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Corporate and Financial Weekly Digest

June 27, 2008

A Note from the Editor

In light of the Independence Day holiday, please note that *Corporate and Financial Weekly Digest* will not be published next Friday, July 4. The next issue will be distributed on July 11.

SEC/Corporate

Auditor Attestation Requirement in Sarbanes-Oxley Act Delayed for Small Businesses

On June 20, the Securities and Exchange Commission announced that it had approved a one-year extension of the compliance date for smaller public companies to meet the Section 404(b) auditor attestation requirement of the Sarbanes-Oxley Act. The release adopting the final amendments to the temporary rule extending the compliance date for smaller public companies was posted to the SEC website on June 26. With the extension, smaller companies will now be required to provide attestation reports in their annual reports for fiscal years ending on or after December 15, 2009.

The SEC also announced that it received Office of Management and Budget approval to proceed with data collection for a study of the costs and benefits of Section 404 implementation, focusing on the consequences for smaller companies and the effects of the Section 404 auditor attestation requirements. The SEC staff's cost-benefit study, which was announced in February when the extension was proposed, is being led by the SEC's Office of Economic Analysis with assistance from the Office of the Chief Accountant and the Division of Corporation Finance. The SEC staff will now move forward with in-depth interviews and a web-based survey to collect real-world data from a broad array of companies, analyzing what drives costs, particularly for smaller companies, and where companies and investors derive benefits from Section 404. The study will help determine whether the new internal control guidance the SEC issued in June 2007 and the Public Company Accounting Oversight Board's (PCAOB) Auditing Standard No. 5, approved by the SEC in July 2007, are having the intended effect of facilitating more cost-effective internal control evaluations and audits of smaller reporting companies. The results of the study are expected to become available during the extension period. Additionally, the extension will provide time for the PCAOB's issuance of final staff guidance on the auditing of internal control over financial reporting (ICFR) for smaller public companies, which is under preparation.

Section 404 has two provisions: 404(a), which went into effect for smaller public companies this year, requires company management to assess the effectiveness of a company's ICFR, while 404(b) requires an auditor attestation on management's assessment. The amendments will also continue the temporary distinction with respect to liability for the management's report on ICFR by treating the management's report as "furnished" not "filed" until non-

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accelerated filers are also required to comply with 404(b). Larger companies, comprising more than 95 percent of the market capitalization of U.S. equity securities markets, have been subject to both provisions since 2004 and are filing their first 404(b) reports under the new audit standard this year.

The amendments will take effect 60 days after the release is published in the *Federal Register*.

http://www.sec.gov/rules/final/2008/33-8934.pdf

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"Storm warnings" Give Rise to Duty of Inquiry

The Second Circuit affirmed a District Court's decision granting defendants' motion to dismiss a federal securities class action complaint on statute of limitations grounds. The issue presented on appeal centered on whether plaintiffs' claims were time-barred, as the District Court held, because the limitations period began to run when the plaintiffs were placed on "inquiry notice" (often called "storm warnings" in the securities context). The "storm warning" came in the form of another class action complaint that was filed by other plaintiffs against the company in February 2001.

The Second Circuit held that inquiry notice was established in February 2001, when the class action complaint was filed by different plaintiffs alleging material misrepresentation of the company's financial results for the third and fourth quarters of 2000. Plaintiffs contended that the 2001 action did not alert them to the fraud giving rise to their own action because they had acquired the company shares prior to the third quarter of 2000, and, therefore, had no reason to believe that they were the victims of the fraud alleged in the 2001 action. The Court disagreed, holding that the class-action allegations would have alerted an investor of ordinary intelligence that financial statements issued earlier may have suffered from the same infirmities plaguing the third and fourth quarter of 2000. The Court then applied the one-year pre-Sarbanes Oxley (SOX) statute of limitations established by 15 U.S.C. § 78(e) because the longer statute of limitations established by SOX was held not to apply to claims existing prior to the passing of the SOX in July 2002. The Court held that the statute expired in February 2002, one year after the filing of the 2001 action, and so plaintiffs' 2005 complaint was time barred. (*Domenikos v. Roth*, 2008 WL 2329315 (2d Cir. June 5, 2008))

Inference of Scienter Must Be at Least as Compelling as Opposing Inference

A New York federal District Court granted defendants' motion to dismiss a complaint filed against a pharmaceutical company and its officers and directors, alleging that the defendants had violated federal securities laws by making material misstatements and omissions concerning one of the company's drugs which was in its late-stage clinical trials. The complaint alleged that the drug was not as safe or effective as defendants' public statements made it out to be, and that several risks associated with the drug were not disclosed over the course of the class period. When the Food and Drug Administration subsequently denied approval of the drug, the company's stock price declined. Defendants' motion to dismiss was based upon a number of grounds including subject matter jurisdiction and the plaintiffs' failure to plead scienter sufficiently.

