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Corporate and Financial Weekly Digest

July 25, 2008

SEC/Corporate

House Subcommittee Approves Securities Act of 2008 to Enhance SEC Enforcement Powers

On July 9, the Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee approved the Securities Act of 2008 for consideration by the House Financial Services Committee. The Act would amend numerous provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The following is a summary of the certain substantive changes contained in the Act.

1. Civil Penalties in Cease and Desist Proceedings

Section 8A of the Securities Act would be amended by adding a new provision that would provide the Securities and Exchange Commission with the authority to impose civil money penalties in cease and desist proceedings before an SEC administrative law judge, against anyone alleged to have violated the Act.

Section 21B(a) of the Exchange Act, Section 9(d)(1) of the Investment Company Act, and Section 203(i)(1) of the Advisers Act would be similarly amended by adding subsections that would authorize the SEC to impose civil penalties in cease and desist proceedings against any defendant before administrative law judges.

2. Scope of Exemption from State Securities Registration

The Act proposes to add a provision to the Securities Act that would allow the New York Stock Exchange, the NASDAQ Stock Market LLC and the American Stock Exchange to establish tiers on which stocks can be listed, even if those stocks would not otherwise qualify as “covered securities” exempt from state registration requirements.

3. Exempt Offerings

The Act would amend Section 18(b)(4)(D) of the Securities Act to provide that states can require that notice filings for exempt securities contain all of the information required by Form D including the appendix to Form D.

Other changes approved by the Subcommittee include:

- Amending provisions of the Exchange Act and Advisers Act to prevent associated persons who violate federal securities laws in one capacity (i.e., as an associated person of a broker dealer) from being associated with other securities businesses in a different capacity (i.e., as an associated person of an investment adviser).

SEC/CORPORATE

For more information, contact:

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

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

Palash I. Pandya
212.940.6451
palash.pandya@kattenlaw.com

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

- Amending Section 205 of the Advisers Act to provide that such Section regarding contractual provisions between clients and advisers does not apply to state registered advisers.

- Adding Section 24 to the Exchange Act which would provide that the SEC shall not be deemed to have waived any privilege by sharing information with another agency of the U.S. government, any foreign securities authority, any foreign law enforcement authority and any state securities or law enforcement authority.

- Amending provisions of the Securities Act, Exchange Act, Investment Company Act and Advisers Act to allow for nationwide service of subpoenas.

http://www.securitiesindustry.com/news/22598-1.html
http://www.house.gov/apps/list/speech/financialsvcs_dem/securities_act_committee_print.pdf

Is SARBOX Constitutional?

A decision is expected soon from the D.C. Circuit Court of Appeals in a case against the Public Company Accounting Oversight Board (PCAOB) which alleges, among other things, that the provisions in the Sarbanes-Oxley Act of 2002 creating the PCAOB are unconstitutional. Because the Act does not contain a "severability" clause, which, if a court were to declare a portion of the Act unconstitutional, would only remove the particular unconstitutional provisions, if a portion of the Act is declared unconstitutional, the Act as a whole will cease to have force of law. The plaintiffs in this case argued that the Act violates constitutional separation of powers by impermissibly insulating the PCAOB and its members from presidential control and supervision and that the appointment of PCAOB members by the Securities and Exchange Commission violates the constitution's appointment clause. The Federal District Court for the District of Columbia heard the case, and on March 21, 2007 summarily ruled in favor of the PCAOB. The D.C. Circuit Court of Appeals has heard oral arguments regarding the plaintiffs' appeal. (2007 WL 891675 (D.D.C.))

Litigation

Delaware Supreme Court Strikes Down Proposed Bylaw to Reimburse Stockholder Proxy Expenses

CA, Inc. (CA), a Delaware corporation of which the American Federation of State, County and Municipal Employees (AFSCME) is a stockholder, requested from the Division of Corporation Finance (the Division) of the Securities and Exchange Commission a no-action letter stating that the Division would not recommend any enforcement action if CA excluded from its proxy materials AFSCME's proposed bylaw to reimburse stockholders or groups of stockholders for reasonable expenses incurred in connection with nominating candidates in a contested election of directors. To help it respond to CA's request for a no-action letter, the SEC certified these two questions to the Supreme Court of Delaware: (i) whether under Delaware law AFSCME's proposal was a proper subject for action by shareholders, and (ii) would AFSCME's proposal, if adopted, cause CA to violate any Delaware law.

