

June 2010

SECURITIES ALERT

Senate Preserves Viability of Private Offering Exemption

In a move that brings a sigh of relief more audible from Main Street than Wall Street, the Senate approved a bipartisan amendment to its financial reform bill to preserve the viability of the registration exemption most frequently used to raise capital for early stage companies.

Currently, the Securities and Exchange Commission (SEC) allows any company to sell securities in a private offering to “accredited investors” without registration pursuant to Rule 506 of Regulation D. The Senate financial reform legislation (the Dodd Bill), in its originally proposed form, would have directed the SEC to significantly increase the \$1 million net worth and \$200,000 annual income thresholds for individuals to qualify as accredited investors. As our Life Sciences group previously reported, such a change would have dramatically decreased the pool of accredited investors and made it much more difficult for early stage companies to raise needed capital. The amendment maintains the current accredited investor

In this issue:

<i>New SEC Interpretive Guidance</i>	2
<i>Some Shareholders Just Say No To Compensation</i>	3
<i>Congress Takes On Wall Street Reform</i>	3
<i>SEC Rule-Making Agenda</i>	8

thresholds but directs the SEC to exclude from the net worth calculation the value of an investor's primary residence. The amendment allows the SEC to review accredited investor standards for adjustment and modification, but the \$1 million net worth standard will be in place for four years.

Companies should still be permitted to accept an individual investor's self-certification that he or she satisfies the new net worth accredited investor standard absent a reason to suspect otherwise.

The amendment also deletes a requirement that Regulation D offerings be registered with the SEC and subjected to a 120-day SEC review period and potential review by state securities administrators. This feature would have increased the time required to complete a Rule 506 offering by up to at least four months.

While some angel investors may no longer qualify as accredited investors if the value of their primary residence is deducted from their net worth calculation, we believe the amendment is a better compromise between investor protection and the public interest in funding innovation than the pre-amendment version.

The amendment adds a "bad boy" provision to Rule 506, prohibiting persons cited for securities fraud or violations of banking or insurance regulations at any time during the previous 10 years from participating in the offering. State securities administrators could apply their own bad boy provisions. Since many states define even technical violations as "fraudulent, manipulative, or deceptive," this could give each state a new veto power over some Rule 506 offerings.

New SEC Interpretive Guidance

The SEC has provided new interpretive guidance in the form of June 4, 2010 updates to various Compliance and Disclosure Interpretations (CDIs):

- *Regulation S-K*. Technical interpretations of S-K Item 402 (Executive Compensation)
- *Securities Act Sections*. Resale registration of shares underlying convertible debt
- *Securities Act Forms*. S-3 eligibility for companies that default on indebtedness or preferred dividends
- *Exchange Act Rules*. Updated fee rate guidance on proxy statements in corporate control transactions.
- *Form 8-K*. Clarifies that new Item 5.07(b) applies to all proposals considered at shareholder meetings
- *Regulation FD*. Directors may meet privately with shareholders who commit to a written or oral confidentiality agreement or when it's not reasonably foreseeable the shareholder would trade on the basis of any information shared

Some Shareholders Just Say No to Compensation

Among the features of the Dodd Bill is a provision giving public company shareholders an annual non-binding vote on executive compensation (Say on Pay).

A few hundred companies placed Say on Pay proposals on the ballot for this year's shareholder meetings, either voluntarily or in response to shareholder proposals. A Say on Pay vote is nonbinding and purely advisory. That said, a "no" vote could embarrass management and the compensation committee, attract unfavorable analyst comment and market reaction, and persuade committees to revise their compensation policies and scale back future awards.

Risk Metrics Group (Risk Metrics) has announced it may recommend a "no" vote on a Say on Pay proposal if the company's compensation policies do not comply with Risk Metrics' compensation guidelines. If a Say on Pay proposal is defeated and the compensation committee fails to modify its policies accordingly, Risk Metrics may recommend withhold votes in future elections of committee members.

Although the vast majority of Say on Pay proposals were approved this year, shareholders at Motorola, Key Bank and Occidental Petroleum voted down their companies' proposals.

