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Corporate and Financial Weekly Digest

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Please note that *Corporate and Financial Weekly Digest* will not be published September 4. The next issue will be distributed September 11.

SEC/CORPORATE

SEC Issues Guidance on FASB Accounting Standards Codification

On August 18, the Securities and Exchange Commission issued interpretive guidance addressing the effect of the transition to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles (Codification), upon the SEC's rules, regulations, releases and staff bulletins. The guidance states that all references to specific pre-Codification GAAP standards in the SEC's rules, releases and staff bulletins, including Regulation S-X, should be understood to mean the corresponding references under the Codification. In particular, the SEC is directing users to the cross-reference finding tool in the subscription version of the Codification which matches prior GAAP standards to their new Codification references. In the future, the SEC intends to embark on a long-term initiative to revise and update its rules and staff guidance to refer to the Codification.

The FASB adopted the Codification, which supersedes all existing U.S. GAAP standards previously issued by the FASB and other accounting standard-setters, in June 2009, although it has been available for review since January 2008. Along with SEC rules and regulations, the Codification will serve as the primary source of authoritative GAAP principles in the United States. The Codification, which is effective for all financial statements issued for interim and annual periods ending after September 15, incorporates and reorganizes prior GAAP standards but does not create new accounting and reporting guidance.

In its June and August meetings with the SEC Regulations Committee of the Center for Audit Quality, the SEC staff affirmed its stance that all citations of GAAP standards in financial statements for financial statement periods ending after September 15 should use new Codification references. The SEC staff has also stated that companies are not expected to revise or amend financial statements for periods ending prior to September 15 which refer to pre-Codification GAAP literature, even if such financial statements are incorporated by reference into future registration statements.

Click here to read the SEC's guidance regarding the transition to the Codification.
Additionally, click here to read the free access portions of the Codification.

LITIGATION

D.C. Circuit Holds Limited Partnership Units to Be Securities

The plaintiffs, successors in interest to a publicly traded real estate investment trust (REIT) and its affiliated limited partnership (LP), appealed the dismissal of their complaint which asserted claims arising under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The REIT and LP were established by the defendants, who consisted of a real estate development corporation and two of its corporate officers. The two officers collectively "owned over 9% of the [REIT], were trustees, and held executive positions within the [REIT]."

Defendants caused the defendant corporation to transfer its rights in a real estate development "professional services agreement" with a Florida municipality (the Contract) in exchange for a substantial number of limited partnership interests in the LP. Plaintiffs' securities law claim alleged that defendants wrongfully withheld material information concerning the true value of the Contract in connection with the transaction. Specifically, plaintiffs alleged that defendants failed to disclose that they had engaged a commissioner of the Florida municipality as a consultant notwithstanding provisions in the Contract that appeared to prohibit such an engagement. Plaintiffs filed

the lawsuit after the commissioner pled guilty to accepting bribes in unrelated transactions, which led to the municipality providing notice of its intention to terminate the Contract.

The District Court dismissed the federal securities laws claims, ruling that the limited partnership interests issued to the defendant corporation should not be considered securities because “the same parties stand on both sides of the transaction.” The District Court found that (i) the individual defendants, who owned 100% of the defendant corporation, were integrally involved in the REIT’s management and possessed ownership interests in the REIT, and (ii) that the REIT owned 88% of the LP’s limited partnership interests and was its general partner. Based on these findings, the District Court ruled that defendants could not be liable under the federal securities claims because plaintiffs’ claims, in essence, charged defendants with failing to disclose material information *to themselves* in connection with the exchange of the Contract for limited partnership interests.

The appellate court reversed, ruling that the District Court’s analysis unacceptably “pierced two corporate veils” by disregarding the formal structure of both the defendant corporation and the LP in determining that the defendants themselves were on both sides of the transaction. After finding that the defendants had chosen to take advantage of the corporate form to purchase the LP interests, the appellate court ruled that defendants “may not disregard that form to avoid liability for the same transaction.” Having made that ruling, the appellate court then held that the limited partnership units were “securities” under *SEC v. W.J. Howey* and its progeny because they were investments in an enterprise in which profits were expected to be generated predominantly by the efforts of others. (*Limited Property Trust v. Republic Properties Corp.*, 2009 WL 2568102 (D.C. Cir. Aug. 21, 2009))

Ninth Circuit Affirms Conviction for Participation in Backdating Scheme

The defendant Vice President of Human Resources (Jensen) appealed her conviction for falsifying corporate books and records in willful violation of the federal securities laws based upon her participation in a stock option backdating scheme used to compensate employees. Jensen’s conviction, along with that of the company’s former CEO, represented the first criminal convictions for backdating practices that were once, according to the appellate court, widespread, particularly in Silicon Valley, where the defendant’s company was located. (The ex-CEO’s conviction was reversed and remanded to the District Court for a new trial due to prosecutorial misconduct.)

