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Corporate and Financial Weekly Digest

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SEC/CORPORATE

Please see "SEC Proposes Revisions to Structured Finance Offering Rules" in **Structured Finance and Securitization** below.

BROKER DEALER

FINRA Issues Guidance on Master Accounts and Sub-Accounts

The Financial Industry Regulatory Authority issued guidance relating to master and sub-account arrangements in Regulatory Notice 10-18. Although FINRA acknowledged that there are bona fide reasons to establish master/sub-account arrangements in certain circumstances (e.g., bona fide investment advisers and omnibus clearing arrangements), FINRA cautioned that certain arrangements raise questions regarding whether the master account and all sub-accounts can legitimately be viewed as one customer account. According to FINRA, where a firm becomes aware of the identities of the beneficial owners of sub-accounts, it may be required to recognize the sub-accounts as separate customer accounts. The Notice sets out certain "red flags" that FINRA believes would put a firm on notice that sub-accounts should not be treated as one single customer account.

Read more.

PRIVATE INVESTMENT FUNDS

Treasury Secretary Recommends That European Commission Maintain Level Regulatory Playing Field

In a letter to UK Chancellor of the Exchequer Alistair Darling, U.S. Treasury Secretary Timothy Geithner expressed his desire that in further considering the Alternative Investment Fund Manager (AIFM) directive, the European Commission consider "our shared commitment to create regulatory reform that does not discriminate against foreign firms and maintains a level playing field." In his letter, Secretary Geithner says that he understands that the AIFM directive currently under discussion would discriminate against third country funds and fund managers (including U.S. funds and fund managers) by denying them the opportunity to access the EU market via a passport approach, and he expressed his hope that this provision be revised to allow non-EU funds, fund managers and global custodians the same access to promote a single market. The letter also highlights the U.S. commitment to strengthen regulation and oversight of hedge funds, legislation recently proposed by the Obama administration and passed by the U.S. House of Representatives requiring certain reporting requirements and registration for all hedge fund managers with assets under management that exceed a modest threshold, and that "our regime will treat all advisors and funds operating in the U.S. equally regardless of their origin—domestic or non-U.S." The letter was also sent to Wolfgang Schauble, Christine Lagarde and Elena Salgado Mendez, the finance ministers to Germany, France and Spain, respectively.

To view the text of the letter, click here.

INVESTMENT COMPANIES AND INVESTMENT ADVISERS

Please see "Treasury Secretary Recommends That European Commission Maintain Level Regulatory Playing Field" in **Private Investment Funds** above.

LITIGATION

Last-Misrepresentation Theory Did Not Render Claims Against All Defendants Timely

In *Take-Two Interactive Software, Inc. v. Brant,* Take-Two Interactive Software, Inc. asserted claims for violations of Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder against four of its former executives who received backdated stock options. Between 1997 and 2003, each of the four defendants allegedly received backdated option grants and signed off on public filings and proxy statements misrepresenting the expenses resulting from the backdating scheme. As a result, Take-Two was forced to restate and lower its earnings by $54.6 million for the period 1997–2005.

The defendants each moved to dismiss, asserting, among other things, that the action, which was originally commenced in July 2006, was untimely. In opposing the motion, Take-Two argued that the misrepresentation-based Section 10(b) claims were timely because misrepresentations concerning the financial impact of the backdated option grants continued into 2005.

The court rejected Take-Two's attempt to utilize a "last-misrepresentation" theory to render timely all of the defendants' alleged misrepresentations, finding that such a theory could not be used against all defendants because the statements were not made by a single entity or by "a static group of speakers acting in concert." In particular, the court noted that certain of the defendants were only affiliated with Take-Two for a short time and that by 2005, when the last misrepresentation allegedly was made, they had all ceased to be associated with Take-Two. The court did, however, deny the motion to dismiss with respect to two defendants whose misrepresentations were alleged to have continued into the period covered by the statute of repose, choosing instead to allow the parties to develop the record before it ruled on the viability of the last-misrepresentation theory with respect to Section 10(b) claims. (*Take-Two Interactive Software, Inc. v. Brant*, No. 06 Civ. 05279 (LTS), 2010 WL 1257351 (S.D.N.Y. March 31, 2010))

Misrepresentations Allegedly Made After Sale Held Insufficient to Sustain Securities Fraud Claim

The district court for the Eastern District of New York recently dismissed claims of securities fraud brought by a *pro se* plaintiff under Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder.

