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IPO INVESTIGATION ALERT

By Joel Cohen*

SEC and Grand Jury Investigations Focus on Distribution of Hot Issues

Several weeks ago, following a spate of articles in December 2000/January 2001, there were a number of articles in *The New York Times* and *The Wall Street Journal* about joint criminal/SEC investigations in New York concerning how Wall Street investment banks have distributed shares of hot IPO issues, particularly technology stocks.

The focus has been on investors who both received significant shares of the IPO's and paid large commissions on later trades. The question has been whether these investors were asked – or, perhaps, simply decided – to pay such commissions, and whether the commissions (reported to be as much as $1 per share as compared to a typical, institutional rate of 5 cents per share) were a *quid pro quo* – a "kickback" – for obtaining shares in the valued IPO's.

U.S. Attorney and SEC Subpoena Investors and Securities Firms

As is typical (and appropriate), the United States Attorney's Office and the SEC have been mum. Nonetheless, regulatory filings and interviews conducted by business publications make clear that large-share IPO recipients, as well as underwriters and securities firms, have received either grand jury or SEC subpoenas (in some cases, both) seeking at a minimum, relevant documents. Some subpoenas have required testimony; in some instances, interviews were sought or accorded in lieu of testimony.

The Search for a Quid Pro Quo

A number of intricate legal questions immediately arise. Can the SEC or the United States Attorney actually prove a *quid pro quo*? In other words, can the authorities prove there was a direct, causal connection between the allocation by an underwriter of shares in a hot issue, and the subsequent payment to the underwriter or its affiliate of a particular commission? Or, can the

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investigators establish agreements by which favored clients are given substantial allocations of shares in the IPOs in exchange for large purchases by them in the aftermarket. Would such proof enable investigators to establish "market manipulations"?

Possible 1933 Act Violations

Unfortunately, negative answers to these questions won't end the inquiry or the authorities' enthusiasm for the hunt. First, IPO commissions may be viewed as violating the Securities Act of 1933, if prospectuses do not adequately disclose the commissions paid on shares. Thus, if the underwriting fees, but not commissions, are disclosed in the prospectuses, the prospectuses may be viewed as false. Second, "books and records" violations also may conceivably come into play.

Put simply, the brokerage firms must record all elements of a transaction. Broker-dealers, however, may fail to record the details of every transaction. The SEC, and perhaps even the United States Attorney, may use the "back door" of a technical "books and records" violation to "get their man" when they come up short in trying to prove a *quid pro quo*.

Lies, Damn Lies, and Intentionally Flawed Responses

Even when all else fails, prosecutors still hope to catch an unsuspecting subpoenaed party in an intentionally "flawed" response to either an SEC or a grand jury subpoena. All too often, subpoenaed parties literally turn a nuisance into a Federal prosecution by engaging in conduct viewed as obstruction of justice, such as "tailoring" false stories, or destroying (or even creating) records. The reward for such behavior often is a prosecution that would not otherwise have been brought on the substantive offense.

What to Do When a Subpoena Arrives

Clearly, the best approach is not to wait until the subpoena arrives to try to comply with the rules. If a subpoena does come, however, subpoenaed parties should contact outside counsel immediately – before the compliance process begins. This will help minimize any opportunity for in-house conduct that may unnecessarily raise the stakes, as even inadvertent conduct may cause the government to become suspicious.

It is a given that the goal of a responsible company will be to comply with a subpoena so information that, under law, must be disclosed is disclosed. Nonetheless, there will be information that need not be disclosed, and should be protected. Throughout the subpoena compliance process, every effort should be made to ensure in-house communications remain under the cloak of confidentiality accorded by the attorney-client and work product privileges.

There may be circumstances when, strategically, full disclosure – including disclosure of information not subpoenaed, and even occasionally, disclosure of privileged information – should be made. Nonetheless, until a thorough analysis of a particular situation is conducted, such a decision cannot be made. In the meantime, individuals within the company whose communications will not be protected by applicable privileges, but who are likely to be contacted by the authorities, should not learn more information than they had before the subpoena arrived.

Finally, parallel investigations by the SEC and federal prosecutors raise special problems – particularly when the separate agencies join forces in conducting them. In some situations, there may be strategic advantages in cooperating fully with both, in others in cooperating with only one or with neither. A coherent strategy should be reached as soon as possible after a company learns that an investigation that may affect it is underway – ideally before official government contacts are made to the company or its personnel.