In answering the first question affirmatively, the Supreme Court of Delaware explained that pursuant to section 109(b) of the Delaware General Corporation Law (GCL) shareholders have the power to adopt, amend or repeal bylaws. On the other hand, the court noted that section 141(a) of the GCL provides that the business and affairs of every corporation shall be managed by the board of directors, and therefore the shareholders' power to adopt bylaws is not unlimited. The court reconciled these two provisions by holding that

LITIGATION

For more information, contact:

Anthony L. Paccione
212.940.8502
anthony.paccione@kattenlaw.com

Vikas Khanna
212.940.6427
vikas.khanna@kattenlaw.com

shareholders have the power to adopt a bylaw if it is one that establishes or regulates a process instead of one that mandates a decision. Applying this standard, the court held that AFSCME's proposed bylaw was one that regulated a process because its purpose was to promote the integrity of the director elections by promising reimbursement of the nominating stockholders' proxy expenses if one or more of its candidates are elected.

In answering the SEC's second question affirmatively, the court held that AFSCME's proposed bylaw, if adopted, would violate Delaware law, because it could interfere with the board of directors' ability to exercise its fiduciary duty. The court noted that under GCL section 141(a), contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties are prohibited. The court explained that in situations where the proxy contest is motivated by personal or petty concerns, the board's fiduciary duty could compel it to deny reimbursement. It provided as an example a circumstance in which a shareholder group affiliated with a competitor caused the election of a minority slate to obtain proprietary information. The court held that because AFSCME's proposed bylaw contained no language that would allow the directors to decide whether in some circumstances reimbursement was not appropriate, the bylaw, if adopted, would violate Delaware law. (*CA, Inc. v. AFSCME Employees Pension Plan*, 2008 WL 2778141 (Del. Supr. July 17, 2008))

Second Circuit Holds Interpositioning Does Not Constitute Securities Fraud

The defendant, David Finnerty, was charged with three counts of securities fraud under Section 10(b) and Section 32 of the Securities Exchange Act. The indictment alleged that while Finnerty was employed by Fleet Specialists, Inc., he caused approximately 26,300 instances of interpositioning, a practice in which a specialist on the New York Stock Exchange trading floor acts as an arbitrager by taking a profit on the spread between the bid price and the ask price of the customers' orders. Prior to trial, the district court let stand only the government's allegations that were based on subsections (a) and (c) of Rule 10(b)-5. At trial, the government presented evidence that demonstrated Finnerty had executed interpositioning trades, and the jury rendered a guilty verdict on all three counts. However, after trial, Judge Chin of the United States District Court in the Southern District of New York granted Finnerty's post-trial motion for a judgment of acquittal on the ground that the government failed to prove that interpositioning constituted a deceptive act within the meaning of the federal securities laws. On appeal, the Second Circuit affirmed.

The Second Circuit explained that Finnerty could be guilty of violating Section 10(b) of the 1934 Act only if he said or did something deceptive. The court noted that at trial the government did not identify any way in which Finnerty communicated anything false to his customers or conveyed any impression that was misleading. The court further rejected the government's argument that Finnerty was guilty because some customers may have understood that NYSE rules prohibit specialists from interpositioning and therefore assume that such a practice would not occur. The court held that Finnerty could not violate Section 10(b) unless his customers' understanding was based on Finnerty's statements or conduct. Finally, the court held that even if the government proved that Finnerty knowingly violated an NYSE rule, the violation of an NYSE rule does not establish securities fraud. As such, the court affirmed the district court's judgment of acquittal. (*U.S. v. Finnerty*, 2008 WL 2778830 (2d Cir. July 18, 2008))

NYSE Proposes New Market Structure That Would Eliminate Specialists

The New York Stock Exchange (NYSE) filed rule changes that propose a significant transformation of its current market structure. Among other things, the rule proposals would redefine the role of specialists on NYSE by creating a new category of Designated Market Makers (DMMs) and formally eliminating the specialist category. The rule changes would also increase market participants' ability to post hidden liquidity on the NYSE trading platform and would modify certain key aspects of the current NYSE rules dealing with priority and parity.

