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Corporate and Financial Weekly Digest

May 16, 2008

A Note from the Editor

In light of the Memorial Day holiday, please note that *Corporate and Financial Weekly Digest* will not be published next Friday, May 23. The next issue will be distributed on May 30.

SEC/Corporate

SEC Votes to Propose Interactive Technology for Financial Statements

On May 14, the Securities and Exchange Commission voted unanimously to propose rules requiring issuers to utilize interactive technology in their SEC reports. These rules would require issuers to file a new exhibit with their annual, quarterly and transition reports and registration statements in the Extensible Business Reporting Language, or XBRL, which would supplement, rather than replace, the current ASCII and HTML filing formats.

The proposed rules would require companies to provide the SEC with "tagged" financial statements, using labels from a standard list. This interactive data would uniquely identify individual items in an issuer's financial statements, notes and schedules so they could easily be searched on the Internet, downloaded into spreadsheets, reorganized in databases or employed in any number of comparative or analytical tools used by investors and analysts. SEC Chairman Christopher Cox noted that XBRL would "replace the current time-consuming methods involved in retrieving corporate shareholder information and put that information at the fingertips of each investor within seconds, exactly as they wish to see it."

The rule proposal recommends a three-year phase-in schedule for XBRL requirements. If the SEC were to adopt the proposed rules this fall, they would apply to domestic and foreign large accelerated filers that use U.S. Generally Accepted Accounting Principles (GAAP) and have a worldwide public float above $5 billion, beginning with fiscal periods ending on or after December 15, 2008. In the second year of the phase-in, all other domestic and foreign large accelerated filers using U.S. GAAP would be subject to interactive data reporting. In the third year of the phase-in all remaining filers using U.S. GAAP, including smaller reporting companies, and all foreign private issuers that prepared their financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board would be subject to the interactive data reporting requirements.

http://www.sec.gov/news/press/2008/2008-85.htm

SEC/CORPORATE

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Securities Fraud Claims Based Upon Backdating Stock Options Partly Dismissed

The Securities and Exchange Commission filed suit alleging that the defendant violated various securities laws, including § 10(b) of the Securities Exchange Act and Rule 10b-5, by masterminding stock option backdating schemes that she devised for two companies at which she had worked as General Counsel. The SEC alleged that as a result of the scheme the companies issued false and misleading financial statements that understated hundreds of millions of dollars of stock option compensation expenses. The SEC asserted that defendant should be held liable because she had reviewed, discussed and, on one occasion, finalized the companies' annual and quarterly reports. Defendant moved to dismiss on a variety of grounds, including that claims relating to one of the companies were time barred and that none of the claims adequately pleaded Rule 10b-5 liability.

The court noted that the applicable five-year limitations period applied only to claims seeking "punitive" relief and did not bar claims seeking equitable or remedial relief and, accordingly, ruled that the SEC's request for disgorgement and to enjoin the defendant from serving as an officer/director of a public company were not subject to the statute. The court also noted that the limitations period would be subject to "equitable tolling" if the defendant's conduct concealed operative facts and the SEC had acted diligently before ultimately discovering such facts. The court then dismissed the SEC's "civil penalties" claim as time barred but granted leave to amend to allege facts that would support an "equitable tolling" of the limitations period with respect to such claim.

With respect to the Rule 10b-5 claim, the court gave to the defendant with one hand, but took away with the other. It agreed with the defendant that allegations that the defendant had reviewed, discussed and finalized publicly filed documents that allegedly contained false information were insufficient to establish that defendant herself had made any material misrepresentations. However, the court ruled that the SEC had sufficiently alleged defendant's participation in a "scheme to defraud" in violation of Rule 10b-5, finding that such a violation did not require the defendant to make any false statements but merely to have made a deceptive contribution to a fraudulent scheme. The Court held that the SEC's allegations of defendant's falsification of documents in connection with the stock option grants satisfied this requirement. (*S.E.C. v. Berry*, 2008 WL 2002537 (N.D. Cal. May 7, 2008))

Investment Adviser Owes Duty Only to Hedge Fund, Not to Hedge Fund Investors

The Securities and Exchange Commission sued the investment adviser of two hedge funds for, among other things, violation of the anti-fraud provisions of the Investment Advisers Act. The SEC alleged that the investment adviser had failed to disclose to investors in the hedge funds, among other things, his difficulty receiving information from a company to whom the adviser had transferred a substantial amount of the hedge funds' assets, that the same company was "in dire straights" and that its chief executive had recently been arrested for investment adviser fraud.