The subject matter jurisdiction argument related to the extraterritorial effect of the United States' securities laws, a significant issue given that over 90% of the members of the putative class were foreigners who purchased the company's shares on foreign exchanges. In order to determine whether the

court had subject matter jurisdiction, it needed to evaluate whether defendants' U.S.-based conduct was both more than merely preparatory to the fraud and that the U.S.-based conduct directly caused the losses to the foreign investors abroad. Even though the Court found that several of the alleged misrepresentations took place in the United States, it did not find that the complaint sufficiently alleged that the conduct "directly caused" the foreign investors' loss abroad. In doing so, the Court refused to grant the non-U.S. investors the benefits of the fraud-on-the-market presumption. That doctrine allows U.S. purchasers to prove reliance on the presumption that in an open and developed securities market the price of a company's stock is determined by available material information, including material misrepresentations or omissions. So, even if an individual claimant did not see or rely on a specific alleged misrepresentation, it is still presumed to have suffered under the theory that the market suffered.

The District Court, however, refused to apply this presumption to non-U.S. markets in light of the absence of any authority from the Second Circuit and because of a concern that applying a "global" fraud-in-the-market authority would expand the jurisdictional reach of the United States' securities laws "too far."

The District Court also found that the complaint failed to adequately allege scienter. It looked to the "motive and opportunity" of the defendants to commit a fraud and found, despite defendants' sale of stock at one instance early in the class period, that plaintiffs' allegations did not establish a "cogent and at least as compelling inference" of scienter. (*In re Astrazeneca Securities* Litigation, 2008 WL 2332325 (S.D.N.Y. June 3, 2008))

Broker Dealer

NASDAQ Proposes a Rule Change to Modify the Opening of Trading on the NASDAQ Options Market

The NASDAQ Stock Market LLC has filed with the Securities and Exchange Commission a proposed rule change to modify the opening of trading on the NASDAQ Options Market. The proposal, as described below, goes into effect, immediately.

Presently, the NASDAQ opening is delayed if the NASDAQ Best Bid or Offer (NASDAQ BBO), after execution of the opening print, would be wider than the predetermined authorized trading thresholds. NASDAQ proposes to allow the opening of trading in instances wherein trading interest at the National Best Bid and Offer (NBBO) is within the currently authorized trading thresholds. Subject to certain exceptions, executions will only be permitted if they will not result in a trade-through of the NBBO.

NASDAQ believes that this proposal will allow it to open more series earlier in the trading day without risk of additional erroneous trades. Moreover, analyzing both the NASDAQ BBO and NBBO when determining when to open trading will enhance the opportunities for market participants to execute trades at the beginning of the trading day.

http://www.sec.gov/rules/sro/nasdaq/2008/34-57977.pdf

FINRA Proposes Adoption of Certain Rules in Consolidated Rulebook

The Financial Industry Regulatory Authority filed proposed rule changes to adopt NASD Rules 2840 through 2853 (regarding trading in Index Warrants, Currency Index Warrants and Currency Warrants), NASD Rule 2860 (Options) and NASD Rule 2865 (Security Futures) as FINRA Rules in the consolidated FINRA rulebook. In addition, the rule proposal would delete the corresponding

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provisions in NYSE Rules 414, 424 and the 700 Series. The proposed new FINRA rules would include certain minor changes from their NASD predecessors. These minor modifications include, for example, deleting certain obsolete definitions and incorporating interpretive material directly into the new rule text. The proposed changes also include substantive changes. For example, under new FINRA Rule 2360, Series 9/10 supervisors would be allowed to approve the opening of options accounts in addition to Series 4 qualified supervisors.

http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p038812.pdf

SEC Votes to Propose Changes Regarding Foreign Broker Access

In an open meeting held June 25, the Securities and Exchange Commission voted to propose new rules on a number of issues including amendments to current rules that govern how foreign securities brokers access U.S. markets. The new rules would purportedly ease current restrictions in SEC Rule 15a-6 and, among other things, permit a diminished role for "chaperoning" U.S. brokers. It was reported that the new rules would also allow foreign firms to send research reports to individuals or institutions with $25 million or more assets. This is a sharp decrease from the current $100 million test.

