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DECEMBER 2002

UNFINISHED BUSINESS

Rereading the brief transcript of Harvey Pitt's confirmation hearings before the United States Senate, one is struck simultaneously by how much, and yet how little, has changed since July 19, 2001. Chairman Pitt's fifteen months in office have shown the country what can happen when an agency becomes reactive, as September 11, the bursting of the technology bubble, and the string of spectacular public company failures have forced the SEC to be. Perhaps as a result, only two of the action items identified at the hearing — "real-time enforcement" and the abolition of Staff-driven regulation through such devices as substantive Staff Accounting Bulletins — could fairly be said to have been implemented. Other planned actions have, at least for now, been overtaken by events, including Mr. Pitt's stated interest in fostering a less-confrontational relationship between the Commission and those it regulates, and his desire to undertake a wholesale (and presumably deregulatory) review of all of the SEC's rules. In the next few months, as in the past five, the Commission will be doing all it can to meet the requirements imposed on it by the Sarbanes-Oxley Act, and to deal with the enforcement caseload that the agency has shouldered.

The time will come, though, and we hope soon, when a new Chairman and four nearly-new Commissioners will once again be able to take control of events and return to planning for the future. When that happens, there will be serious work to do in the following four areas, which were on the agenda fifteen months ago and will not go away:

Reforming the rules that govern the raising of capital. When the new issues market comes back, it will resume under the same archaic statutes, rules and regulations that have, in the main, been in force for 70 years. Many of those rules are throwbacks to another era in technology and communications, and impose requirements that have little or nothing to do with inspiring and maintaining investor confidence. In many ways (SEC workload aside), this is the ideal time to overhaul those rules. Recent events should sharpen the debate over what rules are needed — presumably, those that will best communicate reality to investors and thereby minimize the number of 21st-century Enrons — and those that are simply anachronisms that will impose a valueless drag on a rebounding economy; moreover, the SEC's new "current disclosure" rules would seem to have removed the reason for many of the regulatory burdens on secondary offerings, leaving IPOs as the major area for study.

Securities analysts. Since Mr. Pitt endorsed self-regulation and disclosure as the answer to analyst conflicts of interest, this field has been thoroughly occupied by state law enforcement, although at press time there are indications that the state enforcement process may finally be running its course. The analyst story illustrates the dangers of SEC abdication; both investors and the financial services industry deserve an industry-wide effort to restore trust in the markets, and neither is well served by approaching this issue as if it were a game of involuntary Russian roulette in which firms, and even individuals at those firms, are targeted by chance.

Securities market structure. Both Chairman Pitt and the senators who questioned him in his confirmation hearings identified market structure, and particularly concerns over fragmentation and the impact of decimalization, as important parts of the SEC's regulatory menu. The Commission recently held public hearings on the structure of the U.S. equity markets at which the participants discussed the collection, consolidation, and dissemination of market data broker-dealers' duty of best execution and the rules relating to intermarket

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DIRECTED BROKERAGE — The Best Execution Disconnect

Recent pending litigation focuses renewed attention on the question of how an investment adviser should tackle the duty of best execution when a client directs the adviser to execute all or a portion of its transactions through particular broker-dealers. These directed brokerage arrangements frequently arise in the context of commission recapture programs that allow retirement plans to use brokerage commissions to pay consulting fees or other expenses that the plans would otherwise have to bear. Although these arrangements may benefit clients, from the adviser's perspective they often complicate the best-execution analysis. This is particularly true where the adviser receives a "qualified" direction that is "subject to best execution."

The current dispute between the City of Gainesville Consolidated Police Officers' and Firefighters' Retirement Plan and its former investment adviser involves exactly this type of "qualified" direction. In that case, the retirement plan maintained that it had instructed the adviser to use its "best efforts to direct the plan's trades through the recapture program broker-dealers, pursuant to [the adviser's] fiduciary duty to obtain best execution." The trustees of the retirement plan later questioned whether the adviser was obtaining best execution given their contention that trades for the retirement plan were consistently executed after the adviser had placed block trades for its free-trading (or nondirected) accounts. The trustees alleged that these block trades, which were substantial in size, drove up (or down) the price of the security and resulted in a price and execution that was less favorable than that obtained for the adviser's free-trading accounts.

Advisers that receive this type of qualified directed brokerage instruction confront a "Catch-22." That is, the adviser essentially becomes caught between its duty of best execution and the client's expectation that the adviser will direct trades to particular broker-dealers so that certain commission targets will be met. Advisers use different approaches to address issues surrounding directed brokerage arrangements, including:

Considering the Directed Brokerage Arrangement in the Best-Execution Analysis — One approach is to consider the economics of the client's directed brokerage arrangement in the best-execution analysis. For example, an adviser may get comfortable executing trades through a directed broker at a commission rate higher than free-trading accounts pay by factoring in the directed broker's rebates to the client of a certain percentage of the commissions. Of course, an adviser needs to know the material terms of the recapture arrangements to factor them into its best-execution analysis. For this purpose, some advisers even work into their standard directed brokerage letters a requirement that the client inform them of the material terms of any commission recapture arrangements.

