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Corporate and Financial Weekly Digest

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SEC/Corporate

SEC Issues Final Report on Improvements to Investor Financial Reporting

In July 2007, the Securities and Exchange Commission created an Advisory Committee on Improvements to Financial Reporting (CIFR) to examine the U.S. financial reporting system and make recommendations to reduce unnecessary complexity and make financial reports more useful and understandable to investors.

On August 1, CIFR presented its Report to SEC Chairman Christopher Cox. The Report contains twenty-five recommendations, providing practical proposals to improve financial reporting in the following five areas:

- increasing the usefulness of information in SEC filings,
- enhancing the accounting standards-setting process,
- improving the substantive design of new standards,
- delineating authoritative interpretive guidance, and
- clarifying guidance on financial restatements and accounting judgments.

To make financial information more useful to investors and less complex, CIFR recommended the inclusion of a short executive summary at the beginning of a company's annual report on Form 10-K (with material updates in quarterly reports on Form 10-Q), describing concisely the most important themes or other significant matters with which management is primarily concerned. It also expressed support for the SEC's Extensible Business Reporting Language, or XBRL, initiative.

To enhance the accounting standards-setting process and to ensure that financial reports will be useful to investors, CIFR suggested increased investor representation on the Financial Accounting Standards Board (FASB) and the Financial Accounting Foundation (FAF).

CIFR recommended a new approach to the design of accounting standards focused on underlying objectives and principles, and advocated a move away from industry-specific guidance in authoritative literature to guidance based on the nature of the business activity itself, since the same activities may be carried out by companies in different industries. CIFR also recommended that the FASB eliminate alternative accounting methods for transactions with similar economics.

To reduce complexity associated with U.S. GAAP, CIFR strongly supported the FASB's efforts to complete the codification of all U.S. GAAP in one document. Others such as audit firms may still publish their views on accounting issues, but they should be labeled as non-authoritative. CIFR also called for a clearer delineation of functions on interpreting accounting standards — with the FASB

SEC/CORPORATE

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taking the lead on broad issues and the SEC on registrant-specific issues.

Finally, to clarify guidance on financial restatements, CIFR recommended that the determination of whether an accounting error is material be separated from the decision as to how to correct the error. CIFR suggested that the correction of an accounting error should not automatically result in a restatement of financial statements for several prior years, expressing concern that during the time period involved in preparing restatements companies generally cease filing current financial reports, often resulting in a "dark period" during which investors receive only limited information. CIFR recommended that prior period financial statements be restated only if the error would be material to investors in making current investment decisions.

Chairman Cox has asked the SEC staff to immediately begin analyzing these recommendations, and to prepare relevant regulatory proposals wherever appropriate.

http://www.knowledgemosaic.com/gateway/Rules/PRE.2008-166.080108.htm
http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf

Litigation

Second Circuit Dismisses Claims but Validates "Corporate Scienter" Theory

The Second Circuit vacated and remanded a district court's decision denying defendants' motion to dismiss a putative securities fraud class action filed against a financial service company, its subsidiary and two executive officers. The complaint alleged that the defendant companies systematically originated defective loans despite clear signs that borrowers were not creditworthy, publicly misrepresented the companies' reasons for restating their loan loss reserves, and concealed the faulty underwriting procedures employed in their loan approval process. The District Court granted the individual defendants' motion to dismiss the complaint for failure to adequately plead scienter, but denied that motion as to the corporate defendants.

