accounted for option grants using a measurement date that is other than the date at which all required granting actions have been completed. Where a company's facts, circumstances, and pattern of conduct evidence that the terms and recipients of a stock option award were determined with finality on an earlier date prior to the completion of all required granting actions, it may be appropriate to conclude that a measurement date under Opinion 25 occurred prior to the completion of these actions.

- uncertainty as to the validity of prior grants – In certain circumstances, the validity of past option grants has been called into question, even though both a company and the affected employees have and continue to comply with the terms of such options. For example, an option plan may preclude grants that are in-the-money at the grant date, or may contain a cap on the number of options that may be issued. Notwithstanding these restrictions, options that may not have complied with the terms of the plan were awarded to employees. In those circumstances, the staff believes that the substantive arrangement that is mutually understood by both the company and its employees represents the underlying economic substance of the past option grants, and should serve as the basis for the company's accounting. When a company either does not intend to or does not have a reasonable basis to conclude that it will be able to honor the award or settle it in stock, further

analysis of the facts and circumstances would be necessary to determine the appropriate accounting for the options.

The letter can be accessed on the SEC's website at the following link:
http://www.sec.gov/info/accountants/staffletters.shtml.

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Broker Dealer

SEC Approves CBOE STOC

The Securities and Exchange Commission approved the Chicago Board Options Exchange, Inc.'s rules on a pilot basis governing the trading of non-option securities on an electronic platform known as Stock Trading on CBOEdirect (STOC). CBOE currently trades a small number of non-option securities on a stand-alone platform in an open outcry environment. The new platform will trade such non-option securities in an electronic environment. The STOC program requires that the public customer priority overlay be activated whenever pro rata priority is in use and amends the requirements for executing a facilitation or crossing transaction with priority over existing interest on the book.
http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/E6-15321.pdf

NYSE Proposes Changes to Rules Regarding Block Cross Transactions

New York Stock Exchange LLC proposed to amend Exchange Rule 127 governing the execution of a block cross transaction at a price outside the prevailing NYSE quotation. Execution of block crosses at a price outside the NYSE quotation would occur as follows: the member organization representing the block order will first trade with the displayed bid or offer, then with all limit orders in the Display Book system priced better than the block clean-up price, and then execute the cross at the clean-up price. NYSE expects that this procedure would result in executions at a maximum of three prices: the displayed bid (offer) price, a price one cent better than the clean-up price, and the block clean-up price. Percentage orders entered at each price would be entitled to trade at those prices. The block cross will have execution priority at the clean-up price.
http://apps.nyse.com/commdata/pub19b4.nsf/docs/C84A8F223EED9989852571E8005A107A/$FILE/NYSE-2006-73.pdf

NYSE Amends Cross-Margining Proposal

The New York Stock Exchange LLC filed amendment No. 1 to NYSE Rule 431- Margin Requirements. The amendment would expand the scope of products that are eligible for treatment as part of the Securities and Exchange Commission approved Portfolio Margin Pilot Program and Expanded Pilot. The amendment eliminates the $5 million equity requirement except for accounts that carry unlisted derivatives, and permits the use of securities futures, securities options and derivatives, including forwards, security based swap agreements and unlisted options on an equity or equity index

In a portfolio margining program the member firm must monitor the credit pursuant to a written risk analysis methodology filed with its designated examining authority and the SEC. The rule proposal sets forth 8 items to be covered in the credit risk analysis on a customer by customer basis. The rule proposal applies to the theoretical gains or losses on a portfolio based on formulas similar to that used for options in SEC Rule 15c3-1 Appendix A (gain or loss at 10 equidistant price changes up and down).

http://apps.nyse.com/commdata/pub19b4.nsf/docs/F38EAB43BF641B5E852571E8005C434D/$FILE/NYSE-2006-13%20A-1.pdf

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Litigation

"Nonfraud" Securities Act Claims Must Be Pled With Particularity When Misrepresentation Claimed Is Also Alleged to Support Securities Fraud Claims

