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SEC/Corporate

SEC Adopts New Rules for Business Development Companies and Reproposes New Categories of Eligible Portfolio Companies

On October 25, the Securities and Exchange Commission adopted new rules under the Investment Company Act which expand the definition of eligible portfolio companies. These are the companies that are included in the required portfolios of business development companies (BDCs), a type of closed-end investment company that makes capital available to small, developing and financially troubled companies. While the Investment Company Act defines eligible portfolio companies to include domestic operating companies that do not have any class of marginable securities under Federal Reserve Board rules, a recent expansion by the Federal Reserve Board of the definition of margin securities had, in effect, limited the pool of portfolio companies eligible for investment by BDCs. The SEC's new rules expand the definition to provide that eligible portfolio companies include all private companies and all companies whose securities are not listed on a national securities exchange (even if their securities are marginable under Reserve Board rules). Moreover, under the new rules a BDC can include in its portfolio follow-on investments in a company that met the new definition of eligible portfolio company at the time of the business development company's initial investment in it, but no longer meets that definition.

Finally, the SEC also re-proposed for comment an additional definition of eligible portfolio company that would expand the definition to include certain companies that list their securities on a national securities exchange. The comment period on the proposed additional definition expires 60 days after publication in the Federal Register. (*SEC Release No. IC-27538; Proposed Rule Release No. IC-27539*)

SIA and ICI Object to Mandatory Disclosure of Compensation of Non-Executive Officers

On October 23, in comment letters to the Securities and Exchange Commission, the Securities Industry Association and the Investment Company Institute said that they strongly object to the SEC's proposal to require companies to disclose compensation paid to highly compensated employees who are not executive officers. The SEC's original proposal on compensation disclosure would have required the disclosure of total compensation and job description of up to an additional three highly compensated employees who earn more than any of the named executive officers, but the additional disclosure was not included in the final rules adopted on July 26. Instead, the SEC requested additional comment on this proposed disclosure requirement.

SIA commented that the SEC has not articulated a compelling rationale for the proposed disclosure requirement, and that, among other things, such information would tell investors nothing about the incentive or integrity of the issuer's executive officers. In addition, SIA was concerned about significant adverse practical consequences, such as the loss of talent and the disruption of internal pay scales, and the expense and difficulty of administration.

ICI noted that investment funds are significant investors in public companies and do not view information about the compensation paid to a company's non-executives as material to their decisions about whether to hold the company's stock or how to vote its proxies as such individuals are not charting a company's future course and are not responsible for significant policy decisions. ICI also noted disclosure of non-executive compensation could have serious negative implications for public companies, such as making it easier for competitors to lure away the company's top talent, potentially leading to losses in value. ICI stated that any investor benefit from this disclosure would be clearly outweighed by the negative impact.

The full texts of SIA's and ICI's comment letters to the SEC are available at
http://www.sia.com/comment_letters/14914.pdf
http://www.sec.gov/rules/proposed/s70306/s70306-745.pdf

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Banking

FDIC Approves New Risk-Based Premiums for Deposit Insurance

On November 2, the Federal Deposit Insurance Corporation (FDIC) adopted final regulations that implement the Federal Deposit Insurance Reform Act of 2005. Among the final regulations is a new rule on the risk-based assessment system that will enable the FDIC to more closely tie each bank's premiums to the risk it poses to the deposit insurance fund. In addition, the FDIC has new flexibility to manage the deposit insurance fund's reserve ratio within a range. Under the new risk-based assessment system, the FDIC will evaluate each institution's risk based on three primary sources of information -- supervisory ratings for all insured institutions, financial ratios for most institutions, and long-term debt issuer ratings for large institutions that have them. FDIC believes that the ability to differentiate on the basis of risk will improve incentives for effective risk management and will reduce the extent to which safer banks subsidize riskier ones.

As a result of the final rulemaking, the FDIC also set the assessment rates that will take effect at the beginning of 2007. The new rates for nearly all of the industry will vary between five and seven cents for every $100 of domestic deposits. As part of the Reform Act, Congress provided credits to institutions that paid high premiums in the past to bolster the FDIC's insurance reserves. As a result, the majority of banks will have assessment credits to initially offset all of their premiums in 2007.

