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SEC/Corporate

Proposed Amendment to SEC Rule Governing Director Nominations by Shareholders

On September 7, the Securities and Exchange Commission announced that the Division of Corporation Finance will recommend an amendment to Rule 14a-8 under the Securities Exchange Act of 1934, as amended, concerning director nominations by shareholders. The staff proposal, still to be developed, will address issues raised by a decision of the U.S. Court of Appeals for the Second Circuit on September 5, which disagreed with the SEC staff's longstanding interpretation of Rule 14a-8.

In *American Federation of State, County & Municipal Employees, Employees Pension Plan v. American International Group, Inc.*, the Second Circuit held that a shareholder proposal that seeks to amend the corporate bylaws to establish a procedure by which shareholder-nominated candidates may be included on the corporate ballot does not relate to an election within the meaning of Rule 14a-8 and therefore cannot be excluded from corporate proxy materials under that regulation. The SEC had previously issued a no-action letter to AIG indicating that the SEC would not recommend an enforcement action against AIG should AIG exclude from its proxy statement a proposal which would amend AIG's bylaws to require AIG, under certain circumstances, to publish the names of shareholder-nominated candidates for director positions together with any candidates nominated by AIG's board of directors. The Second Circuit reasoned that the election exclusion provided for in Rule 14a-8 applies to shareholder proposals that relate to a particular election and not to proposals that would establish the procedural rules governing elections generally.

In announcing the calendaring of the proposed amendment, SEC Chairman Christopher Cox stated that shareholders' rights in the proxy process are best secured under consistent national application of Rule 14a-8 to shareholder proposals and therefore, to provide certainty with regard to shareholder proposals in every judicial circuit, the staff has been directed to prepare recommendations for revisions to Rule 14a-8 that will assure its consistent nationwide application.

The SEC has the recommendation for consideration by the SEC at an open meeting to be held on October 18.
http://www.sec.gov/news/press/2006/2006-150.htm
http://www.directorship.com/pdf/AFSCMEvAIG.pdf

California Legislature Passes Majority Vote of Shareholders Bill

On August 30, the California Senate passed Senate Bill 1207, previously passed by the California Assembly on August 23. S.B. 1207 will add a new Section 708.5 to the California Corporations Code and authorize a listed corporation that has eliminated cumulative voting to amend its articles of incorporation or bylaws to provide that in an uncontested election of a listed corporation, approval of a majority of the shares represented and voting that also represent a majority of the required quorum would be required to elect each director. California law currently requires plurality voting for California corporations.

Section 708.5 will also provide that if, in an uncontested election of a listed corporation that has amended its articles of incorporation or bylaws pursuant to Section 708.5, an incumbent director fails to be approved by the shareholders, then, unless the incumbent director has earlier resigned, the term of the incumbent director will end on the date that is the earlier of 90 days after the date of the election and the date on which the company's board of directors selects a person to fill the vacancy.

California is one of the few states with a strong commitment to cumulative voting and the interaction of cumulative voting and majority voting was a hotly contested issue. The Bill was changed significantly in the last few weeks to address the concerns expressed by the State Bar and the business community that its application be limited to listed California companies that had eliminated cumulative voting and who "opt in" to the majority voting requirement. Residual concerns about the number of votes required to achieve the majority threshold have prompted some to speculate that Governor Schwarzenegger may veto the Bill.

