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Corporate and Financial Weekly Digest

MARCH 5, 2010

SEC/CORPORATE

SEC Issues New Interpretations on Executive Compensation

In connection with the February 28 effective date of the Securities and Exchange Commission's new executive compensation disclosure rules, on March 1, the SEC's Division of Corporation Finance updated related Compliance and Disclosure Interpretations (C&DIs).

The SEC's revised guidance on executive compensation disclosures included the following revisions to previous C&DIs:

- Issuers may disclose the assumptions in determining the grant date fair value of equity-based awards required to be included in their Summary Compensation Table (SCT) by reference to the Grants of Plan-Based Awards Table (Awards Table) if the issuer chooses to report such assumption information in that table.
- Where a named executive officer exercises "reload" options and receives additional options upon such exercise, the issuer is required to report the additional options as an option grant in the SCT and the Awards Table and at the grant date fair value of the additional options.

The SEC also added a C&DI addressing the year of reporting in the SCT and Awards Table for an equity plan award over a multi-year performance period where the compensation committee retains negative discretion to reduce the award until the end of the performance period. While Financial Accounting Standards Board Accounting Standards Codification Topic 718 provides that negative discretion may cause, in certain circumstances, the grant date of the award to be deferred for financial statement reporting until the date of the compensation committee's final decision, the staff believes that the grant should be reported in the SCT and the Awards Table in the year in which service begins in the multi-year period because this better reflects the compensation committee's decisions. The amount reported in both tables should be the fair value of the award at the service inception date, based upon the then-probable outcome of the performance conditions.

Click here to view the C&DIs (Questions 119.16 and 119.24 and Interpretation 220.01) under Regulation S-K.

LITIGATION

Delaware Chancery Court Rules on Use of Poison Pills

On February 26, the Delaware Chancery Court issued its long-awaited opinion in the case of *Selectica, Inc. v. Versata Enterprises, Inc*. The opinion is the culmination of a closely watched legal battle between Selectica's directors, who sought judicial validation of their use of a poison pill to protect Selectica's tax assets, and defendants Versata Enterprises, Inc. and Trilogy, Inc., who had deliberately triggered the pill and sought to invalidate its provisions, reverse its effects and recover damages. The court ultimately validated the poison pill, upholding the Selectica directors' adoption and implementation of a shareholder rights plan, and their subsequent decision to dilute an acquiring person who deliberately crossed the pill's triggering threshold to effect a takeover.

In order to prevent a takeover by Trilogy, the Selectica directors: (1) amended the company's poison pill to decrease the beneficial ownership trigger from 15% to 4.99%; (2) implemented an exchange feature in the poison pill that doubled the amount of outstanding common stock held by each stockholder other than Trilogy and Versata; and (3) "reloaded" the pill by declaring a new dividend of purchase rights on similar terms that would become exercisable after another triggering event. Thereafter, Selectica sought a court order validating the amendments to the pill, the exercise of the exchange feature and the decision to "reload" the pill. Trilogy

contended that the same conduct was invalid and requested rescission, redemption of the “reloaded” pill and money damages for breach of fiduciary duty.

The court applied the familiar two-pronged *Unocal* test to determine the validity of the challenged conduct. Under the first prong of the *Unocal* test, the “directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed.” Under the second prong, the board must demonstrate that “its defensive response was reasonable in relation to the threat posed.” A defensive response will not survive *Unocal* scrutiny if it is determined to be disproportionate, i.e., coercive or preclusive. A measure is coercive if it is aimed at “cramming down” on shareholders management’s preferred course of action; a measure is preclusive if it renders an alternative transaction “mathematically impossible” or “realistically unobtainable.”

Under the first prong of *Unocal*, the court found that the board had reasonable grounds to conclude that Trilogy and Versata presented a threat to a valid corporate objective—the preservation of the company’s net operating loss carryforwards (NOLs). The court found that “a board may properly conclude that the company’s NOLs are worth protecting where it does so reasonably and in reliance on expert advice”, notwithstanding the fact that there was no certainty, or even a confirmed probability, that Selectica would ever be able to realize the value of its NOLs. Central to the court’s analysis was the board’s reliance on outside financial, tax and legal advisors.

