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Corporate and Financial Weekly Digest

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SEC/Corporate

SEC Commences Work on Congressionally Mandated Study on Accounting Standards

On October 7, the Securities and Exchange Commission announced additional details on the process and initial steps that the SEC has undertaken to conduct a study on "mark-to-market" accounting, as authorized by Sec. 133 of the Emergency Economic Stabilization Act of 2008 (EESA), signed into law by President Bush on October 3. The study is to be completed by January 2, 2009, in consultation with the Secretary of the Treasury and the Board of Governors of the Federal Reserve System. Under the terms of the EESA, the study will focus on:

- The effects of such accounting standards on a financial institution's balance sheet.
- The impacts of such accounting on bank failures in 2008.
- The impact of such standards on the quality of financial information available to investors.
- The process used by the Financial Accounting Standards Board (FASB) in developing accounting standards.
- The advisability and feasibility of modifications to such standards.
- Alternative accounting standards to those provided in FASB Statement No. 157.

The SEC also announced that it is scheduling public roundtables to obtain input on the study from investors, accountants, standard setters, business leaders and other interested parties.

http://www.sec.gov/news/press/2008/2008-242.htm

Litigation

SEC Adequately Pleads Aiding and Abetting Violations Against Officer of a Vendor That Sold Goods to a Primary Violator

A federal district court in Washington, D.C. has held that the Securities and Exchange Commission adequately pled that the owner of a company that sold certain products to a corporate subsidiary aided and abetted the subsidiary's violations of the Securities Exchange Act of 1934 by signing and returning audit confirmation letters that he knew, or was reckless in not knowing, were materially false by understating promotional allowances. This holding reminds

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us that while a private lawsuit may not be brought on an aiding and abetting theory against a vendor who sells to the primary violating company, the SEC may bring such claims. In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., et al.,* 128 S. Ct. 761 (2008), corporate investors could not maintain a Section 10(b) securities fraud action against corporation's vendors and customers for allegedly entering into a sham transaction with the corporation that inflated corporation's reported revenues and cash flow when vendors and customers did not directly mislead plaintiffs.

In its complaint, the SEC noted that the parent company of U.S. Foodservice (USF) had restated its income for fiscal years 1998 through 2002 due to its overstating of its income and sales in its original SEC filings and other public statements. The SEC alleged that the erroneous filings were facilitated by the scheme undertaken by USF's executives to inflate the value of "promotional allowances" received from USF's vendors by urging them to sign and return false audit confirmation letters that included fictitious or inflated promotional monies earned, paid, or received by the vendors. These false amounts were included in USF parent company's SEC filings and other public statements. The complaint alleged that defendant, an owner of one of the vendors, aided and abetted the fraud perpetrated by USF's executives by signing and sending an audit confirmation letter that contained materially false information to USF's auditors. Moreover, the complaint alleged that on the same day that he sent the allegedly false confirmation letter, defendant obtained a side letter from USF, which explained that the information in the confirmation letter was inaccurate.

In rejecting defendant's motion to dismiss the complaint, the court noted that the SEC can plead a claim for aiding and abetting by alleging that defendant had a "general awareness that his role was part of an overall activity that was improper," and that such "general awareness" can be established through a showing of "extreme recklessness," such as defendant's encountering of "red flags" or "suspicious events creating reasons for doubt." Emphasizing defendant's alleged awareness of the discrepancy of information contained in the audit confirmation letter and the side letter and the close temporal proximity between the two letters, the court concluded that the SEC satisfied its pleading burden. (*SEC v. Grendys et al.,* 2008 WL 4377450 (D. D.C. Sept. 29, 2008))

In Rare Instance, Court Grants Plaintiff's Summary Judgment Motion on Fraud Claim

A federal district court adopted a U.S. magistrate judge's recommendation to grant the Securities and Exchange Commission's motion for summary judgment and to enter an order for a permanent injunction and disgorgement with prejudgment interest against a registered investment adviser as well as its president and 50% owner.

The court found that summary judgment for the plaintiff was appropriate—a rare decision in a securities fraud case. The court noted that the SEC had put forth overwhelming evidence of defendants' severe recklessness which the defendants failed to rebut. As shown by the SEC, the investment adviser's president organized a purported private investment firm and marketed its shares directly to the investment adviser's clients. He received more than $1.62 million for investment purposes. The money, however, was used for other purposes and was transferred to the defendant investment adviser, the individual defendant (or used to pay his personal debts), and otherwise withdrawn by checks for unknown purposes. Significantly, defendants brought forward no evidence demonstrating that the transfers in question were for legitimate investment purposes. In addition, the individual defendant attempted to conceal many of the fraudulent transfers by, among other things, converting funds to cash by writing checks directly to banks and by falsely characterizing contributions from the private investment firm to the corporate defendant as capital contributions. Moreover, the individual defendant did not dispute that he overstated the value of the private investment firm's shares to its investors after the shares dropped significantly in value.