In related actions, the FDIC Board adopted regulations that:

- Set the designated reserve ratio for the deposit insurance fund during 2007 at 1.25 percent of estimated insured deposits;

- Make operational changes intended to enable the assessment system to react more quickly and more accurately to changes in an institution's risk profile;

- Require banks and savings associations to use the same FDIC sign and follow the same advertising rules; and

- Establish penalties for institutions that fail to pay their deposit insurance premiums in a timely manner.

The rules adopted on November 2 are in addition to previous regulations implementing the reform law, including those governing the one-time assessment credit, a temporary system of dividend payments to insured institutions, and an increase in the deposit insurance coverage for certain retirement accounts. The FDIC has now adopted all of the regulations required by the Reform Act within the 270-day deadline set by Congress.
http://www.fdic.gov/news/news/press/2006/pr06101.html

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Broker Dealer

SEC Approves Proposed Amendment to NASD Rule 3170 to Require Members to Electronically File Certain Regulatory Notices with the NASD

The Securities and Exchange Commission has approved a proposed amendment to NASD Rule 3170. As amended, Rule 3170 now requires member firms to file electronically with the NASD any regulatory notice or other document that is required to be filed with the NASD. Although the rule, as amended, does not specify the particular regulatory notices or documents that the NASD will require members to file electronically, the NASD will issue a Notice to Members (or other member communication) to advise members which regulatory notices or documents they will be required to file electronically and the date on which electronic filing will be required. Members will be required to file the specified notices via an electronic, internet-based receiving and processing system accessible through the NASD's web site.
http://www.sec.gov/rules/sro/nasd/2006/34-54654.pdf

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United Kingdom Developments

FSA Publishes Proposals for More Principle-Based Regulation

On October 31, the Financial Services Authority (FSA) published proposals for a radical simplification of its conduct of business rules - the rules that firms must follow in carrying on investment business with customers.

The details are set out in two consultative papers: CP06/19: 'Reforming Conduct of Business Regulation' and CP06/20: 'Financial Promotion and Other Communications'. CP 06/19 also includes proposed amendments to other (non-conduct of business) parts of the FSA rules which are necessary for implementation of the EU Markets in Financial Instrument Directive (MiFID). These papers represent the final parts of FSA consultation for implementation of MiFID. Earlier CPs published this year were CPs 06/9 'Organisational systems and controls – Common platform for firms; 06/14 'Implementing MiFID for Firms and Markets' and 06/15 'Reforming the Approved Persons Regime.'

The reform of the conduct of business rules is a key part of the FSA move towards more principle-based regulation and away from detailed prescriptive rules. The FSA is aiming to remove around half the content of the old rulebook with the end result being a very substantially shorter rule book. The deadline for comments on CP06/19 and CP06/20 is November 28 for MiFID related material and February 23, 2007 for other proposals.
http://www.fsa.gov.uk/pubs/cp/cp06_19.pdf
http://www.fsa.gov.uk/pubs/cp/cp06_20.pdf

FSA Proposes to Encourage the Use of Industry Guidance

On November 1, the Financial Services Authority (FSA) issued a discussion paper in which it sets out proposals to encourage greater use of Industry Guidance as part of its moves towards "more principle-based regulations."

Industry Guidance includes codes of practice and similar statements generated by trade associations and professional bodies to help their members understand and follow good practice in meeting regulatory requirements.

Discussion Paper DP06/5: 'FSA Confirmation of Industry Guidance' sets out the FSA's thinking on the role of Industry Guidance and proposes a standardized process for FSA's recognition of Industry Guidance. It also makes clear the standards that will be applied in recognizing such guidance. The FSA has indicated that it will not take enforcement action against a firm which complies with recognized Industry Guidance covering the issue concerned.
The deadline for comments on DP06/5 is January 31, 2007.
http://www.fsa.gov.uk/pubs/discussion/dp06_05.pdf

