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LITIGATION

"Obey-the-Law" Injunction Too Vague in Sham Transaction Case

The U.S. Court of Appeals for the Eleventh Circuit last month held that a generic Securities and Exchange Commission injunction barring the owner of a securities firm from further violating securities laws was invalid because it lacked the specificity required. Richard Goble, owner of securities firm North American Clearing Inc., was held liable for aiding and abetting violations of the Consumer Protection Rule and Sections 15(c)(3) and 17(a) of the Securities Exchange Act of 1934 (the Exchange Act). The SEC issued an injunction barring Goble from the securities business and from violating securities laws. On appeal, the Eleventh Circuit held that the generic "obey-the-law" injunction was too vague and did not clearly give fair notice to the defendant. The court reasoned that a defendant could not be subject to the constantly changing judicial interpretation of the Exchange Act without some objective criteria. This reasoning seems to bar routine SEC injunctions prohibiting violations of securities laws without sufficient specificity or guidance as to what would be violative of the injunction.

Securities & Exchange Commission v. Goble, No. 11-12059 (11th Cir. May 29, 2012).

Government May Not Use Work Product Protected Communications Made to a Cooperator

The U.S. District Court for the Southern District of New York last week sustained claims of work product privilege with respect to information the government obtained during an investigation into alleged guaranteed investment contract (GIC) rigging. Defendants Peter Ghavami, Gary Heinz and Michael Welty are currently on trial for rigging bids for GICs, instruments sold by financial institutions to the issuers of municipal bonds. Third-parties sought to claw back privileged communications made unwittingly to government cooperators who were employees of corporate entities asserting privilege. Communications were made in the course of conversation to cooperators by other employees who were targets or subjects of the government investigation.

The court's primary basis for barring the government's use of the communications was that they were protected by work product privilege. Several of the communications were made between and among individuals subject to investigation, and thus "in anticipation of litigation." Work product, which can only be waived if the disclosure substantially increased the risk that it would be obtained by an adversary, was not waived by disclosure to a third party whom the claimants did not know was a government agent. Further, because some of the communications were privileged under the attorney-client doctrine, the remainder were protected under the joint defense doctrine, which protects communications to other persons that share a common legal interest. This had the practical effect of precluding the government from using information obtained from cooperating witnesses such as former or current employees of the company at which the privilege claimants worked.

United States of America v. Ghavami, No. 10 Cr. 1217 (KMW)(JCF) (S.D.N.Y Jun. 5, 2012).

CFTC

SEC Issues “Roadmap” for the Remaining Security-Based Swaps Rules

On June 11, the Securities and Exchange Commission issued a policy statement on the sequencing of issuance and compliance dates for the remaining Dodd-Frank Wall Street Reform and Consumer Protection Act rules related to security-based swaps. The SEC’s statement discusses issues related to and presents a general sequence for the following five categories of rules: (1) rules defining “security-based swap,” security-based swap agreement,” and “mixed swap” (Definitional Rules) and the rules concerning treatment of cross-border security-based swap transactions and certain activities of non-U.S. persons (Cross-Border Rules); (2) rules pertaining to the registration and regulation of swap data repositories (SDRs), the reporting of security-based swap transactions, and the public dissemination of security-based swap transaction data; (3) rules related to the mandatory clearing process of security-based swap transactions, clearing agency standards, and the end-user exemption from mandatory clearing; (4) rules pertaining to the registration and regulation of security-based swap dealers (SBSDs) and major security-based swap participants (MSBSPs); and (5) rules related to the mandatory trading of security-based swap transactions, including registration and regulation of security-based swap execution facilities (SEFs).

The statement does not provide specific compliance dates or a conclusive sequencing of compliance dates for final rules. Rather, it provides a general framework for sequencing compliance dates that will allow market participants to comment on the general order of the remaining final rules. The statement also discusses the previous relief the SEC has granted related to security-based swaps and when these exemptions will expire.

