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Corporate and Financial Weekly Digest

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SEC/Corporate

SEC Chairman Cox Advocates Regulatory Reforms

In a November 4 op-ed piece in the *Washington Post,* Christopher Cox, Chairman of the Securities and Exchange Commission, outlined proposals for regulatory reform in the wake of the global financial crisis. The crisis has exposed many weaknesses and gaps in securities regulatory systems that are far greater and more consequential than was previously understood, according to Cox. He believes that legislators and policymakers should be guided by four core principals while addressing regulatory reform: closing regulatory gaps, providing clear statutory authority, consolidating regulatory agencies and increasing transparency. Among the reforms Chairman Cox advocates are:

- consolidating the SEC and the Commodity Futures Trading Commission into a single agency with a clear mandate to regulate the markets in all financial instruments, including securities, futures and derivatives;
- regulating credit default swaps;
- increasing oversight by the SEC of municipal securities;
- eliminating the divide at the SEC between the supervision of broker-dealers under the Securities Exchange Act of 1934 and that of investment advisers under the Investment Advisers Act of 1940;
- the need for Congress to grant explicit statutory authority where it is needed so that voluntary regulation may be avoided; and
- greater transparency with respect to Fannie Mae and Freddie Mac.

http://www.washingtonpost.com/wp-dyn/content/article/2008/11/03/AR2008110302606.html

SEC Corp Fin Director John White to Leave Commission

John White, Director of the Division of Corporation Finance of the Securities and Exchange Commission, has announced that he will leave the SEC at the end of this year.

Mr. White, having joined the SEC in March 2006, led several Corporation Finance initiatives, including the SEC's adoption of extensive changes in executive and director compensation disclosure. He has also been a prime mover in the SEC's drive toward the adoption of extensible business reporting language and the push both for convergence of generally accepted accounting

SEC/CORPORATE

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principles and international financial reporting standards (IFRS) and the ultimate adoption of IFRS by U.S. reporting companies.

http://www.sec.gov/news/press/2008/2008-265.htm

Litigation

Court Denies Motion to Lift PSLRA Discovery Stay

Under the Private Securities Litigation Reform Act (PSLRA), a discovery stay is automatically triggered by a defendant's motion to dismiss. Here, the plaintiffs, who initiated a stockholder derivative suit against Sunrise Senior Living, Inc., sought to lift the automatic stay following defendant's motion to dismiss. The court noted that in order to overcome the stay, the PSLRA requires the moving party to show that particularized discovery is necessary to preserve evidence or prevent undue prejudice.

The court denied plaintiffs' motion, holding that it had not made the requisite showing. The court first ruled that preservation of evidence was not a concern in this case. While the stay could be lifted to allow access to evidence that is at risk of being destroyed or lost, plaintiffs failed to show that such a risk existed with respect to the documents they were requesting. To the contrary, because those documents had all been produced in other litigations, the court ruled that they were not at risk. The court then ruled that the plaintiffs also would not suffer undue prejudice if the discovery stay remained in place. The court recognized that a plaintiff might suffer undue prejudice if the defendant was simultaneously defending numerous legal actions that were not subject to the stay—because the resolution of those actions could deplete the defendant's assets before a plaintiff subject to a PSLRA discovery stay could effectively plan and execute its settlement and litigation strategy. However, the court ruled that the pending actions against the defendant—a separate shareholder derivative lawsuit and an SEC investigation—did not create the requisite prejudice. Because the separate derivative action, like plaintiffs' actions, sought a recovery on behalf of the corporation, the court was not concerned that its resolution would deplete assets sought by plaintiffs. Further, because it was customary for SEC investigations to occur contemporaneously with private litigations, the court ruled that the pendency of a routine SEC litigation did not constitute the type of "undue prejudice" required to lift the stay. (*In re Sunrise Senior Living, Inc.*, 2008 WL 4726050 (D.D.C. October 28, 2008))

Securities Fraud Jury Verdict Against Defendant Hedge Fund Operator Affirmed

The Securities and Exchange Commission won a jury verdict in a civil enforcement action that it brought against Conrad Seghers, who, through a company he controlled, was the general partner of three hedge funds (Integral Funds). The SEC asserted claims in the action under, among other things, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.

