

# Corporate and Financial Weekly Digest

Business/Financial News in Brief  
**September 29, 2006**

## SEC/Corporate

### **SEC Publishes Executive Compensation and Related Person Disclosure Transition Questions and Answers**

The Securities and Exchange Commission has published questions and answers representing the views of the Division of Corporate Finance with respect to issuers' transition to compliance with the amendments and new rules adopted by the SEC in its recent Executive Compensation and Related Person Disclosure rulemaking.

The Questions and Answers clarify, among other things, that the rules adopted in the Executive Compensation rulemaking become effective on November 7, and that companies must comply with the amended requirements of Form 8-K for triggering events occurring on or after November 7. They also clarify that in the first year that inclusion of the new summary compensation table is required, in most cases information for the most recently completed fiscal year will be the only information required. The remaining Questions and Answers address optional compliance during the transition. Generally, early compliance is not permitted with regard to any of the new rules, including the amended Form 8-K rules, prior to the effective date of November 7.

<http://www.sec.gov/divisions/corpfin/faqs/execcompqa.pdf>.

### **SEC Awards \$54 Million in Contracts Towards Transformation of EDGAR Database**

On September 25, the Securities and Exchange Commission announced that it had awarded four contracts worth a total of \$54 million for its program designed to make the information that companies are required to disclose in SEC filings easier to find and understand.

The so-called XBRL, or extensible business reporting language, will transform the SEC's EDGAR online reporting system, in place since the late 1980s. The move to interactive data using XBRL computer language, which will take about a year to complete, will transform the SEC's public company disclosure system from a form-based electronic filing cabinet to a dynamic real-time search tool with interactive capabilities. XBRL language provides a unique identifying tag for each individual item of data, such as company net profit, which will enable users to extract specific information more easily from SEC filings, run calculations and aggregate data as desired. Company revenue, for example, could be tracked over several years without having to open up and review multiple filings. The new system is also expected to result in fewer errors in the data.

Companies will not be required to use the new data system initially, but they will be encouraged to do so as it will make it cheaper and faster for them to make regulatory filings. According to the SEC, more than two dozen companies already have committed to use the system.

<http://www.sec.gov/news/press/2006/2006-158.htm>

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## Broker Dealer

### **NASD Revises Sanction Guidelines to Further Address Consideration of a Firm's Size**

The NASD recently issued Notice to Members 06-55, which advises member firms of modifications to the NASD Sanction Guidelines. NASD's adjudicators rely on the Guidelines to determine remedial sanctions, and its Departments of Enforcement and Market Regulation rely on the Guidelines in negotiating settlements in disciplinary matters. NASD has amended the Guidelines to state that in determining sanctions for violations that are not egregious and do not involve fraud, adjudicators should take into account a firm's revenues, as well as other factors indicative of firm size. The revisions also provide for sanctions below the minimum level otherwise recommended in the Guidelines when the sanction is proportionately scaled to the firm's size. The revisions to the Guidelines are effective immediately.

[www.nasd.com/sanctionguidelines](http://www.nasd.com/sanctionguidelines).

[http://www.nasd.com/web/groups/rules\\_regs/documents/notice\\_to\\_members/nasdw\\_017523.pdf](http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_017523.pdf)

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## Banking

### **OTS Announces CRA Revisions Intended to Align Agency with Other Federal Banking Agencies**

On September 27, the Office of Thrift Supervision announced that it intended to publish a Notice of Proposed Rulemaking that revised the agency's Community Reinvestment Act (CRA) regulations and aligned such regulations with those issued by the other federal banking agencies in August 2005.

According to the agency's press release, the proposed rule is intended to "align its CRA regulations with those of the other federal banking agencies to best serve the interests of insured depository institutions and their communities by providing for consistency in regulation and compliance." In addition, the press release noted that consistent standards for all insured depository institutions "would improve comparability in assessing the performance of all institutions in meeting the needs of their communities, including low- and moderate-income neighborhoods."

