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Corporate and Financial Weekly Digest

June 20, 2008

SEC/Corporate

SEC's Proposal on Reforming Credit Ratings

On June 16, the Securities and Exchange Commission, pursuant to its statutory authority to register and oversee nationally recognized statistical rating organizations (NRSROs), voted to propose a series of credit rating agency reforms to address concerns about the integrity of their credit rating procedures and methodologies in the light of the role they played in determining credit ratings for securities collateralized by or linked to subprime residential mortgages.

The SEC's proposal comes on the heals of New York Attorney General Andrew M. Cuomo's settlement agreement with the nation's three largest credit rating agencies. The agreement with these agencies is designed to increase their independence by altering how they are compensated and ensuring that crucial loan data be provided to them before they rate loan pools.

The SEC's more comprehensive proposals are in three parts, with the first two portions outlined below and the third portion to be considered by the Commission before the end of June.

Some of the key items in the first part of the SEC's proposal are:

- Prohibiting credit rating agencies from issuing a rating for structured products unless disclosure is made of the information provided to the NRSRO and used by the NRSRO in determining the rating. This will allow other NRSROs to rate the instrument as well, and "potentially expose an NRSRO whose ratings were influenced by the desire to gain favor with an arranger in order to obtain more business."

- Prohibiting NRSROs from making recommendations to obligors, issuers, underwriters and sponsors or arrangers about how to obtain a desired rating during the rating process.

- Requiring NRSROs to keep a record of the rationale for any material difference between any quantitative model that is a substantial component in the process of determining the credit rating, and the final credit rating issued.

- Requiring credit rating agencies to make all of their ratings and subsequent rating actions publicly available in an XBRL Interactive Data File.

- Requiring credit rating agencies to publish performance statistics for 1, 3, and 10 years within each rating category, in a way that facilitates comparison of the accuracy of the NRSRO's credit ratings with its competitors in the industry.

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

Jarrod N. Weber
212.940.6317
jarrod.weber@kattenlaw.com

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

- Prohibiting gifts in any amount in excess of $25 from those who receive ratings to those who rate them, other than items provided in the context of normal business activities such as may be incidental to meetings.

- Requiring credit rating agencies to furnish to the SEC an annual report of the number of credit ratings that were changed during the fiscal year in each class of credit ratings for which the NRSRO is registered with the Commission.

- Prohibiting individuals who participate in determining a credit rating from negotiating the fee that the issuer pays for it.

- Requiring disclosure of how frequently credit ratings are reviewed, whether different models are used for ratings surveillance than for initial ratings, and whether changes made to models are applied retroactively to existing ratings.

The second, and apparently more controversial, part of the proposal would require credit rating agencies to differentiate, by symbol, report or other identifier, ratings and methodologies they use or issue on structured products from those used or issued on bonds and other securities.

http://www.oag.state.ny.us/press/2008/june/june5a_08.html
http://www.sec.gov/news/press/2008/2008-110.htm
http://www.sec.gov/rules/proposed/2008/34-57967.pdf

SEC's Division of Corporation Finance Releases Staff Legal Bulletin on Section 3(a)(10) of the Securities Act of 1933

On June 18, the Securities and Exchange Commission's Division of Corporation Finance released a Staff Legal Bulletin which provides its views regarding the exemption under Section 3(a)(10) of the Securities Act of 1933 from the registration requirements of the Securities Act of 1933.

Section 3(a)(10) of the Securities Act is an exemption from registration under the Securities Act for offers and sales of securities in specified exchange transactions which meet the following conditions:

- the securities must be issued in exchange for securities, claims, or property interests and not be offered for cash;

- a court or authorized governmental entity expressly authorized by law must hold a hearing and approve the fairness of the terms and conditions of the exchange; and

- the fairness hearing must be open to everyone to whom securities would be issued in the proposed exchange without improper impediments for such persons to appear; and

- adequate notice must be given to such persons.

The bulletin provides guidance with respect to issues that commonly arise in "no-action" requests under Section 3(a)(10) such as:

- The Division of Corporation Finance will not issue a no-action response concerning a transaction after the fairness hearing has been held and may not issue a no-action response if an issuer submits a no-action request very close to the fairness hearing date due to time constraints.

