

SEC & Hedge Fund Activism: Shifting Focus, New Risks



SOCIETY OF CORPORATE SECRETARIES
& GOVERNANCE PROFESSIONALS



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SEC & Hedge Fund Activism: Shifting Focus, New Risks

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12:00 p.m. – 1:00 p.m.

Presented by:

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Foley & Lardner LLP

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Today's Presenters

■ **Laurene Horiszny**



■ **Steven Keller**



■ **Patrick Daugherty**



■ **Patrick J. Haddad**



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Welcome

- The Society of Corporate Secretaries and Governance Professionals, Inc. acts as a positive force for enlightened corporate governance.
- We comment regularly on proposed and existing rules and regulations of governmental agencies and other bodies, and occasionally on legislative matters in areas of particular interest to members.
- We also promote and assist in the voluntary exchange of information and experience relating to the duties, problems, and practices of corporate secretaries and their companies through our committees, chapters, publications and research, and its seminars and conferences.



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Poll Question

- Are you a member of the SCSGP?
 - Yes
 - No



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Synthetic Stock: Do You Know Who Owns Your Company?

Patrick Daugherty



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Poll Question

- Do you work with a company that is or has been the subject of a Schedule 13D filing?
 - Yes
 - No



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Poll Question

- Do you work with a company whose larger shareholders are known to include hedge funds?
 - Yes
 - No



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Property Rights in Stock

- **What is property?** “A common idiom describes property as a ‘**bundle of sticks**’ – a collection of individual rights which, in certain combinations, constitute property.” U.S. v. Craft, 535 U.S. 274 (2002) (O’Connor, J.), citing Cardozo, Paradoxes of Legal Science (1928).
- What are “the sticks”? Examples:
 - “**Title**”
 - Right to **dispose of title**
 - Right to **use**
 - Right to **let others use** (for consideration)
 - Right to **exclude others**
 - Right to **divide**
 - Right to **build upon**



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What does it mean to “own” stock?

- Basically, there are two elements:
 - **Economic return**
 - **Capital appreciation (depreciation)**
 - **Dividends and other distributions**
 - **Voting power**
- Per **SEC Rule 13d-3**, “**Beneficial Ownership**” is:
 - The power to **vote**, or direct voting of, the security; OR
 - The power to **dispose**, or direct disposition of, same; OR
 - The **right to acquire** either such power within 60 days; OR
 - Contriving to “**evade**” reporting one’s ownership.



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When must ownership be disclosed?

- **Schedule 13D**
 - Must file within 10 days after directly or indirectly acquiring beneficial ownership of more than 5% of the outstanding stock
- **Schedule 13G**
 - Must file within 45 days after end of year in which 5% threshold was breached
 - Acquisition must have been in OCB and not with purpose or effect of changing or influencing control
- **Schedule 13F**
 - Applies to “institutional money managers,” including hedge funds
 - Must file within 45 days of quarter-end
 - No disclosure required for short exchange-traded options
 - No disclosure required for short or long OTC derivatives
- **Section 16**
 - Must file within 10 days of reaching 10% threshold



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How to “Decouple” Voting and Economic Rights

- Stock lending
 - Stock borrower has voting power but no equity economic return
 - Stock lender has title and equity economic return but no voting power
- OTC equity swap
 - The long equity side (the “equity leg”) has equity economic return but no voting power
 - The short side (the “interest leg”), if hedged with stock ownership, has title and voting power but no (net) equity economic return



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How to “Couple” Voting and Economic Rights

- With puts and calls on the stock:
 - A long call option and a short put option (with the same exercise price and expiry) amount to a synthetic long stock position.
 - A long put option and a short call option (with the same exercise price and expiry) amount to a synthetic short stock position.
- With an OTC equity swap:
 - Acquire the equity leg
 - Acquire the interest leg OR the interest leg holder’s voting power
- **OTC equity swaps and other OTC derivative instruments are easily structured to exclude voting power over the underlying stock for 60 days from any particular date and thus avoid “beneficial ownership”**



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Imagine receiving this letter. . . .