On appeal, the Second Circuit rejected defendants' argument that plaintiff could not, as a matter of law, plead scienter against the corporate defendants because it had failed to plead scienter against the individual executive officer defendants. To the contrary, the Second Circuit ruled that a plaintiff could satisfy the Private Securities Litigation Reform Act's scienter pleading standard with respect to a corporate defendant by pleading facts creating a "strong inference" that someone whose intent could be imputed to the company acted with the requisite scienter—even if the actor is not specifically identified and named as a defendant. However, after analyzing the plaintiff's allegations, the Second Circuit ruled that plaintiff had not satisfied this burden either with respect to the individual defendants or any other employee or agent of the corporate defendants. (*Teamsters Local 445 Freight Div. Pension Fund. V. Dynex Capital Inc.*, 531 F.3d 190 (2d Cir. June 26, 2008))

Plaintiff Adequately Pleaded Defendants' Failure to Disclose Material Facts

A federal district court denied in part defendants' motion to dismiss a putative shareholder class action complaint filed against a corporation and its directors and officers based upon alleged omissions and misrepresentations in a proxy statement relating to a shareholder vote on a merger transaction pursuant to which the company would be sold. Plaintiff alleged that the proxy statement circulated by defendants and filed with the Securities and Exchange Commission in August 2005 failed to disclose current revenues and profits of the company's "crown jewel" asset (the popular MySpace website) and internal

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management projections forecasting the growth of the company based upon the operations of its "crown jewel."

In denying the portion of defendants' motion to dismiss based on their contention that the alleged omissions were not material, the court ruled that the omission of current financial information showing the rapid growth of the "crown jewel" was material—notwithstanding defendants' public filing of its 10-Q, which disclosed the company's financial performance (including that of its "crown jewel") through June 30, 2005. The court specifically found that there was a reasonable likelihood that a reasonable shareholder would have considered specific, current information about a "critical asset" important in deciding how to vote on the merger. Similarly, the court ruled that the failure to disclose management projections for the years 2005 to 2009 was a material omission, citing Ninth Circuit precedent recognizing that such data would "surely [pique] the average investor's interest." (*Brown v. Brewer, et al.*, 2:06-cv-03731 (C.D. Cal. July 14, 2008))

Broker Dealer

NYSE Euronext to Acquire Amex and Rename it "NYSE Alternext US"

On August 1, the American Stock Exchange (Amex) filed a proposal with the Securities and Exchange Commission to permit its merger into the NYSE Group, a wholly owned subsidiary of NYSE Euronext, and its renaming as "NYSE Alternext US." The proposal would also make certain other changes relating to corporate governance and other items to accommodate the transformation of the Amex from its current status as a subsidiary of a not-for-profit member-owned corporation into its post-merger status as a U.S.-regulated subsidiary of NYSE Euronext. Upon completion of the NYSE/Amex merger, NYSE Alternext US will continue to engage in the business of operating a national securities exchange registered under Section 6 of the Securities Exchange Act of 1934, and will continue to have self-regulatory responsibilities over its members. NYSE Alternext US will contract for the performance of its regulatory responsibilities with NYSE Regulation, an indirect wholly owned subsidiary of NYSE Euronext, pursuant to a regulatory services agreement.

NYSE Euronext has filed a concurrent proposal to approve certain rules changes to effect the merger. Under the proposal, a number of technical changes will be made to the NYSE Euronext bylaws to properly reflect the post-merger corporate structure. The proposal also modifies the SEC-approved independence policy of the NYSE Euronext board of directors by decreasing the "look-back period" with respect to directors' relationships with members of the Exchange and NYSE Arca from three years to one year. The proposal will also expand the Committee for Review, which hears disciplinary appeals for NYSE Alternext, to include four individuals associated with member organizations of NYSE Alternext.

NYSE Proposal: http://www.sec.gov/rules/sro/nyse/2008/34-58285.pdf
AMEX Proposal: http://www.sec.gov/rules/sro/amex/2008/34-58284.pdf

NYSE Euronext to Waive in Amex Members and Trade Amex Securities

NYSE Euronext has filed a proposal with the Securities and Exchange Commission to amend its rules governing membership in order to waive into the Exchange members in good standing of the Amex following the merger with NYSE Euronext. Under the proposal, Amex Equities and Options trading systems will be migrated to the NYSE facility at 11 Wall Street, with Amex members receiving temporary permits to continue trading on existing Amex systems until the migration is complete. After the Equities systems migrate to NYSE Alternext systems, a holder of a temporary permit will only be able to

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trade products other than those that have relocated. Amex members that do not immediately qualify for membership under the NYSE Alternext Equities rules will be given a six-month grace period in which to come into compliance. Conforming rules changes will provide that an NYSE Alternext member organization is deemed qualified and approved as an NYSE member organization and is thus eligible to hold an NYSE trading license. The proposal also states that Exchange membership would be automatic for NYSE Alternext member organizations and that such NYSE Alternext member organizations would be exempt from the Exchange's new member organization application fee.