- The Division of Corporation Finance will not object to a vote of security holders before the fairness hearing if required by a statute governing fairness hearings.

- The subsequent issuance of securities upon exercise and conversion of options, warrants, or other convertible securities that are issued in the Section 3(a)(10) transaction are not themselves exempt under Section 3(a)(10) of the Securities Act.

- The term "any court" in Section 3(a)(10) of the Securities Act may include a foreign court, provided that all requirements that apply to exchanges approved by U.S. courts must be met and the issuer must provide the Division of Corporation Finance with an opinion from counsel licensed to practice in the foreign jurisdiction that states that, before the foreign court can give its approval, it must approve the fairness of the proposed exchange to persons receiving securities in the exchange.

- Section 3(a)(10) of the Securities Act does not specify the information that must be included in the required notice and therefore the Division of Corporation Finance will consider the adequacy of the notice only to the extent that it adequately advises those who are proposed to be issued securities in the exchange of their right to attend the hearing and gives them the information necessary to exercise that right.

http://www.sec.gov/interps/legal/cfslb3a.htm

Litigation

Second Circuit Affirms Convictions: LLC Units Deemed "Securities"

The Second Circuit affirmed convictions under Sections 10(b) and 32 of the Securities Exchange Act of 1934 against two defendants for their role in soliciting investments in two film production companies formed as LLCs. The defendants offered and sold membership interests in the two LLCs and retained commissions materially in excess of amounts described in the offering memoranda. On appeal, the defendants argued that even if the commissions were not accurately disclosed, they still were not guilty of securities fraud because the membership units were not "investment contracts" and, thus, not "securities" as defined in the Securities Exchange Act. According to defendants, one element of an "investment contract" is that the investor expects profits "solely" from the efforts of others. Defendants argued that such an expectation could not be established because it was contrary to the companies' organizational documents, which required members to participate in the LLC—a requirement that was included to minimize the possibility that the LLC units would be deemed "securities."

In affirming the defendants' convictions, the Second Circuit first ruled that the "'solely' from the efforts of others" element should not be construed literally, but rather as to whether there was a reasonable expectation of significant investor control so that the protections of the federal securities laws would be unnecessary. Based upon "the reality of the transaction," the Second Circuit then ruled that no such opportunity for investor control existed. In addition to the fact that the investors played "an extremely passive role in the management of the companies," the Court found significant that (i) the films were entirely preproduced prior to soliciting investments, thereby limiting the opportunity for investor input, (ii) the LLC agreements were provided to investors on a non-negotiable, take-it-or-leave-it basis, and (iii) the large number and geographic dispersion of the investors left them dependent on centralized management. (*United States v. Leonard*, 2008 WL 2357233 (2nd

LITIGATION

For more information, contact:

Alan R. Friedman
212.940.8516
alan.friedman@kattenlaw.com

Cameron Balahan
212.940.6437
cameron.balahan@kattenlaw.com

Cir. June 11, 2008))

Wisconsin Supreme Court Affirms Conviction for State Securities Fraud

The Wisconsin Supreme Court affirmed a conviction for, among other things, criminal securities fraud under Wisconsin's securities laws in connection with an allegedly fraudulent real estate venture. The defendant allegedly approached an individual with a potential opportunity to invest with four other investors to purchase real property. The State alleged that the defendant did not disclose material facts about the deal to the individual, including that the defendant was on parole for previous theft convictions that precluded him from closing business deals of the magnitude of the proposed real estate venture.

On appeal, the defendant contended that he did not sell a "security" to the individual and, thus, could not be charged under Wisconsin's securities laws. Citing the United States Supreme Court's interpretation of parallel provisions of the federal securities laws, the defendant argued that the investment interest he allegedly sold was not an "investment contract," and, thus, not a "security," because to constitute an "investment contract" the alleged investor could not put forth any efforts of his own. In affirming the conviction, the Court ruled that (i) Wisconsin law is broader than the federal law and to constitute a "security," the Wisconsin statute required only that the investment be in a venture under the "essential managerial efforts of someone other than the investor," and (ii) there was sufficient evidence to support the jury's conviction on this basis. (*Wisconsin v. LaCount*, 2008 WL 2344641 (Wis. June 10, 2008))

