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SEC/CORPORATE

SEC Implements Secure E-mail System for Confidential Submissions

Effective May 14, the Division of Corporation Finance of the Securities and Exchange Commission has implemented a secure e-mail system that allows it to receive confidential submissions from "emerging growth companies" (EGCs) under the Jumpstart Our Business Startups Act (JOBS Act), as well as from certain foreign private issuers under the Division of Corporation Finance's pre-existing policy that permits such issuers to submit draft registration statements to the SEC for non-public review. According to the SEC, the new system, which is mandatory for such submissions, will allow companies and the Division of Corporation Finance to correspond securely regarding draft registration statements.

As reported in the April 13 edition of *Corporate and Financial Weekly Digest*, the JOBS Act permits EGCs to confidentially submit draft registration statements to the SEC for non-public review. Prior to the implementation of the secure e-mail system described above, EGCs were required to submit such drafts in a PDF file on a CD/DVD or in paper form.

All draft registration statements submitted confidentially pursuant to the JOBS Act or for non-public review under the Division of Corporation Finance's policy for certain foreign private issuers must be submitted in accordance with instructions published by the Division of Corporation Finance. The submissions must be in text-searchable PDF format and must include a transmittal letter in which the submitting company must confirm its status as an eligible foreign private issuer or an EGC and must identify the type of submission being made. To view such instructions, click here.

LITIGATION

Seventh Circuit Court of Appeals Rejects Argument That Wisconsin Corporate Law is Part of Articles of Incorporation

The U.S. Court of Appeals for the Seventh Circuit rejected the argument of a dissenting shareholder in a freezout merger that provisions of Wisconsin's corporate law were binding contractually on a company's founders and its investors.

Everett Smith Group, Ltd. (Smith), which owned 89% of the stock of Albert Trostel & Sons Company (Trostel) voted to acquire the remaining stock through a freezeout merger. Trostel became a wholly owned subsidiary of Smith and the minority shareholders were to receive $11,900 per share in compensation. Edward Notz, owner of 5.5% of the stock, rejected that amount, contending that the shares were worth twice as much.

The Wisconsin statute provided that when investors reject the compensation offered in a merger, the corporation must commence an appraisal proceeding in the circuit court for the county where its principal office is located. Trostel filed the appraisal action in Wisconsin federal district court, asserting that jurisdiction was proper there

based on federal diversity jurisdiction. Mr. Notz moved to dismiss, contending that the district court lacked jurisdiction. He argued that all of Wisconsin's corporate law—including the provision requiring where such an action must be brought—is part of all articles of incorporation, and thus bound the parties as a contractual matter, even though neither party affirmatively consented. The district court denied the motion and, after a trial, concluded that the fair value of the stock was $11,900 per share.

The Seventh Circuit affirmed. It concluded that the Wisconsin law established a rule of venue applicable within its own judicial system and not a rule allowing corporations to defeat diversity jurisdiction. It found that Wisconsin's corporate law provisions are legislative and not "contracts" because they do not depend on the consent of private parties.

Albert Trostel & Sons Co. v. Notz, No. 10-3509 (7th Cir. May 10, 2012).

District Court Rejects Argument that Investment Advisers Act Cannot be Applied Extraterritorially

The Securities and Exchange Commission brought a complaint against the former Chief Financial Officer of a now defunct investment adviser seeking enforcement of the Investment Advisers Act of 1940 (IAA). The U.S. District Court for the Southern District of New York denied the defendant's motion to dismiss, rejecting his argument that the SEC was barred from enforcing the IAA where the alleged fraud was not directed at domestic clients of the adviser.

D.B. Zwirn & Co. L.P. (Zwirn) managed five hedge funds from 2002 to 2009, including D.B. Zwirn Special Opportunities Fund, Ltd. (the Offshore Fund) and D.B. Zwirn Special Opportunities Fund, L.P. (the Onshore Fund). The SEC alleged that Zwirn's former CFO authorized more than $870 million in improper transfers of client cash from the Offshore Fund to the Onshore Fund. The defendant argued that based on a recent Supreme Court decision in *Morrison v. National Australia Bank Ltd.*, fraud claims involving the IAA must be directed only at domestic clients and that the IAA could not be applied extraterritorially. He contended that since the alleged fraud involved a Cayman Islands entity (the Offshore Fund), the SEC should be barred from enforcing the IAA against him.

The court rejected the argument and distinguished *Morrison*. It noted that *Morrison* involved the enforcement of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 as opposed to the IAA which focuses on investment advisers. Because the IAA regulates advisers rather than clients, the defendant's argument that the SEC's claim seeks extraterritorial application of a federal statute was unpersuasive. The court also found that Morrison, even if applicable in this case, would not bar the SEC's complaint because more than half of the Offshore Fund's investors were located in the U.S. and investors of both funds were affected by the transfers. Further, the defendant approved the transfers, involving U.S. bank accounts, in New York.