With the advent of majority voting in director elections (another feature of the Dodd Bill), the recent New York Stock Exchange (NYSE) rule forbidding member brokers from exercising discretionary voting authority in director elections, and the potential adoption of large shareholder proxy access, director re-election may become increasingly less automatic. The implications for compensation committees are clear. If Say on Pay becomes mandatory, committees will not have the last word on compensation policy, and should ensure that the rationale for their policies and awards is clearly articulated and responsive to owner interest.

Congress Takes On Wall Street Reform

The Restoring American Financial Stability Act of 2010 (the Dodd Bill) has emerged from the mosh pit of Senate debate, and entered House-Senate reconciliation. Compromises with the House version of the bill, and in response to Republican and financial industry concerns, are foreseeable. Together with new rules proposed by the SEC and those mandated or permitted by the Dodd Bill, this promises to be the most sweeping financial reform since the Great Depression.

How We Got Here

We all understand how we got here. The financial crisis was at its core a mortgage crisis. Government promotion of home ownership by families with lower credit scores, a favorable interest rate environment, and "creative" new mortgage products and underwriting practices ignited an explosion in subprime mortgage borrowing. Wall Street financed the demand by creating residential mortgage

backed securities (RMBS) for subprime loans. A new class of subprime lenders offloaded their default risk on RMBS investors. To further capitalize on the mortgage boom, Wall Street created complex new derivatives called collateralized debt obligations (CDOs) which bet on specific RMBS pools, and synthetic CDOs, highly abstract, esoteric bets on the mortgage market itself.

To protect against counterparty default, or to bet against the durability of the subprime mortgage boom, mortgage derivative investors and market “shorts” acquired billions in credit default swaps from AIG and other counterparties.

To ensure a market for mortgage derivatives, Wall Street engaged rating agencies to rate their credit quality. In a failure of independence, integrity and imagination, the agencies assigned high ratings to subprime mortgage derivatives, giving investors a false sense of security about their safety. In many cases, CDOs were even rated higher than the underlying RMBS.



Mortgage derivatives, credit default swaps and agency ratings relied upon sophisticated mathematical models based on the theory that efficient markets will rationally price for stress. Unfortunately, the stress assumptions fed into the models failed to imagine the earthquake we actually experienced.

Investment banks went long on mortgage securities using high levels of short-term leverage, paying little attention to capital adequacy or mortgage default risk. The SEC and the Federal Reserve saw no reason to intervene. The entire system, largely unregulated and opaque, resembled a tower of Chinese acrobats

precariously balanced one upon the other. Things worked fine so long as the bottom acrobat didn't sneeze.

When he did, real estate and commercial credit froze, markets crashed, and eight million Americans lost their jobs. In time, we discovered that trillions had been invested in unjustified reliance on rating agencies' reputation for independence and critical analysis, that the formal powers of government were too limited, or were used too timidly, to effectively manage the crisis, that there was too little transparency, accountability and comprehension in the system, and that our faith in the predictive power of mathematical models was entirely misplaced.

The Dodd Bill

In response to these events, the Dodd Bill was adopted by the Senate on May 10, 2010. The bill addresses the last crisis in the hope of preventing the next one. Human experience may be too random and unpredictable for that assumption, but the bill does attempt to alter the playing field and may have a

profound impact on the workings of our financial system, at least until Wall Street firms create work-arounds.

The devil in the Dodd Bill is in the details to be supplied by implementing regulations. Although the bill may undergo changes during reconciliation and a complete analysis is beyond the scope of this alert, here is a brief description of some of its key provisions:

Financial Stability Oversight Council. A Financial Stability Oversight Council, consisting of the Treasury Secretary, the Federal Reserve (Fed) Chairman, other top financial regulators, and an independent presidential appointee, would be tasked with the following:

1. Identifying “systemically important” nonbank financial companies, financial market utilities, and payment, clearance and settlement activities
2. Promoting market discipline and reducing moral hazard by eliminating expectations of future taxpayer bailouts
3. Responding to emerging threats to financial market stability.