As the SEC observed, the Definitional Rules need to be adopted first, because they help inform market participants about the applicability of the other remaining rules. The SEC noted that the Cross-Border Rules also need to be adopted before other rules that have cross-border implications. The SEC indicated that the second step in the implementation process would be for SDRs to register to enable security-based swap transaction reporting. The statement suggests that compliance with the SDR rules should be required as soon as practicable after the effectiveness of the Definitional Rules and Cross-Border Rules taking into account the amount of time necessary for market participants to analyze and understand the Definitional Rules and test new policies and systems that are required as a result of the rule.

The statement indicates that the final rules related to mandatory clearing should not become effective until after the later of: (1) the compliance date for certain clearing agency standards rules; (2) the compliance date of final rules resulting from the end-user clearing exception proposal; and (3) the SEC’s determining whether to propose amendments to its net capital and customer protection rules to accommodate cleared security-based swaps.

The compliance date for the fourth category, related to the registration of SBSDs and MSBSPs, would reflect the amount of time that these entities might need to comply with the new recordkeeping, business conduct, and trade documentation rules. After all of the foregoing rules are in place, the registration requirements and core principles for security-based SEFs and mandatory trade execution requirements would become effective.

It is not clear whether the SEC’s statement will have any effect on the Commodity Futures Trading Commission's approach to setting issuance and compliance dates, and it could be that the pace of implementation of the new regulatory regime will be different for swaps and security-based swaps.

The SEC is seeking public comment on all aspects of the statement.

The SEC’s statement is available here.

BANKING

Agencies Seek Comment on Regulatory Capital Rules and Finalize Market Risk Rule

The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies) are seeking comment on three notices of proposed rulemaking (NPRs) that would revise and replace the agencies' current capital rules. The agencies also announced the finalization of the market risk capital rule that was proposed in 2011. The Board took its action late last week, while the FDIC and OCC took action this week. Reportedly, the agencies were under pressure to issue the rules prior to the June G-20 summit in Los Cabos, Mexico, which will be attended by President Obama and Treasury Secretary Geithner, particularly in light of a recent Basel Committee on Banking Supervision progress report that found deficiencies in how Basel III was being adopted by the 27 member countries, including the United States. In addition, Thomas Hoenig and Jeremiah Norton, the two newest directors on the FDIC board, voiced concerns about the complexity of the risk-based capital rule proposal and the potential insufficiency of the leverage rule proposal, the latter of which both believed should be higher.

In the first Basel III NPR, "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions" (Basel III NPR), the agencies are proposing to revise their risk-based and leverage capital requirements consistent with agreements reached (Basel III) by the Basel Committee on Banking Supervision (BCBS). The Basel III NPR would apply broadly to all insured banks and savings associations, top-tier bank holding companies domiciled in the United States with more than $500 million in assets, and savings and loan holding companies that are domiciled in the United States. Provisions of this NPR that would apply to these banking organizations include implementation of a new common equity tier 1 minimum capital requirement, a higher minimum tier 1 capital requirement, and, for banking organizations subject to the advanced approaches capital rules, a supplementary leverage ratio that incorporates a broader set of exposures. Additionally, consistent with Basel III, the agencies propose to apply limits on a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not hold a specified "buffer" of common equity tier 1 capital in addition to the minimum risk-based capital requirements. The proposals in this NPR and the Standardized Approach NPR would apply to all banking organizations that are currently subject to minimum capital requirements (including national banks, state member banks, state nonmember banks, state and federal savings associations, and top-tier bank holding companies domiciled in the United States not subject to the Board's Small Bank Holding Company Policy Statement (12 CFR part 225, Appendix C)), as well as top-tier savings and loan holding companies domiciled in the United States (together, banking organizations). The Basel III NPR also includes transition provisions for banking organizations to come into compliance with its requirements. The Basel III NPR also would revise the agencies' prompt corrective action framework by incorporating the new regulatory capital minimums and updating the definition of tangible common equity. Prompt corrective action is an enforcement framework that constrains the activities of insured depository institutions based on their level of regulatory capital.