The principal issue at Jensen’s trial was whether she possessed criminal intent. The District Court rejected Jensen’s request for an instruction that would have required the jury to find that she knew what law she was violating in order to find that she had the requisite intent. Instead, the District Court instructed the jury that it must find that the government proved Jensen acted with knowledge that her falsification of records was “wrongful” in order to find that she had acted “willfully” and, thus, with the requisite intent to support the criminal claim asserted against her.

Citing to precedent and legislative history that specifically foreclosed the defendant’s interpretation of the “willfulness” requirement, the appellate court affirmed the conviction, reiterating that a willful falsification does not require knowledge of a specific law being violated, but only that the defendant knowingly committed the act of falsification. In making its ruling, the Court further held that there was no different or higher standard applicable when the violation alleged was of a federal securities law. (*United States v. Reyes*, 2009 WL 2501920 (9th Cir. Aug. 18, 2009))

BROKER DEALER

SEC Approves Unsolicited Customer Order Exception Amendments

The Securities and Exchange Commission has approved Financial Industry Regulatory Authority amendments relating to the recordkeeping requirements for firms claiming the unsolicited customer order exception to Rule 15c2-11 of the Securities Exchange Act of 1934, as amended. The amendments become effective September 21.

Rule 15c2-11 prohibits a broker-dealer from publishing or submitting for publication a quotation for a covered over-the-counter equity security unless the broker-dealer has obtained and reviewed accurate and reliable current information about the issuer of the security. Rule 15c2-11(f)(2) excepts from this requirement quotations that represent a customer’s unsolicited order or indication of interest (the unsolicited customer order exception). In light of FINRA’s findings that some firms relying on the unsolicited customer order exception have been unable to produce any proof that a quote in fact represented a customer’s unsolicited order or indication of interest, Rule 15c2-11(f)(2) has been amended to promote more uniform recordkeeping and compliance with the exception. Among other things, the amendments require that firms record certain customer and order information contemporaneously with the receipt of any unsolicited customer order or indication of interest, including the identity of the associated person (if applicable) at the receiving firm, the identity of the customer and the date, time

and terms of the unsolicited customer order or indication of interest. In addition, FINRA has amended FINRA Rule 6540 (requirements applicable to market makers), which will require FINRA members to demonstrate compliance with, or qualify for an exception or exemption from, Rule 15c2-11.

Click here to read FINRA Regulatory Notice 09-51.

FINRA Reminds Alternative Trading Systems of Their Reporting Obligations

The Financial Industry Regulatory Authority has issued Regulatory Notice 09-46 reminding alternative trading system firms or firms operating alternative trading systems that in addition to filing reports with the Securities and Exchange Commission as required by Regulation ATS of the Securities Exchange Act of 1934, as amended, they must simultaneously file duplicate copies of most of these reports with FINRA. Rule 301(b)(2) of Regulation ATS requires alternative trading systems to file an initial operation report, necessary amendments and cessation of operations reports on Form ATS within specified time frames.

Click here to read FINRA Regulatory Notice 09-46.

NYSE Issues Memo on Questioned Trade Resolution During Comparison of Executed Transactions

On August 14, NYSE Regulation, Inc. issued an Information Memo regarding the procedures related to questioned trade resolution during comparison of executed transactions pursuant to Rules 134 of the New York Stock Exchange, LLC (NYSE) and NYSE Amex LLC (NYSE Amex). The questioned trade resolution process, governed by NYSE and NYSE Amex Rules 134, requires that clearing member organizations resolve any trades that have not been successfully compared by the first business day after the trade date (T+1). NYSE and NYSE Amex Rules 134 were amended on May 28 to clarify that, depending on the trade, the exchanges will assign a clearing firm or a designated market making unit as the contra side to an imbalance in any omnibus account that is used by the On-Line Comparison System. The assignment of a default contra side will allow the omnibus accounts to balance while any open trade or imbalance is researched and resolved subsequent to the second day after the trade.

Click here to read Information Memo 09-41.

CFTC

CFTC Seeks Comments on Request by North American Derivatives Exchange for Amended DCO and DCM Orders

The Commodity Futures Trading Commission has requested public comment on the application of the North American Derivatives Exchange (Nadex) (formerly known as HedgeStreet) for an amendment to the CFTC orders designating Nadex as a derivatives clearing organization and a designated contract market. Nadex is requesting the amendments to allow intermediated trading on the exchange by customers through registered futures commission merchants in addition to the currently permitted non-intermediated trading. Nadex lists and clears simplified derivative contracts on a variety of equity index, commodity and currency products, as well as binary options on certain financial events.

The comment period closes September 21.

The CFTC press release is available here. The Nadex request letter is available here.

