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Corporate and Financial Weekly Digest

April 3, 2009

SEC/Corporate

House Passes Bill Linking Executive Pay To Performance For TARP Beneficiaries

On April 1, by a vote of 247 to 171, the U.S. House of Representatives passed the Pay For Performance Act of 2009.

The bill prohibits compensation payments that are "unreasonable or excessive" based on standards to be established by the U.S. Treasury Secretary. It also prohibits any bonus or other supplemental payment that is not directly based on performance-based standards to be set by the Treasury Secretary and will apply to executive bonuses and other performance compensation regardless of when employment contracts were signed. Affected companies will be required to file annual reports with the Treasury Secretary for all officers, directors and employees whose compensation exceeds $500,000, without naming them. Certain severance payments are excluded from the definition of "compensation payment."

The bill also establishes a new federal "Commission on Executive Compensation" to study the executive compensation system for recipients of TARP funding and recommend legislative and executive actions.

The bill would apply to financial institutions that received or will receive capital investments by the Treasury Department under the Troubled Asset Relief Program (TARP) or the Housing and Economic Recovery Act, which covers Fannie Mae and Freddie Mac. Community financial institutions that receive no more than $250 million in TARP funds, as well as companies that have entered into a TARP pay-back schedule approved by the Treasury Department would not be covered by the bill.

http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1664eh.txt.pdf

Litigation

Complaint Satisfied PSLRA's Strong Inference of Scienter Requirement

A federal district court denied a motion to dismiss class action claims filed against a gambling equipment company, its CEO and its CFO for violations of, among other things, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The plaintiffs asserted that the defendant company improperly recognized revenue from inter-company transactions, engaged in improper accounting practices, failed to correct flawed internal controls and made material misrepresentations in its public filings. Defendants moved to dismiss, asserting that the complaint failed to sufficiently allege scienter.

SEC/CORPORATE

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Analyzing plaintiffs' allegations under the Supreme Court's *Tellabs v. Makor Issues & Rights, Ltd.* standard, the Court denied defendants' motion. Although the Court found that many of plaintiffs' allegations did not independently demonstrate the requisite level of scienter, it ruled that "the totality of the specific circumstances . . . all demonstrate an inference of scienter that is at least as compelling as an opposing inference of nonfraudulent intend."

The Court emphasized that the company was forced to restate earnings from a subsidiary company one year after restating earnings from the same subsidiary and making public assurances that it had reevaluated its internal controls to ensure that no future errors would occur. The court ruled that the subsequent restatement in conjunction with its magnitude—without which the defendant company would not have met consensus earnings estimates—"len[t] to an overall inference of scienter." The Court similarly found the defendants' SOX certifications—which stated that defendants had properly designed, implemented and supervised adequate internal controls—constituted "sufficient reason to infer that defendants acted with reckless disregard in failing to rectify [the company's] past internal deficiencies." (*Stocke v. Shuffle Master, Inc.*, 2009 WL 798927 (D. Nev. Mar. 23, 2009)).

Attorney's Motion to Dismiss Federal Securities Law Claims Denied

Plaintiffs asserted claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder against an attorney who represented the co-defendant company, which allegedly offered and sold oil and gas securities in violation of state and federal securities laws. The defendant attorney moved to dismiss, arguing that the complaint did not adequately allege scienter against him and, in any event, did not state a claim since there is no aider and abettor liability under Section 10(b) or Rule 10b-5. The Court denied the motion, ruling that plaintiffs allegations satisfied the PSLRA's scienter standard and that the attorney could be liable as a primary violator under Rule 10b-5 based upon the legal work he performed for the defendant company in connection with its offer and sale of securities.

With respect to the scienter issue, the Court found plaintiffs' allegations that defendant "prepared private placement memoranda or offering documents on behalf of [the company] which contained material misrepresentations" sufficient. Among other things, the defendant allegedly misrepresented the terms of an order issued by an Alabama court that prohibited the company from selling securities within the state by indicating merely that the defendants were "currently negotiating" with the State of Alabama a "temporary" order. While recognizing that an inference could be drawn that the defendant was simply negligent in making this and other misstatements in the offering documents, the Court found that "the inference that [he] acted with the requisite scienter is just as strong as the inference that he was negligent."