Unless Governor Schwarzenegger returns S.B. 1207 before September 30, it will become law and take effect on January 1, 2007.
http://www.leginfo.ca.gov/pub/bill/sen/sb_1201-1250/sb_1207_bill_20060901_enrolled.html

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Broker Dealer

NASD Provides Guidance on Rule 2441 – Net Transactions with Customers

In Notice to Members 06-47, the NASD provided guidance on recently approved NASD Rule 2441 - Net Transactions with Customers. The rule is effective on October 2. Rule 2441 requires a member firm to provide disclosure to, and obtain consent from, a customer prior to executing a transaction with a customer on a "net" basis, i.e., a principal transaction in which a market maker that received an order to buy (sell) an equity security, purchases (sells) the equity security at one price and then sells to (buys from) the customer at a different price. Rule 2441's requirements are different for transactions with institutional and non-institutional customers. To execute a net transaction with a non-institutional customer, the member firm must obtain the customer's written consent prior to order execution on an order-by-order basis. To execute a net transaction with an institutional customer, the member firm may obtain consent on an order-by-order basis or for multiple transactions through a negative consent letter. An institutional customer's consent may be oral or written. If the member firm chooses to obtain oral consent for a net transaction on an order-by-order basis, the member firm must (i) explain to the customer, prior to order execution, the terms and conditions for handling the order; (ii) provide the customer with an opportunity to object to execution on a net basis; and (iii) document the customer's consent and understanding of the terms and conditions.

http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_017303.pdf

NASD Provides Guidance on Amendments to Rules 2210 and 2211

In Notice to Members 06-48, the NASD provided guidance on the amendments to NASD Rules 2210 and 2211, which impose disclosure and presentation requirements on member firm communications with the public, other than institutional sales material, and public appearances, that present non-money market mutual fund performance sales material. The rule amendments become effective on April 1, 2007. While Rule 482 under the Securities Act of 1933 and Rule 34b-1 under the Investment Company Act of 1940 primarily govern the disclosure of fund performance sales data, the amendments to NASD Rules 2210 and 2211 impose additional requirements on member firms. To the extent applicable, a member firm must also disclose a fund's (i) maximum sales charge imposed on purchases or the maximum deferred sales charge; and (ii) total annual operating expense ratio, gross of any fee waivers or expense reimbursements (the unsubsidized expense ratio), as stated in the fee table of the fund's prospectus. The amendments also require that all of this information be presented prominently and, in any print advertisement, in a text box.
http://www.nasd.com/RulesRegulation/NoticestoMembers/2006NoticestoMembers/NASDW_017301

NASD Best Execution Rule Amendment Approved

The Securities and Exchange Commission has approved amendments to the best execution rule (Rule 2320) of the NASD The amended rule applies a duty of reasonable diligence on a member firm for orders received from its customers and for orders received from another broker dealer for the customers of that other broker-dealer. The duty to customers of another broker-dealer arises when the customer order is routed to the member firm for purposes of order handling and execution, as is the practice in a fully disclosed clearing arrangement. The NASD and the SEC made clear that the rule applies to trades in bonds as well as equities. A five part test will now be applied to determine if a member firm used reasonable diligence so that the resultant price to the customer was as favorable as possible under prevailing market conditions. The test includes: (i) the character of the market for the security, e.g. price, volatility, relative liquidity and pressure on available communications; (ii) size and type of transaction; (iii) number of markets checked; (iv) accessibility of the quotation; and (v) terms and conditions of the order as communicated to the member firm.
http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/E6-14196.pdf
http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_015336.pdf

NYSE Clarifies Use of Error Account

In Information Memo 06-63 the New York Stock Exchange LLC clarified NYSE Rule 134(d) which requires everyone executing trades on the floor to have an error account. A member firm may have only one error account. However, in light of the restructuring of the NYSE, a member firm may establish an error account for each of its designees on the floor of the NYSE if the member firm is also a named person on the account. Errors include: (i) trades for which an erroneous report was given; (ii) an order, in whole or in part, that was not executed but was reported as executed; and (iii) where an order, in whole or in part, was executed but reported as not executed. A customer to whom an erroneous report was given may treat the erroneous report as the actual trade if the customer refuses to accept a corrected report. In such a case the trade is posted to the error account as is the offsetting correction. Otherwise, error accounts may only be used for executions outside of an order's written instructions or missing the market on a "held" order. Errors must be reported to the NYSE, an audit trail data element retained and a mandatory error account detail log is to be maintained with relevant records to document an error and the facts and circumstances surrounding an erroneous report. The NYSE noted that profits and losses in an error account may not be netted and that all profits are to be transmitted to the New York Stock Exchange Foundation.

