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Corporate and Financial Weekly Digest

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SEC/Corporate

SEC Chairman Cox Outlines Anticipated Rulemaking for Credit Agencies

Against a background of criticism of rating agencies for their role in the sub-prime crisis, on April 22, Christopher Cox, Chairman of the Securities and Exchange Commission, gave testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs regarding increasing the SEC's oversight over credit rating agencies.

Chairman Cox noted that in recent years, a large number of structured finance products were brought to the credit rating agencies for their review, many of which were novel and complex. Newer products securitized sub-prime, adjustable rate and second lien loans, and often combined such loans with products like credit default swaps. Issuers of these structured finance products, looking to sell their securities to as broad an audience as possible, structured these securities to obtain high credit ratings from the credit rating agencies for at least the largest tranches. As the housing market declined, the credit rating agencies downgraded their ratings for an unprecedented number of residential mortgage-backed securities and collateralized debt obligations, and investors suffered substantial losses.

In 2006, the Credit Rating Agency Reform Act became law and gave the SEC regulatory responsibility over such agencies. While the SEC has had a formal regulatory program in place for such agencies since June 2007, in response to the current credit crisis Chairman Cox indicated that the Commission's credit agency rulemaking would now focus on three distinct areas:

1) Accountability. The Commission may consider rules that include requiring enhanced disclosure about ratings performance, enabling market participants to compare rating agencies' track records. The Commission may also consider rules that include specific prohibitions on certain practices and the establishment of requirements designed to address potential conflicts that impair the process of rating structured products.

2) Transparency. The Commission may consider rules requiring the disclosure of information about assets underlying structured products that the credit agencies are rating, which would allow market participants to perform improved due diligence on their investments. The Commission will also consider requiring credit agencies to disclose their methodology in determining a security's rating.

3) Competition. The Commission may also consider rules designed to ensure that enhanced disclosure about a firm's ratings performance affords other credit rating agencies a chance to identify flaws or

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For more information, contact:

Robert L. Kohl
212.940.6380
robert.kohl@kattenlaw.com

Mark A. Conley
310.788.4690
mark.conley@kattenlaw.com

David S. Kravitz
212.940.6354
david.kravitz@kattenlaw.com

opportunities for improvement on competitors' approaches and to demonstrate the superior performance of their rating methodology.

http://www.sec.gov/news/testimony/2008/ts042208cc.htm

Litigation

Plaintiff Cannot Use Transaction Causation to Plead Loss Causation

A Pennsylvania federal court granted defendants' motion to dismiss plaintiff's complaint under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 because plaintiff failed to plead economic loss and loss causation. Plaintiff alleged defendants made material omissions of fact when selling plaintiff securities relating to securities in wells in West Virginia and Ohio, and asserted that he would not have purchased the securities if material facts had been disclosed.

Defendants moved to dismiss, asserting that plaintiff's allegation of transaction causation (that, but for the omission, he would not have bought the security) could not also meet the requirement of loss causation (that the omission actually caused the economic loss suffered). The Court, relying on the Third Circuit's decision in *McCabe v. Ernst & Young LLP*, rejected the argument that plaintiff could plead loss causation by showing a causal nexus between defendants' omissions and plaintiff's decision to buy the securities. Holding that plaintiff was "essentially relying on transaction causation to prove loss causation but these two elements of a 10b-5 claim have to be proved separately," the Court granted defendants' motion and dismissed the complaint. (*Joyce v. Bobcat Oil & Gas, Inc.*, 2008 WL 919724 (M.D. Pa. Apr. 3, 2008))

Statements Concerning Dividend Increase Insufficient for Scienter Requirement

A Texas federal court granted defendants' motion to dismiss plaintiffs' claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 because plaintiffs failed to plead sufficient facts that would give rise to a strong inference of scienter as required by the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*

Plaintiffs alleged that defendant fraudulently induced them to participate in a tender offer by failing to disclose that there would be a dividend increase and stock repurchase after the tender offer. The tender offer stated that management was reevaluating whether, if at all, it would recommend changes to the company's dividend policy. Less than a month after the tender offer, the company raised the dividend and announced a stock repurchase plan, causing a dramatic stock price increase.