In 2003, plaintiff Robert Wilson and defendants Frank and Roy Dalene entered into an agreement to create a construction service company through the implementation of a "roll-up strategy" through Hamptons Luxury Homes, Inc. (HLH), which Wilson had controlled. Although the Dalenes initially appeared to be pursuing the roll-up strategy crafted by plaintiff, they later decided not to pursue the roll-up strategy because of, among other things, the change in economic conditions. The complaint alleged numerous misrepresentations made by the Dalenes and HLH beginning in 2006 and continuing through 2009.

The court held that the alleged misrepresentations, in addition to being insufficiently particular, could not sustain a claim of securities fraud because they were made years after the issuance of stock to the Dalenes and thus were not made in connection with the purchase or sale of a security. In so holding, the court pointed out that any decision to refrain from buying or selling securities could not "give rise to an actionable claim under Section 10(b)." (*Wilson v. Dalene*, No. 09 Civ. 1394 (JFB), 2010 WL 1189558 (E.D.N.Y. Mar. 29 2010))

Correction: The article "Amended SEC Claims Against Internet Media Executives Sustained" in the April 2 edition of *Corporate and Financial Weekly Digest* summarized a recent decision by the U.S. District Court for the Southern District of New York sustaining, in substantial part, an amended complaint by the Securities and Exchange Commission against the senior executives of StarMedia Network, Inc., an Internet portal targeting Spanish- and Portuguese-speaking markets. The article erroneously indicated that the SEC's amended complaint included allegations that StarMedia's CEO and President each had actual knowledge regarding a particular sales transaction in which a buyer had the right to pay only a small percentage of the purchase price if the buyer was dissatisfied with StarMedia's services. The article should have stated that the SEC's amended complaint alleged that three of StarMedia's senior and/or executive vice-presidents, and not the CEO and President, had actual knowledge regarding this contingent transaction. (*Securities and Exchange Commission v. Espuelas*, No. 06 Civ. 2435, 2010 WL 1170664 (S.D.N.Y. March 26, 2010))

BANKING

FDIC Sells Equity Interest in Loans

On April 1, the Federal Deposit Insurance Corporation (FDIC) closed the sale of an equity interest in a limited liability company (LLC) created to hold certain assets transferred from 19 failed bank receiverships. The purchaser of the interest in the Multibank Structured Transaction Single Family Residential 2010-1 is Roundpoint Mortgage Servicing Corporation (Roundpoint). The sale was the result of a competitive auction held on February 24. Nine different qualified groups submitted bids, and the winning bid was submitted on the leveraged ownership interest whereby Roundpoint will hold 50% of the equity interest and the FDIC will hold the remaining 50% in its receivership capacity.

The FDIC will share in the returns on the assets owned by the LLC, but the interests in the LLC may be adjusted based on the performance of the mortgage loans. The loans have an unpaid principal balance of approximately $490 million, and approximately 80% of the collateral of the portfolio is located in Florida, Georgia and Arizona.

The bid for the interest was determined to be the offer that resulted in the greatest return to the participating receiverships. All of the loans contributed to the portfolio came from banks that had failed between August 2008 and March 2009.

For more information, click here.

STRUCTURED FINANCE AND SECURITIZATION

SEC Proposes Revisions to Structured Finance Offering Rules

On April 7, the Securities and Exchange Commission announced at its Open Meeting the release of proposed changes to rules surrounding public and private asset-backed securities (ABS) offerings.