http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256FCB005E19E8852571D8005B5818/$FILE/Microsoft%20Word%20-%20Document%20in%2006-63.pdf

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Banking

Agencies Seek Public Comment on Basel II and Market Risk Proposed Rulemakings

The federal bank and thrift regulatory agencies announced on September 5 that they will request public comment on a notice of proposed rulemaking (NPR) that would implement new risk-based capital requirements in the United States for large, internationally active banking organizations. The NPR details the agencies' plans for implementing the Basel Committee on Banking Supervision's (BCBS) new capital accord (Basel II) that was issued in 2004. The agencies also will request comment on proposed Basel II supervisory reporting templates.

The Agencies first adopted risk-based capital standards in 1989. Those standards were based on the Basel Capital Accord that the BCBS originally issued in 1988 (Basel I). For banking organizations that meet qualifying criteria, the Basel II NPR would replace U.S. rules implementing Basel I. The proposed framework would be mandatory for large, internationally active banking organizations and optional for others.

In March of this year, the Agencies released a preliminary draft of the Basel II NPR. The version being made available today differs in some respects from the March draft. For example, the Agencies have responded to certain requests from the industry to seek comment on alternative risk-based capital approaches and have clarified that in evaluating credit risk, banking organizations should not rely on the possibility of U.S. government financial assistance, except for the financial assistance that the government has legally committed to provide. The final document, which will be published in the Federal Register shortly, should be used as the basis for comments.

Separately, several of the banking regulatory agencies announced that they will request comment on proposed revisions to the market risk capital rules that the Office of the Comptroller of the Currency, the Federal Reserve, and the Federal Deposit Insurance Corporation have used since 1997 for banking organizations with significant exposure to market risk. Under the market risk capital rule, certain banking organizations are required to calculate a capital requirement for the general market risk of their covered positions and the specific risk of their covered debt and equity positions. The proposed revisions would enhance the rule's risk sensitivity and would require public disclosures of certain qualitative and quantitative market risk information.

The notice of proposed rulemaking on the market risk capital rule would implement changes the BCBS approved in 2005 and also would apply to certain savings associations, which currently are not covered under the rule. The agencies will also seek comment on proposed supervisory reporting templates related to the market risk capital rule. The Agencies request comments on the proposals within 120 days of publication in the Federal Register.

The Agencies also indicated that they remain committed to issuing in the "near future" additional proposed revisions to their existing risk-based capital rules, known as Basel IA, in a timeframe that will allow for overlapping comment periods for both the Basel II NPR and the NPR for the proposed Basel IA revisions.
http://www.federalreserve.gov/GeneralInfo/Basel2/NPR_20060905/
http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060905/NPR_Market_Risk.pdf

Federal Reserve Issues Final Rule Regarding Reg. E and Payroll Accounts

On August 24, the Board of Governors of the Federal Reserve announced its approval of a final rule that confirms that payroll card accounts are covered by Regulation E, the agency's regulation governing electronic fund transfers such as transfers initiated through ATM machines, point of sale terminals, and remote banking services.

Importantly, the final rule provides financial institutions with flexibility in providing certain account information to payroll card users. Periodic statements generally required by Regulation E are not required if the institution: (i) makes available balance information to the consumer through a readily available telephone line; (ii) makes available to the consumer an electronic history, such as through an Internet web site, of the consumer's account transactions covering a period of at least 60 days preceding the date the consumer electronically accesses the account; and (iii) upon the consumer's oral or written request, promptly provides a written history of the consumer's account transactions covering a period of at least 60 days prior to the request.