Reformulating the Instruction — Another approach is to convert the client's qualified direction into a "flat" instruction that the adviser execute all client transactions through a particular broker-dealer. The theory under this approach is that the adviser is not subject to traditional concepts of best execution with regard to the directed trades because the client has removed the adviser's discretion to select brokers and negotiate commission rates. This approach puts a burden on the adviser to inform its clients of the consequences of directed brokerage arrangements, including that the direction will affect the way the account is traded and may result in less favorable prices and execution than would be the case if the adviser were free to select brokers and negotiate commission rates. For this purpose, many advisers rely on detailed Form ADV disclosure and also ask clients to sign letters, commonly referred to as "Bailey letters" after a 1988 enforcement action against Mark Bailey & Co. Bailey letters generally make clear, in addition to the fact that the client direction may result in less favorable prices and execution, that clients who direct trades to particular brokers may not be able to participate in block trades, and that the adviser routinely executes trades for directed accounts only after it has executed trades for its free-trading accounts.

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SEC ACCELERATES FILING DATES FOR FORMS 10-K AND 10-Q

Earlier this year, the SEC announced that it intended to accelerate the filing of annual and quarterly reports by public companies as one of a series of steps designed to improve the financial reporting and disclosure system. On September 5, 2002, the SEC adopted rules to implement this initiative with respect to most domestic public companies. Under the new rules, the filing deadline for annual reports on Form 10-K will be accelerated from 90 days to 60 days following the end of a company's fiscal year. The filing deadline for quarterly reports on Form 10-Q will be accelerated from 45 days to 35 days following the end of the company's fiscal quarter. The accelerated filing deadlines will be phased in over a three-year period, although there will be no change in the current requirements until the second year.

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As adopted, the accelerated filing requirements differ somewhat from the rules as initially proposed. The proposed accelerated filing requirements would have become effective for public companies following the first fiscal year ending after October 31, 2002. In addition, the Form 10-Q filing deadline initially was proposed to be 30 days after the end of a company's fiscal quarter. However, the SEC adopted the "phase in" approach and the 35-day filing deadline for Forms 10-Q in response to a number of comments on the rules as proposed. Among other things, commentators argued that acceleration of the filing of annual and quarterly reports would negatively affect the quality and accuracy of reports. The SEC acknowledged that, while deadlines for filing periodic reports had not changed in over 30 years, "some companies . . . face additional complexities" in the current disclosure environment. The SEC also recognized that small or "unseasoned" companies may not have the resources and infrastructure in place to prepare reports on a shorter time frame "without undue burden and expense." In adopting a phase-in approach, the SEC stated that "companies will have additional time to plan for and adjust their reporting schedules and processes" and will also be able to adjust to "significant new changes and requirements in the reporting system" resulting from the Sarbanes-Oxley Act. In addition, the SEC, in determining to change the filing deadline for Form 10-Q to 35 days, rather than 30 days, after the end of the quarter, noted that a majority of commentators addressing the issue believed that it would be more difficult to accelerate the filing of the quarterly report than the annual report.

The new rules become effective for fiscal years ending on or after December 15, 2002. For the first year following effectiveness, there is no change in the reporting deadlines — they will remain at 90 days following the fiscal year-end for Forms 10-K and 45 days after the fiscal quarter-end for Forms 10-Q. In year two, the Form 10-K filing deadline will be accelerated to 75 days following the fiscal year-end and the Form 10-Q filing deadline will be accelerated to 40 days following the fiscal quarter-end. The phase-in will be complete in year three, during and after which the filing deadline for Forms 10-K will be 60 days following fiscal year-end and the filing deadline for Forms 10-Q will be 35 days following fiscal quarter-end.

The new filing requirements will be applicable to so-called "accelerated filers" (other than foreign private issuers, which are not subject to the new requirements). An accelerated filer is a public company that meets the following conditions:

- The company's common equity public float (the market value of voting and nonvoting common equity held by nonaffiliates) is $75 million or more.
- The company has been subject to the reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act for at least 12 calendar months.
- The company has filed at least one annual report under Section 13(a) or 15(d) of the Securities Exchange Act; and
- The issuer is not eligible to use Forms 10-KSB and 10-QSB (these are small business reporting forms for companies that are eligible to rely on the disclosure requirements of Regulation S-B) for its annual and quarterly reports.

The $75 million public float requirement is to be calculated as of the last business day of the company's most recently completed second fiscal quarter. Therefore, a calendar-year company that has been subject to Exchange Act annual and periodic reporting for at least 12 months and has filed at least one annual report would look to its public float as of June 30, 2002 in determining whether it meets the public float test under the new rules.

The following information relating to calendar-year accelerated filers illustrates the application of the new filing requirements. For these companies, the change in reporting deadlines will become effective as follows:

- Filings during 2003 — There is no change in the reporting deadlines. The Form 10-K must be filed by March 31, 2003 and the Forms 10-Q must be filed by May 15, August 14 and November 14, 2003.
- Filings during 2004 (a leap year) — The Form 10-K will be due on March 15, 2004. The Forms 10-Q will be due on May 10, August 9 and November 9, 2004.
- Filings during 2005 and thereafter — The Form 10-K must be filed no later than March 1 (February 29 in leap years). The Forms 10-Q will be due on May 5, August 4 and November 4.