The proposed rule is to be published in the Federal Register in the near future and will include a comment period.

<http://www.ots.treas.gov/docs/7/776045.html>

## **Banking Agencies Issue Final Guidance on Nontraditional Mortgage Product Risks and Seek Additional Comment**

The federal financial regulatory agencies today issued final guidance to address the risks posed by residential mortgage products that allow borrowers to defer repayment of principal and sometimes interest (Interagency Guidance on Nontraditional Mortgage Product Risks). These products, referred to variously as "nontraditional," "alternative," or "exotic" mortgage loans (referred to below as nontraditional mortgage loans), include "interest-only" mortgages and "payment option" adjustable-rate mortgages. These products allow borrowers to exchange lower payments during an initial period for higher payments later.

While similar products have been available for many years, the number of institutions offering them has expanded rapidly. At the same time, these products are offered to a wider spectrum of borrowers who may not otherwise qualify for a similar-size mortgage under traditional terms and underwriting standards. The agencies are concerned that some borrowers may not fully understand the risks of these products. While many of these features exist in other adjustable-rate mortgage products, the agencies' concern is elevated with nontraditional products because of the lack of principal amortization and the potential for negative amortization. In addition, institutions are increasingly combining these loans with other features that may compound risk (risk layering). These features include making simultaneous second-lien mortgages and relying on reduced or no documentation in evaluating an applicant's creditworthiness.

The final guidance discusses the importance of, and provides strategies for, carefully managing the potential heightened risk levels created by these loans.

The agencies also published for comment proposed interagency guidance on Nontraditional Mortgage Products on December 29, 2005. Comments were received from financial institutions, trade associations, consumer and community organizations, state and financial regulatory organizations, and other members of the public. The agencies made a number of changes to the proposal to respond to the commenters' concerns and to provide additional clarity.

Several commenters on the proposed guidance encouraged the agencies to include model or sample disclosures or other descriptive materials as part of the interagency guidance. In response, the agencies are issuing for comment Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products. The agencies believe that illustrations of consumer information may be useful to institutions as they seek to implement the consumer information recommendations of the guidance. The agencies seek public comment on all aspects of the proposed illustrations, including whether these illustrations or a modified form should be adopted by the agencies.

<http://www.federalreserve.gov/BoardDocs/Press/bcreg/2006/20060929/addendum.htm>

<http://www.federalreserve.gov/BoardDocs/Press/bcreg/2006/20060929/attachment1.pdf>

<http://www.federalreserve.gov/BoardDocs/Press/bcreg/2006/20060929/attachment2.pdf>

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## Litigation

### **Shoe Design is Protectable Under Trademark Law, But Not Under Copyright Law**

The creator of a shoe design sued a national department store that was selling a similar shoe for violation of plaintiff's copyright and trademark rights. Defendant moved to dismiss the complaint. The Court held that the plaintiff had sufficiently alleged a claim of trade dress infringement under Section 1125(a) of the Lanham Act and under analogous state law. Section 1125(a) prohibits the unauthorized use of "any word, term, name, symbol, device, or any combination thereof" which is likely to cause confusion as to the origin or sponsorship of the alleged infringer's goods or services. The Court ruled that the statute applies both to trademarks and to the "trade dress" of a product, which the Court defined as the total image of the product including features such as size, shape, color or color combinations, texture, or graphics. To state a claim under Section 1125(a) based upon "trade dress," a plaintiff must establish that (i) its trade dress is distinctive as to the source of the goods, (ii) there is a likelihood of confusion between plaintiff's and defendant's goods, and (iii) the trade dress is not "functional." After finding that the "trade dress" was the shoe design itself, the Court sustained the claim. While recognizing that a feature is "functional" and therefore not protectable if it is essential to the use or purpose of the article or merely aesthetic, the Court found that, as alleged, the overall shoe design could be non-functional even if its component parts (e.g., the stitching, sole and strap) were not. Conversely, the Court dismissed plaintiff's copyright infringement claim, which was based upon plaintiff's copyright registration of a two-dimension etching of its shoe. "Useful articles" – which the Court described as items (like shoes) with intrinsically utilitarian functions – are not entitled to copyright protection. Accordingly, even though the shoe was a derivative work of the copyrighted etching, it was not protectable. The Court also ruled that the design elements of the shoe were not entitled to independent copyright protection because they were not physically or conceptually separable from the shoe's functional elements. (*Eliya, Inc. v. Kohl's Department Stores*, No. 06 Civ. 195(GEL), 2006 WL 2645196 (S.D.N.Y. September 13, 2006))