In addition, the final rule does not cover employers and third-party service providers as "financial institutions" under Regulation E because they "typically do not hold payroll card accounts, or issue payroll cards and agree to provide EFT services to payroll card holders. However, if an employer or service provider were to undertake either of these functions, it would become a financial institution subject to the rule." The final rule is effective July 7, 2007.
http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060824/default.htm

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Litigation

Seller of Tying Product Must Have Direct Economic Interest in Sale to Establish Illegal Tying Arrangement

In antitrust suit against managed health care company (MHC) for exclusion from its network, a group of optometrists claimed both an unlawful conspiracy between the MHC and its panel ophthalmologists and that the MHC unlawfully tied the ophthalmologist's sale of non-surgical eye care to the MHC's sale of managed care plans. The Tenth Circuit affirmed the summary judgment dismissal of the claims. Although at "first blush" the Court found the evidence might appear to support the conspiracy claim, because the claim was supported solely by circumstantial evidence, the plaintiffs bore a high burden, needing to present evidence that "tends to exclude the possibility" that the alleged conspirators acted independently. After reviewing the evidence offered by the plaintiff and noting the absence of any "plus factors" to support an inference of antitrust conspiracy, the Court ruled that the plaintiffs had not met its burden. With respect to the tying claim, the Court first clarified that an illegal tying claim can succeed where, as in the case before it, the seller of the tying product (managed health care plans) requires the purchaser to buy the tied product (non-surgical eye care) from a designated third party (ophthalmologists), rather than from any other competitive source the buyer might prefer. The Court ruled, however, that to constitute an

illegal tying arrangement in such circumstances, the tying product seller must have a direct economic interest in the sale of the tied product. Because the MHC reimburses its panel ophthalmologists each time they provide non-surgical eye care, the Court concluded that the MHC had no such interest in the sale. (*Abraham v. Intermountain Health Care Inc*., No. 05-4043, 2006 WL 2556357 (10th Cir., September 6, 2006))

Corporate Form Disregarded, Fiduciary Personally Liable for Misappropriation of ERISA Plan Assets

The trustees of a multi-employer employee benefit plan sued the president/sole shareholder of a construction company, the company itself and another employee for failure to pay fringe benefit contributions. On plaintiffs' motion for summary judgment, plaintiffs argued that the president was personally liable because (i) the corporate entity should be disregarded as merely an alter ego of the president, and, alternatively (ii) the president was an ERISA fiduciary who misappropriated plan assets. The Court found that ERISA was enacted in part to protect employees from being deprived of benefits by their corporate employers and that courts have more readily disregarded the corporate form in ERISA contexts to protect such benefits than in other contexts. The Court ruled that the corporate veil should be pierced because the undisputed facts, including the president's personal loans to the corporation, payment of corporate expenses, and withdrawal of money from the corporation, demonstrated a failure to observe the corporate form. The Court also found summary judgment warranted on the fiduciary duty claim. After ruling that the president was an ERISA fiduciary because she exercised authority or discretion over the disposition of funds which were owed to plaintiffs, the Court determined that she had breached that duty by using such funds to pay herself and others, including company creditors. (*Operating Engineers Local 324 Fringe benefit Funds v. Pavement Munchers, Inc.*, Civil No. 04-40380, 2006 WL 2514013 (E.D. Mich. Aug. 29, 2006))

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CFTC

CFTC Allows Futures Contract Based on the Mexican Stock Exchange IPC Index to be Offered and Sold in the United States

The Commodity Futures Trading Commission issued a no-action letter on August 24, permitting the offer and sale in the United States of the Mexican Stock Exchange's Price and Quotation Index (IPC) futures contract that is traded on MexDer (Mercado Mexicano de Derivados, S.A. de C.V.). The IPC is a broad-based, market-capitalization-weighted composite security index of highly capitalized and actively traded stocks listed on the Mexican Stock Exchange.
http://www.cftc.gov/opa/press06/opa5223-06.htm

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