THE DERIVATIVES PRACTITIONER: CONSEQUENCES OF DRAFTING CHOICES IN ISDA MASTER AGREEMENT SCHEDULES – EVENTS OF DEFAULT VERSUS TERMINATION EVENTS

By Sherri Venokur*

This is the first in a series of articles that will highlight practical issues faced when documenting derivatives transactions.

Every derivatives practitioner is familiar with "Events of Default" and "Termination Events." The purpose of this article is to focus on certain consequences of choosing to label specified (and, usually, credit-driven) events as one versus the other when negotiating the Schedule to an ISDA Master Agreement.

Section 5 of the ISDA Master Agreement

Section 5 of the 1992 form of ISDA Master Agreement (the "ISDA Agreement") provides for both Events of Default and Termination Events. Under Section 5, these events are similar in that the occurrence of either permits the Non-defaulting Party (in the case of an Event of Default) or the Non-affected Party (in the case of a Termination Event) to liquidate the parties' entire portfolio by designating an Early Termination Date. However, the ISDA Agreement contemplates that the parties may specify Additional Termination Events in the Schedule (see Section 5(b)(v)) but does not address what might be called "Additional Events of Default."

The omission has important consequences. A portfolio close-out triggered by an Event of Default proceeds along a shorter timetable than does one triggered by a Termination Event. In addition, a Non-Defaulting Party has a greater range of options than does a Non-Affected Party. Parties should consider these differences when negotiating ISDA Agreements so that they can be in the best position in a worst-case scenario.

Conditions Precedent to Payment or Delivery Obligations

Practitioners also need to consider the impact of certain drafting decisions on the payment and delivery obligations of the parties. Section 2(a) of the ISDA Agreement describes the conditions under which the parties are to make the payments or deliveries specified in Transaction Confirmations. While the general rule under Section 2(a)(i) and (ii) is that payments or deliveries must be made for value on the due date, Section 2(a)(iii) sets forth the conditions precedent to the payment or delivery obligations:

> (iii) Each obligation of each party under Section 2(a)(i) is subject to (1) the condition precedent that no **Event of Default** or **Potential Event of Default** with respect to the other party has occurred and is continuing, (2) the condition precedent that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated and (3) each other applicable condition precedent specified in this Agreement.

(Emphasis added).

Thus, if an event is included among the events listed in the Events of Default Section of the ISDA Agreement (Section 5(a)), or the parties, during the documentation negotiation process, choose to make the event part of Section 5(a) through a provision in the Schedule (in either case, without regard to whether the applicable grace period has elapsed), then if the event occurs, the party that has not suffered the event is relieved of any obligation to make payment or delivery to the other party because the condition precedent specified in Section 2(a)(iii) has not been met. If the event ultimately ripens into an Event of Default through the passage of time and/or the giving of notice, the Non-defaulting Party may choose to designate an Early Termination Date but need not do so. The Non-defaulting Party has the flexibility to maintain the existing portfolio and, at the same time, to use its leverage to strengthen its credit position with its counterparty.

On the other hand, if the parties instead provide in the Schedule that this same event is an Additional Termination Event, then the occurrence

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of that event will *not* act as a condition precedent to the Section 2(a) payment obligations unless (1) such event ripens into a Termination Event, and (2) the Non-affected party chooses to designate an Early Termination Date for the entire portfolio. According to the User's Guide to the 1992 ISDA Master Agreements (the "User's Guide"), because most Additional Termination Events are credit driven and therefore affect the entire portfolio, "It is presumed that, in the case of an Additional Termination Event, all Transactions will be Affected Transactions . . .."[1] This could put the "Non-affected Party" in the difficult position of having to choose between making a payment to a party that may be unable to meet its future obligations (*e.g.*, where the Additional Termination Event is a percentage decline in net asset value) and terminating Transactions in unfavorable market conditions.

Interestingly, the ISDA Credit Support Annex Elections and Variables (Paragraph 13 of the New York law form) contemplates that parties will designate Additional Termination Events as Specified Conditions, so that collateral "Transfers" need not be made to an Affected Party.[2] It is also interesting to note that if an Additional Termination Event occurs with respect to a party and, without the Non-Affected Party having been notified, the parties enter into a new Transaction, then under Section 3(b) of the ISDA Agreement, the Affected Party will be deemed to have made a misrepresentation with respect to its status under the Agreement. This is because under Section 3(b), each party represents that "No Event of Default or Potential Event of Default or, to its knowledge, Termination Event [which, of course, includes Additional Termination Event] with respect to it has occurred and is continuing," and the Section 3 Representations are deemed to be repeated "on each date on which a Transaction is entered into." The Affected Party's failure to disclose the occurrence of an Additional Termination Event would constitute an Event of Default under Section 5(a)(iv) ("Misrepresentation").