The court next rejected defendant's aider and abettor argument. While agreeing that plaintiffs could not maintain an aider and abettor claim under Section 10(b) and Rule 10b-5, the court ruled that plaintiffs' allegations that the defendant prepared the allegedly materially misleading offering documents constituted the supply of information to potential investors in a sufficiently direct manner to provide a basis for primary liability under Rule 10b-5. Finally, the court also ruled that the defendant's inclusion of a disclaimer in the offering documents stating that he "ma[de] no representation as to the accuracy of the materials" would not "shield" him from liability if he knowingly made false statements in the offering documents. (*Clayton v. Heartland Resources, Inc.*, 2009 WL 790175 (W.D. Ky. Mar. 24, 2009))

Broker Dealer

FINRA Releases Guidance on Its Enforcement Process

The Financial Industry Regulatory Authority (FINRA) recently provided guidance on its enforcement process in order to increase transparency of the process, assist firms and their associated persons in understanding how the investigative process works and highlight procedural safeguards of the process. Topics include enforcement procedures and managerial oversight, conducting investigations, sufficiency of evidence review, FINRA's process regarding recommendation of formal disciplinary action (the "Wells" process), Disciplinary Advisory Committee review, the Litigation Group consultation process and the independence of the Office of Disciplinary Affairs and Office of Hearing Officers.

http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118171.pdf

Options Exchange Penny Pilot Program Extended

The options exchanges made filings to extend the industry-wide Penny Pilot Program "as is" until July 3. The Pilot Program, which was initially implemented in January, 2007, was scheduled to expire on March 27. The extensions were intended to allow further analysis of the impact of the Pilot Program.

http://www.sec.gov/rules/sro/cboe/2009/34-59630.pdf
http://www.sec.gov/rules/sro/nasdaq/2009/34-59632.pdf
http://www.sec.gov/rules/sro/nyseamex/2009/34-59642.pdf
http://www.sec.gov/rules/sro/bx/2009/34-59629.pdf
http://www.sec.gov/rules/sro/ise/2009/34-59633.pdf
http://www.sec.gov/rules/sro/nysearca/2009/34-59628.pdf
http://www.sec.gov/rules/sro/phlx/2009/34-59631.pdf

Private Investment Funds

G20 Summit Calls for Hedge Fund Regulation

The G-20 affirmed in its communiqué released at the close of the London Summit 2009 the commitment of the members to strengthening financial supervision and regulation and to better international cooperation to build a globally consistent supervisory and regulatory framework. They also issued a Declaration, entitled "Strengthening the Financial System," in which the G20 agreed that all systemically important financial institutions, markets, and instruments should be subject to an appropriate degree of regulation and oversight. In particular, hedge funds or their managers should be registered and should be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of the systemic risks that they pose individually or collectively. Where appropriate, registration should be subject to a minimum size. A mechanism should be developed by the end of 2009 for cooperation and information sharing between relevant authorities in order to ensure that effective oversight is maintained where a fund is located in a different jurisdiction from the manager.

http://www.g20.org/Documents/g20_communique_020409.pdf

http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf

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SEC Chairman Discusses Proposed Regulatory Reforms

In testimony before the Senate Committee on Banking, Housing and Urban Affairs, the Chairman of the Securities and Exchange Commission, Mary L. Schapiro, discussed the Commission's views on enhancing investor protection through regulation of the securities markets. She stated that the SEC is considering asking for legislation that would require the registration of investment advisers that advise hedge funds, and the registration of hedge funds themselves. The SEC is also considering recommending legislation that would apply the same statutory regime for both investment advisers and broker-dealers, who are now separately regulated even though the services they provide often are virtually identical from the investor's perspective.