The Council would have broad rulemaking authority, including the imposition of prudential standards and reporting requirements on large, interconnected bank holding companies with consolidated assets over \$50 billion and nonbank financial companies whose failure could cause systemic risk (covered companies). Investment banks that adopted commercial bank charters to access Fed lending during the crisis would be unable to escape regulation by abandoning those charters.

Too Big to Fail. The Federal Deposit Insurance Corporation (FDIC) would be empowered to put distressed non-bank financial companies into orderly liquidation. The FDIC would fund resolutions by issuing debt secured by the insolvent company’s assets, with shareholders and creditors taking any loss. Taxpayer funded bailouts would be prohibited. Covered company directors and officers could face personal liability for gross negligence or breach of fiduciary duty. The FDIC could recover compensation paid to senior executives responsible for the institution’s failure and impose industry bans on officers and directors.

Supervisory Power Transfers. The Office of Thrift Supervision (OTS) would be abolished and its functions transferred to the Fed, the Office of the Comptroller of the Currency (OCC) and the FDIC.

Prudential Standards. An egregious error by financial firms and regulators alike was the exaltation of liquidity over capital. Firms were liquid so long as they could borrow, but had inadequate capital to withstand a credit freeze and the spoilage of their mortgage assets. To remedy this deficiency, the Fed will impose prudential standards on covered companies that address (a) derivatives, securitized products, securities borrowing and lending, and repurchase arrangements (repos), (b) concentration in assets for which reported values are based on models, and (c) concentration in market share that could cause substantial disruption if an institution goes dark.

M&A. Covered companies must obtain Fed approval to acquire financial companies with consolidated assets of \$10 billion or more.

Hotel California. Any bank holding company with \$50 billion in assets that participated in TARP would take on enhanced regulation if it gives up its bank charter.

Living Wills. Covered companies must submit resolution plans to the Fed and FDIC.

Pay it Back. TARP authorization will be reduced to \$500 billion. Companies that repay TARP funds could not reborrow them absent systemic risk.

Volker Rule. Covered companies would be prohibited from proprietary trading in securities and derivatives, barred from sponsoring hedge funds and private equity funds, and subjected to limits on their future growth through a cap on market share. The proprietary trading ban would not apply to trading on behalf of customers, trading in government obligations, or investing in credit default swaps as a hedge against loan loss. The Volker Rule is highly controversial, with both the industry and Senate Republicans arguing that the rule would severely limit bank profits.

Lending Limits. Credit exposure from derivatives, repos and securities lending would be included in computing bank lending limits.

Emergency Stabilization. The Fed must establish emergency lending procedures to provide systemic liquidity, but not to rescue failed firms. The FDIC could guaranty the obligations of solvent organizations in times of stress.

Consumer Financial Protection Bureau. A consumer financial protection bureau would be established inside the Fed, with broad power to regulate consumer financial products. State attorneys general could enforce the bureau's rules against national banks and thrifts operating inside their borders. Credit card issuers would be subject to limitations on interchange fees. Mortgage originators could not be compensated based on any loan terms other than the principal amount. Residential mortgage lenders would be required to obtain "verified and documented information" on a consumer's ability to repay. Lenders who take adverse action based on a consumer's credit score will be obligated to provide specified disclosures. Treasury would be empowered to award facilities to mainstream institutions to provide alternatives to payday lending.

Derivatives. The Commodity Futures Trading Commission (CFTC) and SEC would jointly regulate the derivatives market. The government would be prohibited from providing federal assistance to swap market participants. A controversial provision introduced by Senator Blanche Lincoln would require covered companies to spin off swap operations into separately capitalized affiliates. Swaps dealers would be subject to registration, collateral, anti-commingling and margin rules. A controversial provision would impose a fiduciary duty on dealers that provide swap advice to government agencies, pension plans, retirement plans and endowments. The bill would impose clearing requirements on swaps acquired other than for commodity hedging. Swaps subject to the clearing requirement must be

traded on an exchange or swap execution facility. Derivatives clearing organizations would be subject to financial criteria. The CFTC/SEC would adopt rules for real-time public reporting of swaps transactions and pricing, and could impose position limits on swaps. The SEC would amend its beneficial ownership reporting rules to include security-based swaps positions.