http://www.sec.gov/news/openmeetings/2008/agenda062508.htm

FINRA Annual Certification of Compliance and Supervisory Processes

The Financial Industry Regulatory Authority filed a proposed rule change to adopt NASD Rule 3013 (Annual Certification of Compliance and Supervisory Processes) and IM-3013 (Annual Compliance and Supervision Certification) as a FINRA rule in the consolidated FINRA rulebook without material changes and to delete the corresponding provisions in certain Incorporated NYSE rules and interpretations. The proposed rules will address the following four differences in the rules:

i. NASD IM-3013 requires that the member provide to its board of directors and audit committees (or equivalent bodies) the report that evidences the processes to which the CEO(s) certifies either prior to execution of the certification or at the earlier of their next scheduled meetings or within 45 days of certification. The Incorporated NYSE rules require submission of the report to those bodies prior to certification.

ii. The current rules also differ in the certification deadline. Incorporated NYSE Rule 342.30 requires certification as part of the submission of a member's annual compliance report, which is due by April 1 of each year. NASD Rule 3013 requires certification not later than the anniversary of the prior year's certification.

iii. Incorporated NYSE Rule 342.30 requires that the member submit its certification to the exchange, whereas the NASD rule requires only that the certification be maintained for inspection.

iv. While both rules permit designation of multiple CCOs subject to certain conditions, Incorporated NYSE Rule Interpretation 311(b)(5) requires exchange approval of the allocation of supervisory responsibilities between those CCOs, while the NASD rules rely on the business judgment of the member and require only that member define and document the areas of responsibility allocated to each CCO.

The proposed rule change would replace NASD Rule 3013 and IM-3013 with a single rule that integrates the substance of the IM either as provisions in the new rule or as supplementary material.

http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p038785.pdf

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SEC Announces Third Set of Proposed Rules on Reforming Credit Ratings

On June 25, the Securities and Exchange Commission unveiled the third of three sets of proposed rule changes regarding nationally recognized statistical rating organizations (NRSROs) to address concerns about the process by which NRSROs rate asset-backed securities in light of the subprime mortgage crisis and subsequent credit crunch. As reported in the June 20, 2008 edition of *Corporate and Weekly Financial Digest*, the first two sets of proposed rules issued on June 16 involved changes to prohibit or manage certain conflicts of interest, in part by requiring increased disclosure of information used by NRSROs when rating asset-backed securities, and to differentiate structured finance credit ratings from credit ratings on other bonds through the use of a symbol, report or other identifier. The SEC's third set of proposals is focused on reducing the reliance upon and reference to credit ratings in the SEC's own rules.

The SEC's own rules regarding credit ratings "may have played a role in encouraging investors' overreliance on ratings," SEC Chairman Christopher Cox told an open meeting of the Commission. The SEC, after a review of its rules and forms, identified 44 references to credit ratings. The SEC is proposing to drop any reference to credit ratings in 11 of its rules, change the wording of 27 others and leave six rules unchanged. "The recommendations we consider today are consistent with the objective of having investors make an independent judgment of the risks associated with a particular security," Cox said.

The proposed changes include replacing the Securities Act requirement that only investment grade asset-backed securities are eligible for Form S-3 (and shelf registration) with a rule that an asset-backed securities offering would be Form S-3 eligible, regardless of the credit rating, if initial and subsequent sales of the securities are made in minimum denominations of $250,000 and initial sales are made only to qualified institutional buyers, as defined in Rule 144A. The reference to "mortgage related securities" in Rule 415 would be modified so that delayed offerings of mortgage-backed securities would be permitted in the same way. Other Regulation AB Items and SEC rules that affect offerings of asset-backed securities make reference to credit ratings and also will be affected by the SEC's proposed rule changes.

http://www.sec.gov/news/speech/2008/spch062508cc_credit.htm
http://www.sec.gov/news/speech/2008/spch062508sh.htm

New York Legislature Passes Mortgage Foreclosure Crisis Legislation

On June 23, both houses of the New York State Legislature passed legislation to address mortgage foreclosures, which have increased by 55% from 2005 in the State of New York. The law would provide additional protections to mortgagors facing foreclosure, establish standards for subprime mortgage loans (including an ability to repay standard) and high-cost mortgage loans, create registration requirements for loan servicers, strengthen standing requirements for plaintiffs in foreclosure actions and create legal requirements for "mortgage consultants" aimed at preventing certain foreclosure rescue scams.