Under the second prong of *Unocal*, the court found that the amended 4.99% beneficial ownership trigger under the shareholder rights plan was neither “preclusive” nor “coercive,” because the pill did not render a successful proxy contest by Trilogy “a near impossibility or else utterly moot.” The court recognized that a pill triggered at 4.99% was unusual (though not unprecedented), but determined that this low threshold was permissible given the risk that additional share purchases by Trilogy could lead to a “change in control” under IRS regulations that would preclude any possibility of Selectica ever realizing the value of its NOLs. Notably, the court left open the possibility that a 4.99% trigger might be inappropriate in other circumstances—“As a result of its unique objective, a pill designed to protect NOLs necessitates precluding a lesser accumulation of shares than might be appropriate for a pill designed to prevent a hostile acquirer from establishing a control position in the company.”

Finally, the court concluded that the use of the rights plan fell within *Unocal*’s “range of reasonableness,” finding the board’s response reasonable in response to the conduct of a “longtime competitor” who “sought to employ the shareholder franchise intentionally to impair corporate assets, or else to coerce the company into meeting certain business demands under the threat of such impairment.” Significantly, the opinion indicates that the proportionality analysis required by the second prong of the *Unocal* test does not require a board’s response to be perfect, or even “narrowly tailored” to correspond to the identified threat. Instead, the response need only be *reasonable under the circumstances*. (*Selectica, Inc. v. Versata Enters., Inc.*, C.A. No. 4241-VCN, 2010 WL 703062 (Del. Ch. Ct. February 26, 2010))

Shareholder Claims of Federal Securities Fraud Survive CEO’s Motion to Dismiss

Plaintiff shareholders of NutraCea, a public corporation that produces stabilized rice bran to sell as a nutritional supplement, sued CEO Bradley Edson and CFO Todd Crow for violations of Section 10(b) of the Securities Exchange Act of 1934, and Securities and Exchange Commission Rule 10b-5 promulgated thereunder, control person liability under Section 20(a) of the Exchange Act, and violations of the Arizona Securities Act. Both Mr. Edson and Mr. Crow moved to dismiss the complaint; the court granted Mr. Crow’s motion as to the Rule 10b-5 claim, but denied the motions in all other respects.

Plaintiff shareholders alleged that defendants misled investors concerning four corporate transactions by attesting to the correctness of NutraCea’s public financial statements, which improperly recognized over $9.6 million in revenue from the transactions. Plaintiffs claim that defendants knew, or were deliberately reckless in not knowing, that NutraCea improperly recognized revenue from four “sale” transactions that did not satisfy the revenue recognition criteria under generally accepted accounting principles.

Under Section 10(b) and Rule 10b-5, plaintiffs must prove the following elements: (1) a material misrepresentation or omission of fact; (2) scienter; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation. Defendants challenged these claims on the elements of scienter, reliance and loss causation.

The court reviewed the facts of the four transactions in question and determined that the nature of the “sales” were suspicious and helped support a scienter finding. One transaction was actually a pure consignment sale, while another involved a purchaser whose payment was financed by a consultant to, and former officer of, the seller.

The court found that the combination of Mr. Edson’s negotiation of one of the transactions at issue, his monitoring of NutraCea’s revenue recognition, and a personal profit motive created a strong inference of scienter. The court

was also persuaded that plaintiffs had met their initial burden of alleging an efficient market in which NutraCea's shares were traded, providing the foundation for a presumption of reliance on the efficiency of the market. Finally, plaintiffs' claim of a drop in NutraCea's stock price after the company's announcement that it had uncovered improper revenue recognition was sufficient to suggest loss causation. Therefore, Mr. Edson's motion to dismiss the claims under federal securities law was denied. Similarly, plaintiff's claim for violation of Section 20(a) of the Exchange Act survived Mr. Edson's motion to dismiss, as a well pled Section 10(b) and Rule 10b-5 claim against a corporate officer is sufficient to state a primary violation against the corporate entity itself. Finally, the rationale for denying Mr. Edson's motion to dismiss the federal securities law claims applied with equal force to their state securities law counterparts.