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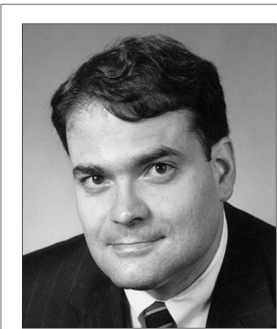
INTERNATIONAL STANDARDS OF CORPORATE GOVERNANCE

Recent corporate scandals have caused investors, market regulators and government officials worldwide to focus their attention on corporate governance standards. Clear standards and a strong rule of law are essential ingredients for improving investor confidence and economic growth in emerging markets. Fundamental changes in the structure of capital flows to emerging markets have taken place over the last decade, causing a shift from debt to equity financing. This shift has resulted in intense competition among companies in emerging markets for foreign institutional and portfolio equity investment. The international standards of corporate governance described below are characteristics that major international investment fund managers look for when determining where they will invest around the world.



This article is based on a speech delivered by our partner, Eduardo Vidal, at conferences in Brazil earlier this year. For more information, contact Mr. Vidal at 212.309.6955 or evidal@morganlewis.com.

The main objective of international corporate governance standards is to protect public and minority shareholders against improper asset diversion by controlling shareholders and senior management. As a general rule, companies should treat international and local shareholders equally, and not limit international ownership rights. Shareholders should determine mechanisms for fair voting, and should have the legal right to vote on all matters of importance, including mergers and acquisitions, and sales of substantial assets. Regulators should impose rules designed to limit controlling shareholders' ability to sell blocks of shares, auction off corporate assets, or take other actions that might disadvantage minority shareholders. Minority shareholders must also have the right to formally present issues to the board of directors if the minority shareholders own some predefined minimum threshold of outstanding shares.

A board of directors should be structured to provide an independent check on corporate management. A substantial majority of board members in foreign companies should be independent from corporate management. Prevailing international standards define an independent director as one who (1) has never been an employee of the company or its affiliates, (2) provides no services and is not employed by any entity providing services to the company, (3) is not a relative of any employee of the company, and (4) receives no compensation from the company, other than director's fees. In order to avoid major conflicts of interest, companies should consider separating the functions of the chief executive officer and the chairman of the board of directors. If independent board members participate actively in major corporate decisions, they will boost their company's credibility and appeal to institutional and portfolio equity investment managers.

Boards of directors should also form committees to monitor company operations effectively. Companies should consider having a nomination committee, a compensation committee, and an audit committee. The provisions of the Sarbanes-Oxley Act already by their terms apply to "foreign private issuers," which are non-U.S. companies that file public reports in the United States. These would include, for example, the Act's new standards for audit committee responsibility and independence, as well as its requirements that companies adopt codes of conduct for senior financial officers, and that senior officers certify companies' financial statements. The NYSE's amended listing standards, as currently proposed, would provide a more flexible approach by allowing "foreign private issuers" to continue to follow home-country corporate governance practices, so long as they disclose differences between those practices and the NYSE's standards. However, some have speculated that the NYSE approach will prove inconsistent with the Act, and may have to be revisited before final adoption of the amended listing standards. Application of U.S. corporate governance standards to foreign issuers would reverse a traditional reluctance of both regulators and lawmakers to apply U.S. governance standards to foreign issuers.

Ongoing discussions between U.S. regulators and regulators in other countries on the implementation of the new U.S. standards may provide an opportunity for the non-U.S. regulators to strengthen corporate governance standards generally in their home countries.

Accurate accounting and auditing are at the core of transparency and good corporate governance, and strongly influence investment decisions. In the current market, where investor confidence has reached record-low levels, companies should comply with international accounting and auditing standards in order to attract investors. Reports and accounts should include detailed information on off-balance-sheet transactions and business risks associated with such transactions.

The audit committee is a crucial element in corporate risk management. An audit committee should be composed of independent and financially literate directors, create a written charter spelling out the committee's responsibilities, and interact and discuss the company's accounting principles with its independent auditors. The audit committee should also be responsible for reviewing and discussing all audited financial statements, and disclosing its findings to shareholders.

In order to allay investors' fears, companies should publicly disclose their controlling and significant ownership

interests in other companies and ventures. Disclosure of accurate, adequate and timely information is essential to allow investors to make informed decisions about acquisitions, ownership obligations and rights, and stock sales. Companies should disclose minimally significant ownership (5% to 10%), and designate significant ownership (between 20% and 50%) as a controlling interest. Companies should abide by transparent and strict standards to protect investors; otherwise, they will not attract international institutional and portfolio investment.

A country's regulatory environment should also be credible and transparent in order to bolster investor trust and confidence. Regulatory bodies should not be perceived to be under the control or influence of any particular interest group. Regulators should be independent from industry and the executive branch of a country's government, and regulatory bodies should have enforcement and oversight powers. Exchanges should have the power to grant, review, suspend and terminate securities listings, and should be responsible for monitoring all listed securities. Countries that establish and maintain an effective rule of law will attract international investment and develop their equity capital markets.

Recent corporate scandals should serve as a wake-up call that nonobservance of corporate governance standards has impeded economic growth. Emerging market economies and companies competing for highly sought-after institutional and portfolio equity investment need to realize that they must conform to international standards of corporate governance in order to attract investment. The main goal of corporate governance standards is to protect public and minority shareholders from losses arising out of corporate malfeasance. Boards of directors should become more independent and act as a check on corporate officers' actions to avoid corporate disasters and increase investor confidence. Companies should follow international accounting and auditing standards and comply with regulatory requirements to create more valuable stock markets. Companies and their countries' economies will succeed in their efforts to grow and attract foreign investment when they comply with international standards of corporate governance.