Broker Dealer

FINRA Issues Guidance Relating to Illiquid Investments

The Financial Industry Regulatory Authority has issued Regulatory Notice 08-30 providing guidance to member firms on obligations that may arise in connection with customer requests to sell generally illiquid securities and informing customers of buy interest in such securities. Recent questions have been raised regarding a firm's obligations when it receives a customer's unsolicited instruction to liquidate a position in an illiquid security when the customer is aware of specific buying interest in that security. Firms should not delay or decline executing such a transaction in an illiquid security in circumstances where: (i) the customers on both sides of the transaction have indicated their understanding that the firm is not recommending the transaction or making a suitability determination; (ii) the customers understand that the firm cannot reach a view as to the sufficiency or competitiveness of pricing; and (iii) there are no legitimate concerns as to the ability of both sides to settle the proposed transaction.

Customers may also learn of buy interest from their firm. When informing customers of buy interest, firms should also consider appropriate disclosure, including, as applicable, information regarding the firm's inability to make a representation as to the nature, fairness or sufficiency of the pricing; and any pecuniary interest the firm may have in the transaction. If the firm recommends the transaction to a customer, the firm has additional obligations and must ensure that the transaction is suitable pursuant to NASD Rule 2310.

http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p038699.pdf

NYSE Arca Proposes Trading Options on Index-Linked Securities

The Securities and Exchange Commission is seeking comments on an NYSE Arca proposal to list and trade options on Index-Linked Securities. The proposed rule change would enable the listing and trading of options on equity

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

index-linked securities, commodity-linked securities, currency-linked securities, fixed income index-linked securities, futures-linked securities, and multifactor index-linked securities. Despite the fact that Index-Linked Securities are linked to an underlying index, each trade as a single, exchange-listed security. Accordingly, rules pertaining to the listing and trading of standard equity options would apply to Index-Linked Securities.

Index-Linked Securities must meet the criteria and guidelines for underlying securities set forth in NYSE Arca Rule 5.3(a), or the Index-Linked Securities must be redeemable at the option of the holder at least on a weekly basis through the issuer at a price related to the applicable underlying Reference Asset. In addition, the issuing company is obligated to issue or repurchase the securities in aggregation units for cash or cash equivalents satisfactory to the issuer of Index-Linked Securities which underlie the option as described in the Index-Linked Securities prospectus.

Options on Index Linked Securities initially approved for trading may be subject to the suspension of opening transactions as follows: non-compliance with the terms of certain NYSE Arca Rules; in the case of any Index-Linked Security trading pursuant to NYSE Arca Rule 5.3(j), the value of the Reference Asset is no longer calculated or available; where the underlying security is no longer listed on a national securities exchange and is not an NMS security; or such other event shall occur or condition exist that in the opinion of the Exchange makes further dealing in such options on the Exchange inadvisable. The NYSE Arca will implement surveillance procedures for options on Index-Linked Securities, including adequate comprehensive surveillance sharing agreements with markets trading in non-U.S. components, as applicable.

http://www.sec.gov/rules/sro/nysearca/2008/34-57950.pdf

SEC Approves New DTC/NSCC Service for Institutional Delivery Netting

The Securities and Exchange Commission has approved simultaneous proposals from the Depository Trust Company (DTC) and the National Securities Clearing Corporation (NSCC) to offer the ID Net Service that will allow subscribers to net all eligible affirmed institutional delivery (ID) transactions at DTC against their Continuous Net Settlement system (CNS) transactions at NSCC. The reporting between brokers of ID transactions is one of the conditions of the SEC's prime broker no-action letter. Currently, ID transactions are not netted, and settle on a trade-for-trade basis at DTC. In order to extend netting benefits and efficiencies to institutional transactions, NSCC will extend its clearance and settlement functionalities to net the broker-dealer's side of institutional transactions with the broker-dealer's broker-to-broker activity that is eligible for processing through the CNS service.