With regard to Mr. Crow, the court granted his motion to dismiss the Section 10(b) claim on the ground that plaintiffs failed to allege, in contrast with their claim against Mr. Edson, particularized facts raising a strong inference that Mr. Crow had actual knowledge of the improper revenue recognition practices. The court, however, denied Mr. Crow's motion to dismiss the Arizona state law securities claim because, in the court's view, the Arizona statute broadly authorized liability against any person who potentially "induced" a securities purchase by disseminating false information into the marketplace. (*Burritt v. NutraCea*, No. CV-09-00406, 2010 WL 668806 (D. Ariz. Feb. 25, 2010))

BROKER DEALER

Bankruptcy Judge Makes Important Ruling Impacting Madoff Investors

A recent court ruling by U.S. Bankruptcy Judge Burton Lifland clarifies the process for determining how much money investors may be entitled to receive in connection with the Securities Investor Protection Corporation (SIPC) proceeding involving the Madoff Ponzi scheme. The new ruling specifically related to whether investors could receive amounts equaling the totals appearing on their last account statements. The judge sided with the SIPC-appointed trustee, Irving Picard, who argued that investors could claim only the amount they first invested with Madoff (minus any withdrawals).

Read more.

FINRA Issues Annual Exam Priorities Letter

The Financial Industry Regulatory Authority issued its 2010 annual examination priorities letter to highlight new and existing areas of significance to FINRA's regulatory program for the year. After describing a few key organizational developments, including the newly constituted Office of Fraud Detection and Market Intelligence and the new eFOCUS filing platform, the letter begins with a number of "Regulatory and Business Considerations" for firms, including, among others: direct market access/sponsored access, member private offerings, new FINRA financial and operational rules and liquidity issues. With respect to 2010 examinations, FINRA listed a vast array of priorities including: fraud detection, information barriers, variable annuities, protection of customer information and IT/Cyber-Security, anti-money laundering, pandemic preparedness/business continuity planning, branch office supervision, outsourcing, inventory and collateral valuation, customer margin debts collateralized by nonmarketable securities, accounting and spreadsheet controls, day-trading margin, fully paid lending programs, market regulation options examination program, short sales and Regulation SHO compliance, and algorithmic trading controls.

Read more.

PRIVATE INVESTMENT FUNDS

Connecticut General Assembly Re-proposes Transparency and Disclosure Bill

The Connecticut General Assembly has re-proposed a transparency and disclosure bill, originally proposed in January 2009, after not taking it to a vote last year. The bill, if enacted in its current form, would require any investment adviser to a hedge fund with an office in the state to disclose to investors and prospective investors (not later than 30 days before any such investment) in such fund when the investment adviser may have a conflict of interest that could affect its duties and responsibilities to such fund or its investors. The bill would become effective October 1.

To read the text of the bill, click here.
Click here for more information on the original bill in the February 27, 2009, edition of *Corporate and Financial Weekly Digest*.

INVESTMENT COMPANIES AND INVESTMENT ADVISERS

Custody Rule Changes to Become Effective

The Securities and Exchange Commission amendments to Rule 206(4)-2, the custody rule under the Investment Advisers Act of 1940, as amended, will become effective on March 12.

Click here to read Katten's *Client Advisory* regarding the rule changes.

BANKING

Federal Agencies Issue Guidance Regarding the Bank Secrecy Act and Beneficial Ownership

On March 5, the Financial Crimes Enforcement Network, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission released guidance to clarify and consolidate existing regulatory expectations for obtaining beneficial ownership information for certain accounts and customer relationships (the Guidance).

According to the Guidance, "Heightened risks can arise with respect to beneficial owners of accounts because nominal account holders can enable individuals and business entities to conceal the identity of the true owner of assets or property derived from or associated with criminal activity."