Payment, Clearance and Settlement. The bill would give the Fed supervisory authority over systemically important market utilities and financial institution payment, clearing and settlement activities.

Securities Lending and Investor Protection. The SEC would be required to enhance the transparency of securities lending, and empowered to require point-of-sale disclosures by broker-dealers to retail customers.

Municipal Securities. Securities advisers to municipal issuers would be required to register with the Municipal Securities Rulemaking Board (MSRB). MSRB's rulemaking authority would be expanded. An Office of Municipal Securities would be created within the SEC.



Registration of Hedge Fund Advisers. The bill would eliminate the "private investment adviser" exemption from registration in Section 203(b)(3) of the Investment Advisers Act, and require that hedge fund managers with more than \$100 million in assets under management register with the SEC and maintain records on their funds' activities. Advisers to venture capital and private equity funds would be exempt from this requirement. Investment advisers with less than \$100 million in assets under management would no longer be under SEC regulation and would be regulated by the states.

Office of National Insurance. In an attempt to prevent another AIG tsunami, an Office of National Insurance would be created inside Treasury, with authority to monitor the insurance industry and recommend remedial measures that would preempt state regulation.

Credit Ratings Agencies. The bill would require greater transparency and more thorough SEC regulation of nationally recognized statistical rating organizations (NRSROs). NRSROs will be required to adopt an internal control structure. The SEC would be empowered to impose penalties for misconduct and to revoke registration of NRSROs that lack adequate resources to consistently produce reliable ratings. NRSROs would be required to have at least two independent directors. Compliance personnel would be prohibited from engaging in sales and marketing, rate setting, and compensation-setting. The SEC would establish a new self-regulatory organization for NRSROs, with authority to approve initial ratings for structured finance products. NRSROs would be required to consider third party information about an issuer in setting ratings, to maintain procedures to better evaluate default risk, and to publicly disclose information on initial ratings and subsequent upgrades or downgrades.

Credit ratings would not be protected by the safe harbor for forward-looking statements in the Private Securities Litigation Reform Act. Investors would have a private right of action against rating agencies if they knowingly or recklessly fail to conduct a reasonable investigation or obtain independent verification of issuer representations. NRSROs would be required to make a criminal referral if they receive information indicating an issuer has committed a material violation of law. The SEC would be required to adopt rating agency qualification and training standards. Federal reliance on bond ratings would be phased out.

The SEC adopted a series of rating agency reforms last year (see “SEC Rule-Making Agenda” below).

Fannie and Freddie. Treasury would be required to develop options for the conservatorship of Fannie Mae and Freddie Mac, including such alternatives as a gradual wind-down and liquidation, privatization, transfer of functions to other agencies, and break-up.

Asset-Backed Securities. The Dodd Bill would require issuers of asset-backed securities (ABS) to retain “skin-in-the-game” of at least 5 percent of each pool, unless the assets meet low credit risk standards. Securitizers would be prohibited from hedging credit risk, but permitted to share the risk with originators. The SEC would adopt improved ABS reporting and disclosure rules. Securitizers would be required to report any repurchase demand based upon breach of representations and warranties.

Corporate Governance and Executive Compensation. The Dodd Bill would give public company shareholders an annual non-binding Say on Pay (TARP-mandated Say on Pay is a routine proxy statement item under Exchange Act Rule 14a-6(a)(7)). Additional independence standards would be imposed on compensation committees. The SEC would require public companies to disclose a chart showing the relationship between executive pay and corporate performance. Employee and director hedging of their companies’ securities would be disclosable, as would any company policies permitting hedging. Bonuses awarded on the basis of financials that are later restated due to material noncompliance (not just misconduct, as in the Sarbanes-Oxley Act) would be subject to claw-back. Large shareholders would have access to the company’s proxy statement to nominate directors. Directors would be elected by majority vote in uncontested elections, as opposed to the mere plurality typically required by state corporate law. Public companies would be required to disclose the reason the company has either combined or separated the functions of Chairman and CEO. The SEC would amend Item 402 of Regulation S-K to require internal pay equity disclosure. Broker discretionary voting would be prohibited in director elections and Say on Pay.