The investment adviser moved for summary judgment dismissing the Investment Advisers Act claims, arguing that he owed no duties under the Act to the hedge fund investors. The court agreed. It first ruled that the investment adviser owed fiduciary duties to the hedge funds themselves, but not to the hedge fund investors. The Court then rejected the SEC's effort to side-step this

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barrier by alleging that the failure to disclose material information to the hedge fund investors constituted a breach of the adviser's fiduciary duties to the hedge fund. (*S.E.C. v. Northshore Asset Management*, 208 WL 1968299 (S.D.N.Y. May 5, 2008))

Broker Dealer

SEC Approves NSCC Hedge Fund Settlement Service

On May 12, the Securities and Exchange Commission approved a proposal by the National Securities Clearing Corporation (NSCC) to establish an Alternative Investment Products Service (AIP Service), a processing platform for hedge funds, funds of hedge funds, commodity pools, managed futures, and Real Estate Investment Trusts. The AIP Service is the result of an industry task force that worked with the NSCC in the development stages. Membership in the AIP Service is open to (i) SEC registered and foreign brokers, (ii) domestic and foreign banks, (iii) domestic and foreign insurance companies, (iv) hedge funds and funds of hedge funds, (v) SEC registered and unregistered investment advisers, (vi) Commodity Futures Trading Commission registered and exempt commodity pool operators and commodity trading advisers, (vii) hedge fund administrators, and (viii) others that the NSCC deems will benefit from the service. The service will handle subscriptions, tenders and redemption, dividend and distributions, commissions and fees, position reporting, product information, account maintenance, and automated transmission of imaged documents, e.g., pdfs. Settlements must be prefunded and will be paid on a gross basis—no netting of debits against credits. The NSCC will not guarantee any payment, and no AIP Service participant will have to make a deposit to the NSCC guaranty fund.

http://www.sec.gov/rules/sro/nscc/2008/34-57813.pdf

SEC Director Erik Sirri Discusses the Options Markets

Erik Sirri, Director of the Securities and Exchange Commission's Trading and Markets Division, recently addressed current developments in the options markets in his remarks to the 2008 Options Industry Conference in Las Vegas. Sirri noted that institutional participation in the options markets, including hedge funds and mutual funds, has been growing over time, and that these new market participants have brought new trading strategies and needs to the marketplace. In light of new markets, new participants and regulatory developments, adaptation and innovation in the trading and business models of the exchanges and options markets participants will, in Sirri's opinion, be required.

Sirri covered several hot options markets topics, including:

- Penny Pilot. The ability to *quote*, as well as trade, certain options in penny and nickel increments started in January 2007 with the Penny Pilot, and has been expanded twice to include over 50% of total options trading volume.

- Maker-Taker Fees. Several exchanges now charge transaction fees to anyone who "takes" liquidity and pays those who "add" liquidity. This fee structure has resulted in a shift from the model in which customers have priority and generally are not charged transaction fees. Sirri noted this model exists among markets that trade stocks.

- Linkage. A proposed new linkage plan filed by the Chicago Board Options Exchange, International Securities Exchange and New York Stock Exchange Arca would allow market participants to use Intermarket Sweep Orders, which would allow a market participant to

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sweep down liquidity on one market so long as it simultaneously attempts to take out better priced interest at the top of book on other markets.

- Undisplayed Liquidity. Though it is undisputed that finer quoting increments reduce the displayed depth at the top of book, undisplayed liquidity is harder to measure but, nevertheless, is an important source of liquidity. The SEC recognizes this is a fact of life and it will not now seek display of these interests.