The law would require lenders and servicers to send a notice to borrowers with subprime, payment option or interest-only mortgage loans generally originated after January 1, 2003 at least 90 days before beginning legal foreclosure actions. Courts would be required to conduct settlement conferences to attempt to reach resolutions so that borrowers do not lose their homes. Subprime and high-cost mortgage loans would not be allowed to have negative amortization, prepayment penalties or teaser rates, among other requirements. Subprime mortgage lenders and brokers would be required to have a reasonable good faith belief that a mortgagor has the ability to repay all loans with respect to any property at the fully-indexed rate. Mortgage brokers with respect to any home loan would be required to act in the borrower's interest, in good faith, in order to present the borrower with a range of appropriate loan products, among other requirements. The ability to pay standard along with the mortgage broker duty of care are intended to prevent borrowers from being steered into home loans they cannot afford.

The law would create a new crime of "residential mortgage fraud" consisting generally of knowingly, and with intent to defraud, making written statements in connection with the origination or underwriting of a residential mortgage loan that contain material false information or that intentionally conceal material facts. The crime would have five degrees, and the four degrees that involve the receipt of proceeds in any dollar amount would all constitute felonies.

http://assembly.state.ny.us/leg/?bn=A10817A

New Jersey Legislature Passes "Save New Jersey Homes Act of 2008"

On June 23, both houses of the New Jersey State Legislature passed the "Save New Jersey Homes Act of 2008," which is expected to be signed by Governor Corzine. The legislation applies to certain hybrid mortgage loans that have an initial fixed-rate interest period of five years or less followed by an adjustable-rate interest period and that are secured by owner-occupied properties. The law would require creditors to notify eligible mortgagors prior to the first interest-rate reset date, and prior to the commencement of foreclosure proceedings, of the mortgagor's rights under the law. After receipt of the notice, if the mortgagor certifies he or she is unable to make monthly payments at the fully-indexed mortgage rate, the mortgagor would be entitled to an extension of three years, during which the interest rate payable on the mortgage loan would not be allowed to increase above the introductory rate. A mortgagor would forfeit the benefits of the law if the modified mortgage loan becomes 60 days or more delinquent, and all deferred interest must be repaid when the mortgage loan is ultimately repaid.

http://www.njleg.state.nj.us/2008/Bills/A3000/2780_R2.PDF
http://www.njleg.state.nj.us/2008/Bills/S2000/1853_R2.PDF

CFTC

Exchanges, Industry Groups Comment on FTC Rulemaking

In a joint June 23 comment letter addressed to the Federal Trade Commission (FTC), the Futures Industry Association, CME Group, New York Mercantile Exchange and Managed Funds Association addressed the FTC's implementation of Section 811 of the Energy Independence and Security Act of 2007, which gives the FTC anti-manipulation authority over wholesale purchases and sales in crude oil, gasoline and petroleum distillates. In the letter, the commenters urged the FTC to respect the Commodity Futures Trading Commission's exclusive jurisdiction under the Commodity Exchange Act to regulate the futures markets by providing a safe harbor or similar exception from the FTC's rules for matters subject to exclusive CFTC

CFTC

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jurisdiction. In addition, the commenters urged the FTC to employ a similar anti-manipulation standard to that of the CFTC (as opposed to a standard modeled after U.S. securities laws) in adopting and enforcing its new regulations, including a requirement to prove "specific intent" as an element of a manipulation claim.

http://www.futuresindustry.org/downloads/FTCCommentLetterJune%2023Final129720.pdf

Speaker Pelosi Urges White House to Direct CFTC to Act

Speaker of the House Nancy Pelosi sent a letter to President Bush on June 25 in which she called on President Bush to direct the Commodity Futures Trading Commission to use its existing statutory emergency authority to restrict excessive speculation in energy markets. Citing recent congressional testimony regarding the possible relationship between "excessive speculation in the oil futures market" and recent increases in oil prices, Speaker Pelosi urged this action as a means to ensure that market prices for such commodities are fair.

http://www.speaker.gov/newsroom/pressreleases?id=0718

ERISA

U.S. Supreme Court Addresses Conflicts of Interest in Deciding Benefit Claims

Sponsors and administrators of employee benefit plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) should consider the effect of the U.S. Supreme Court's June 19 decision in *Metropolitan Life Insurance Co. v. Glenn*, which has implications for plan administration and governance.