### **Limited Liability Company Member's Informal Actions Can Bind LLC**

Plaintiff filed a derivative action seeking an accounting and judicial expulsion of the majority member of a limited liability company, who allegedly had caused irreparable harm to the LLC. When plaintiff became a minority member, he executed a demand promissory note payable to the LLC as his capital contribution. At the time, the majority member (the only other member of LLC) told him "not to worry about [the note], the company would take care of it." Plaintiff made no payments on the note and the LLC made no demands. After the relationship between plaintiff and the majority member deteriorated, the majority member amended the Articles of Organization to permit the elimination of any member who failed to pay his capital contribution and, then, terminated plaintiff's membership for failing to make any payments on the promissory note. The trial court ruled that the membership had been properly terminated so that the plaintiff could not maintain the derivative lawsuit, holding, in part, that although the majority member had waived payment of the note, there was no evidence that the LLC had affirmed his actions. On appeal, the Supreme Court of Virginia ruled for the first time that informal actions of LLC members can bind the LLC, but only if a showing is made that members and managers of the LLC conducted its business in an informal manner, e.g., by ignoring statutory requirements or requirements set out in the articles of organization or operating agreement. Because plaintiff failed to make such a showing, the Supreme Court affirmed the trial court's ruling that the majority member's oral waiver of the note obligation did not bind the LLC. The Supreme Court held, however, that the elimination of plaintiff's membership was improper on the alternative ground that the plaintiff was not in default on the Note, and therefore his interest could not be eliminated, because payment was not overdue since no demand had ever been made and the obligation had not remained outstanding for an unreasonably long time. (*Gowin v. Granite Depot, LLC*, No. 052240, 2006 WL 2637499 (Va. September 15, 2006))

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CFTC

**Treasury Market Surveillance Focuses on Suspicious Trading Activity**

Deputy Assistant Secretary for Federal Finance James Clouse delivered remarks on September 27 to the Bond Market Association about market surveillance and related issues in the U.S. Treasury market. Among other things, Mr. Clouse referred to investigations being conducted by the Securities and Exchange Commission and the Commodity Futures Trading Commission of potentially suspicious trading in the cash, repurchase and futures markets for Treasury securities. He indicated that firms “appeared to gain a significant degree of control over highly sought-after Treasury issues and seemed to use that market power to their advantage,” as well as a concern that manipulations appear to have “distorted to varying degrees” prices in the Treasury cash, repurchase and futures markets. Mr. Clouse further stated that regulators, who are concerned about potential trading improprieties, will continue to examine trading data, positions and financing arrangements in the securities markets, focusing (among other things) on whether trading desks are intentionally exerting control over a particular security.

<http://www.treas.gov/press/releases/hp118.htm>

**CFTC Issues No-Action Letter to Hong Kong Futures Exchange**

The Commodity Futures Trading Commission issued on September 27 a no-action letter to the Hong Kong Futures Exchange Limited permitting the offer and sale in the United States futures contracts based on the FTSE/Xinhua China 25 Index and the Hang Seng China Enterprises Index.

<http://www.cftc.gov/opa/press06/opa5235-06.htm>

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