The court found that these allegations were insufficient for a strong inference of scienter under *Tellabs*, which requires courts to consider opposing inferences of non-fraudulent intent. The court noted that there is a "fine (but important) distinction between *planning* for a *possible* dividend increase and *concealing* an *imminent* dividend increase." Therefore, because the opposing inferences of non-fraudulent intent were as plausible as plaintiffs' allegations of scienter, the Court dismissed the complaint. (*Flaherty & Crumrine Preferred Income Fund Inc. v. TXU Corp.*, 2008 WL 918339 (N.D. Tex April 4, 2008))

LITIGATION

For more information, contact:

Bruce M. Sabados
212.940.6369
bruce.sabados@kattenlaw.com

David S. Stoner
212.940.6493
david.stoner@kattenlaw.com

ISE Proposes Rule Change to Expand the Applicability of Its PIM

The International Securities Exchange, LLC (ISE) has filed with the Securities and Exchange Commission a proposed rule change that will allow members to enter orders into the ISE Price Improvement Mechanism (PIM) at a price that matches the national best bid or offer (NBBO) when the ISE market is inferior to the NBBO.

Currently, the PIM allows members to enter two-sided orders for execution at a price that improves upon the NBBO. In an effort to provide broker-dealers with an alternative method of achieving an execution at the NBBO for their customers without having to pay taker fees, the proposal would extend the application of the PIM to permit a member to enter an order into the PIM at a price that is equal to the NBBO when the ISE's best bid or offer is inferior to the NBBO. Members will therefore be guaranteed execution of their customer orders on the ISE at a price that is at least as good as the NBBO. Allowing members to guarantee their customers an execution at the NBBO on an exchange that does not charge a taker fee will lower the cost of trading and promote a more efficient marketplace.

http://www.sec.gov/rules/sro/ise/2008/34-57632.pdf

CBOE Proposes to Delete RMM from Rulebook

The Chicago Board Options Exchange (CBOE) received Securities and Exchange Commission approval for proposed rules changes that, among other things, delete the category of Remote Market Makers (RMMs) from the CBOE rulebook. The CBOE noted that the RMM category had essentially become obsolete given the expansion of opportunities for Market Makers to quote outside the floor and the fact that the existing obligations of Market Makers and RMMs under CBOE rules were now generally the same. CBOE made a number of additional rule changes in connection with this filing, including: amending the definition of Market Maker to include member organizations and clarifying Market Maker as a status that is approved by the Membership Committee, adopting changes to allow any member organization that is the owner or lessee of more than one membership to designate one individual to be the nominee for all memberships utilized by the organization, adding language to existing CBOE Rule 8.3 to provide for no restriction on affiliated Market Makers holding an appointment and submitting electronic quotations in the class under certain circumstances.

http://www.sec.gov/rules/sro/cboe/2008/34-57615.pdf

CBOE Proposes a New Mechanism for Auctioning Certain Orders

The Securities and Exchange Commission has approved a Chicago Board Options Exchange (CBOE) proposal to establish a new automated mechanism for auctioning larger-sized orders and to modify its existing automated improvement mechanism (AIM) to permit its use for the execution of complex orders. CBOE developed AIM to permit unsolicited agency orders (Agency Orders) to be electronically executed against principal or solicited interest. CBOE has enhanced AIM to accommodate larger-sized simple and complex Agency Orders that are to be executed against solicited orders (Auction). The new rule implements this functionality in options classes designated by CBOE.

The rule would also require members to deliver to customers a written document, in a form approved by CBOE, describing the terms and conditions of the Auction mechanism prior to executing Agency Orders using the Auction mechanism. In addition, the rule would prohibit members of CBOE from using

BROKER DEALER

For more information, contact:

James D. Van De Graaff
312.902.5227
james.vandegraaff@kattenlaw.com

Daren R. Domina
212.940.6517
daren.domina@kattenlaw.com

Patricia L. Levy
312.902.5322
patricia.levy@kattenlaw.com

Morris N. Simkin
212.940.8654
morris.simkin@kattenlaw.com

Janet M. Angstadt
312.902.5494
janet.angstadt@kattenlaw.com

Ross Pazzol
312.902.5554
ross.pazzol@kattenlaw.com

Lance A. Zinman
312.902.5212
lance.zinman@kattenlaw.com

the Auction mechanism to circumvent CBOE's rules limiting principal order transaction.

http://www.sec.gov/rules/sro/cboe/2008/34-57610.pdf

CFTC

CFTC Hosts Agricultural Markets Roundtable

The Commodity Futures Trading Commission hosted a roundtable discussion regarding unusual volatility and other developments in agricultural markets. Participants, including CFTC Commissioners and staff and representatives from other government agencies, academia and industry, discussed current concerns regarding the incomplete price convergence recently observed in certain commodity markets, as well as the dramatic price increases for agricultural commodities within the past year.