Labeling an event as an Event of Default rather than an Additional Termination Event not only expands the options of the Non-defaulting Party but, after designation of an Early Termination Date, also expedites the due date for payment obligations. According to Section 6(d)(ii) (which sets forth the due date for settlement payments), if the Early Termination Date results from an Event of Default, then the settlement amount is payable on the date that notice of the amount calculated is sent to the Defaulting Party. If, instead, the Early Termination Date results from a Termination Event, then the settlement amount is not payable until two Local Business Days after notice of the amount calculated is sent to the Affected Party. Interest accrues from the Early Termination Date until the date payment is made, but under Section 6(d)(ii), even the interest rate differs depending upon whether an Event of Default or Termination Date caused the termination:

- With respect to a Defaulting Party, interest is payable at the "Applicable Rate," (which, according to Section 14, is the "Default Rate" – the payee's cost of funds plus one percent);
- With respect to a Non-Defaulting Party, interest is payable at the "Non-default Rate" (the payee's cost of funds);
- In all other cases, interest is payable at the "Termination Rate" (the arithmetic mean of the cost of funds of each party).

This means that following the designation of an Early Termination Date triggered by an Additional Termination Event, interest on the settlement amount will accrue at a lower interest rate than would be applicable if the triggering event were labeled an Event of Default. If, however, the settlement amount payable under Section 6(e) is not paid when due, then interest begins to accrue at the Default Rate without regard to the original triggering event, since the failure to pay the settlement amount when due constitutes an Event of Default under Section 5(a)(i).

Bankruptcy and Insolvency Considerations

When a counterparty is "quickly going south," the *first* creditor to be paid may be the *only* creditor to be paid. This is especially significant in the context of the types of financial transactions covered by an ISDA Agreement because, under Section 546 of the U.S. Bankruptcy Code, a trustee in bankruptcy "may not avoid a transfer under a swap agreement, made by or to a swap participant, in connection with a swap agreement and that is made before the commencement of the case . . ." other than fraudulent transfers under Section 548(a)(1)(A).

Recommendations of the CRMPG

Despite the advantages of labeling negotiated trigger events as Events of Default rather than Additional Termination Events, most institutional market participants traditionally have chosen the

1 User's Guide to the 1992 ISDA Master Agreements at p. 20.
2 *See* Paragraphs 3, 4 and 13(d) of the Credit Support Annex New York law form.

latter. This probably has been attributable to the conventional wisdom that ISDA Agreements would take even longer to negotiate if they included additional Events of Default. Indeed, while the ISDA Agreement *explicitly* permits the parties to add, through negotiation, individual Additional Termination Events, the concept of Additional Events of Default is mentioned nowhere in the document. The omission may reflect concern that defining events as Events of Default could trigger cross-default provisions in other agreements or that the term "Event of Default" sounds more draconian than does "Termination Event."

Whatever the explanation, there has been a gradual shift since the Asian currency crisis and the collapse of Long Term Capital Management, as market leaders have become more aggressive in protecting themselves against market and credit risk. In January 1999, twelve major commercial and investment banks formed the Counterparty Risk Management Policy Group ("CRMPG") in order to "promote enhanced strong practices in counterparty credit and market risk management." In June 1999, the CRMPG issued a report entitled "Improving Counterparty Risk Management Practices." The Report recommends, among other things, reducing notice and grace periods so that effective action may be taken sooner upon the occurrence of a trigger event. These recommendations currently are utilized by many market participants and are being incorporated in upcoming revisions of ISDA's basic agreement forms. Thus, many market participants negotiate shortened grace periods for various Events of Default, include various affiliates as Specified Entities and expand the definition of Specified Transactions.

Conclusion

Given the diversity of derivatives transactions, no single approach to drafting ISDA Master Agreement Schedules will be appropriate for all situations. Practitioners need to consider, for each derivative counterparty relationship, whether the credit-driven termination triggers required by the firm's risk managers will accomplish their intended results.