The Guidance notes that the customer due diligence (CDD) procedures used by a financial institution should be reasonably designed to identify and verify the identity of beneficial owners, as appropriate, based on the institution's evaluation of risk pertaining to an account. The Guidance also describes certain CDD procedures that may be used by a financial institution to verify the beneficial owner of an account.

For more information, click here.

EXECUTIVE COMPENSATION AND ERISA

Treasury, IRS Issue Proposed Regulations and Guidance Addressing FBAR Reporting Requirements for Retirement Plans

At the end of February, the Financial Crimes Enforcement Network (FinCEN) bureau of the U.S. Department of the Treasury issued proposed amendments to the Bank Secrecy Act regulations governing Reports of Foreign Bank and Financial Accounts, commonly referred to as "FBAR." (Proposed Regulations). The Internal Revenue Service (IRS) also issued Notice 2010-23 (the Notice), providing relief on some plan-related FBAR filing requirements, and Announcement 2010-16 (the Announcement), clarifying that the filing requirement for 2009 and prior years relates only to U.S. citizens, residents and domestic entities.

These reporting requirements relate to foreign financial accounts owned or controlled by U.S. persons and are aimed primarily at money laundering and other evasion of U.S. law. However, the broad scope of the FBAR requirements raised questions about what compliance was necessary by U.S. retirement plans, many of which utilize foreign-based accounts or investment vehicles. The following are important points discussed in the Proposed Regulations and Notice.

- No prior year or current reporting requirement for most private investment funds. The Proposed Regulations describe the types of accounts for which reporting is required. These include foreign bank accounts, securities accounts, accounts with a broker or dealer in futures and commodities, and mutual funds or similar pooled funds available to the general public which have regular valuations and redemptions. FinCEN reserved a determination whether other investment funds, such as private equity, venture capital and hedge funds, will be accounts for which reporting is required. The IRS stated in the Notice that interests in commingled accounts other than foreign mutual funds would not be required for 2009 or prior years. Such reporting may be required for future years, however, as a result of future FinCEN action.
- Plan participants and IRA holders do not have individual FBAR reporting obligations. Under the Proposed Regulations, a participant in a tax-qualified retirement plan, 403(a) or 403(b) annuity plan, or the owner of a traditional or Roth individual retirement account (IRA) is not required to make an FBAR filing with respect to foreign financial accounts held by or on behalf of the retirement plan or IRA. This does not mean there is no FBAR filing requirement, but it is the responsibility of the plan or the IRA trustee, which FinCEN believes will

be in a better position to determine the existence of a foreign financial account. Accordingly, a plan participant or IRA holder with no other foreign financial accounts would not check any box on his or her individual tax return indicating ownership or control over such an account.

- FBAR filing requirements suspended for individual fiduciaries and administrators with no financial interest in a foreign financial account. There has been concern that persons such as plan administrators or members of plan investment committees who have signature authority for, but no financial interest in, a foreign financial account had to make an FBAR filing and disclose the signature authority on their personal tax returns. The FBAR filing deadline for such persons with respect to 2010 and prior calendar years has now been extended until June 30, 2011 (presumably to allow FinCEN more time to determine what filing requirements should apply to such persons). In addition, the Notice explains that an individual who is subject to this relief and who has no other interest or authority in a foreign financial account should answer "no" to questions on federal tax forms for 2009 and prior years that ask about a financial interest in, or signature authority over, a foreign financial account.
- FBAR filing requirements suspended for persons who are not U.S. citizens, U.S. residents or domestic entities. When the IRS changed the definition of "United States person" in October 2008 to encompass anyone in or doing business in the United States, it raised numerous questions regarding the filing requirements for foreign persons and entities who were arguably doing business in the United States. The Announcement suspends the FBAR filing requirement for 2009 and prior years for all persons who are not U.S. citizens, U.S. residents or domestic entities, but filing requirements for persons who are eligible for this relief may be subject to other requirements in future years.

The Proposed Regulations, Notice and Announcement can be accessed here.