CFTC Acting Chairman Walter Lukken stressed the need for a measured response to present conditions. To that end, Lukken signaled that the CFTC is unlikely to move forward swiftly on its pending proposals to raise speculative position limits for domestic agricultural commodities and to create a new "risk management" exemption for commodity index traders, hedge funds and other professional money managers. Jeff Harris, the CFTC's Chief Economist, noted, however, that it is not apparent that participation by these types of investors can be linked to recent price surges in the commodities markets, or more generally to the failure of futures and cash prices to converge when futures contracts are delivered. Harris observed that participation by professional money managers was relatively constant during 2007, and suggested that increasing costs of arbitrage (including increases in freight and storage costs with respect to the underlying commodities) have contributed to decreasing price convergence between cash and futures prices.

http://www.cftc.gov/newsroom/cftcevents/2008/oeaevent042208.html

CFTC

For more information, contact:

Kenneth Rosenzweig
312.902.5381
kenneth.rosenzweig@kattenlaw.com

Fred M. Santo
212.940.8720
fred.santo@kattenlaw.com

Kevin Foley
312.902.5372
kevin.foley@kattenlaw.com

Lance A. Zinman
312.902.5212
lance.zinman@kattenlaw.com

Banking

Banking Regulators Release Revised Guidance on Business Continuity Planning

On March 19, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Conference of State Bank Supervisors (collectively, the Banking Agencies) issued, as members of the Federal Financial Institutions Examination Council (the FFIEC), revised guidance for examiners, financial institutions and technology service providers to identify business continuity risks and evaluate controls and risk management practices for effective business continuity planning.

The guidance rescinds and replaces a previous Business Continuity Planning booklet that was issued by the FFIEC in March 2003.

According to the FFIEC, the "focus of the booklet continues to be based on an enterprise-wide, process-oriented approach that considers technology, business operations, testing, and communication strategies that are critical to business continuity planning for the entire business, instead of just the information technology department." The introduction to the booklet notes that changes in technology and business operations, increased terrorism concern, recent catastrophic natural disasters, and the threat of a pandemic have focused enhanced attention on business continuity planning.

BANKING

For more information, contact:

Jeff Werthan
202.625.3569
jeff.werthan@kattenlaw.com

Christina J. Grigorian
202.625.3541
christina.grigorian@kattenlaw.com

Adam Bolter
202.625.3665
adam.bolter@kattenlaw.com

As the regulators noted in the introduction to the guidance, “financial institutions play a crucial role in the overall economy [and] disruptions in service should be minimized in order to maintain public trust and confidence in the financial system.”

http://www.ots.treas.gov/docs/7/778011.html

* Click here to access the *Corporate and Financial Weekly Digest* archive.

Katten

Katten Muchin Rosenman LLP

www.kattenlaw.com

Charlotte
401 S. Tryon Street
Suite 2600
Charlotte, NC 28202-1935
704.444.2000 tel
704.444.2050 fax

Chicago
525 W. Monroe Street
Chicago, IL 60661-3693
312.902.5200 tel
312.902.1061 fax

Irving
5215 N. O’Connor Boulevard
Suite 200
Irving, TX 75039-3732
972.868.9058 tel
972.868.9068 fax

London
1-3 Frederick’s Place
Old Jewry
London EC2R 8AE
+44.20.7776.7620 tel
+44.20.7776.7621 fax

Los Angeles
2029 Century Park East
Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel
310.788.4471 fax

New York
575 Madison Avenue
New York, NY 10022-2585
212.940.8800 tel
212.940.8776 fax

Palo Alto
260 Sheridan Avenue
Suite 450
Palo Alto, CA 94306-2047
650.330.3652 tel
650.321.4746 fax

Washington, DC
1025 Thomas Jefferson Street, NW
East Lobby, Suite 700
Washington, DC 20007-5201
202.625.3500 tel
202.298.7570 fax