Gentlemen,
Funds managed by [us] have an aggregate economic interest in approximately 50 million shares of [your company] (the "Company"), equivalent to 8.4% of the outstanding shares. As we assume you are aware, [we] have each filed requests for permission under the antitrust laws to substantially increase [our] direct ownership positions. . . .
Based on our due diligence, we believe that the Company can dramatically increase long-term shareholder value through a combination with [Merger Partner A] or [Merger Partner B]. However, we believe that [members of your] Board of Directors (the "Board"), despite glaring and untenable conflicts of interest, may be standing in the way of this result for shareholders. . . .
We believe that the only way to remedy this situation is for the Board to create a special committee . . . to oversee the immediate pursuit of a strategic combination. . . .
While we have sent this letter privately in the hopes of reaching a prompt resolution to this matter, should the Board fail to promptly task a special committee we will have no alternative but to resort to other steps we consider appropriate. . . .

Sincerely,
/s/ Hedge Fund A

/s/ Hedge Fund B



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How would *you* react?



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The CSX Case

- The Facts
- The SEC's Position
- The SDNY Opinion
- The Shareholder Vote
- The Appeal



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The Regulators

- **SEC**
 - John White told the Bar last month that the SEC is pondering what disclosure to require for shorts, equity swaps, other derivative instruments
- **FSA**
 - In the UK, equity swaps are called “contracts for differences” (or “CFDs”)
 - In a CFD, one party pays the other for virtual shares based on performance over time of the underlying stock price
 - Dealers run “matched books” in which they hold actual shares to offset the loss or gain on the CFD
 - Reportedly, some dealers agree to sell their actual shares to the CFD contra party (which may be an activist hedge fund) upon the CFD expiry, and/or to vote the actual shares as desired by the activist, as an unspoken term of the CFD arrangement
 - **FSA draft regulations to take effect next year would require disclosure of any combination of actual stock and synthetic stock that exceeds a 3% stake in the company (or, for a non-UK, LSE-listed company, a 5% stake)**



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SEC Enforcement Update

Patrick J. Haddad



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Enforcement Fast Facts

- 656 actions brought
 - 2nd highest number
 - Civil actions and administrative proceedings
- Issuer Reporting and Disclosure—33%
- Broker-Dealer—14%
- Investment Advisers—11%
- Securities Offerings—10%
- Delinquent filings—8%



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Enforcement Fast Facts

- 46 fraud cases, senior citizen victims
- 24 options backdating cases
 - 19 individual defendants, including 7 lawyers
- 47 insider trading cases—7% of total
 - 110 defendants
 - 21 hedge fund cases, with fraud on markets or on investors
- 5 municipal finance cases—1% of total



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Enforcement Fast Facts

- 5 “intrusion” cases (i.e., hacking in to IT systems)
- 219 Issuer Reporting and Disclosure
 - 33% of all cases
 - Includes 15 issuer penalties—a record
- 94 trading suspensions
 - Includes some from spam e-mails
- 24 trials
 - 70% success rate



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Enforcement Fast Facts

- Civil and administrative orders for disgorgement of \$1.093 billion of illegal profits
- Penalties of \$507 million
- Reported collection success rates vary due to various factors—timing issues affecting reporting, financial status and size of parties, etc.



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Enforcement Fast Facts

- SOX Fair Funds provision
- Return disgorged funds to harmed investors; penalties reduce losses to injured parties
- FY 2007 distributions included \$176.8 million transferred to the General Fund of the Treasury
- \$580.5 million distributed to harmed investors
 - \$260.7 million of total transferred from the Fiduciary Fund to cover distributions to the public



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Most Common Complaints

- Spam: Unwanted emails/faxes—Down 10%
- Advance fee fraud—Down 19%
- Manipulation of securities, prices, markets—Down 6%
- Account records: errors or omissions—Up 4%
- Transfer of account—Down 3%
- Delivery of funds or proceeds—Up 15%