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The filing deadlines will not affect timing with regard to the incorporation by reference of information from the proxy statement into the Form 10-K. So long as the annual meeting proxy statement is filed within 120 days following a company's fiscal year-end, proxy statement information regarding principal shareholders, directors and executive officers, executive compensation, business relationships and related-party transactions may be incorporated by reference into Part III of Form 10-K.

In addition, the SEC made clear that financial statements included in a registration statement filed under the Securities Act or in a proxy statement will be required to be at least as current as financial statements filed in annual and periodic reports under the Exchange Act. This means that financial statements in a registration statement may become "stale" earlier than is currently the case, in conformity with the accelerated filing deadlines for reports on Forms 10-K and 10-Q.

While the three-year phase-in will provide more time for companies to adjust to the accelerated reporting requirements, they should act now to enhance their ability to report on a timely basis in future years, particularly considering the significant increases in the volume and complexity of disclosures proposed and, in some cases, already adopted as a result of the Sarbanes-Oxley Act, as well as the recently adopted requirements relating to disclosure controls and procedures.

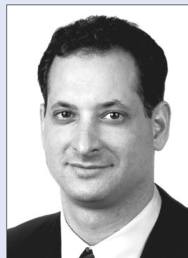
SIDEBAR

Employment Law Issues for Securities Firms

Overview of Sarbanes-Oxley Whistleblower Provisions

The Sarbanes-Oxley Act, signed into law by President Bush on July 30, 2002, contains far-reaching protections for employees who "blow the whistle" on securities fraud and corporate corruption. The Act includes two separate whistleblower provisions, one civil and the other criminal.

The civil liability provision applies to all companies with a class of securities registered under Section 12 of the Exchange Act or that are required to file reports under Section 15(d) of the Exchange Act, and to officers, employees, contractors, subcontractors, and agents of such companies. This provision prohibits retaliation against an employee who provides information or assists in an investigation regarding conduct that the employee "reasonably believes" constitutes a violation of any rule or regulation of the SEC; any provision of federal law relating to fraud against shareholders; or federal criminal law provisions prohibiting mail fraud, bank fraud, or fraud by wire, radio, or television. To be protected, the employee must have lawfully provided information to, or assisted in an investigation by, a federal regulatory or law enforcement agency; a member or committee of Congress; a person with supervisory authority over the employee; or a person working for the company who has the authority to investigate, discover, or terminate misconduct. The civil liability provision also protects an employee who has filed, testified at, or participated in legal proceedings relating to an alleged violation of the same laws, rules and regulations. An employee who establishes a violation is entitled to recover "all relief necessary to make the employee whole," including reinstatement, back pay, and "special damages" sustained as a result of the discrimination, including litigation costs, expert witness fees, and reasonable attorneys' fees. Unlike under other federal discrimination laws, there is no provision for the recovery of punitive or liquidated damages. An aggrieved employee must file a complaint with the Secretary of Labor within 90 days of the alleged violation. The Secretary is empowered to investigate the complaint, hold a hearing, and issue a final decision on the merits. However, the complainant has the right to initiate a private lawsuit in federal court if the Secretary has not issued a final decision within 180 days of the filing of the complaint. One very unusual provision requires the Secretary of Labor to issue a "preliminary order" ***reinstating*** the complainant with back pay ***before an evidentiary hearing is held*** in any case in which the Department of Labor determines there is "reasonable cause" to believe the complaint has merit. Employers should invest substantial time and effort during the investigatory stage to avoid the potential of the complainant's reinstatement pending a hearing.



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Sarbanes-Oxley also imposes criminal penalties for retaliation against whistleblowers. This criminal provision makes it unlawful to "knowingly, with the intent to retaliate, take[ ] any action harmful to any person, including interference with lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of ***any*** Federal offense." (Emphasis added.) Thus, while this whistleblower provision broadly covers the reporting of any federal offense (not just offenses relating to fraud) and any type of retaliatory action (not just adverse employment actions), it applies only where the information is provided to a law enforcement officer and is truthful. Individuals who violate this provision are subject to a fine of up to $250,000, imprisonment for up to 10 years, or both. Corporations may also be subject to criminal penalties and face fines of up to $500,000. The criminal penalty provisions are not limited to public companies; criminal penalties can be imposed on any company or person.

Important Issues Under the Act

- What procedures and burdens and allocations of proof will apply in proceedings before the DOL? Will the same burdens and allocations of proof apply in private lawsuits filed in federal court? Will employees be permitted two bites at the apple — *i.e.,* will they be permitted to pursue complaints that have been before the DOL for more than 180 days and then initiate a court action if they are dissatisfied with the results of the hearing before the Administrative Law Judge as long as they do so before a final decision is issued by the Secretary of Labor?
- Under what circumstances will a rogue broker, compliance officer or other employee terminated for a compliance violation be reinstated based on a whistleblower complaint before an evidentiary hearing is held?
- Will a jury trial be available to employees who elect to pursue a private lawsuit in federal court?
- Will registered employees and other employees with arbitration agreements be required to arbitrate Sarbanes-Oxley whistleblower claims?
- Under what circumstances will criminal penalties be imposed for discharging a whistleblower?