Chairman Schapiro has already requested the SEC staff to prepare a proposal that would require investment advisers with custody of client assets to undergo an annual unannounced third-party audit to confirm the safekeeping of client assets and compliance with the law. Under the forthcoming proposal, a senior officer from each firm will need to attest to the sufficiency of controls of investor assets, and a list of all certifying firms would be publicly available on the SEC's website.

http://www.sec.gov/news/testimony/2009/ts032609mls.htm

OTC Derivatives

CDS Big Bang Protocol Closes April 7, Determinations Committees Membership Announced

The deadline for adherence to the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol is April 7. Adherence to the Protocol will automatically modify existing CDS confirmations for the types of covered transactions and the forms of confirmations for any new transactions (or transactions novated to another adhering party) entered into between April 8, 2009 and January 31, 2011 to incorporate the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement to the 2003 ISDA Credit Derivatives Definitions (the Supplement) and to elect Auction Settlement without further action by the parties. If a party does not adhere to the protocol, existing trades would continue to settle in accordance with the existing contractual terms, rather than through the auction settlement process. Trades entered into from and after April 8 with non-adhering parties are expected to incorporate the Supplement by reference expressly in the confirmation.

ISDA also announced on March 31, the initial members of the Determinations Committees as follows:

Dealers:
Bank of America / Merrill Lynch
Barclays
Citibank
Credit Suisse
Deutsche Bank AG
Goldman Sachs
JPMorgan Chase Bank, N.A.
Morgan Stanley
The Royal Bank of Scotland
UBS

Non-dealers:
Elliott Management Corporation
Legal & General Investment Management Limited

OTC DERIVATIVES

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Pacific Investment Management Company LLC
Primus Asset Management, Inc.
Rabobank International

Global Non-Voting Dealers (for all regions):
BNP Paribas
HSBC Bank

Regional Non-Voting Dealer (for Americas, Europe, Japan, and Australia / New Zealand):
Societe Generale

Regional Non-Voting Dealer (for Asia Ex-Japan):
Standard Chartered Bank

Non-Voting Non-Dealer (for all regions):
Prudential Investment Management

http://www.isda.org/

Investment Companies and Investment Advisors

SEC Staff Provides Guidance on Valuation for Registered Investment Companies

In a recent speech by Andrew Donohue, Director of the Division of Investment Management of the Securities and Exchange Commission, at the Investment Company Institute, 2009 Mutual Funds and Investment Management Conference, Mr. Donohue recognized the challenges of valuing portfolio securities in an uncertain market. Mr. Donohue highlighted the availability of a bibliography prepared by the staff of the Division of Investment Management that lists select relevant provisions of the Investment Company Act (the Act), related rules and Commission guidance concerning valuation. The bibliography is intended to assist funds and their counsel in understanding and applying valuation requirements under the Act and includes proposing releases, select staff guidance (e.g., no-action letters), and related enforcement actions.

http://sec.gov/divisions/investment/icvaluation.htm

Banking

Call Report Changes Effective for March 31 Report Date

On April 1, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System (collectively, Banking Agencies) issued a notice to banks reminding management of the revisions to the Consolidated Reports of Condition and Income (Call Report) are effective for the March 31 report date.

These revisions include reporting changes that respond to newly effective accounting standards by adding items to the Call Report loan schedules for held-for-investment loans and leases acquired in business combinations during the current year, and revising several report schedules for financial reporting changes applicable to noncontrolling (minority) interests in consolidated subsidiaries.

Sample Call Report forms for the March 31 report date are available on the Federal Financial Institutions Examination Council website. Completed Call Reports for the March 31 report date must be received by April 30.

http://www.fdic.gov/news/news/financial/2009/fil09016.html

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FDIC Seeks Comment on Legacy Loans Program

The Federal Deposit Insurance Corporation (FDIC) on March 26 announced the opening of the public comment period for the Legacy Loans Program (LLP). The FDIC and the Department of the Treasury recently announced the LLP, which will remove troubled loans and other assets from FDIC-insured institutions and attract private capital to purchase the loans. (For more information, please see Katten's *Client Advisory* published March 26). The FDIC is seeking public comment from interested parties on the critical aspects of the LLP. Comments are requested no later than April 10.