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Most Common Complaints

- Account closing: Redemption, liquidation or closing—Down 11%
- Short selling—Down 4%
- Theft of funds or securities—Down 13%
- Misrepresentations: Inaccurate or incomplete disclosures—Up 8%
- SEC Investor Contacts—Even at 77,200



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SEC Enforcement Staff

- Division of Enforcement created in 1972
- One of four main divisions
- Consolidated enforcement activities
- Enforcement staff investigates possible violations of the federal securities laws
- Prosecutes the Commission's civil suits in federal courts and its administrative proceedings
- 11 Regional Offices: Enforcement & Compliance Inspections
- 4 working groups on special topics
 - Subprime lending
 - Options Backdating
 - Municipal Securities
 - Hedge Funds



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Enforcement Actions

Civil suits in federal courts

- Commission seeks injunctive relief, prohibiting future violations
- A person who violates an injunction is subject to fines or imprisonment for contempt
- Commission often seeks civil money penalties and the disgorgement of illegal profits
- The courts may bar or suspend individuals from acting as corporate officers or directors



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Enforcement Actions/Civil Suits

- 9 trials in 2008 to date
 - 8 wins for government
- Insider trading, financial fraud, touting, etc.
- Real remedies obtained:
 - Penalties of 2x or more
 - Lengthy Director and Officer bars
- Over last 3 years in federal courts
 - 26 wins and 3 losses
- Administrative proceedings over last 3 years
 - 80% win record



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Enforcement Actions

Administrative Proceedings

- Variety of administrative proceedings available
- Heard by administrative law judges and the Commission
- Cease and desist order—proceeding brought against any person who violates federal securities laws
- Commission may order disgorgement of ill-gotten funds
- Regulated entities (e.g., brokers, dealers and investment advisers) and their employees—proceedings to revoke or suspend registration, or to impose bars or suspensions from employment
- Authority to order payment of civil penalties and disgorgement



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Staff Enforcement Best Practices

- “Tone at the top” is key to avoiding trouble
- Problems are expensive to fix; big problems are very expensive
- “Tone at the top,” “ethical culture,” “compliance systems,” etc.
- “Credible cooperation” can reduce the all-inclusive cost of fixing the problem
 - Cost of defense and ultimate cash settlement
- Cooperation is especially helpful in avoiding criminal charges
- “Independent counsel” not always necessary for investigation
 - Depends on how high the misconduct, how pervasive, etc.
 - But it must be “credible” cooperation to count



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Insider Trading

- 66% of cases--trading in advance of M&A transactions
 - 50 cases, including 8 married couples
- Higher disgorgement/penalties--\$150 million, '07
- Increasingly international and recidivist
- People who should know better:
 - Securities professionals
 - Corporate officials
 - Attorneys



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Insider Trading

- Individuals from every major U.S. investment bank
- Sanctions/People who should know better
 - 1x or 2x penalties, D&O bars or “time out” from the industry
- Proposed agreement among the SROs
 - Improve detection of insider trading by centralizing surveillance, investigation and enforcement



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Insider Trading

Recent Examples

- Dow Jones
 - Dow Jones director tip of unsolicited cash share acquisition offer, before publicly known
 - Tipper: \$8.1 million penalty
- Credit Suisse
 - Insider misappropriation, unannounced business combinations, foreign nationals



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Subprime Issues

- Enforcement Subprime Working Group-'07
- Subprime mortgage lenders
- Investment banks and others that created, bought or sold credit derivative products — e.g. securities backed by pools of mortgages
- Retail and institutional sales of such products
- Other participants in subprime lending and credit markets, such as credit rating agencies, insurers, investment advisers and home builders
- Commission-wide Task Force- established '08



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Subprime Issues

- Enforcement Actions
- Doral (9/06) and First Bank (9/07) involve valuation of future income streams and interest-only (IO) strips
- Issue of true sale in transactions between the parties; full recourse agreements were not disclosed