Recommended Actions for Employers

- Employers should establish and publicize policies to encourage employees to complain about any adverse employment actions

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UNFINISHED BUSINESS *continued from page 1*

access, trade-throughs, and price protection; the roles of national exchanges, ECNs, and alternative trading systems; and the SRO system. It is a credit to the Commission that this subject, even though deferred until now by public company disclosure and accounting matters, has remained on the agenda. It must stay there.

Globalization. True to its name, this is of course the biggest issue of all. In one of its aspects — international accounting standards — there has been real progress in recent months, and the current ferment in U.S. accounting standards has created a unique climate in which the discussion of international standards can flourish. In other areas, there remains much to do. The Sarbanes-Oxley Act's approach to foreign issuers — in short, "our way or the highway" — has raised doubts among overseas issuers about this country's true interest in considering common solutions to common problems. Until we modernize our capital-raising process and take stock of our approach to the trading of securities, we will have great difficulty in moving toward the global capital market that modern times demand.

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DIRECTED BROKERAGE *continued from page 2*

Focusing on Trade Sequencing Issues — One way to avoid claims, like those in the Gainesville case, that directed accounts arguably may be disadvantaged is for the adviser to batch trades for directed accounts together with those for free-trading accounts and instruct the executing broker to "step out" a portion of the trade to the directed broker. Alternatively, advisers can rotate the order in which trades for directed and free-trading accounts are executed so that trades for directed accounts are not always executed at "the end of the queue." Like rotational systems used in the allocation of investment opportunities, this approach generally is designed to ensure that an adviser's trade sequencing decisions are fair and equitable over time. However, on any particular trade a client may receive a more or less favorable execution relative to the adviser's other clients. Accordingly, it is important for advisers using a rotational system to inform clients through Form ADV disclosure or otherwise about that practice and the impact it might have on client trades. Regardless of the approach, advisers may wish to reexamine their trading procedures to ensure that all types of directed accounts, whether involving commission recapture arrangements, wrap programs or other types of restricted trading accounts, are traded appropriately.

Disclosing Trading Practices Clearly — The Gainesville case also reinforces the importance of disclosing to clients the implications of their directed brokerage arrangements. In that litigation, the trustees claimed that the adviser did not inform them, either directly or through Form ADV disclosure, that the plan's trades would routinely be executed at "the end of the queue" and that this approach would result in less favorable price and execution. In light of the Gainesville case, advisers should review their directed brokerage practices to ensure that they are documenting client directions and informing clients through Bailey letters, Form ADV disclosure or advisory agreements, as appropriate, of the consequences of those directions.

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SIDEBAR: OVERVIEW OF WHISTLEBLOWER PROVISIONS *continued from page 6*

that they believe were based on conduct protected by Sarbanes-Oxley. This will allow the employer to become aware of the issue, investigate it and, if appropriate, take remedial action, which, in turn, may reduce the risk of liability.

- Employers should develop training programs to educate all employees and other agents about the Act's whistleblower provisions. Officers, managers, and supervisors should be advised that they risk discipline up to and including discharge, as well as civil liability and criminal penalties, if they retaliate against employees who engage in protected conduct.
- Employers should review releases, settlement agreements, employment agreements, and confidentiality agreements, policies and codes of conduct regulating communications with regulatory or law enforcement agencies, reporting of corporate wrongdoing, and protection of confidential information, to ensure that they do not prohibit or penalize employees for engaging in conduct protected by the Act. For example, employers should review such documents for restrictions on communicating with, providing information to or assisting in investigations by governmental bodies or officials, or filing or participating in proceedings before governmental bodies. Such restrictions are commonly found in nondisclosure and nondisparagement provisions and in covenants not to sue.
- Employers should take special care in dealing with employees who have engaged in conduct protected by the Act.

SEC HISTORICAL SOCIETY SEEKS MEMBERS

The SEC Historical Society is undertaking a membership drive. The Society's mission is to preserve historical records, to provide access to information and to encourage scholarship on the SEC's role in sustaining vibrant capital markets. (Several Morgan Lewis attorneys, including SEC alumni and nonalumni, are active in the Society.) More information — including information on how to become a member of the Society — is available on the Society's website: www.sechistorical.org.

SRO PROPOSALS ON INTERNAL CONTROLS AND SALES PRACTICE SUPERVISION

Cases involving the misappropriation of customer funds and securities have focused the NYSE staff's attention on the effective implementation of internal controls and sales practice supervision. In response to issues raised by such cases — including the highly publicized matter earlier this year involving a producing branch manager, Frank Gruttadauria — the NYSE recently submitted to the SEC several proposed rule changes that, in the Exchange's view, are designed to strengthen the requirements relating to internal controls and supervision. The proposed rule changes include amendments to NYSE Rule 342 (*Offices — Approval, Supervision and Control*) and related interpretations, Rule 401 (*Business Conduct*), Rule 408 (*Discretionary Power in Customers' Accounts*) and Rule 410 (*Records of Orders*). The proposal has not yet been published for comment.