Glenn arose from a lawsuit under ERISA challenging a claims administrator's denial of a claim for long-term disability benefits. The issue faced by the Supreme Court was whether, and to what extent, a court in an ERISA suit should take into account the fact that the entity reviewing a benefit claim is the same entity who will pay for the benefit if it grants such claim. This conflict could be present where, as in *Glenn*, an insurance company both reviews and pays claims, or where an employer reviews claims and also funds the plan.

In its decision, the Supreme Court concluded that the dual status of being (i) the decision maker on benefits eligibility and (ii) payor (directly or indirectly) of benefits creates a conflict of interest. The Supreme Court determined that the conflict of interest must be factored into a court's review of a benefits determination, even if such determination is entitled to deference (in 1989, the Supreme Court previously ruled that, if certain criteria are met, a court should only overturn a benefit claim determination if there had been an "abuse of discretion" by the claim determiner). However, the weight given to the conflict of interest will vary on a case-by-case basis and such conflict could prove of considerable or maybe little importance, "perhaps to the vanishing point."

The *Glenn* decision makes it important for plan sponsors and administrators to examine and address conflicts of interest in their plans' claims administration process. Specifically, plan sponsors and administrators should consider actions aimed at minimizing the weight a court will give to a conflict of interest (*e.g.*, ensure that the claims review procedure is full, fair and impartial, creation of administrative procedures to isolate claim determinations from the analysis and budgeting of plan costs, internal or external quality control of claims reviews).

ERISA

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A more detailed Client Advisory on *Glenn* is available here.

http://www.supremecourtus.gov/opinions/07pdf/06-923.pdf

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Banking Agencies Issue Host State Loan-to-Deposit Ratios

The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency yesterday issued the host state loan-to-deposit ratios that the banking agencies will use to determine compliance with section 109 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. These ratios update data released on June 12, 2007.

In general, section 109 prohibits a bank from establishing or acquiring a branch or branches outside of its home state primarily for the purpose of deposit production. Section 109 also prohibits branches of banks controlled by out-of-state bank holding companies from operating primarily for the purpose of deposit production.

Section 109 provides a process to test compliance with the statutory requirements. The first step in the process involves a loan-to-deposit ratio screen that compares a bank's statewide loan-to-deposit ratio to the host state loan-to-deposit ratio for banks in a particular state. A second step is conducted if a bank's statewide loan-to-deposit ratio is less than one-half of the published ratio for that state or if data are not available at the bank to conduct the first step. The second step requires the appropriate banking agency to determine whether the bank is reasonably helping to meet the credit needs of the communities served by the bank's interstate branches.

A bank that fails both steps is in violation of section 109 and is subject to sanctions by the appropriate banking agency.

The loan-to-deposit ratios are available at:

http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080626a1.pdf

Federal Reserve Proposes "Less Complex" Risk-Based Capital Requirements

The Federal Reserve Board yesterday proposed a rule for public comment that would implement certain of the less-complex approaches for calculating risk-based capital requirements that are included in the international Basel II capital accord. The long-awaited proposal is well over 300 pages.

The proposal, known as the Standardized Framework, would be available for banks, bank holding companies, and savings associations not subject to the advanced approaches of Basel II. Under the advanced approaches rule, which took effect April 1 and is mandatory only for large, internationally active banking organizations, banking organizations are required to develop rigorous risk-measurement and risk-management techniques as part of a new risk-sensitive capital framework. Though different in requirements from Basel II, the Standardized Framework also seeks to more closely align regulatory capital requirements with institutions' risk and should further encourage improvements in their risk-management practices.

Federal Reserve Board Governor Randall S. Kroszner stated, "Recognizing the diversity of banking organizations in the United States, we want to provide these banks the option of using a more updated capital framework without unduly increasing regulatory burden."

The proposed Standardized Framework addresses a number of areas including:

- Expanding the number of risk-weight categories to which credit exposures may be assigned.
- Using loan-to-value ratios to risk weight most residential mortgages to enhance the risk sensitivity of the capital requirement.
- Providing a capital charge for operational risk using the Basic Indicator Approach under the international Basel II capital accord.
- Emphasizing the importance of a bank's assessment of its overall risk profile and capital adequacy.
- Providing for comprehensive disclosure requirements to complement the minimum capital requirements and supervisory process through market discipline.