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FCPA Cases

- Foreign Corrupt Practices Act--1977
- Prohibits bribes to foreign officials to obtain or retain business
- Record keeping and internal controls
- Other countries have followed suit
- Since Jan. 2006, more than 30 FPCA actions—More than filed in 27 prior years



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FCPA Cases

- Since 2004, 23 cases coordinating with Dept. of Justice
- Self-reporting is on rise
- Lucent: \$10 million paid to transport 1,000 Chinese officials to places like Disney World
- Cross-border cooperation
- Extensive range of penalties



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FCPA Cases

- Self-reporting of violations is advised
- StatOil found its scheme revealed in the Norwegian press
 - Company did diligence to confirm Iranian official's authority to pay out these sums
 - Management delayed disclosure and then responded inadequately
 - \$10.5 mm disgorgement/\$10.5 mm criminal penalty



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Enforcement Quotient Quiz

- It's time to test your Enforcement Quotient!
- Following the next screen, you'll view a video
- You will then be prompted to take a short quiz and to send us your answer



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Quiz

- Graystone Park Enterprises, Inc.
 - Colorado company, offices in Orlando
 - OTC/Pink Sheets (GPKE)
 - Assume not a 1934 Act filer
 - Promotional video on YouTube
 - Press releases
 - Statements on company website on financial condition, operations, management, and stock promoting activity



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Quiz



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Quiz

- Question: Why did the SEC suspend trading in GPKE?
- Was it due to:
 - a. The message?
 - b. The messenger?
 - c. The medium?
 - d. All of the above?
 - e. None of the above?



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Quiz

- Answer: (e) None of the above
- Questions regarding adequacy and accuracy of publicly disseminated information including current financial condition, management, business operations, and/or stock promoting activity
- Enforcement Action: Trading suspended, 10 day period ending 4/3/08. §12(k), 1934 Act



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Quiz

- Anti-Spam initiative, Microcap Fraud Working Group
- Trading suspended in 50 companies & other enforcement actions
- Trading not suspended in all stocks described in promotional videos
- SEC's Online Complaint Center--spam-related complaints down 68% from 166,741+ in Feb. 2007 to 53,785 in Feb. 2008



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Options Backdating

- 7 cases include former general counsel options backdating usually requires cooperation of GC acting as keeper of corporate minutes
- Parallel to US Attorney's prosecution
- Brocade – the first criminal conviction
- Monster – civil and criminal charges for conduct from 1997 to 2005



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Options Backdating

- SOX Section 304 “clawback” powers first used in UnitedHealth
 - CEO/Chairman repaid \$468 million in addition to penalty and D&O bar
- 80 cases in inventory – expected to run off in 2008



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Attorneys

- 39 cases against lawyers in 2007; average is 20 per year since 2002
- 15 issuer disclosure/ reporting cases; 8 insider trading charges
- 8 pump-and-dump cases with lawyers as enablers
- Cooperation and remedial acts can avoid issuer penalty:
 - “the stick of penalties”
 - “the carrot of cooperation”



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Attorneys

- Apple Corporation is the gold standard; it was not sued at all
- Many cases closed without public mention because of (i) cooperation and (ii) remediation; even if not closed without action, can result in “no penalty”



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Short Selling—Financial Stocks

- Temporary emergency action prohibiting short selling, financial stocks only—1934 §12(k)(2)
- 799 financial stocks; short selling prohibited from Sept. 19 to Oct. 2, unless extended
- Normal market: short selling contributes to price efficiency and adds liquidity
- Unbridled short selling appears a contributing factor to sudden price declines unrelated to true valuation
- Action in United Kingdom; NY AG investigation



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Questions and Answers



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Closing

- Mark Your Calendar
 - On November 19, 2008, the Society will be participating in the Fall Conference in Chicago
 - For more information visit:
<http://www.governanceprofessionals.org/chapters/chapdt.shtml>



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Poll Question

- From your personal perspective, would you prefer that the Detroit Chapter offer:
 - A) Only information sessions by webinar
 - B) A combination of webinar and in-person information sessions



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