SEC AND NASD ADOPT RULES REGULATING SECURITIES ACTIVITIES OF BANKS; BANKS OPPOSE SEC BROKER-DEALER RULES

by Michael Basile and Victoria Prussen Spears*

For more than 60 years, the Banking Act of 1933 (the "Glass-Steagall Act"), and the Bank Holding Company Act, have formed a legislative barrier separating commercial banks, bank holding companies, and their affiliates from the investment banking and securities industries. Banks, however, traditionally have been exempt from regulation as "brokers" and "dealers" under the Securities Exchange Act of 1934 (the "1934 Act"), because the definitions of the terms "broker" and "dealer" under the 1934 Act expressly excluded banks.

The regulatory landscape changed dramatically in 1999 following enactment of the Gramm-Leach-Bliley Act (the "GLBA"), a far-reaching effort to modernize the regulation of financial services. Although the GLBA lowered the barriers between the banking and the securities industries, it also amended the definitions of "broker" and "dealer" in the 1934 Act to eliminate the banks' blanket exclusion from broker-dealer registration requirements.

The amended definitions, and the bank exceptions to broker-dealer registration (the so-called "push-out" provisions of the GLBA), which were to become effective May 12, 2001, raised concerns among banks as they struggled to determine whether their securities activities fell within "functional exceptions" to broker-dealer registration requirements and, for those that did not, to shift them to a registered broker-dealer.

Functional Exceptions to Broker-Dealer Registration Requirements

The GLBA establishes a system of "functional regulation," under which each "industry segment"

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of a multi-industry organization will be regulated by the agency that, under law, is responsible for the regulation of that industry. In keeping with this change, the traditional bank exclusion from broker-dealer regulation has been replaced by 15 specific "functional" exceptions for certain activities of banks.

On May 11, 2001, the Securities and Exchange Commission (the "SEC") adopted interim final rules (the "Interim Final Rules") under the 1934 Act, addressing the bank exceptions of the GLBA and adopted temporary exemptions to extend until October 1, 2001 the "full exception" of banks from broker-dealer registration. According to the SEC release adopting the Interim Final Rules, the exceptions include:

- *Trust and fiduciary activities:* permits banks to act as securities brokers and dealers provided they act as "trustees" or "fiduciaries" and meet certain other conditions;
- *Permissible securities transactions:* permits banks to act as brokers and dealers with respect to exempted securities, Canadian government obligations, and Brady bonds;
- *Identified banking products:* permits banks to act as brokers and dealers for certain "identified banking products," as defined in Section 206 of the GLBA;
- *Third party brokerage arrangements:* permits banks to enter into contractual arrangements with registered broker-dealers to sell securities to bank customers under specified conditions;
- *Certain stock purchase plans:* permits banks, as part of their transfer agent activities and under specified conditions, to effect certain securities transactions in employee benefit plans, dividend reinvestment plans, and issuer plans;
- *Sweep accounts:* permits banks to sweep customer funds into no-load money market funds;
- *Affiliate transactions:* permits banks to effect transactions for affiliates, other than affiliates that are registered broker-dealers or affiliates engaged in merchant banking;
- *Private securities offerings:* permits banks that are not affiliated with broker-dealers to privately place securities under specified conditions;
- *Safekeeping and custody activities:* permits banks to hold securities, pledge securities, lend securities held in custody, and reinvest collateral;
- *Municipal Securities:* permits banks to act as brokers in municipal securities;
- *De minimis exception:* permits banks to engage in 500 securities transactions annually without registering as brokers; and
- *Asset-backed products:* permits banks to underwrite and sell asset-backed securities representing obligations predominantly originated by a bank, an affiliate of the bank other than a broker-dealer, or a syndicate in which the bank is a member, for some types of products.

ABA Opposes Interim Final Rules

Release of the Interim Final Rules has done nothing to calm the waters. In fact, the Interim Final Rules have generated intense opposition from the banking industry, culminating with a letter on June 4, 2001 from the American Bankers Association (the "ABA") and the ABA Securities Association to the SEC Division of Market Regulation.

In the June 4th letter, the ABA highlights several aspects of the Interim Final Rules that have generated opposition from the banking industry. According to the ABA, the Interim Final Rules are based on the SEC's overly narrow interpretation of the GLBA. Among the examples cited by the ABA is the scope of the trust and fiduciary exception:

> The SEC also suggested that only certain directed trust arrangements come within the trust and fiduciary exception. With respect to this last point, the statute defines fiduciary to include all trust arrangements. No distinction between types of trustee appointments – directed or otherwise – is made. Yet, conspicuously absent from the SEC's list of permissible directed trust arrangements are personal trusts, charitable foundation trusts, insurance and viatical trusts, and rabbi and secular trusts.