Comments will be accepted for 90 days from the date of publication in the *Federal Register*.

http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080626b1.pdf

UK Developments

FSA Publishes *Market Watch 28*

On June 19, the UK Financial Services Authority (FSA) published issue 28 of its *Market Watch* newsletter. The newsletter included further information on: (i) the FSA's new telephone and electronic recording rules, (ii) client categorization with respect to private placing, (iii) systems and controls for the prevention of market abuse in commodity firms, (iv) issues with debt capital markets businesses, and (v) transaction reporting.

The FSA's telephone and electronic recording rules are due to come into effect in March 2009, as reported in the March 7, 2008 edition of *Corporate and Financial Weekly Digest*. The newsletter states that the FSA may ask authorized firms to retain recordings for longer than the six months provided in the rules where it considers that the recordings might assist the FSA in a market abuse investigation.

The FSA has also clarified the application of its client categorization and financial promotion rules with respect to a private placing and has provided feedback on anti-market abuse systems and controls following its market abuse thematic project with firms that trade (or facilitate trading) in UK exchange-traded commodities markets.

The newsletter called for authorized firms to undertake a review of their systems and controls in relation to public and private side interaction within their debt capital markets businesses.

Finally, the FSA confirmed in the newsletter that it will not require authorized firms to report transactions in non-securities derivatives admitted to trading on regulated markets.

www.fsa.gov.uk/pubs/newsletters/mw_newsletter28.pdf

LSE Censures and Fines Firm for Breaches of AIM Rules

On June 19, the London Stock Exchange (LSE) announced that it had publicly censured and fined Meridian Petroleum plc £75,000 ($150,000). Meridian breached the rules of the Alternative Investment Market (AIM) by repeatedly failing to take reasonable care to ensure announcements made to the market

UK DEVELOPMENTS

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between August 2004 and February 2007 were not misleading and failing to update the market.

www.londonstockexchange.co.uk/NR/exeres/8C1B6C5D-7315-482D-BF8C-51AC4EBF7EC9.htm

FSA Bankrupts Boiler Room Controller

On June 26, the UK Financial Services Authority (FSA) announced that it obtained a bankruptcy order against Samuel Nathan Kahn who controlled the affairs of Chesteroak Limited (Chesteroak) and Bingen Investments Limited (Bingen). Chesteroak and Bingen were two UK-based companies that helped illegal offshore boiler rooms sell shares to investors.

The bankruptcy order follows the liquidations of Chesteroak and Bingen in September 2007 after the FSA alleged that they were dealing in shares or arranging deals in shares without authorization, as reported in the September 28, 2007 edition of *Corporate and Financial Weekly Digest*.

www.fsa.gov.uk/pages/Library/Communication/PR/2008/060.shtml

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

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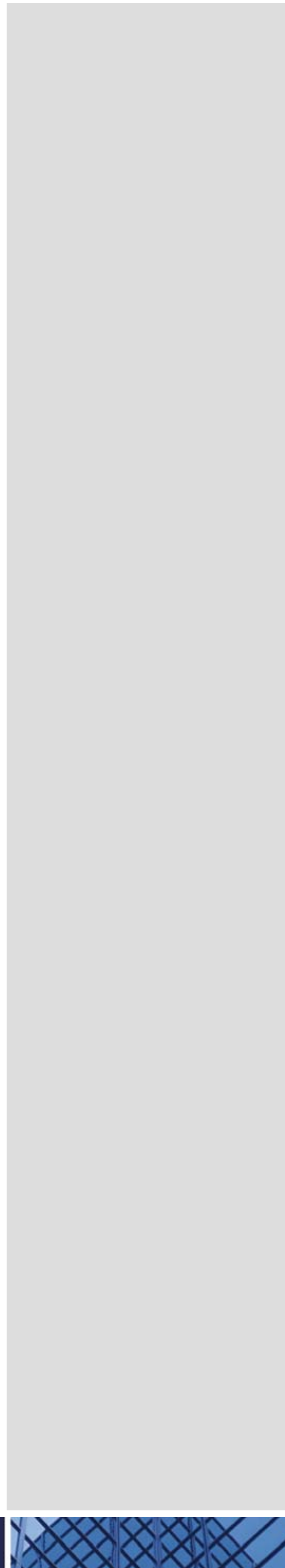

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