ADDITIONAL INTERNAL CONTROLS REQUIREMENTS

With a view toward highlighting the importance of internal controls systems, identifying areas where such systems can be most effectively implemented, and providing minimum standards for application, the NYSE's proposal first sets forth both general and specific internal controls requirements.

The NYSE proposes to add paragraph .23 to Rule 342 to further describe the general requirement that members develop and maintain adequate internal controls over all of their business activities. Paragraph .23 would require members and member organizations to memorialize controls for the "independent verification and testing" of business activities "separate and apart from the day-to-day supervision" of such activities.

In addition to the general independent verification and testing requirements, the NYSE proposes to amend Rule 401 to require firms to adopt specific internal controls policies and procedures over two areas of recent concern to the staff:

- Transmission of Customer Funds and Securities — Members would be required to establish controls over transmittals to outside entities, third-party accounts, locations other than a customer's primary residence, and between customers and registered representatives.
- Customer Changes of Address — Firms would be required to establish controls over changes of account addresses, which would be required to include "a reasonable method of customer notification that can be documented."

PROPOSED CHANGES ADDRESSING SUPERVISION

The NYSE also proposes changes to certain specific supervision requirements, some of which relate to alleged weaknesses identified by the staff in recent cases and reviews.

Supervision of Producing Managers

The NYSE proposes new Rule 342.19, which would require firms to develop and implement "written policies and procedures to independently supervise sales managers and other supervisory personnel who handle customer accounts" (*e.g.*, branch office, regional, or district managers). Pursuant to the proposal, to meet the requirement of "independent sales supervision," the supervisor would not be able to have a personal interest in the activity supervised. In the NYSE's view, this would remove doubt as to whether producing managers can "self-approve" their activities.

The NYSE provided little guidance on the meaning of the phrase "independent sales supervision." However, in recent congressional testimony concerning issues raised by the Gruttadauria matter, the Director of the SEC's Office of Compliance Inspections and Examinations, Lori Richards, stated that an independent review of a producing manager should be conducted by someone who is not "supervised by the manager" and whose "compensation is not controlled by the manager." The NYSE staff itself has indicated that whether a producing manager has control over the person supervising the manager's activity is important in evaluating the supervisor's independence. Specifically, in a survey sent to a number of

Recent Publications

NASD Sets Standards to Evaluate Delays in Disciplinary Actions, Ben A. Indek and John F.X. Peloso, *New York Law Journal* (October 17, 2002)

SEC Adopts Rules Accelerating Section 16 Reporting, Alan Singer, *Insights* (October 2002)

SRO Research Analyst Conflict of Interest Rules, Ben A. Indek and John V. Ayanian, *NSCP Currents* (September/October 2002)

Killing Two Birds With One Stone — Obtaining From Foreign Bank Clients Information Required by Sections 312 and 319(b) of the USA PATRIOT Act, Denise Speas Saxon, *CCH's Securities Regulatory Update*, Volume 5, Issue 18 (September 16, 2002)

Broker Liability: The Three Faces of Zandford, Christian J. Mixter, *The Journal of Investment Compliance* (Summer 2002)

firms prior to the issuance of the proposal, the staff asked firms whether producing managers were supervised by someone "outside of the control of the branch office manager" and, if so, whether the manager controlled the supervisor's salary and compensation.

Time-and-Price Discretionary Authority

According to the NYSE, Rule 408 does not currently provide guidance concerning the duration of a customer's grant of time-and-price discretion over an order. The NYSE's proposal would amend Rule 408(d) to "limit the authority of registered representatives to exercise time-and-price discretion over customer orders . . . to the end of the business day on which the customer granted such discretion."

Account Name and Designation Changes

Believing that account name and designation changes can be "indicative of serious sales practice violations," the NYSE proposes the following amendments to Rule 410:

- expanding the scope of Rule 410 to all orders, "not just those carried or transmitted to the floor,"
- requiring that the "person designated to approve account or name designation changes" be Series 9/10 or Series 14 qualified,
- clarifying that Rule 410 "applies to all account name and designation changes," not only "cancel-and-rebills," and
- requiring a firm to maintain "documentation of the essential facts relied upon when approving an account name or designation change."

Annual Branch Office Inspection

Finally, the NYSE's proposal would amend the interpretation of Rule 342 to clarify that persons who conduct annual branch office reviews "must be independent of any particular ongoing supervision, control, or performance evaluations in connection with the particular office." The NYSE adds that a person may maintain independence "by having no interest in a branch's 'bottom line' and by being outside of the branch's supervisory structure." In addition, the NYSE would require annual branch office inspection programs to include testing and verification of internal controls over certain areas, including safeguarding of customer funds and securities, supervision of customer accounts serviced by branch office managers, and changes in customer addresses and other account information.

NASD Proposal

As we went to press, the NASD submitted to the SEC its own proposal relating to internal controls and supervision. The proposal covers much of the same ground as the NYSE's. With respect to the supervision of managers' activities, the NASD proposal would require firms to "establish, maintain, and enforce written policies and procedures . . . reasonably designed to independently review and monitor servicing of customer accounts" by managers. The NASD proposal, like that of the NYSE, provides little guidance on the meaning of the phrase "to independently review and monitor" the activities of managers, only indicating that the sales activities of producing managers "should be subject to independent oversight to ensure that supervisors do not perform final review of their own sales activities."