In 2000, the Integral Funds hired Olympia Capital Associates, L.P. (Olympia) as the fund administrator. Seghers sent to Olympia monthly valuations of the Integral Funds' assets, which included values for the Galileo Fund L.P., a fund in which the majority of Integral Funds' assets were invested. Significantly, despite having received a letter from the clearing broker stating that the statement values for the Galileo Fund had been incorrect since February, 2001, Seghers never reported this acknowledged problem to investors. Nor did Seghers disclose that (i) the Galileo fund manager had advised that he could not value the Galileo fund for a four-month period due to the clearing broker's errors, or (ii) Seghers had written to the broker that its errors had "materially damage[d]" the Integral Funds and its investors. The SEC alleged that Seghers committed fraud by, among other things, not disclosing errors by the clearing

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broker that adversely affected the valuation of the Integral Funds.

On appeal, the Fifth Circuit held, among other things, that the SEC presented sufficient evidence that Seghers made material representations to support the jury verdict. The court ruled that a "misrepresentation" occurs if the information disclosed, understood as a whole, would mislead a reasonable investor and ruled further that the misrepresentation is "material" if there is a substantial likelihood that a reasonable investor would consider the information important in making a decision to invest. The court then found that the SEC's evidence that Seghers' failures to disclose and misrepresentations of the existence and impact of the clearing broker's errors supported the jury's verdict. In addition to finding that Seghers caused account statements that he knew contained values in excess of market value to be sent to investors, the court found that Seghers' statement to the clearing broker that its errors "materially damage[d]" Integral Funds' investors confirmed the materiality of his misrepresentations. (*SEC v. Seghers*, 2008 WL 4726248 (5th Cir. Oct. 28, 2008))

Broker Dealer

SEC Approves Major Changes to NYSE's Market Structure

The Securities and Exchange Commission recently approved a New York Stock Exchange proposal to significantly modify the NYSE's current market structure. The approval signals the phase-out of the current specialist model in favor of a new category of market participants with responsibility for maintaining an orderly market and providing liquidity, Designated Market Makers (DMMs). The changes also amend current NYSE priority and parity rules; for example, DMM quotes will be on parity with those of floor brokers and those on the NYSE's Display Book. Further, under the new rules, all NYSE market participants will now be able to post hidden liquidity (there will be a new type of reserve order with a published quantity of "zero"). Certain components of the new NYSE market model are scheduled to operate on a one-year pilot basis. In addition, the NYSE announced a pilot program that establishes a new category for upstairs, electronic, high volume members, the Supplemental Liquidity Provider, with a number of incentives (including financial rebates) that are designed to encourage aggressive liquidity providers.

http://edocket.access.gpo.gov/2008/pdf/E8-25797.pdf
http://www.sec.gov/rules/sro/nyse/2008/34-58877.pdf
http://www.sec.gov/rules/sro/nyse/2008/34-58845.pdf

ISE Proposes Rule Changes Regarding Quoting Obligations of Competitive Market Makers

On October 21, the International Securities Exchange, LLC (ISE) submitted a proposal to the Securities and Exchange Commission to amend ISE Rules 713, 804, and 805 to establish a new quoting obligation for ISE Competitive Market Makers (CMMs). These proposed rule amendments are the result of a pilot program ISE conducted from September 2007 to September 2008.

The ISE currently requires CMMs to participate in the opening rotation and maintain continuous quotations in the lesser of: (i) all of the series of at least 60% of the options classes for the group to which the CMM is appointed, or (ii) 60 options classes in the group.

The ISE now proposes that CMMs be required to maintain continuous quotations for the lesser of: (i) at least 60% (rather than all) of the series of 60% of the options classes for the group to which the CMM is appointed (except for CMMs that receive preferenced order flow, which would be required to maintain continuous quotations for 90% of the options series for which they are making a market), or (ii) 40 (rather than 60) options classes in the group.