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Litigation

Collateral Estoppel Supports SEC's Motion for Summary Judgment

The Securities and Exchange Commission successfully invoked the doctrine of offensive collateral estoppel to support its motion for summary judgment against defendants Grotto and Leffers, the former CEO and CFO of Busybox.com, Inc., a defunct corporation. The SEC claimed that the defendants violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 in connection with Busybox.com's initial public offering by, among other things, knowingly signing and disseminating offering documents to potential investors that they knew contained material misrepresentations. Several years earlier, in a state court action based upon the same alleged misconduct, a private investor won a judgment against Grotto, Leffers and other defendants. The court in that case held the defendants liable for statutory fraud, common law fraud, fraudulent concealment and violations of Section 11 of the Securities Act of 1933. After finding that all of the elements for application of offensive collateral estoppel were met, the Court rejected the defendants' effort to come within the exception to the doctrine that applies when the later action affords the defendant procedural opportunities (e.g., full scale discovery and the right to call witnesses) that were unavailable in the earlier action that could readily lead to a different result. Accordingly, the defendants' effort to relitigate issues necessarily resolved against them in the earlier action was insufficient to prevent the entry of summary judgment in favor of the SEC. (*SEC v. Grotto, 2006 WL 3025878 (S.D.N.Y. Oct. 24, 2006)*)

Fraudulent Change in Ownership of Stock Does Not Establish Rule 10b-5 Violation

Plaintiff corporation asserted violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 in connection with the defendant's allegedly fraudulent acquisition, distribution and sale of stock in the plaintiff company. The gist of the complaint was that the defendant obtained the shares fraudulently (by misrepresenting himself as the sole heir entitled to shares held by his deceased father) and immediately thereafter sought to transfer the shares to seventeen separate entities. After ruling that to meet the "in connection with" requirement of Rule 10b-5 the alleged fraud must "concern the fundamental nature of the securities: namely, characteristics and attributes that would induce [an] investor to buy or sell the particular securities," the Court dismissed the federal securities law claims. Because the alleged fraud concerned the manner in which the defendant obtained possession of already issued shares, it did not concern the fundamental nature of plaintiff's securities and did not occur in connection with the purchase or sale of securities. (P*remier Information Management, Inc. v. Pidgeon, 2006 WL 3051874 (D. Ariz. Oct. 25, 2006))*

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CFTC

CFTC Issues Statement of Policy on Direct Access to Foreign Boards of Trade

The Commodity Futures Trading Commission issued a Statement of Policy (SOP) that affirms the use of the no-action process to authorize foreign boards of trade to grant direct access to their electronic trading systems to their members in the U.S. The CFTC explained that this process gives it the necessary flexibility to consider the various factual indicators of "U.S. presence" and broad discretion to determine whether the foreign exchange and the applicable regulatory regime meet relevant regulatory objectives. In endorsing the no-action process, the CFTC chose not to adopt any of the "objective 'bright line' tests of U.S. location" that had been suggested in connection with the CFTC's earlier public hearing on this matter. *See* 71 Fed. Reg. 30,665 (May 30, 2006). In particular, the CFTC stated that it will not deem either U.S.-originating volume or the nature of an underlying contract to be a "determinative factor" in deciding whether a foreign exchange is "located" in the United States or is a "U.S.-based" exchange. Further, the CFTC will not use the no-action process as a means of addressing competitive issues.

The CFTC also clarified in the SOP that it does not view the transmission of intermediated orders via "automated order routing systems" (AORS) for execution on a foreign exchange to be direct access to that exchange for purposes of the no-action process, since "mere intermediated electronic access by AORS does not create a presence in the U.S." Lastly, the CFTC noted that the SOP is not intended to alter current Commission rules that require any person engaging in the offer or sale of a foreign futures contract or foreign futures option transaction for or on behalf of a U.S. customer to register as a FCM or to operate pursuant to a CFTC Rule 30.10 Order.
http://cftc.gov/foia/fedreg06/foi061102a.htm

CFTC Proposes to Require All FCMs to Become Members of NFA

The Commodity Futures Trading Commission has proposed to expand the scope of CFTC Rule 170.15, which currently requires only persons *required* to be registered as FCMs to become and remain a member of the sole registered futures association, the National Futures Association (NFA). As proposed to be amended, the rule would require any person that is fully registered as an FCM – regardless of whether it is required to be so registered – to become and remain a member of NFA. The proposed amendment would not apply to broker-dealers that are "notice" registered with the CFTC in connection with transactions in single stock futures and other security futures products.

The comment period relating to this proposed amendment closes on December 1.
http://cftc.gov/foia/fedreg06/foi061101a.htm

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