BANKING

Agencies Seek Comment on Proposed Regulatory Capital Standards Related to Financial Accounting Standards No. 166 and 167

On August 26, the federal banking and thrift regulatory agencies announced that they are seeking comment on a proposed regulatory capital rule related to the Financial Accounting Standards Board's (FASB's) adoption of Statements of Financial Accounting Standards Nos. 166 and 167. Beginning in 2010, these accounting standards will make substantive changes to how banking organizations account for many items, including securitized assets, that are currently excluded from these organizations' balance sheets. On June 12, FASB finalized modifications to FAS 140 and FIN 46(R) (the 2009 GAAP modifications) through Statement of Financial Accounting Standards No. 166, Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140 (FAS 166) and Statement of Financial Accounting Standards No. 167, Amendments to FASB Interpretation No. 46(R) (FAS 167).

FAS 166 and FAS 167 are effective for the first annual financial statement reporting periods that begin after November 15 and for interim and annual periods thereafter.

The 2009 GAAP modifications, among other things, remove the concept of a Qualified Special Purpose Entity from GAAP and alter the consolidation analysis for Variable Interest Entities (VIEs), thereby subjecting many VIEs that are not consolidated under current GAAP standards to consolidation requirements. These changes will require some banking organizations to consolidate the assets, liabilities, and equity of certain VIEs onto their balance sheets for financial and regulatory reporting purposes.

Banking organizations affected by the new accounting standards generally will be subject to higher minimum regulatory capital requirements. The agencies' proposal seeks comment and supporting data on whether a phase-in of the increase in regulatory capital requirements is needed. It also seeks comment and supporting data on the features and characteristics of transactions that, although consolidated under the new accounting standards, might merit an alternative capital treatment, as well as on the potential impact of the new accounting standards on lending, provisioning and other activities.

Read more.

FDIC Issues New Policy Statement on Distressed Acquisitions

On August 26, the Federal Deposit Insurance Corporation (FDIC) issued its long-awaited final policy statement on corporate acquisitions of failed institutions. The final policy statement was issued by the FDIC after its proposed policy statement, issued on July 9, was the subject of criticism by potential investors for creating an unlevel playing field vis-à-vis banks and holding companies. Particularly criticized were requirements in the proposal that new investors wishing to purchase a failed bank from the FDIC put up 15% Tier 1 capital for a period of three years, that investing companies serve as a "source of strength" to the institution acquired, and that any investor with a majority interest in an acquired institution that owned another institution cross-guarantee, via a pledge of stock, their interest in each institution to cover losses to the Deposit Insurance Fund caused by the failure of such insured depository institution.

In the final policy statement, the Tier 1 requirement was lowered to 10% Tier 1 capital for three years, the source of strength requirement was removed, and the cross-guarantee trigger was raised to 80% instead of a majority ownership requirement. Other notable requirements include the following:

- After application, the policy statement will no longer apply to an institution that has maintained a Camels rating of 1 or 2 for seven years.
- The policy statement will not apply to holding companies with a strong track record of successful institution management.
- The policy statement will not apply to investors that own 5% or less of the voting power of the company.
- All extensions of credit to investors will be prohibited.
- Investors utilizing entities that are domiciled in bank secrecy jurisdictions will not be eligible to own a direct or indirect interest in an insured depository institution unless they are otherwise subject to comprehensive consolidated supervision.
- Investors will be prohibited from selling or otherwise transferring their securities for a three-year period.
- Complex and functionally opaque ownership structures (known as Silos) will be unacceptable.

The final policy statement was reportedly a compromise between Comptroller of the Currency John Dugan and Office of Thrift Supervision Acting Director John Bowman, on the one hand, who argued that new investors should not be unduly penalized compared to other potential acquirers, and other members of the FDIC board, including Chair Sheila Bair, who favored tighter controls given a lack of supervisory history with new entrants into the industry.

It remains to be seen whether the final policy statement will induce significant new investment in failed institutions, or whether potential entrants will seek higher returns elsewhere.

Read more.

Enhanced Supervisory Procedures for Newly and Recently Insured FDIC-Supervised Depository Institutions

Today, the Federal Deposit Insurance Corporation (FDIC) advised the banking industry of supervisory changes for state nonmember institutions insured seven years or less (de novo period). Under current policy, newly insured institutions are subject to higher capital requirements and more frequent examination activities during the first

three years of operation. Based on supervisory experience, the FDIC announced it will now extend the de novo period from the current three-year period to seven years for examinations, capital, and other requirements. During the seven-year de novo period, these institutions will remain on a 12-month risk management examination cycle and be subject to enhanced supervision for Compliance examinations and Community Reinvestment Act evaluations. In addition, material changes in business plans for newly insured institutions will require prior FDIC approval during the first seven years of operation. De novo institutions that are subsidiaries of existing "eligible" holding companies generally will be excluded from these procedures.

Read more.

STRUCTURED FINANCE AND SECURITIZATION

Please see "Agencies Seek Comment on Proposed Regulatory Capital Standards Related to Financial Accounting Standards No. 166 and 167" in **Banking** above.

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