- Portfolio Margining. Self-Regulatory Organization rules have expanded the ability of broker-dealers to determine customer margin requirements using a portfolio margin methodology. Firms have, thus far, limited portfolio margin methodology to their most sophisticated customers, but Sirri hopes to see it more widely available in the future.

- Execution Quality Disclosure. Options customers and order routers need and deserve the transparency tools that will enable them to assess whether there are material differences in execution quality at different option markets and to act accordingly. Sirri urged the options exchanges to develop and make public execution quality reports that contain statistics that illuminate the critical issues for effective order routing.

http://www.sec.gov/news/speech/2008/spch050208ers.htm

SEC Director Erik Sirri Addresses Maximizing Liquidity in the U.S. Equity Markets

On May 9, Erik Sirri, Director of the Securities and Exchange Commission's Trading and Markets Division, addressed the Securities Industry and Financial Markets Association's Market Structure Conference on the subject of maximizing liquidity in the U.S. equity markets. Sirri started by commenting on some of the key characteristics of the post-Regulation National Market System (NMS) equity market structure, including the distinguishing feature of exceptionally strong competition among a variety of markets to attract order flow and trading volume. He noted that in actively traded stocks, there generally will be at least three and often as many as five markets that quote aggressively on price and size, and that the most successful gainers of market share in recent years have been markets that compete for order flow by publishing aggressive quotes. The other notable characteristic of the post-NMS market structure Sirri discussed was the proliferation of so-called dark pools of liquidity that are organized as Alternative Trading Systems and which do not appear to have materially reduced transparency in the U.S. market because of their post-execution reporting of trades.

Sirri's remarks also covered the issue of best execution for a customer's non-marketable limit orders. While as a practical matter it is almost certain that a non-marketable order will in fact be executed at any venue if quoted prices subsequently move through the order's limit price and it becomes a marketable order, Sirri noted that the more difficult determination is the order routing calculus that occurs if the order never becomes marketable. In this scenario, Sirri said that there could potentially be significant differences in the likelihood of execution at different venues based on a complex assessment of numerous factors—the first being the extent to which a venue displays its non-marketable orders.

Sirri's remarks also addressed the initiatives that markets have used to attract liquidity providers, including offering direct economic inducements, offering advantageous access to trading mechanisms, giving trading rule and information advantages to designated liquidity providers over other traders,

and seeking to parse liquidity providers' public customer base by providing differential treatment to professional and non-professional orders. Sirri concluded that regulators should be open and diligent in assessing whether the balance of public policy objectives and liquidity provider advantages remains appropriate in the context of electronic markets.

http://www.sec.gov/news/speech/2008/spch050908ers.htm

CFTC

Study Finds No Manipulation in Silver Futures Market

The Division of Market Oversight (DMO) of the Commodity Futures Trading Commission issued a report finding no evidence of manipulation in the silver markets for the period 2005-2007. DMO analyzed price movements across silver products as well as across markets for silver and other metals. The report concluded, among other things, that silver futures prices are not depressed relative to the prices of other metals and that silver futures prices on the New York Mercantile Exchange tend to track closely the price of physical silver.

http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5499-08.html

Banking

FinCEN Releases New SAR Activity Review Booklet

The Financial Crimes Enforcement Network (FinCEN), a division of the U.S. Treasury, recently issued *The SAR Activity Review: Trends, Tips & Issues*, a document which is published under the auspices of the BSA Advisory Group. In addition to including examples of how law enforcement uses the Bank Secrecy Act in pursuing criminal investigations (including health care fraud, tax evasion and drug investigations), the report also highlights three analytical reports. Those include: *Insurance Industry Suspicious Activity Reporting: An Assessment of Suspicious Activity Report Filings; Mortgage Loan Fraud: An Update of Trends Based Upon an Analysis of Suspicious Activity Reports;* and *Money Laundering in the Residential Real Estate Industry: An Assessment Based Upon Suspicious Activity Report Filing Analysis*.

The *Review* is published biannually. Feedback is also solicited in connection with the issuance.

http://www.fincen.gov/news_room/rp/files/sar_tti_13.pdf

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