In addition, NYSE Alternext will adopt NYSE Rules 1 to 1004, as applicable, as its rules.

Amex Equities will relocate to 11 Wall Street as soon as practicable after the acquisition. Amex Options will relocate to 11 Wall Street about February 2009. The Amex expects to discontinue listing and trading of exchange-traded funds and certain structured products, including index and currency warrants. These products will be listed and traded on NYSE Arca. There will be no cross-listing of NYSE listed securities or Amex listed securities.

http://www.sec.gov/rules/sro/nyse/2008/34-58290.pdf
http://edocket.access.gpo.gov/2008/pdf/E8-18073.pdf

Investment Companies and Investment Advisers

SEC Proposes Guidance on Directors' Duties to Oversee Portfolio Trading Practices

On July 30, the Securities and Exchange Commission published proposed guidance regarding the fiduciary responsibilities of boards of directors of registered investment companies with respect to the oversight of investment adviser portfolio trading and related "soft dollar" practices. The proposed guidance addresses the duty to seek best execution and consideration of transaction costs, the use of fund brokerage commissions, the limitations of Section 28(e) of the Securities Exchange Act of 1934 and the fiduciary duties of investment advisers to fund clients. Suggested information to be considered in a board of directors' review process is provided. The proposed guidance does not impose any new obligation on directors, but is intended to assist in their review of investment advisory agreements under Section 15(c) of the Investment Company Act of 1940 and their ongoing review of investment adviser practices. The comment period for the proposal ends October 1.

http://sec.gov/rules/proposed/2008/34-58264.pdf

Identity Theft Prevention Rules Apply to Certain Investment Companies

Effective November 1, investment companies that allow account holders to make withdrawals that are payable to third persons by check, transferable or negotiable instruments, or similar items (e.g., debit cards) must have established and obtained board approval of an identity theft prevention program designed to identify and detect relevant "red flags" pursuant to the 2003 amendments to the Fair Credit Reporting Act. The program must have written approval from the board of directors or an appropriate committee thereof, and the board of directors, an appropriate committee, or a designated employee at the senior level of management must be involved in the oversight, development, and administration of the program.

http://ftc.gov/os/fedreg/2007/november/071109redflags.pdf

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SEC Re-Opens Comment Period on Investment Company Disclosure Proposals

On July 31, the Securities and Exchange Commission re-opened the public comment period on its November 2007 proposals (Securities Act Release No. 8861 (Nov. 21, 2007) [72 FR 67790 (Nov. 30, 2007)]) to standardize, and increase the plain-English content of, investment company disclosures. The 2007 proposals included the requirement for a summary prospectus and a modification of fund prospectus delivery requirements. The new comment period for these proposals ends on August 29.

http://www.sec.gov/rules/proposed/2008/33-8949.pdf

Structured Finance and Securitization

American Securitization Forum Files UDAP Comment Letter with Federal Reserve Board

On August 4, the American Securitization Forum (ASF) filed a comment letter with the Federal Reserve Board regarding rule changes to Regulation AA (the Proposed Rule) relating to credit card unfair or deceptive acts or practices (UDAP) which were proposed by the Fed, the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) on May 19. Among other requirements, the Proposed Rule would prohibit institutions from engaging in certain acts or practices in connection with consumer credit card accounts.