http://www.sec.gov/rules/sro/nyse/2008/34-58184.pdf

ISE Proposes Rule Change Governing Conduct of Doing Business with the Public

The International Securities Exchange (ISE) filed a rule change proposing to amend certain rules that govern the members' conduct of doing business with the public, which would be modeled after the New York Stock Exchange and Financial Industry Regulatory Authority rules. Namely, the proposed rule change would require members to integrate the responsibility for supervision of their public customer options business into their overall supervisory and compliance programs as well as to strengthen such supervisory procedures and internal controls. The proposed rule change would also conform ISE rules to those of the Chicago Board Options Exchange, which has eliminated the requirement that a member qualified to do a public customer business in options must designate a single person to act as a Senior Registered Options Principal for the member and that each such member designate a specific individual as a Compliance Registered Options Principal.

http://sec.gov/rules/sro/ise/2008/34-58129.pdf

FINRA's Assessment of the Trading Activity Fee

The Financial Industry Regulatory Authority (FINRA) issued a regulatory notice reminding member firms that they should ensure that the Trading Activity Fee (TAF) that is assessed on all member firms for the sale of covered securities is reported and paid on exchange-listed options in conformity with the FINRA By-Laws. Although one of the types of transactions excluded from the TAF is transactions in exchange-listed options effected by a member firm for which FINRA is not the designated options examining authority (DOEA), FINRA currently serves as DOEA for all FINRA member firms. Due to the consolidation of National Association of Securities Dealers and New York Stock Exchange (NYSE) member regulation operations in 2007, FINRA assumed DOEA responsibilities for firms that were previously assigned to the NYSE.

http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p038939.pdf

NYSE Arca Amends Rules Related to Definition and Execution of Complex Orders

NYSE Arca, Inc. received approval from the Securities and Exchange Commission for its rule proposal to amend the definition of "Complex Orders" and to describe the priority and execution of Complex Orders. Previously, there were specific definitions for a variety of complex order types, but the amended rule (NYSE Arca Rule 6.62) promulgates a generic definition for Complex Orders: "any order involving the simultaneous purchase and/or sale of two or

BROKER DEALER

For more information, contact:

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

Gary N. Distell
212.940.6490
gary.distell@kattenlaw.com

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

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

Ross Pazzol
312.902.5554
ross.pazzol@kattenlaw.com

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

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

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

more different option series in the same underlying security, for the same account, in a ratio that is equal to or greater than one-to-three (.333) and less than or equal to three-to-one (3.00) and for the purpose of executing a particular investment strategy." Under approved NYSE Arca Rule 6.91, Complex Orders entered into the NYSE Arca system will be routed to the Complex Matching Engine (CME) for possible execution. The CME will execute Complex Orders against each other, if possible, or against individual quotes and orders in the Consolidated Book. Complex Orders that are not immediately executed by the CME are routed to the Consolidated Book. Options trading permit holders and firms will have the ability to view Complex Orders in the Consolidated Book via an electronic interface and to submit orders to the CME to trade against such Orders.

http://www.sec.gov/rules/sro/nysearca/2008/34-58174.pdf

SEC Alerts Compliance Officers About Deficiencies and Weaknesses Found During Recent Compliance Examinations

The Securities and Exchange Commission issued a new *ComplianceAlert* letter identifying common deficiencies and weaknesses that SEC examiners found during compliance examinations of firms registered with the SEC.

With respect to broker-dealer firms, the SEC staff examined and observed, in part, the following practices and procedures:

- Securities firms which provided "free lunch" sales seminars used misleading advertisements in order to encourage attendance. For example, the seminar would be advertised as "educational" but the intent of the seminar was to induce attendees to open new accounts with the sponsoring firm and to purchase investment products that were discussed at the seminar. Moreover, many of the broker-dealer firms did not submit their sales material to the Financial Industry Regulatory Authority (FINRA) for review, as required by National Association of Securities Dealers advertising rules. The SEC recommends that financial services firms should take steps to supervise sales seminars more closely and to specifically review and approve all advertisements and sales materials in order to ensure accuracy.

- Large broker-dealer firms were examined to assess their valuation and collateral management practices with respect to subprime mortgage-related products, with an emphasis on the controls surrounding the valuation process. Specifically, the SEC monitored the verification by independent personnel of the valuations assigned by trading personnel, a practice called "product control." Examiners found that firms were having difficulty verifying their inventory valuations due to market illiquidity and because the product control groups were insufficiently staffed and insufficiently experienced. Thus, firms have become more reliant on modeled prices as opposed to independent third party pricing services.