Securities and Exchange Commission v. Gruss, No. 11 Civ. 2420 (S.D.N.Y. May 9, 2012).

BANKING

Agencies Finalize Stress Test Guidance for Banks With More Than $10 Billion in Assets; Guidance Not Applicable to Smaller Banks

The Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC, and together, the agencies) on February 14 issued final supervisory guidance regarding stress-testing practices at "banking organizations" with total consolidated assets of more than $10 billion. (The term banking organization means national banks, federal savings associations, and federal branches and agencies supervised by the OCC; state member banks, bank holding companies, savings and loan holding companies, and all other institutions for which the Federal Reserve Board is the primary federal supervisor; and state nonmember banks, and all other institutions for which the FDIC is the primary federal supervisor.) The agencies noted that supervisors will examine firms' stress testing methodologies through the supervisory process.

The proposed guidance identified and included a discussion of four key principles for a banking organization's stress testing framework and related stress test results, namely that: (i) a banking organization's stress testing framework should include activities and exercises that are tailored to and sufficiently capture the banking

organization’s exposures, activities, and risks; (ii) an effective stress testing framework employs multiple conceptually sound stress testing activities and approaches; (iii) an effective stress testing framework is forward-looking and flexible; and (iv) stress test results should be clear, actionable, well supported, and inform decision-making. In the final guidance, the agencies have incorporated a fifth principle specifying that an organization’s stress testing framework should include strong governance and effective internal controls. The elements of the fifth principle had been set forth in section VI of the proposed guidance, and the fifth principle does not expand on this aspect of the proposed guidance. Rather, the agencies reorganized this discussion into a fifth principle "in order to underscore the importance of governance and controls as a key element in a banking organization’s stress testing framework."

The agencies have modified the final guidance to clarify that senior management, not the board of directors, should have the primary responsibility for stress testing implementation and technical design. "However, the agencies emphasize that a banking organization’s board of directors should be provided with information from senior management on stress testing developments (including the process to design tests and develop scenarios) and on stress testing results (including from individual tests, where material). As a general matter, the board of directors is also responsible for monitoring effectiveness of the overall framework, and using the results to inform their decision making process."

The guidance "highlights the importance of stress testing at banking organizations as an ongoing risk management practice that supports a banking organization's forward-looking assessment of its risks and better equips it to address a range of adverse outcomes…, and builds upon previously issued supervisory guidance that discusses the uses and merits of stress testing in specific areas of risk management." The guidance also "outlines general principles for a satisfactory stress testing framework and describes various stress testing approaches and how stress testing should be used at various levels within an organization…and also discusses the importance of stress testing in capital and liquidity planning and the importance of strong internal governance and controls as part of an effective stress-testing framework."

According to the agencies, "the guidance does not implement the stress testing requirements in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) or in the Federal Reserve Board's capital plan rule that apply to certain companies, as those requirements have been or are being implemented through separate proposals by the respective agencies." Nonetheless, "the agencies expect that banking organizations with total consolidated assets of more than $10 billion would follow the principles set forth in the guidance--as well as other relevant supervisory guidance--when conducting stress testing in accordance with the Dodd-Frank Act, the capital plan rule, and other statutory or regulatory requirements."

In their Statement to Clarify Supervisory Expectations for Stress Testing by Community Banks, also issued on May 14, the agencies stated that "community banks are not required or expected to conduct the types of stress testing specifically articulated in the initiatives noted above, which are directed at larger organizations.” In particular, "community banks are not required or expected to conduct the enterprise-wide stress tests required of larger organizations under the capital plan rule, the proposed rules implementing Dodd-Frank Act stress testing requirements, or as described in the stress testing guidance for organizations with more than $10 billion in total consolidated assets." The agencies continue to emphasize, however, that "all banking organizations, regardless of size, should have the capacity to analyze the potential impact of adverse outcomes on their financial condition." The agencies noted that "certain portions of existing interagency guidance applicable to all banking organizations discuss addressing potential adverse outcomes as part of sound risk management practices" and that "such existing guidance, including that covering interest rate risk management, commercial real estate concentrations, and funding and liquidity management (among others), continues to apply."

For more information, click here and here.

UK DEVELOPMENTS

FSA Fines Habib Bank and its Money Laundering Reporting Officer for AML Control Failings

On May 15, the UK Financial Services Authority (FSA) announced that it had fined Habib Bank AG Zurich (Habib Bank) £525,000 (approximately $830,000) and Syed Itrat Hussain (Hussain) its former Money Laundering Reporting Officer (MLRO) £17,500 (approximately $28,000) for failure to take reasonable care to establish and maintain adequate anti-money laundering (AML) systems and controls.

The FSA stated that the AML failings at Habib Bank lasted almost three years and represented an unacceptable risk of laundering money. Approximately 45% of Habib Bank's customers were based outside the UK and about half of its deposits came from jurisdictions which, according to independent international organizations, had less stringent AML requirements or were perceived to have higher levels of corruption than the UK.