In the second Basel III NPR, "Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule" (Advanced Approaches and Market Risk NPR), the agencies are proposing to revise the advanced approaches risk-based capital rules consistent with Basel III and other changes to the BCBS's capital standards. Additionally in this NPR, the OCC and FDIC propose that the market risk capital rules apply to federal and state savings associations, and the Board proposes that the advanced approaches and market risk capital rules apply to top-tier savings and loan holding companies domiciled in the United States, if stated thresholds for trading activity are met. Generally, the advanced approaches rules would apply to such institutions with $250 billion or more in consolidated assets or $10 billion or more in foreign exposure, and the market risk rule would apply to savings and loan holding companies with significant trading activity. As described in this NPR, the agencies also propose to codify their regulatory capital rules, which currently reside in various appendices to their respective regulations.

In the third capital NPR, "Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements" (Standardized Approach NPR), the agencies propose to "revise and harmonize" rules for calculating risk-weighted assets to enhance risk sensitivity and address weaknesses identified over recent years, including by incorporating aspects of the Basel II standardized framework, and alternatives to credit ratings, pursuant to section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The revisions include methods for determining risk-weighted assets for residential mortgages, securitization exposures, and counterparty credit risk. The Standardized Approach NPR would apply broadly to the same set of institutions as the Basel III NPR. The NPR also would introduce disclosure requirements that would apply to U.S. banking organizations with $50 billion or more in total assets. The changes in the Standardized Approach NPR are proposed to take effect on January 1, 2015, with an option for early adoption.

Comments on the three proposed rules are due by September 7.

The final market risk rule amends the calculation of market risk to better characterize the risks facing a particular institution and to help ensure the adequacy of capital related to the institution's market risk-related positions. The market risk capital rule supplements both the agencies' general risk-based capital rules and the advanced capital adequacy guidelines by requiring any bank subject to the market risk capital rule to adjust its risk-based capital ratios to reflect the market risk in its trading activities. The final rule applies to a banking organization with aggregate trading assets and liabilities equal to 10 percent of total assets, or $1 billion or more, but would not apply to savings associations or savings and loan holding companies until such time as the agencies' were to finalize their proposal to expand the scope of their market risk capital rules. According to the agencies, the most significant change from the proposal relates to the methods for determining the capital requirements for securitization positions. Specifically, under the final rule the mechanism to calculate the capital charges on securitization exposures when the underlying pool of assets demonstrates credit weakness "was altered to focus on delinquent exposures rather than on cumulative losses. This change has the effect of imposing greater capital requirements on the more subordinate tranches in a securitization. Under the proposal, when the underlying pool of assets demonstrates credit weakness, increased capital requirements would have applied to the entire range of outstanding securities, including the most senior tranches in a securitization." The final rule will be effective on January 1, 2013.

For more information, click here, here, here and here.

UK DEVELOPMENTS

UK Banking Reform White Paper Published

On June 14, HM Treasury and the Department for Business, Innovation and Skills published a White Paper setting out the government's proposals for banking reform, implementing the recommendations of the September 2011 report of the Independent Commission on Banking (ICB) (for details of the ICB recommendations, see the September 16, 2011 edition of *Corporate and Financial Weekly Digest*).

The White Paper confirms that the UK Government will introduce legislation to implement the ICB's recommendations in relation to ring-fencing, depositor preference and primary loss-absorbing capacity requirements. The Government intends to publish a draft version of the legislation for pre-legislative scrutiny in autumn 2012 - following the end of the White Paper comment period on September 6, 2012. The target date for completion of the passage of the legislation is late 2014 or early 2015 with full implementation in 2019.

Ring-fenced banks will be required to be separate legal entities. Services which will be required to be performed within ring-fenced entities will include deposit taking from and lending to individuals and small and medium sized enterprises. Services which must be provided outside the ring-fenced entities will include derivatives business (with a limited exemption introduced in the White Paper with respect to certain derivatives products used to hedge customers' exposure to interest rate and currency movements), secondary market activities, services/activities that would resulting in the holding of trading book assets, services/activities that would result in a requirement to hold regulatory capital against market risk, and services to customers outside the European Union.

The White Paper proposals do not include implementation of the ICB's recommendation to increase the leverage ratio for ring-fenced banks above the ratio required under the Basel III international standard.

For more information, click here.

EU DEVELOPMENTS

European Commission Proposes Bank Recovery and Resolution Framework

On June 6, the European Commission published a legislative proposal for a Directive introducing a recovery and resolution framework covering deposit-taking banks and certain other large financial institutions.