The ABA also opposes the Interim Final Rules "for the sheer magnitude of the regulatory burdens" they impose on banking organizations:

> The trust and fiduciary exception, for example, requires that banks be "chiefly compensated" by way of an annual or administrative fee, a fee

based on a percentage of assets under management, a flat or capped per order processing fee equal to not more than the cost incurred by the bank in processing the securities transaction or any combination of these fees. . . . Unfortunately, the narrative text of the SEC's release requires 15 pages to explain the requirements of the rule.

The ABA objects not only to the rule's complexity, but also to the SEC's statement that "chiefly compensated" is to be determined annually on an account-by-account basis. The ABA estimates that for the banking industry, this would require "yearly analyses of fees charged to over 19 million accounts valued at over $22 trillion." Based on these and other objections, the ABA has requested that the SEC withdraw the Interim Final Rules "and issue a significantly revised proposal."

New Limited Registration Category Eases Transition for Banks

To ease the transition of private placement activities from banks to broker-dealers, Section 203 of the GLBA required the creation of a new limited registration category. On May 8, 2001, the SEC approved a rule change proposed by the National Association of Securities Dealers, Inc. (the "NASD"), through its wholly-owned subsidiary, NASD Regulation, Inc. ("NASD Regulation"), to implement Section 203. The rule change creates the "Limited Representative – Private Securities Offerings," registration category for persons engaged solely in sales of private, non-governmental securities offerings. Applicants must meet the threshold requirements set forth in NASD Rule 1031 for associated persons of an NASD member and, with certain exceptions, pass the newly adopted "Series 82 Limited Representative – Private Securities Offerings" qualifying examination.

Scope of the New Limited Registration Category

Under the "private securities offerings" functional exemption discussed above, a bank that is not registered as a broker-dealer will be eligible to effect private placements without registering its personnel with the NASD, provided:

(a) The bank is not affiliated with any broker or dealer that is engaged in dealing, market making, or underwriting, other than with respect to exempted securities; and

(b) If the bank is not affiliated with any broker or dealer, the aggregate dollar amount of any private offering (excluding government or municipal securities) does not exceed 25% of the bank's capital.

If a bank is not excluded from the definition of "broker," any of its employees that wish to effect sales of private securities offerings will be required to register as associated persons of a registered broker-dealer, to comply with other NASD regulations, and except for persons who engaged in such sales as bank employees during the period from May 12, 1999 to November 12, 1999, to pass an NASD qualifying exam.

Persons wishing to effect sales of securities as part of public offerings pursuant to Sections 3(b), 4(2) or 4(6) of the Securities Act of 1933 will not be able to take advantage of the limited registration category. Moreover, the new category is applicable only to primary offerings of private placement securities, so persons wishing to engage in resales of, or secondary market transactions in, private placement securities must register either as a "General Securities Representative" or, if applicable, as a "Limited Representative – Corporate Securities."

In addition, the new limited registration category will not qualify a person to sell municipal securities, government securities, or equity interests in or the debt of direct participation programs ("DPP securities"). The SEC's adopting release provides a rationale for each of these exclusions.

With respect to the sale of municipal securities, the SEC noted that persons effecting such sales, including bank employees, are required to pass a specific qualification examination under the rules of the Municipal Securities Rulemaking Board ("MSRB"). To include such sales within the scope of the limited registration category would "create a subcategory of persons that are eligible to engage in certain offerings of municipal securities without meeting the specific qualification requirements of the MSRB."

According to the SEC's adopting release, the sale of government securities is excluded for similar reasons. NASD Rule 1032(g) already provides a limited registration category for the solicitation, purchase or sale of government securities. Consequently, "it is important to exclude government securities from the limited registration

category" – particularly because of the treatment of these securities in the GLBA.

Sales of DPP securities are excluded from the scope of the new registration category based on three main factors: 1) NASD Rule 1032(c) already provides a limited registration category for DPP securities; 2) the "highly specialized" nature of DPP securities; and 3) the belief of NASD Regulation that unregistered bank employees generally do not effect sales of DPP securities. As an ancillary benefit, the qualification examination "will not be burdened with questions on these highly specialized products." Finally, notes the adopting release, the SEC has exemptive authority to permit, on a case-by-case basis, bank employees experienced in DPP securities transactions to register under the new limited registration category instead of under NASD Rule 1032(c).

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