BROKER DEALER

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The ISE also proposes to restrict the volume of contracts that a CMM may execute per quarter in options classes to which that CMM is not appointed.

http://www.sec.gov/rules/sro/ise/2008/34-58861.pdf

Structured Finance and Securitization

Bernanke's Address at the UC Berkeley/UCLA Symposium: The Mortgage Meltdown, the Economy and Public Policy

On October 31, Federal Reserve Chairman Ben Bernanke discussed the mortgage market and mortgage securitization in the United States at a symposium held in Berkeley, California. Bernanke outlined three principles for successful mortgage securitization: high credit quality in the underlying mortgages, capacity to manage risk by the investors that hold the securities, and transparency in the underlying assets and the security itself. During the credit boom, several of these principles gave way as demand for securities increased.

The mortgage securitization process serves several important purposes, including providing loan originators wider sources of funding and a reduction in the overall cost of providing mortgage credit. In the current market, almost no mortgage securitization is occurring absent some government guarantee. Historically, government-sponsored enterprises (GSEs) have represented a large percentage of the total securitization market in the United States. Bernanke discussed possible alternatives to the current GSE model, including privatization of the GSEs (Fannie Mae, Freddie Mac and Ginnie Mae), which would eliminate the inherent conflict between the private shareholders and public policy objectives. Bernanke also mentioned tying the GSEs even more closely to the government, akin to the model public utilities use, or using a cooperative ownership structure. Creating a different balance between the public/private ownership and oversight of the GSEs might lead to greater flexibility and innovation.

Bernanke discussed issuance of covered bonds as a means to providing successful mortgage financing without GSE-type organizations. To date, there have not been many covered bonds issued in the United States, in part because there have been other, more competitive means to fund mortgage financing, including securitization through the GSEs. Covered bonds are debt obligations issued by financial institutions and secured by a pool of high-quality mortgages or other assets. Covered bonds remain on the balance sheet of the issuing banks, exposing the issuing banks to the credit quality of the underlying assets. This feature better aligns the incentives of investors in securities backed by mortgages to obtain high-quality assets with the incentives of the mortgage lenders. Regardless of the form, the housing finance system must ensure successful funding and securitization of mortgages during financial stress but not create institutions that pose systemic risks to financial markets and the economy.

http://www.federalreserve.gov/newsevents/speech/bernanke20081031a.htm

CFTC

FINRA Addresses Retail Foreign Currency Exchange Activities

The Financial Industry Regulatory Authority (FINRA) has issued a regulatory notice addressing the retail foreign currency exchange activities of broker-dealers that are members of FINRA. In the notice, FINRA expressed concern about the rapid growth of the retail forex market generally and the retail forex activities of broker-dealers in particular. More specifically, FINRA discussed the applicability of FINRA rules to the retail forex activities of broker-dealers,

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and said it would look to the retail forex rules and interpretations issued by the National Futures Association as a basis for determining whether, in conducting similar activities, broker-dealers comply with FINRA Rule 2210, which requires FINRA members to observe high standards of commercial honor and just and equitable principles of trade. FINRA further indicated that it would apply the promotional material pre-filing and other Rule 2210 requirements to member firms' forex activities and require approval of forex dealer activities pursuant to Rule 1017. FINRA reminded broker-dealer members of the applicability of Securities and Exchange Commission Rule 15c3-3 to forex balances that are owed to customers.

http://finra.complinet.com/net_file_store/new_rulebooks/f/i/finra_08-66.pdf

FinCEN Withdraws AML Proposal

The U.S. Treasury Department's Financial Crimes Enforcement Network has withdrawn its proposed rules that would have required the adoption by investment advisers, commodity trading advisors and certain unregistered investment companies of anti-money laundering programs similar to those required of banks, broker-dealers, mutual funds and other industry participants.

http://fincen.gov/news_room/nr/html/20081030.html

Banking

OTS Issues Examination Procedures on Identity Theft Red Flags

On October 24, the Office of Thrift Supervision (OTS) issued examination procedures on identity theft and address discrepancies. The procedures were developed following a joint rulemaking proposed by the other federal banking agencies and the Federal Trade Commission and implement the Fair and Accurate Credit Transactions Act (FACT Act), which amended the Fair Credit Reporting Act.