The aim of the proposed Directive is the introduction of a comprehensive set of measures aimed to ensure that financial regulators have the necessary powers to take action to address developing problems at banks. The key elements of the proposal are prevention and preparation, early intervention, credible resolution tools and co-operation among national regulators. An increased role for the European Banking Authority is also envisaged.

- Prevention and preparation. Banks and regulatory authorities will be required to draw up recovery and resolution plans on how to deal with financial stress or failure at group level and also for individual group entities. Regulators will be able to require banks to take appropriate measures including changes to corporate and legal structures designed to reduce the likelihood of threats to financial stability and costs to taxpayers.

- Early intervention. There will be enhanced powers for regulators to intervene before a bank's problems become critical and its financial situation deteriorates irreparably. These will include powers to dismiss management and appoint a special manager, to convene shareholders' meetings to adopt urgent reforms, and to require a bank to draw up a plan for restructuring its debt.

- Credible resolution tools. These will include the power for regulators to sell or merge weak or potentially failing banking businesses, to set up a temporary entity to operate key functions, to separate good and bad assets and to convert to shares or write down the debt of failing banks.

- Co-operation among national regulators. Mechanisms will be established to facilitate co-operation among national regulators to co-ordinate resolution measures in relation to cross-border banking groups.

The Commission estimates that the proposed Directive will come into effect in 2015.

For more information, click here.

For more information, contact:

FINANCIAL SERVICES

Janet M. Angstadt	312.902.5494	janet.angstadt@kattenlaw.com
Henry Bregstein	212.940.6615	henry.bregstein@kattenlaw.com
Wendy E. Cohen	212.940.3846	wendy.cohen@kattenlaw.com
Guy C. Dempsey, Jr.	212.940.8593	guy.dempsey@kattenlaw.com
Daren R. Domina	212.940.6517	daren.domina@kattenlaw.com
Kevin M. Foley	312.902.5372	kevin.foley@kattenlaw.com
Jack P. Governale	212.940.8525	jack.governale@kattenlaw.com
Maureen C. Guilfoile	312.902.5425	maureen.guilfoile@kattenlaw.com
Arthur W. Hahn	312.902.5241	arthur.hahn@kattenlaw.com
Joseph Iskowitz	212.940.6351	joseph.iskowitz@kattenlaw.com
Carolyn H. Jackson	44.20.7776.7625	carolyn.jackson@kattenlaw.co.uk
Kathleen H. Moriarty	212.940.6304	kathleen.moriarty@jkattenlaw.com
Raymond Mouhadeb	212.940.6762	raymond.mouhadeb@kattenlaw.com
Marilyn Selby Okoshi	212.940.8512	marilyn.okoshi@kattenlaw.com
Ross Pazzol	312.902.5554	ross.pazzol@kattenlaw.com
Kenneth M. Rosenzweig	312.902.5381	kenneth.rosenzweig@kattenlaw.com

Fred M. Santo	212.940.8720	fred.santo@kattenlaw.com
Christopher T. Shannon	312.902.5322	chris.shannon@kattenlaw.com
Peter J. Shea	212.940.6447	peter.shea@kattenlaw.com
Marybeth Sorady	202.625.3727	marybeth.sorady@kattenlaw.com
James Van De Graaff	312.902.5227	james.vandegraaff@kattenlaw.com
Robert Weiss	212.940.8584	robert.weiss@kattenlaw.com
Meryl E. Wiener	212.940.8542	meryl.wiener@kattenlaw.com
Lance A. Zinman	312.902.5212	lance.zinman@kattenlaw.com
Krassimira Zourkova	312.902.5334	krassimira.zourkova@kattenlaw.com
LITIGATION		
Emily Stern	212.940.8515	emily.stern@kattenlaw.com
Dean N. Razavi	212.940.6743	dean.razavi@kattenlaw.com
BANKING		
Jeff Werthan	202.625.3569	jeff.werthan@kattenlaw.com
UK/EU DEVELOPMENTS		
Edward Black	44.20.7776.7624	edward.black@kattenlaw.co.uk

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CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK OAKLAND ORANGE COUNTY SHANGHAI WASHINGTON, DC