The FSA's investigation identified that between December 2007 and November 2010, Habib Bank failed to establish and maintain adequate controls for assessing the level of money laundering risk posed by its customers. In particular, the high risk country list which it maintained excluded certain high risk countries (Pakistan and Kenya) on the basis that Habib Bank had group offices in them. In the FSA's view Habib Bank's local knowledge of these countries did not negate the higher risk of money laundering they presented. The FSA also found that Habib Bank failed to conduct adequate enhanced due diligence in relation to higher risk customers.

The FSA reviewed 68 Habib Bank customer files and identified specific significant AML failings in two thirds of the files that they reviewed. Each had one or more of the following significant AML failings:

- the account had been inappropriately classified as normal risk;
- the enhanced due diligence conducted was inadequate (because insufficient information or supporting evidence had been obtained); or
- no enhanced due diligence had been conducted before transactions occurred through the account.

As MLRO, Hussain was responsible for the oversight and establishment of the Bank's AML systems and controls. The FSA imposed a financial penalty on Hussain for his personal failure to ensure that adequate AML systems and controls were maintained.

Tracey McDermott, FSA's acting director of enforcement and financial crime, said "Habib's failings were unacceptable. Habib's belief that local knowledge of a country through a group office mitigated the higher money laundering risk posed by that country was entirely misconceived."

Habib Bank and Hussain agreed to settle at an early stage and therefore qualified for a 30% reduction in the financial penalty imposed.

For more information on Habib Bank, click here.
For more information on Syed Hussain, click here.

FSA Fines Martin Currie £3.5 Million for Conflict of Interests Failures

On May 10, the UK Financial Services Authority (FSA) announced that it fined Martin Currie Investment Management Limited and Martin Currie Inc (together, Martin Currie) £3.5 million (approximately $5.5 million) for conflict of interest failures. This is the largest fine ever imposed by the FSA in a conflict of interest case. The Securities and Exchange Commission has taken separate enforcement action for similiar failings in respect to the same facts and a civil penalty of $8.3 million has been imposed on Martin Currie under an agreed settlement.

The FSA found Martin Currie to have breached FSA Principle 2 (skill, care and diligence), Principle 3 (management and control) and Principle 8 (conflicts of interest). Martin Currie caused one client (Fund B) to enter into a transaction which rescued another client (Fund A) from serious liquidity concerns. Both Fund A and Fund B were managed by the same Martin Currie fund managers located in its Shanghai office.

The FSA found that:

- In April 2009, Martin Currie caused Fund B to invest around £15 million (approximately $24 million) in an unlisted bond (the 2009 Bond) issued by a Bermuda incorporated entity located in China. Martin Currie failed to ensure that the valuation of the 2009 Bond and the rationale behind Fund B's investment were properly scrutinized at the time of the transaction. The 2009 Bond proved to be a poor investment for Fund B. It was sold in April 2011 at a loss of approximately 50%.
- While the investment in the 2009 Bond was detrimental to Fund B, it had significant advantages for Fund A. In April 2009, Fund A was facing serious liquidity problems due in part to its exposure to illiquid

investments in an affiliate of the issuer of the 2009 bond. Fund A's liquidity problems were solved by Fund B's investment in the 2009 Bond, because 44% of the proceeds of the 2009 Bond issue were used to redeem Fund A's illiquid investment in the bond issuer's affiliate. This in turn helped Martin Currie to avoid any reputational damage which may have arisen if Fund A's liquidity problems had continued and it had been unable to meet pending redemptions by investors.

- Fund B's investment in the 2009 Bond gave rise to a clear conflict of interest between Fund A and Fund B. Martin Currie was slow to identify this and failed to manage the conflict of interest fairly. Martin Currie did not disclose the conflict to Fund B and failed to ensure that Fund B understood that a substantial portion of the proceeds from the 2009 Bond would be used to repay an investment made by Fund A.

- Many of Martin Currie's failings resulted from weaknesses in its systems and controls in relation to unlisted investments. In particular, poor oversight of the fund managers of Fund A and Fund B.

Tracey McDermott, FSA's acting director of enforcement and financial crime, said: "Effective identification and management of potential conflicts of interest between clients is a core requirement for asset managers. This transaction gave rise to an obvious risk of a conflict which Martin Currie was slow to identify and then failed to manage adequately."

Martin Currie settled at an early stage and therefore qualified for a 30% reduction in the financial penalty imposed by the FSA. Without the settlement discount the fine would have been £5 million (approximately $8 million). In assessing the penalty, the FSA also took account of the fact that Martin Currie brought the breaches to the FSA's attention, co-operated fully with the FSA's investigation and compensated Fund B for its investment losses. The FSA also acknowledged that Martin Currie had spent considerable time and resources investigating and addressing the FSA's concerns.

For more information, click here.

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