The program is intended to boost private demand for distressed assets that are currently held by banks and facilitate market-priced sales of troubled assets. The LLP will combine an FDIC guarantee of debt financing with equity capital from the private sector and the Treasury. The partnerships will purchase assets from banks and place them into what will be known as Public-Private Investment Funds (PPIF).

The FDIC has stated that institutions of all sizes will be eligible to participate in the LLP to sell assets, and that the program will particularly encourage the participation of individuals, mutual funds, pension plans, insurance companies and other long-term investors. Investors will be pre-qualified by the FDIC to participate in auctions. For providing a guarantee, the FDIC will be paid a fee, a portion of which will be allocated to the Deposit Insurance Fund. The FDIC stated it will be protected against losses by the equity in the pool, the newly established value of the pool's assets and the fees collected.

www.fdic.gov/llp/index.html

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Structured Finance and Securitization

FASB Decides to Revise "Mark-to-Market" Accounting Rules

On April 2, the Financial Accounting Standards Board (FASB) met to consider changes to proposed FASB Staff Position FAS 157-e, Determining Whether a Market Is Not Active and a Transaction Is Not Distressed (FSP). FASB decided that the final FSP would:

- Affirm that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions (that is, in the inactive market).
- Clarify and include additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active.
- Eliminate the proposed presumption that all transactions are distressed (not orderly) unless proven otherwise. The FSP will instead require an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence.
- Include an example that provides additional explanation on estimating fair value when the market activity for an asset has declined significantly.
- Require an entity to disclose a change in valuation technique (and the related inputs) resulting from the application of the FSP and to quantify its effects, if practicable.
- Apply to all fair value measurements when appropriate.

The FASB also affirmed its previous decision that the FSP would be applied prospectively and that retrospective application would not be permitted.

http://www.fasb.org/action/sbd040209.shtml

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UK Developments

FSA Campaign Against Insider Dealing Continues

On March 31, the UK Financial Services Authority (FSA) announced that it had arrested a "senior corporate finance adviser" and another individual in connection with an ongoing investigation into suspected organized insider dealing. Search warrants were also executed by the FSA at a number of addresses in Greater London as part of the investigation. The FSA announced that its arrest operation involved 25 FSA staff, assisted by 11 police officers.

In a separate development, both defendants found guilty in the FSA's first criminal insider dealing prosecution (as reported in the March 27 edition of *Corporate and Financial Weekly Digest*) were sentenced to jail terms of eight months.

http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/045.shtml

FSA Wins Market Abuse Case Against Market Maker

On April 2, the UK Financial Services Authority (FSA) announced that it had won its market abuse case at the Financial Services and Markets Tribunal (the Tribunal) against Winterflood Securities Limited (Winterflood), the largest market maker of AIM Securities, and two Winterflood traders, Stephen Sotiriou (SS) and Jason Robins (JR).

In June 2008, the Regulatory Decisions Committee of the FSA (RDC) found that Winterflood, JR and SS carried out an illegal share ramping scheme relating to shares in Fundamental-E Investments Plc (FEI), an AIM listed company. In particular, the market maker had misused rollovers and delayed rollovers thereby creating a distortion in the market for FEI shares and in so doing misled the market for about six months in 2004. The RDC fined Winterflood £4 million (approximately $5.9 million) and imposed fines of £200,000 (approximately $295,000) on SS and £50,000 (approximately $73,500) on JR.

The RDC concluded that the FEI share trades executed by Winterflood in the relevant period had a series of unusual features which should have alerted the market maker to the clear and substantial risks of market manipulation. Rather than taking steps to ensure that the trades were genuine, Winterflood continued the trading since it was highly profitable. Winterflood made about £900,000 (approximately $1.3 million) from trading in FEI shares in the relevant period. FEI was its most profitable stock at the time.

Winterflood referred the matter to the Tribunal on a point of law. The Tribunal rejected Winterflood's contentions and upheld the RDC's decision which has therefore now been made public.

http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/046.shtml

UK DEVELOPMENTS

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