SEC Rule-Making Agenda

The SEC has issued a series of new market reform rules and proposals that complement the Dodd Bill:

Adopted Rules

Custody Controls. In the wake of the Madoff scandal, the SEC adopted rules providing greater protection to investors who entrust their assets to financial advisers.

Proxy Enhancements. Companies are now required to provide more meaningful disclosure about their board leadership structure, the qualifications of board nominees, and the relationship between risk-taking and overall compensation policies.

Discretionary Voting for Directors. The SEC approved a NYSE rule forbidding member brokers from exercising discretionary voting authority in director elections.

Short Selling. The SEC adopted rules restricting short selling of stocks experiencing significant downward price pressure, and prohibited “naked” short selling, an abusive practice in which a trader shorts securities it neither borrows nor owns.

Money Market Funds. The SEC adopted rules to strengthen the oversight and resiliency of money market funds.

Central Clearing of Credit Default Swaps. The SEC took action to address counterparty risk and improve transparency in the credit default swap market.

Credit Ratings Agencies. The SEC adopted a more robust regulatory framework for NRSROs, requiring more disclosure, greater independence, conflict avoidance, greater accountability and a prohibition on rate shopping.

Municipal Securities Disclosure. The SEC has beefed up its municipal securities disclosure rules.

Stock-by-Stock Circuit Breakers. In response to the events of May 6, in which the Dow temporarily lost 1,000 points in 30 minutes, the SEC has implemented a five minute trading halt on any individual S&P 500 stock if the price moves 10 percent or more in a five-minute period, giving markets an opportunity to attract new trading interest in the stock, establish a reasonable market price, and resume trading in a fair and orderly manner.

Proposed Rules

Asset-Backed Securities. The SEC has proposed upgrading the disclosure, reporting and offering process for ABS issues.

Proxy Access. Large shareholders would have access to their company’s proxy statement to nominate their own slates of directors.

Large Trader Reporting. The SEC would create a large trader reporting system that would strengthen market oversight by indentifying large traders and collecting trade information.

Options Market Reforms. The SEC has proposed two options investor protection measures that currently exist in stock markets. The first would prohibit options exchanges from unfairly impeding non-member

access to displayed quotations. The second would limit transaction fees assessed against non-members for access to quotations.

Flash Orders. Electronic trading has revolutionized securities markets. Trades that used to take minutes can now be executed in milliseconds. Electronic exchanges clear an increasing number of trades. High frequency trading, a rapid computer trading technique, now accounts for more than half of all U.S. trades. High frequency trading aids market liquidity, but can also increase exposure to volatility, as the events of May 6 suggest. In a flash order, a trader can freeze the order on an exchange for up to half a second, allowing its computer to automatically evaluate pricing and rebates ahead of the rest of the market. The SEC has proposed banning flash orders, on the basis that they give large, high-speed traders an unfair window on market direction not available to other investors.

Sponsored Access. A new rule would prohibit broker-dealers from providing large customers with unfiltered or “naked” access to an exchange or alternative trading system.

Dark Pools. Dark pools are private electronic trading networks that match buyers and sellers anonymously. Dark pool trading makes it difficult for other traders to engage in meaningful price discovery. The SEC is proposing to open up the practice.

Pay-To-Play. The SEC would address pay-to-play practices in the government pension management system.

Consolidated Audit Trail. In yet another response to May 6, the SEC has proposed that stock exchanges and the Financial Industry Regulatory Authority (FINRA) establish a consolidated audit trail system that would enable regulators to track trading information across securities markets and keep watch on emerging market technologies and trading patterns.

FOR MORE INFORMATION



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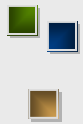
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