In its response, the ASF shared the view of the Fed, OTS and NCUA that UDAP must be addressed to protect consumers. However, it also expressed concern that the Proposed Rule's restrictions on pricing and other provisions would ultimately limit the variety and raise the cost of credit products available to consumers by restricting an issuers' ability to act in certain instances. As an alternative, the ASF proposes that many of the concerns underlying the Proposed Rule could be addressed with simplified disclosures.

http://www.americansecuritization.com/uploadedFiles/ASF_UDAP_Comment_Letter_8_4_08.pdf

House Financial Services Committee Approves Credit Card Legislation

On July 31, the House Financial Services Committee approved credit card legislation, the Credit Cardholders' Bill of Rights Act of 2008, H.R. 5244. The pre-Committee markup form of the bill would, among other things, (i) ban universal cross defaults; (ii) require companies to provide cardholders with 45 days advance notice of rate increases; (iii) prohibit double-cycle billing; and (iv) allow opt-out of creditor authorization of over-the-limit transactions if fees are imposed.

http://maloney.house.gov/documents/financial/h.r.5244billtext.pdf

Banking

FDIC Modifies Deposit Calculation Rules for Some Banks

On July 17, the Federal Deposit Insurance Corporation (FDIC) adopted a Final Rule requiring certain "covered institutions" to modify their systems to facilitate determination of the insurance status of depositors in the event such institution fails. A "covered institution" is any insured depository institution with at least $2 billion in domestic deposits and either more than 250,000 deposit accounts or total assets over $20 billion.

STRUCTURED FINANCE AND SECURITIZATION

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The Final Rule requires covered institutions to adopt mechanisms that would, in the event of the institution's failure, provide the FDIC with standard deposit account and other customer information and allow the placement and release of holds on liability accounts, including deposits.

In the same release, the FDIC also adopted an Interim Rule establishing practices for determining deposit and other liability account balances at a failed insured depository institution. In particular, the Interim Rule addresses how the FDIC will treat sweep accounts in the event of an institution's failure and requires insured institutions to disclose to customers whether the swept funds will be treated as deposits or uninsured claims in the event of such a failure.

The effective date for both rules is August 18, although the requirements in the Interim Rule regarding customer disclosure of the treatment of sweep account funds in the event of an institution's failure will not be effective until the termination of a public comment period on July 1, 2009.

http://www.fdic.gov/regulations/laws/federal/2008/08Interim717.html

UK Developments

FSA Concludes HBOS Investigation

On August 1, the UK Financial Services Authority (FSA) announced the results of its investigations into trading in March in shares of HBOS plc (HBOS). FSA staff from its Enforcement, Markets, Supervision and Intelligence Departments analyzed trading in HBOS and contacted market participants and news organizations to determine whether misleading, false or deceptive information about HBOS had been spread by anyone in order to profit from a reduction in the company's share price.

The FSA concluded that, despite the likelihood that certain rumors contributed to the fall in the company's share price, there was insufficient evidence that these rumors were spread as part of any concerted attempt to profit by manipulating the market. Therefore, no action will be taken against any individuals or firms.

The FSA stated that it is following up various wider issues that this rumor case has highlighted through its ongoing thematic and supervisory work. The FSA's Markets Division has launched a review of the systems and controls at regulated firms for dealing with rumors. There will be a particular focus on what policies are in place and how firms ensure compliance with them, whether and how rumors are verified, whether traders are permitted to pass on or trade on rumors, and how firms ensure staff do not initiate or spread false rumors.

www.fsa.gov.uk/pages/Library/Communication/PR/2008/086.shtml

EU Developments

European Commission Clarifies MiFID Exemption Rules

On August 7, the European Commission published the latest version of its questions and answers database on the EU Markets in Financial Instruments Directive (MiFID). Among the added questions and answers are clarification that firms providing investment services to non-group as well as group companies are subject to MiFID in relation to their whole business, not just non-group services. There are also clarifications on the treatment of offshore funds, the status of third parties in outsourcing arrangements, best execution obligations and securities lending, and the scope of post-trade transaction reporting.

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Although the European Commission's database is not formal, legally binding guidance, it reflects the considered views of the Commission.

ec.europa.eu/internal_market/securities/docs/isd/questions/questions_en.pdf

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

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