- Large broker-dealer firms that had designated their registered representatives as "solicitors" for an investment adviser were examined and were found to have insufficient supervisory controls and had not established or enforced adequate written procedures to supervise solicitor activity. Some of these broker-dealer firms used seemingly false or misleading advertising and sales literature and also failed to file such materials with FINRA.

http://www.sec.gov/about/offices/ocie/complialert0708.htm

The CBOE Files a Proposed Rule Change to CBOE Rule 9.21, "Communications to Customers"

The Chicago Board Options Exchange (CBOE) has filed with the Securities and Exchange Commission a proposal to amend CBOE Rule 9.21 ("Communications with Customers") aimed in part at removing the rule's provisions regarding the Securities Act of 1933 (Securities Act). Since options traded on the CBOE consist solely of standardized options issued by the Options Clearing Corporation (OCC), they are exempt from all provisions of the Securities Act with the exception of the antifraud provisions. Therefore, for example, the CBOE has proposed to delete all references to a "prospectus" from Rule 9.21 since prospectuses are no longer required for standardized options and the OCC has ceased publication of prospectuses.

Moreover, the CBOE's proposal aims to amend the provision found in Rule 9.21(c) which requires members to obtain prior approval for every advertisement and all educational material from the CBOE's Department of Compliance. Proposed Rule 9.21(c) will require approval by the CBOE solely with respect to options communications used prior to the delivery of a current options disclosure statement.

The proposed rule modifications are similar to amendments filed with the SEC by the Financial Industry Regulatory Authority and the New York Stock Exchange. Thus, if the proposal is adopted, it will provide a more uniform approach to communications to customers regarding standardized options.

http://www.sec.gov/rules/sro/cboe/2008/34-58138.pdf

Investment Companies and Investment Advisers

SEC Highlights Investment Adviser Compliance Weaknesses

The Securities and Exchange Commission recently released its July 2008 *ComplianceAlert* identifying common strengths and weaknesses found by SEC examiners (Staff) during compliance examinations of SEC-registered investment advisers, investment companies, broker-dealers and other types of registered firms. For a discussion of the compliance issues noted in examinations of registered broker-dealers, see the *Broker Dealer* section above.

With respect to investment advisers, the Staff focused on personal trading by access persons, proxy voting and soft dollar practices. In the area of personal trading, the Staff identified several common deficiencies, including:

- Maintaining an incomplete code of ethics (e.g., failing to require access persons to obtain pre-clearance before investing in limited investment opportunities); and
- Failing to adhere to code of ethics procedures (e.g., trading in securities posted to the restricted list and failing to monitor personal securities trading reports).

In the area of proxy voting, the Staff noted that some investment advisers had not documented adequately their assessment of third party proxy voting services, preventing the Staff from assessing the adequacy of conflict of interest disclosures.

The Staff also examined the soft dollar arrangements of investment advisers including the frequency of such arrangements, policies and procedures in place to satisfy best execution, and the adequacy of disclosure. Of particular interest to the Staff were situations in which an adviser (i) fails to evaluate the

INVESTMENT COMPANIES AND INVESTMENT ADVISERS

Marybeth Sorady
202.625.3727
marybeth.sorady@kattenlaw.com

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

Peter J. Shea
704.444.2017
peter.shea@kattenlaw.com

Kathleen H. Moriarty
212.940.6304
kathleen.moriarty@kattenlaw.com

value of research received through the use of soft dollar credits, particularly when the commissions are higher than expected for the type of instrument traded or (ii) accumulates large soft dollar credit balances that might raise concerns about the reasonableness of the commissions.

Regarding investment companies, the Staff focused on valuation and liquidity issues in high yield municipal bond funds. Specifically, the Staff noted concerns in overvaluation of illiquid securities and inadequate disclosure of valuation risk.

The *ComplianceAlert* includes a list of internal compliance controls too numerous to report here that "appeared to be effective" in assisting in preventing violations of the Advisers Act.

http://sec.gov/news/press/2008/2008-146.htm

Structured Finance and Securitization

Consultative Documents Issued by the Basel Committee on Banking Supervision

On July 22, the Basel Committee on Banking Supervision issued for public comment "Guidelines for Computing Capital for Incremental Risk in the Trading Book" as well as "Proposed Revisions to the Basel II Market Risk Framework."