Disclosure

The SEC is proposing to revise Regulation AB, which currently requires disclosure of material, aggregate information about the composition and characteristics of asset pools, to provide additional disclosure requirements for ABS offerings. For each loan or asset in the asset pool, the SEC is proposing to require disclosure of specified data relating to the terms of the asset, obligor characteristics and underwriting of the asset. Such data would be provided in a computer-readable, standardized format. Issuers would be required to provide the asset-level data or grouped account data at the time of securitization, when new assets are added to the pool underlying the securities, and on an ongoing basis. The revised rules would also require:

- the filing of a computer program of the contractual cash flow provisions of the securities;
- aggregated and loan-level data relating to the type and amount of assets that do not meet the underwriting criteria that is specified in the prospectus;
- for certain identified originators, information relating to the amount of the originator's publicly securitized assets that, in the last three years, has been the subject of a demand to repurchase or replace;
- for the sponsor, information relating to the amount of publicly securitized assets sold by the sponsor that, in the last three years, has been the subject of a demand to repurchase or replace;
- additional information regarding originators and sponsors;
- descriptions relating to static pool information, such as a description of the methodology used in determining or calculating the characteristics of the pool performance as well as any terms or abbreviations used;
- that static pool information for amortizing asset pools comply with the Item 1100(b) of Regulation AB requirements for the presentation of historical delinquency and loss information; and
- the filing of Form 8-K for a 1% or more change in any material pool characteristic from what is described in the prospectus (rather than for a 5% or more change, as currently required).

Shelf Offerings

Under current rules, asset-backed securities may be registered on a Form S-3 registration statement and later offered "off the shelf" if the securities are rated investment grade by a nationally recognized statistical rating organization. In recognition that investors may in the past have unduly relied on ratings, the proposed rules would eliminate the credit rating requirement and require the following for shelf registration:

- a certification filed at the time of each offering off a shelf registration statement by the chief executive officer of the depositor that the assets in the pool have characteristics that provide a reasonable basis to believe that they will produce, taking into account internal credit enhancements, cash flows to service any payments due and payable on the securities as described in the prospectus;
- retention by the sponsor of a proposed 5% of each tranche of the securitization;
- a provision in the pooling and servicing agreement that requires the party obligated to repurchase the assets for breach of representations and warranties to periodically furnish an opinion of an independent third party regarding whether the obligated party acted consistently with the terms of the pooling and servicing agreement with respect to any loans that the trustee put back to the obligated party for violation of representations and warranties and which were not repurchased; and
- an undertaking by the issuer to file Securities Exchange Act reports so long as non-affiliates of the depositor hold any securities that were sold in registered transactions backed by the same pool of assets.

To give investors more time to consider transactions, the SEC is proposing to revise the filing deadlines applicable to shelf offerings. An ABS issuer would be required to file a preliminary prospectus with the SEC for each takedown off the shelf at least five business days prior to the first sale in the offering.

Privately Issued Structured Finance Products

In order to enhance the disclosure available to investors participating in private offerings of asset-backed securities, the SEC is proposing amendments to Rule 144A and Regulation D. The proposed revisions would require that, in order for a reseller of a "structured finance product" to sell a security in reliance on Rule 144A, or in order for an issuer of a "structured finance product" to sell a security in reliance on Rule 506 of Regulation D, (1) the underlying transaction agreement for the securities must grant to purchasers or the holders of the securities (or prospective purchasers designated by the holder) the right to obtain from the issuer of such securities the information, upon request, that would be required if the transaction were registered under the Securities Act and such ongoing information as would be required by Section 15(d) of the Securities Exchange Act if the issuer were required to file reports under that section, and (2) the issuer must represent that it will provide such information.

Please click here for the SEC proposals.