COBRA Subsidy Extended Through March

Under the Consolidated Omnibus Budget Reconstruction Act (COBRA), certain group health plan participants who lose their coverage are permitted to continue coverage for a period of time by electing continued coverage and paying the relevant premium themselves. The American Recovery and Reinvestment Act of 2009, as amended, provided a subsidy to certain eligible individuals that allowed them a discount of up to 65% of their COBRA premiums for up to 15 months. The COBRA subsidy expired on February 28. However, Congress enacted a law that provides for a one-month extension of the COBRA subsidy. Earlier this week, President Obama signed into law the Temporary Extension Act of 2010 (the TEA), which extends the COBRA subsidy through March, and clarifies certain features of the COBRA subsidy. Under the most recent extension, employees will generally be eligible for up to 15 months of reduced premiums if they are involuntarily terminated from employment on or before March 31 and they lose health plan coverage as a result of such termination. In addition to extending the COBRA subsidy, the TEA also created special COBRA rights for individuals who are involuntarily terminated after incurring a reduction in hours, a special notice obligation related thereto, as well as new civil enforcement provisions.

Various aspects of the COBRA subsidy have been changed since its original enactment.
For more information about the original subsidy, click here.
For information about several important changes to the original subsidy, click here.
The text of the Temporary Extension Act of 2010 can be found here.

EU DEVELOPMENTS

CESR Publishes European Short Selling Disclosure Regime

On March 2, the Committee of European Securities Regulators (CESR) published proposals for a pan-European short selling disclosure regime. The proposals result from CESR's consultation process, which began in July 2009 (see the July 10, 2009, edition of *Corporate and Financial Weekly Digest*).

CESR has proposed a two-tier model (private and public disclosure) for short positions in shares admitted to trading on any European Economic Area (EEA) regulated market or multilateral trading facility (MTF). The regime will not apply to shares whose primary listing is not on an EEA market or MTF. The measure of whether disclosure is required will be based on economic exposure (calculated on a net basis) which is the economic equivalent of a short position. Positions in all financial instruments, including derivatives and cash market positions, will be aggregated to determine whether applicable thresholds are met.

Market participants with short positions will be required to make a non-public disclosure (to the national regulator of the relevant issuer's primary market) of any position in an issuer's share capital reaching 0.2%—an increase from the originally proposed 0.1%. Further non-public disclosures will be required as each successive 0.1% threshold is crossed after the initial disclosure requirement has been triggered. If the higher threshold of 0.5% is

reached, a public disclosure will also be required. Further public disclosures will be required for each 0.1% change thereafter. Disclosure filings will be required on T+1. Intra-day positions are not required to be disclosed. Market making activities will be exempt.

CESR has recommended that the new regime be implemented as soon as possible. Its view is that there should be new European legislation in this area, either (preferably) through the enactment of a new directive or regulation or alternatively through amendments to the Transparency Directive. It recommends that those CESR members that already have powers to implement a permanent disclosure regime should begin the process of implementing the proposals, while those members not having the necessary legal powers should aim at implementation on a best efforts basis.

To read the proposals in full, click here.

INTERNATIONAL DEVELOPMENTS

IOSCO Publishes Template for Hedge Fund Data Collection

On February 25, the International Organization of Securities Commissions (IOSCO) published a template for the global collection of hedge fund data by regulators to facilitate international cooperation in identifying and assessing systemic risks which might arise from the hedge fund sector.

The purpose of the template is to enable the collection and exchange among regulators of consistent and comparable data from hedge fund managers and advisors about their trading activities, the markets they operate in, funding and counterparty information. There are 11 proposed categories of information which incorporate both supervisory and systemic data. The template is not intended to be a comprehensive list of all of the types of information and data which regulators might want to collect; therefore, regulators are not restricted from requiring additional information at a domestic level.

IOSCO stated that it was publishing the template to help inform any planned legislative changes being considered in various jurisdictions, as well as to provide securities regulators with examples of the type of information they could find useful to collect. IOSCO recommends that the first data gathering exercise should be carried out on a best efforts basis in September 2010. As reported in the February 26 edition of *Corporate and Financial Weekly Digest*, the UK Financial Services Authority has just released its own surveys of hedge fund activity which were conducted in October 2009.

To read the publication in full, click here.

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