The Basel Committee's incremental risk proposal sets out to better align regulatory capital requirements with respect to risk exposure of banks' trading book positions. The guidelines address computing capital for incremental default risk, and contain an expansion of the scope of capital charge. Further, the proposed incremental risk charge (IRC) attempts to capture price changes due to defaults as well as other sources of price risk, such as those reflecting credit migrations and significant moves of credit spreads and equity prices. The Basel Committee also proposes modifications to the Basel II Framework concerning internal VaR models, where the objective is to align the language with respect to prudent valuation for positions subject to market risk with existing accounting guidance. In addition, it has clarified that regulators will retain the ability to require adjustments to current value beyond those required by financial reporting standards, in particular where there is uncertainty around the current realizable value of a position due to illiquidity.

Comments on the guidelines and revisions are due by October 15 and may be sent via email to baselcommittee@bis.org.

http://www.bis.org/publ/bcbs141.pdf?noframes=1
http://www.bis.org/publ/bcbs140.pdf

STRUCTURED FINANCE AND SECURITIZATION

For more information, contact:

Eric S. Adams
212.940.6783
eric.adams@kattenlaw.com

Hays Ellisen
212.940.6669
hays.ellisen@kattenlaw.com

CFTC

ITF Releases Interim Report on Crude Oil Markets

The Intermarket Task Force on Commodity Markets (ITF), which is chaired by the Chief Economist of the Commodity Futures Trading Commission and composed of staff from the Departments of Agriculture, Energy and the Treasury, as well as the Federal Reserve Board, Federal Trade Commission and Securities and Exchange Commission, released an interim report on July 22, setting forth the preliminary results of its study of recent crude oil price increases. The interim report is based on the ITF's analysis of public and non-public data, including the positions of commodity swap dealers and other traders, and concludes that fundamental supply and demand factors, rather than speculative trading in the crude oil markets, provide the primary explanation for recent price increases. The ITF will continue its analysis and

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

plans to issue further findings later this year.

http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5520-08.html
http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/itfinterimreportoncrudeoil0708.pdf

NFA Petitions CFTC to Require Electronic Filing of Disclosure Documents

The National Futures Association (NFA) petitioned the Commodity Futures Trading Commission on July 21 to amend CFTC Regulations 4.26 and 4.36, which require commodity pool operators (CPOs) and commodity trading advisors (CTAs) to file copies of their disclosure documents with the NFA. The proposed amendments would require CPOs and CTAs to file their disclosure documents online using the NFA's electronic disclosure document filing system. This would replace the current system, under which most CPOs and CTAs submit their disclosure documents to the NFA via email. The NFA's electronic system will allow filers to track the status of their filing and access copies of previous filings and NFA responses online.

http://www.nfa.futures.org/news/newsPetition.asp?ArticleID=2164

Court Dismisses Clearing Firm from CFTC Enforcement Action

In an order dated July 17, the U.S. District Court for the Northern District of Illinois dismissed Lawrence-Bonfitto Trading Company (Lawrence-Bonfitto) and its principal, Joseph J. Bonfitto, who had been named as nominal defendants in the Commodity Futures Trading Commission's enforcement action against Edward Sarvey and David G. Sklena. Lawrence-Bonfitto had been Sklena's clearing firm at the time of the alleged wrongdoing, which involved a series of non-competitive trades at the Chicago Board of Trade (CBOT) that resulted in approximately $1.65 million in profits for Sklena. The CFTC had named the Bonfitto parties as "nominal defendants," on the theory that they held a portion of the proceeds from Sklena's non-competitive trading, but had no legitimate ownership interest therein.

The Bonfitto parties successfully argued that the CFTC had not established that they had no ownership interest in the retained proceeds from Sklena's trading, noting that Sklena's trades were made in contravention of the clearing firm's instructions to Sklena to reduce his positions. The Bonfitto parties further noted that the disputed amounts had been the subject of a CBOT arbitration proceeding between Sklena and Lawrence-Bonfitto, which resulted in Lawrence-Bonfitto being permitted to retain over $800,000 of the funds in Sklena's account.