Plaintiffs alleged that defendants were liable pursuant to Sections 11 and 12 of the Securities Act of 1933 (which have no scienter or fraud elements) for issuing materially misleading statements in connection with a stock offering. Based on the same alleged misstatements, plaintiffs also claimed that defendants were liable for securities fraud in violation of the Exchange Act of 1934 and Rule 10b-5. In dismissing plaintiffs' claims, the district court found, among other things, that plaintiffs' allegations failed to comport with the particularity requirements of Rule 9 of the Federal Rules of Civil Procedure. On appeal, the Eleventh Circuit noted that the circuits are divided as to whether Rule 9 requires non-fraud claims pursuant to Sections 11 and 12 of the Securities Act to be pled with the same particularity required for claims alleging fraud under the Exchange Act and Rule 10b-5. Siding with the majority of circuits, the Eleventh Circuit found that because the same set of facts formed the basis for plaintiffs' fraud-based securities claims as well as plaintiffs' non-fraud claims, the non-fraud claims were subject to Rule 9's particularity requirements. While the higher pleading standard would not apply if only "nonfraud" securities claims were asserted, the Court ruled that Rule 9's protections against spurious charges damaging to a defendant's reputation are properly invoked when such claims are combined with fraud claims . (*Wagner v. First Horizon Pharmaceutical Corporation*, 2006 WL 266252 (11th Cir. September 18, 2006))

Automatic Adjustment to Conversion Price Not A "Purchase" For Purposes of 16(b) Claim

Plaintiff shareholder brought a derivative suit pursuant to Section 16(b) of the Securities Exchange Act to recover alleged short-swing profits realized by a corporate insider. The insider held convertible preferred stock which included an "anti-dilution" provision which automatically decreased the conversion price in the event of, among other things, the issuance of additional common stock. Plaintiff argued that the automatic adjustment of the conversion price of the insider's preferred stock arising from the company's issuance of additional common stock in the first half of 2003 constituted a "purchase" under Section 16(b). Plaintiff further argued that this "purchase" triggered short swing profits from the insider's June 2003 sale of common stock that the insider had held independent of its convertible preferred stock. Dismissing plaintiff's claim, the Third Circuit ruled that the automatic adjustment of the conversion price did not constitute a "purchase" under Section 16(b). While noting that SEC regulations do provide that derivative securities (including convertible stock) may, in some instances, be subject to the statute, the Court ruled that the SEC's interpretation of its regulations was entitled to "substantial judicial deference." As construed by the SEC, with respect to derivative securities, automatic adjustments for pre-specified events (like the issuance of additional stock) do not constitute "purchases" under Section 16(b). The Court noted that this construction was consistent with the statutory purpose of Section 16(b), which was enacted to prevent the unfair use of information obtained by corporate insiders, since the potential for

abuse was "minimal" when the adjustments were automatic. (*Morrison v. Madison Dearborn Capital Partners III L.P.*, 2006 WL 267094 (3d Cir. September 19, 2006))

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CFTC

Clearing Member Does Not Have Standing to Pursue Commodities Exchange Act Claims Against Customer, Exchange, or Clearing House

The Court of Appeals for the Second Circuit affirmed a district court's decision that Klein & Company, a former futures commission merchant and member of the New York Futures Exchange (NYFE) and the New York Clearing Corporation (NYCC) did not have standing to pursue a claim against its customer, NYFE, the Board of Trade of the City of New York, or NYCC under the private right of action provisions of the Commodity Exchange Act (CEA). The case arose out of the customer's manipulation of the settlement price of option contracts traded on NYFE. The Court noted that the remedies afforded to private litigants under the CEA are only available to those "who engaged in transactions on or subject to the rules of a contract market." The Court concluded that the plaintiff lacked standing under the CEA because it experienced a "credit loss" caused by its customer's failure to cover a margin call and not from transactions that the plaintiff effected on NYFE.
http://www.ca2.uscourts.gov:8080/isysnative/RDpcT3BpbnNcT1BOXDA1LTEzNzQtY3Zfb3BuLnBkZg==/05-1374-cv_opn.pdf#xml=http://10.213.23.111:8080/isysquery/irl8a99/3/hilite

Commodity Futures Trading Commission Proposes Amendments to Rules Concerning Introducing Broker Financial Reports

The Commodity Futures Trading Commission has proposed amendments to its financial reporting rules that would require introducing brokers (IBs) submitting financial reports to the National Futures Association to do so electronically, but to retain hard copies of such documents for a period of five years. An IB that is also a securities broker-dealer would be permitted to file its FOCUS Report in either electronic or paper form. The comment period expires on October 19.
http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-7739.pdf

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