EXECUTIVE COMPENSATION AND ERISA

Health Care Reform Legislation Provides a Surprise to Large Employer VEBAs

The Patient Protection and Affordable Care Act (the Act), as amended by the Health Care and Education Reconciliation Act of 2010 (the Reconciliation Act), promises to provide dramatic changes in the availability, delivery and funding of health care in the United States. Many other provisions that will impact employers and delivery vehicles have not yet received much attention.

One such provision is Section 1406 of the Reconciliation Act, which amended Sections 9010 and 10905 of the Act. These sections collectively impose an annual fee upon "health insurance providers." The fee commences in 2014 in the aggregate amount of $8 billion, increases to $14.3 billion in 2018 and escalates thereafter. The fee is assessed annually upon all providers based upon their proportionate amount of aggregate "net premiums written" in excess of $25 million.

The Act provides exclusions in the case of "(A) any employer to the extent that such employer self-insures its employees' health risks," and "(B) any governmental entity (except to the extent such an entity provides health insurance coverage through the community health insurance option)."

There is no such blanket exclusion provided in the case of voluntary employees' beneficiary associations, typically referred to as "VEBAs" described in Section 501(c)(9) of the Internal Revenue Code. Instead, in the Reconciliation Act Congress enacted a very limited exclusion for VEBAs: "(D) any entity which is described in section 501(c)(9) of such Code and which is established by an entity (other than by an employer or employers) for purposes of providing health care benefits."

As a result, VEBAs established by trade associations or through specific legislation or bankruptcy orders appear to be excluded from the annual fee imposed upon "health insurance providers." But the typical arrangement, whereby a large employer provides its employee health insurance benefits through its own VEBA, appears to be subject to the annual fee.

The Patient Protection and Affordable Care Act can be found here.
The full text of the Reconciliation Act, including Section 1406, can be found here.
Click here to read "Health Reform Legislation Affects Large and Small Employees" in the March 26 edition of *Corporate and Financial Weekly Digest*.

UK DEVELOPMENTS

HFSB Publishes Revised Best Practice Standards

On April 1, the Hedge Fund Standards Board (HFSB) published a revised version of its Best Practice Standards for hedge funds. The HFSB was set up to act as custodian of the Best Practice Standards published by the Hedge Fund Working Group in 2008 and to promote conformity to those Standards. It is also responsible for ensuring that the Standards are amended and updated as appropriate in light of market and other developments. Over 50 hedge fund managers have so far signed up to the Standards, accounting for, in total, over $215 billion in assets under management.

The HFSB had consulted in July 2009 about proposed revisions to the Standards in the areas of disclosure of exit terms and independent administration and safekeeping. As a result, amendments have been made to Standard 2 (commercial terms disclosure) and by introducing a new Standard 17a (operational risk—governance standards and guidance).

The revised Standards will come into effect on August 1. Accordingly, HFSB signatories will need to revisit and adapt their disclosure statements in light of the amendments where necessary.

To read the updated Standards in full, click here.

FSA Consults on Enhancing Client Asset Protection

The UK Financial Services Authority (FSA) has published a consultation paper on enhancing its Client Assets rules—the CASS sourcebook. Issues arising from the administration of Lehman Brothers' London affiliates and other issues which have arisen since mid-2008 have highlighted a number of areas where the FSA considers that investor protection aspects of CASS need to be strengthened. The FSA has engaged in pre-consultation with regulated firms over a period of nearly 18 months, and it has also included proposals based on the UK Treasury's 2009 consultation relating to effective resolution arrangements for investment banks.