Eligibility is based on the participants, the underlying security, the type of trade, and the timing of the affirmation as follows: (i) the broker-dealer must be both an NSCC Member and a DTC Participant; (ii) the custodian bank for the institutional investor must be a DTC Participant; (iii) the broker-dealer and the custodian bank must both elect to participate in the ID Net Service; and (iv) the security must be an equity security eligible for CNS. ID Net Services will initially exclude the following: (i) corporate and municipal bonds and unit investment trust issues; (ii) new issue securities in their first day of IPO trading; (iii) securities that are IPO tracked since the use of omnibus accounts will bypass the tracking system; (iv) trades in issues that are currently undergoing a mandatory or voluntary reorganization; (v) trades in securities with a CNS buy-in; and (vi) trades in securities appearing on the SEC's Regulation SHO list. Each participating NSCC member will have two separate accounts—one to receive and the other to deliver ID Net positions to be added to its CNS positions for settlement at DTC. If the ID Net positions are not settled on

settlement day, they will be dropped from ID Net and will settle on a trade-for-trade basis.

http://edocket.access.gpo.gov/2008/pdf/E8-12667.pdf

FINRA Issues 2007 Annual Report

The Financial Industry Regulatory Authority (FINRA) has issued its annual report for 2007, highlighting its goals and detailing its financial results.

The report notes that FINRA oversees 5,005 securities firms, 171,287 branch offices and 672,688 registered securities representatives. FINRA also performs electronic surveillance of trading on The NASDAQ Stock Market, the American Stock Exchange, the Alternative Display Facility, OTC Equities, the corporate bond market and the International Securities Exchange. All told, in 2007 FINRA monitored an average of 770 million quotes, orders and trades each day.

The report notes that transformation of FINRA's Enforcement department is complete, and legacy National Association of Securities Dealers and New York Stock Exchange examination programs are now fully integrated and up and running. Cycle examinations will be conducted by one team of examiners, which will conduct a single opening meeting and exit meeting with firm management. FINRA will also continue its efforts to make exams more risk-based in order to best deploy resources.

http://www.finra.org/web/groups/corp_comm/documents/home_page/p038602.pdf

CFTC

CFTC Conditions U.S. Customer Access to Foreign Market

On June 17, the Commodity Futures Trading Commission announced an amendment (Amendment) to a prior no-action letter that had allowed ICE Futures Europe (ICE Europe) to offer direct electronic access to U.S. customers. Pursuant to the Amendment, ICE Europe is required, within 120 days, to adopt speculative position limits and position accountability levels for its West Texas Intermediate (WTI) crude oil contract that are equivalent to those that have been established by the New York Mercantile Exchange for its WTI futures and options contracts. The CFTC also is conditioning the continued availability of no-action relief on the adoption of standards for hedge exemptions from position limits that are the same as those that would apply in the U.S. Finally, the CFTC is requiring that ICE Europe report any violations of its position limits to the CFTC. The Amendment follows the recent Memorandum of Understanding between the CFTC and the UK Financial Services Authority (FSA), in which the regulators agreed to share information for market surveillance purposes. The CFTC indicated that it intends to apply these requirements to any future request for direct foreign access to U.S. customers with respect to cash-settled contracts that are linked to contracts listed on a CFTC-regulated U.S. futures exchange.

http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5511-08.html
http://www.cftc.gov/stellent/groups/public/@lrlettergeneral/documents/letter/08-09.pdf

CFTC Seeks Public Comments on Petition from ICE Clear Europe, Ltd.

The Commodity Futures Trading Commission is seeking public comment on a petition by ICE Clear Europe, Ltd. for a CFTC determination, under Section 409(b)(3) of the Federal Deposit Insurance Corporation Improvement Act of

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

1991, that the UK Financial Services Authority satisfies appropriate standards when supervising multilateral clearing organizations. The deadline for comments is June 25.

http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5512-08.html

Banking

OCC Releases Survey Regarding Bank Underwriting Standards

On June 12, the Office of the Comptroller of the Currency (OCC) released its 14th annual Survey of Credit Underwriting Practices. Included in the survey were the 62 largest national banks; the survey covered the 12-month period ending March 31, 2008. The aggregate total loans included in the survey was $3.7 trillion, which represented over 83% of all outstanding loans in the national banking system.