As to office inspections, the proposal would require such examinations to be conducted by reviewers who are "independent from the activities being performed at the office and those persons providing supervision to that office." A member may satisfy the independent office review requirements by any "reasonable means based on the size and resources of the firm and scope and nature of its activities." A firm also would be permitted to seek an exemption from the requirements by satisfactorily showing "that complying with the requirements would be unduly burdensome on the member" and that "the member's internal inspection procedures are reasonably designed to achieve compliance with applicable securities laws and regulations and applicable NASD rules."

Also worth noting is the NASD proposal to require members to submit "no less than annually to the member's senior management" a report "detailing each member's systems of supervisory controls, including a summary of the test results and significant identified exceptions." This requirement is similar to that contained in existing NYSE Rule 342.30.

These proposals — including any differences in the treatment of the phrases "independently supervise" and "independently review and monitor" in connection with producing manager supervision — warrant close watching.

For more information, contact Ben Indek at 212.309.6109 or bindek@morganlewis.com; or Denise Speas Saxon at 202.739.5706 or dsaxon@morganlewis.com.

Morgan Lewis on Securities

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Design and Format by Lauren S. Braun and L. Lorraine Kent

SEC Administrative Proceedings in Fiscal Year 2002

Statistical Recap of Initial Decisions by the ALJs

In our December 2001 issue, we presented updated information on the SEC's administrative enforcement proceedings, following the analysis of dismissal rates and elapsed times that was originally presented in "A Client's Eye View of Outcomes in the SEC's Administrative Adjudication System," 15 *Insights* 14 (Jan. 2001). The data for the fiscal year ended September 30, 2002 are now in, and it's time to take another look.

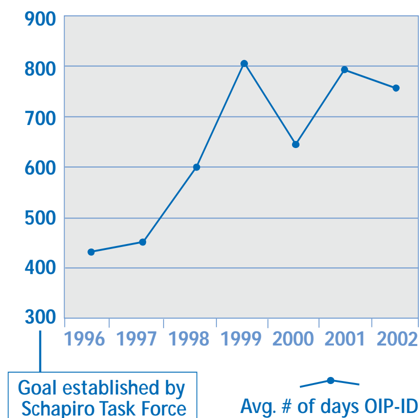
In FY 2002, the SEC released 20 Initial Decisions that represented first-time adjudications of cases; 17 decided original Administrative Proceedings (in which the ALJ was called upon to decide liability as well as sanction), and three decided follow-on proceedings (in which the respondent had already been sanctioned by a court and the only issue before the ALJ was the length of the bar or suspension that was appropriate). Just as in each of the previous six years, none of the follow-on cases was dismissed; because the number of original APs was slightly greater than in FY 2001, the Division of Enforcement's failure rate in original proceedings (defined as number of dismissals divided by number of original proceedings decided) declined slightly, from 33% to 29%, between FY 2001 and FY 2002, even though the number of proceedings dismissed in FY 2001 and FY 2002 remained constant at five. The seven-year average for proceedings dismissed now stands at 28%. The following table updates the judge-by-judge dismissal data presented in last year's issue to include the fiscal year just passed:

ALJ	DISMISSAL RATE IN ORIGINAL APS
Chief Judge Brenda P. Murray	9 percent (2/22)
Judge James T. Kelly	20 percent (2/10)
Judge Robert G. Mahony	33 percent (4/12)
Judge Carol Fox Foelak	41 percent (7/17)
Judge Lillian P. McEwen	60 percent (9/15)

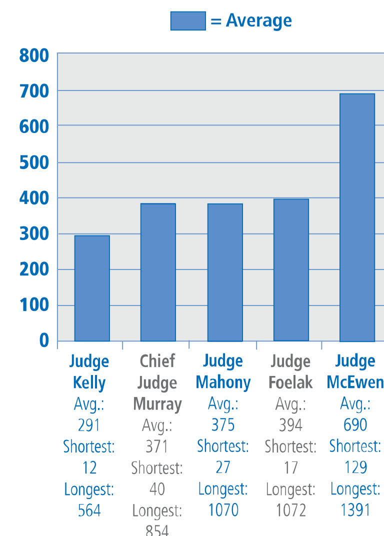
During FY 2002, the SEC decided only two of the six petitions for review of ALJ dismissals that were pending when the fiscal year began. As noted in last year's update, on October 15, 2001 the SEC reversed Judge McEwen's dismissal of *In the Matter of Quest Capital Strategies*; on February 21, 2002, the Commission also reversed Judge Foelak's dismissal of *In the Matter of Herbert Moskowitz*. Despite the snail's pace at which the SEC actually reviews initial decisions, there are indications that the Division of Enforcement is becoming more inclined to petition for review of dismissals. Specifically, of the five new Initial Decisions dismissing proceedings in FY 2002, the Division of Enforcement filed petitions for review in four (*In the Matter of James Thomas McCurdy, CPA, In the Matter of Robert J. Setteducati, In the Matter of Mark David Anderson*, and *In the Matter of Jeffrey M. Steinberg, et al.*), and acquiesced in the dismissal of only one (*In the Matter of Robert L. McCook*), thus appealing 80% of the dismissals in FY 2002 — compared to a 60% appeal rate for dismissals in FY 2001, and a 62% appeal rate for FY 1996-FY 2001 combined. Adding all of the above data to the information presented last year, the "survival rate" for the dismissals that the ALJs handed out in all of FY 1996-FY 2002 now stands at 67%, computed as follows:

3 *(Dismissals Affirmed by SEC)* **plus**
9 *(Dismissals Where No Review Was Sought)*
———————————————— **= 67%**
26 *(Total Dismissals)* **minus 8** *(Dismissals Where Petition for Review Is Pending)*

Compared to FY 2001, the FY 2002 Initial Decisions slightly slowed the long-term trend toward more protracted APs. As in each of the past seven fiscal years, the number of elapsed days from issuance of the Order Instituting Proceedings to issuance of the FY 2002 Initial Decisions (749) exceeded the 300-day goal that the Schapiro Task Force set in 1993; the trend line is shown in the following chart:



The ALJs' speed of decision — measured by the number of days between the end of the administrative hearing and the Initial Decision — still varies widely from judge to judge. With the FY 2002 data included, those figures are as follows:



For more information, contact Chris Mixter at 202.739.5575 or cmixter@morganlewis.com.

Morgan Lewis News

Transition at *Morgan Lewis On Securities*

Frank G. Zarb, Jr., will be assuming the role of coordinating editor of *Morgan Lewis on Securities*, beginning with our next issue. (Paul Huey-Burns has been coordinating editor since we began publishing the newsletter in early 2001.) Mr. Zarb is a partner in our Business and Finance Practice, resident in our Northern Virginia office. He counsels clients on all aspects of federal securities laws. He specializes in providing advice on corporate transactions (including venture capital investments and corporate acquisitions). Prior to joining Morgan Lewis, Frank was special counsel in the Office of Chief Counsel and in the Office of International Corporate Finance in the SEC's Division of Corporation Finance.

Mr. Zarb can be reached at 703.918.1741 or fzarb@morganlewis.com.

Visit Our New Website

Morgan Lewis has launched a new website: www.morganlewis.com. Of particular and timely interest, by clicking on "News," readers can access "Corporate America in Crisis — A Resource for Public Companies." This page focuses on breaking news, recently published articles and other materials that are intended to assist public companies in navigating the rapidly changing legal and regulatory landscape.

Bob Mendelson Appointed to IPO Advisory Committee

Robert C. Mendelson, co-chair of Morgan, Lewis's Securities Practice, has been selected to join the "Blue Ribbon" IPO Advisory Committee created by Richard Grasso (CEO of NYSE) and Robert Glauber (CEO of NASD).

Geoffrey C. Bible, retired Chairman and CEO of Philip Morris, is committee chair, and members include Daniel P. Tully, former Chairman and CEO of Merrill Lynch, John J. Brennan, Chairman and CEO of The Vanguard Group, and Peter A. Brooke, Chairman of Advent International.

Mr. Mendelson can be reached at 212.309.6303 or rmendelson@morganlewis.com.

Tom Lemke's Latest Best-Seller

Thomas P. Lemke, a partner in our Investment Management Practice, has authored *The Money Manager's ERISA Sourcebook*, published by Glasser LegalWorks in August 2002. It is a compendium of ERISA-related materials most frequently consulted by attorneys, compliance professionals, and business personnel who manage assets for pension plans, as well as others subject to the Employee Retirement Income Security Act of 1974.

Mr. Lemke can be reached at 202.739.5875 or tlemke@morganlewis.com.

Tim Levin Elected to the Partnership

Timothy W. Levin has been elected to the partnership, effective October 1, 2002. Mr. Levin's practice focuses on investment management matters for mutual funds, investment advisers, and hedge funds.

Mr. Levin can be reached at 215.963.5037 or tlevin@morganlewis.com.

Morgan Lewis Securities Lawyers Honored

Morgan Lewis is proud to announce that five members of our Securities Practice have been selected for inclusion in the 10th edition of *The Best Lawyers in America*. (A total of 43 Morgan Lewis lawyers — from our various practices — have been selected for this honor.) Published biennially since 1983, *The Best Lawyers in America* is regarded by both the legal profession and the public as the definitive guide to legal excellence in the United States.

The members of our Securities Practice included in the list are:

Linda L. Griggs, *Corporate, M&A, Securities, Washington, DC*

John F. Hartigan, *Corporate, M&A, Securities, Los Angeles*

Andrew J. Schaffran, *Labor and Employment, Securities, New York*

Howard L. Shecter, *Corporate, M&A, Securities, New York*

Marc J. Sonnenfeld, *Business Litigation, Philadelphia*

In Memoriam: Jonathan Kallman

It is with deep regret that we announce the death after a long illness of our friend and former colleague Jonathan Kallman. Jonathan was Of Counsel in Morgan Lewis's Washington and New York offices from 1996 through 2001. Prior to joining Morgan Lewis, he had a long and distinguished career at the Securities and Exchange Commission, where he served as Associate Director in the SEC's Division of Market Regulation, and was responsible for oversight of the nation's stock and options markets and the national clearance and settlement system. Jonathan was widely recognized as one of the leading experts in the country on clearance and settlement issues and Article 8 of the Uniform Commercial Code. He will be sorely missed by his many friends, associates and former colleagues.

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** Alan Singer maintains offices in both Philadelphia and Princeton*