The proposals in the consultation paper include the following:

- Increasing rehypothecation transparency and disclosure to prime brokerage clients, requiring prime brokerage agreements to contain a disclosure annex highlighting contractual rehypothecation provisions. The FSA also proposes to require daily reporting on client money and assets holdings to all prime brokerage clients so that they will know which of their assets, if any, have been rehypothecated.
- Restricting the use of group company banks for client money bank accounts to 20% of the firm's total client money so as to reduce the exposure to group credit risk.
- Prohibiting the use of general liens in custodian agreements. The FSA objects to client assets held with a custodian being subject to a lien due to the debt to the custodian arising from unrelated business of a group entity of the customer to the relevant custodian.
- Creating a new significant influence controlled function within regulated firms holding responsibility for oversight and protection of client assets and money.
- Requiring a client money and asset return, which will be reviewed and authorized on a monthly basis for medium and large regulated firms and twice annually for small regulated firms.

Some of these proposals are subject to discussions with the European Commission. The deadline for receiving comments on the proposals has been set at June 30. The FSA has identified the work on strengthening its client assets regime as a priority and expects to finalize the revised CASS rules during the third quarter of this year.

To read the consultation paper in full, click here.

More FSA Criminal Insider Dealing Cases

The UK Financial Services Authority (FSA) has continued to use its criminal prosecution powers against insider dealing. On March 31 it announced that seven men had been charged with criminal conspiracy to deal on inside information—one of the accused was also charged with money laundering. These charges follow arrests which took place in July 2008.

The charges against the seven men relate to trading in the shares of 12 companies between May 1, 2006, and May 31, 2008. The companies were all takeover targets during this period and were advised by one of two London investment banks. Two of the men charged worked in the print rooms of those investment banks, where they could have had access to confidential price-sensitive information about takeover bids. The investment banks are not themselves the subject of the FSA's investigation.

To read more, click here.

In an unconnected development, the FSA had announced on March 23 the arrests of six men including senior professionals at leading investment banks and a hedge fund on suspicion of being involved in what the FSA described as "a sophisticated and long-running insider dealing ring" and the FSA's largest-ever operation against insider dealing. The arrests (the fifth set of FSA insider dealing arrests since the first use of its criminal powers in 2008) resulted in the first joint arrests between the FSA and the Serious Organised Crime Agency. The joint investigation commenced in late 2007.

To read more, click here.

FSA Announces Fines Totalling £4.2 Million for Transaction Reporting Failures

On April 8, the UK Financial Services Authority (FSA) announced that it had fined three firms (a bank, a market maker trading on electronic markets and an agency broker) a total of £4.2 million (approximately $6.4 million) for multiple breaches that resulted in failures to provide transaction reports promptly and correctly to the FSA.

The FSA found that each of the three firms could have prevented the rule breaches by carrying out regular reviews of its data. Despite repeated reminders from the FSA during the course of 2007 and 2008, none of the firms did this. Firms are required to have systems and controls in place to ensure they submit accurate data for reportable transactions by close of business the day after a trade is executed.

The FSA's Director of Markets said, "Firms and their management must ensure they implement and operate systems and controls that are able to ensure quality transaction reporting. The standard of regulatory reporting by these firms fell far short of what the FSA expects and requires."

To read more, click here.

EU DEVELOPMENTS

CESR Publishes Call for Evidence on European Equity Market Issues

On April 1, the Committee of European Securities Regulators (CESR) published a Call for Evidence on micro-structural issues of the European equity market. Its reason for so doing is that there have been a number of technology-driven developments since CESR last evaluated the impact of the Markets in Financial Instruments Directive (MiFID) on the European equity markets in early 2009, particularly in the areas of high frequency trading, sponsored access and co-location.

CESR now wish to assess these developments in greater depth due to their potential effect on the structure and efficiency of the European equity markets. To assist this process, CESR is undertaking this evidence collecting exercise, seeking information on the following issues:

- High frequency trading
- Sponsored access
- Co-location services
- Fee structures
- Tick size regimes
- Indications of interest

The Call for Evidence takes the form of a number of questions to which CESR invites interested parties to submit responses as well as addressing any related micro-structural issues that respondents consider that CESR should address. Responses are required to be submitted via CESR's website by April 30.

To read the Call for Evidence in full, click here.

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