In undertaking the survey, the OCC relied upon examiner assessments. Primary findings include the following: (i) after four consecutive years of eased underwriting standards, the majority of banks surveyed tightened underwriting standards for both commercial and retail loans; (ii) reasons for the tightening included "overall economic outlook, the downturn in residential real estate, a changing risk appetite, and a decrease in market liquidity"; (iii) risk in both commercial and retail portfolios increased over the past 12 months and was expected to continue; and (iv) key factors in product and portfolio risk included a weaker economy, energy costs, unstable secondary markets, the housing market, and the impact of prior relaxed underwriting standards.

http://www.occ.treas.gov/ftp/release/2008-66.htm

UK Developments

Woolworths Fined £350,000 for Breaches of Disclosure Rules and Listing Principles

On June 11, the UK Financial Services Authority (FSA) fined Woolworths Group Plc £350,000 ($700,000) for failing to disclose information to the market in a timely manner.

Woolworths became aware of a variation to the terms of a major supply contract of one of its subsidiaries, Entertainment UK (EUK) in December 2005, which led to an estimated £8 million ($16 million) reduction in Woolworths' profits for the year 2006–2007. The FSA considered this to be information that should have been disclosed to the market as soon as possible as it was likely to have a significant effect on Woolworths' share price. The FSA took the view that Woolworths' failure to identify and disclose this information created a false market in its shares, which breached Disclosure Rule 2.2.1 and Listing Principle 4, the aim of which is to ensure that all market users get the same information at the same time.

www.fsa.gov.uk/pages/Library/Communication/PR/2008/056.shtml

Companies Act 2006: Application of Accounting and Audit Provisions to Limited Liability Partnerships

On June 16, the draft regulations prepared by the UK Department for Business, Enterprise & Regulatory Reform applying the accounts provisions of the Companies Act 2006 (the Act) to Limited Liability Partnerships (LLPs) were laid before the UK Parliament.

The draft regulations included the following:

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

UK DEVELOPMENTS

For more information, contact:

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

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

- Large and Medium-sized Limited Liability Partnerships (Accounts) Regulations 2008, which specify the form and content of the accounts for large and medium-sized LLPs to be filed with the Registrar of Companies;

- Limited Liability Partnerships (Accounts and Audit) (Application of the Companies Act 2006) Regulations 2008, which apply to LLPs various of the Act's provisions on accounts and audit;

- Small Limited Liability Partnerships (Accounts) Regulations 2008, which specify the form and content of accounts for small LLPs to be filed with the Registrar of Companies; and

- Limited Liability Partnerships (Late Filing Penalties) Regulations 2008, which set out the penalties for late filing of accounts and reports with the Registrar of Companies.

These regulations are due to come into effect for LLPs in the UK and Northern Ireland on October 1, 2008 for financial years beginning on or after that date.

www.opsi.gov.uk/si/si2008/draft/pdf/ukdsi_9780110818351_en.pdf
www.opsi.gov.uk/si/si2008/draft/pdf/ukdsi_9780110818337_en.pdf
www.opsi.gov.uk/si/si2008/draft/pdf/ukdsi_9780110818344_en.pdf
www.opsi.gov.uk/si/si2008/pdf/uksi_20080497_en.pdf

FSA Publishes FAQs on Short Positions Disclosure Regime

The UK Financial Services Authority published on June 17 and revised on succeeding days a set of frequently asked questions to clarify its new requirements for the disclosure of significant short positions as reported in the June 13, 2008 edition of *Corporate and Financial Weekly Digest*. The new reporting requirement takes effect today.

http://www.fsa.gov.uk/pubs/other/Shortselling_faqs.pdf

FSA Publishes Feedback on Deduction of Investments in Subsidiaries

On June 17, the UK Financial Services Authority (FSA) published FS08/4 *Review of the interaction of our solo and group capital requirements* with feedback to its previous discussion paper DP07/5 published in September 2007.

The feedback statement accepted that market forces alone are unlikely to deliver the FSA's desired risk appetite in relation to capital adequacy of individual firms within a group. In DP07/5, the FSA set out its belief that other approaches such as replacing solo requirements with a form of group support or modifying the existing solo capital requirements should be considered to address market failure in a more proportionate manner than under the current deductions regime. The FSA has now concluded that it does not have conclusive evidence to support a change to the current regime and it will not alter the current solo or group capital requirements at this time.

In view of the responses to DP07/5, the FSA has decided that the treatment of investments in subsidiaries will now fall within the scope of a wider consideration of regulatory capital launched in December 2007 (DP07/6 *Definition of Capital*) and further feedback is expected later this year.

www.fsa.gov.uk/pubs/discussion/fs08_04.pdf

* 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

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