The FACT Act requires financial institutions, including federal savings associations, that have "covered accounts" to develop and implement a written Identity Theft Prevention Program to combat identity theft in connection with new and existing accounts. According to the OTS examination procedures, such a program must include reasonable policies and procedures for detecting, preventing and mitigating identity theft and must permit the institution to: (i) identify relevant patterns, practices, and specific forms of activity that are "red flags" signaling possible identity theft and incorporate those red flags into the program; (ii) detect red flags that have been incorporated into the program; (iii) respond appropriately to any red flags that are detected to prevent and mitigate identity theft; and (iv) ensure the program is updated periodically to reflect changes in risks from identity theft.

The examination procedures went into effect on November 1 and are found in OTS Examination Handbook Section 341, *Information Technology Risks and Controls,* and Section 1300, *Fair Credit Reporting Act*.

http://www.ots.treas.gov/?p=PressReleases&ContentRecord_id=3024cbb3-1e0b-8562-eba9-2264928a6151&ContentType_id=4c12f337-b5b6-4c87-b45c-838958422bf3

Treasury Releases Additional Information Regarding TARP Capital Purchase Program

On October 31, the U.S. Department of the Treasury released additional documents for publicly traded financial institutions applying for the capital purchase program authorized pursuant to the Emergency Economic

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Stabilization Act. The documents include the following: (i) a securities purchase agreement describing the financial institution's agreement to issue shares and fulfill other requirements in exchange for Treasury's investment; (ii) a form of letter agreement, describing specific information necessary to implement the securities purchase agreement and representing the institution's commitment to the securities purchase agreement; (iii) certificate of designations, the document that creates the preferred shares; (iv) forms of warrant dependent upon whether stockholder approval is required; (v) a term sheet; and (vi) a Securities and Exchange Commission and Financial Accounting Standards Board letter on warrant accounting.

According to this release, after an institution is granted preliminary approval to participate in the capital purchase program, it must complete and submit the securities purchase agreement, the letter agreement, the certificate of designations and warrant.

The application deadline for all publicly traded eligible institutions remains November 14, at 5 p.m. An application form and term sheet for privately held eligible institutions will be posted at a later date.

http://www.treasury.gov/press/releases/archives/200810.html

FDIC Extends Opt-Out Deadline for Participation in Temporary Liquidity Guarantee Program

On November 3, the Federal Deposit Insurance Corporation (FDIC) announced an extension of its opt-out deadline for participation in its Temporary Liquidity Guarantee Program. That program contains both a debt guarantee component (whereby the FDIC will guarantee until June 30, 2012, the senior unsecured debt issued by eligible financial institutions before June 30, 2009) and an account transaction guarantee component (whereby the FDIC will insure 100% of non-interest bearing deposit transaction accounts held at eligible financial institutions, such as payment processing accounts, payroll accounts and working capital accounts).

The deadline has been extended to December 5, 2008. Institutions that do not opt out before December 5 will be required to pay fees related to participation in the program; institutions that exercise their opt-out right will not be required to pay such fees.

The form required to exercise an opt-out option will be available on the FDIC's website beginning November 12. According to the FDIC's website, the choice as to whether to opt in or opt out, once transmitted to the FDIC, is irrevocable.

http://www.fdic.gov/news/news/press/2008/pr08110.html

UK Developments

FSA Fines Firm and MLRO for Money Laundering Failings

On October 29, the UK Financial Services Authority (FSA) fined Sindicatum Holdings Limited (SHL) £49,000 ($78,000) and SHL's Money Laundering Reporting Officer (MLRO) £17,500 ($28,000) for inadequate anti-money laundering systems and controls between October 2003 and September 2007.

The FSA found that the MLRO failed to take reasonable steps to implement adequate anti-money laundering procedures for verifying and recording clients' identities. This is the first time that the FSA has imposed an individual penalty on a regulated firm's MLRO.

UK DEVELOPMENTS

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In determining the amount of the financial penalties, the FSA took into account SHL's limited financial resources. Since September 2007, SHL and its MLRO have taken steps to improve the firm's systems and controls in relation to financial crime. The FSA stated that it had not found any evidence that any money laundering had actually taken place.

www.fsa.gov.uk/pages/Library/Communication/PR/2008/125.shtml

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

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