The court expressed no opinion as to the relative priority between the claims of Bonfitto parties and the CFTC to the proceeds from Sklena's trades, or as to whether the Bonfitto parties could be properly named as full defendants in the case. (*U.S. Commodity Futures Trading Commission v. Sarvey*, 2008 WL 2788538 (N.D. Ill. July 17, 2008))

Banking

Agencies Issue Final Guidance on Supervisory Review Process (Pillar 2) Related to Implementation of Basel II Advanced Approaches Rule

The federal banking and thrift agencies, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, on July 15 issued final guidance outlining the supervisory review process for banking organizations implementing the new advanced capital adequacy framework known as Basel

BANKING

For more information, contact:

Jeff Werthan
202.625.3569
jeff.werthan@kattenlaw.com

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

II. The final guidance relating to supervisory review is aimed at helping banking organizations meet certain qualification requirements in the advanced approaches rule, which took effect April 1. The advanced approaches rule consists of three pillars: minimum risk-based capital requirements (Pillar 1), supervisory review of capital adequacy (Pillar 2), and market discipline through enhanced public disclosures (Pillar 3). The final Pillar 2 guidance details the agencies' standards for ensuring that each institution subject to the advanced approaches rule has a rigorous process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive strategy for maintaining appropriate capital levels. According to the agencies, this guidance highlights certain aspects of existing supervisory review that are being augmented or clarified to support the implementation of the supervisory assessment of overall capital adequacy under the advanced approaches final rule.

The supervisory review process described in this guidance outlines the agencies' standards for (i) satisfying the qualification requirements provided in the advanced approaches final rule, (ii) addressing the limitations of the minimum risk-based capital requirements for credit risk and operational risk, (iii) ensuring that each institution has a rigorous process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive strategy for maintaining appropriate capital levels, and (iv) encouraging each institution to improve its risk identification and measurement techniques. This supervisory guidance applies to any bank, savings association, or bank holding company implementing the advanced approaches final rule.

http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080715a1.pdf

OTS to Establish Minority Depository Advisory Committee; FDIC Expands Guidelines for Providing Technical Assistance to Minority Depository Institutions

Office of Thrift Supervision (OTS) Director John Reich announced plans on July 17 to establish a Minority Depository Institutions Advisory Committee to help preserve minority institutions and encourage their creation. "The Advisory Committee will serve as an invaluable mechanism for exploring the needs, concerns and challenges unique to minority depository institutions, and to make recommendations concerning OTS' supervisory expectations and processes," Reich said during a speech at an Interagency Minority Depository Institution Conference in Chicago. The Advisory Committee will include representatives from OTS-supervised minority depository institutions, industry trade groups, consumer advocacy organizations and others, he said. More details will be published soon in the Federal Register.

The Federal Deposit Insurance Corporation (FDIC), also on July 17, announced that it continues to pursue strategies to preserve and encourage minority ownership of FDIC-insured financial institutions, including providing technical assistance in operational areas. The FDIC has expanded its guidance on providing technical assistance to minority depository institution (MDI) management to enhance ongoing communication with and support of MDIs.

http://www.ots.treas.gov/docs/7/778031.html
http://www.fdic.gov/news/news/financial/2008/fil08066a.html

UK Developments

FSA Consults on Changes to Disclosure and Transparency Rules

On July 21, the UK Financial Services Authority (FSA) began a consultation on its proposal to allow financial institutions in receipt of liquidity support from a

Adam Bolter
202.625.3665
adam.bolter@kattenlaw.com

UK DEVELOPMENTS

For more information, contact:

Martin Cornish
44.20.7776.7622
martin.cornish@kattenlaw.co.uk

central bank to delay the public disclosure of such support. This change is designed to address the concern that in the past immediate disclosure has led to a loss of confidence which exacerbated liquidity problems and undermined the firm's solvency.

Under the EU Market Abuse Directive, which the FSA's Disclosure and Transparency Rules implement, disclosure of price-sensitive information is required, but the Directive allows disclosure of inside information to be delayed in certain specific circumstances. The FSA proposals do not grant a financial institution an unconditional or indefinite ability to delay disclosure of it receiving liquidity support. Immediate disclosure may still be required in certain circumstances. Accordingly the FSA considers that they comply with the Directive.

The deadline for comments is September 30.

www.fsa.gov.uk/pubs/cp/cp08_13.pdf

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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

Sam Tyfield
44.20.7776.7640
sam.tyfield@kattenlaw.co.uk

Edward Black
44.20.7776.7624
edward.black@kattenlaw.co.uk

Sean Donovan-Smith
44.20.7776.7625
sean.donovan-smith@kattenlaw.co.uk