In adopting the magistrate judge's recommendation to enter a permanent injunction against the defendants, the court noted that defendants engaged in a series of unlawful transfers over a long period of time and further noted that the individual defendant was held in contempt for violating a preliminary injunction and asset freeze that the magistrate judge had previously instituted against him. In addition, the court adopted the magistrate judge's recommendation that the defendants be disgorged of over $800,000 that they had misappropriated from the private investment firm. (*SEC v. Brown,* 2008 WL 4425593 (D. Minn. Sept. 30, 2008))

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SEC Approves FINRA Proposal to Eliminate Yield Reporting to TRACE

The Securities and Exchange Commission has approved a proposal by the Financial Industry Regulatory Authority (FINRA) that effective November 3, yield reporting requirements for transactions in securities eligible for Trade Reporting and Compliance Engine (TRACE) will be eliminated. Currently, a member firm that executes a transaction in a TRACE-eligible security is required to report yield under NASD Rule 6230(c)(13). Also, currently disseminated TRACE data includes the yields reported by firms. FINRA has amended NASD Rule 6230(c) to eliminate the requirement to report yield when a transaction in a TRACE-eligible security is reported to TRACE. In addition, FINRA amends its dissemination practices for TRACE data. Instead of disseminating a member-reported yield, FINRA will disseminate a Standard Yield that is calculated in the TRACE System (Standard Yield) for each transaction in a TRACE-eligible security, with limited exceptions. FINRA believes that disseminating Standard Yields will enhance the usefulness of disseminated TRACE data to market participants.

http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117144.pdf

FINRA Clarifies Bona Fide Market Maker Fail-to-Deliver Settlement Obligations

The Financial Industry Regulatory Authority (FINRA) has issued Regulatory Notice 08-50 to clarify the procedures for submitting written attestation of bona fide market making relating to fail-to-deliver positions. On September 17, the Securities and Exchange Commission issued an Emergency Order adopting a temporary rule to Regulation SHO, Rule 204T, which generally provides that if a participant of a registered clearing agency has a fail-to-deliver position at a registered clearing agency in any equity security for a long or short sale transaction in that equity security, the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date of the transaction that resulted in the fail-to-deliver position, immediately close out the fail-to-deliver position by borrowing or purchasing securities of like kind and quantity. Registered Market Makers conducting bona fide market making activity that qualify for an extension are permitted to close out the fail-to-deliver position attributable to the market maker by no later than the beginning of regular trading hours on the morning of the third settlement day after the settlement date for the transaction that resulted in the fail-to-deliver position. To qualify for the extension, the market maker must attest in writing to the market on which it is registered that the fail-to-deliver position was established solely for the purpose of meeting its bona fide market making obligations and describe the steps it has taken to deliver the securities.

Completed attestations must be faxed to FINRA Operations by the close of business on the settlement day following the original settlement date of the transaction(s).

http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117089.pdf

FINRA Amends Reporting Requirements for OTC Transactions in Foreign Securities

The Securities and Exchange Commission has approved a proposal by the Financial Industry Regulatory Authority (FINRA) to require all over-the-counter (OTC) transactions in foreign securities to be reported to the OTC Reporting facility within 90 seconds of execution. Prior to the amendments approved by the SEC, NASD Rule 6620(a) generally required that transactions in some OTC equity securities—domestic equity securities, American Depositary Receipts (ADRs), and Canadian issues, including those that are not registered with the SEC and otherwise subject to financial reporting—that were executed between 8:00 a.m. and 8:00 p.m. Eastern Time be reported to the OTC Reporting Facility within 90 seconds of execution. Foreign securities other than ADRs and Canadian issues were excluded and were required to be reported by 1:30 p.m. Eastern Time the day after the transaction was executed. Beginning October 27, OTC transactions in foreign securities will be subject to the same reporting requirements that have been in place for domestic securities, Canadian issues, and ADRs pursuant to NASD Rule 6620. By requiring 90-second reporting for foreign securities transactions (unless a specific exception applies), FINRA also will begin uniformly disseminating trading information for all OTC Equity Securities on a real-time basis within 90 seconds of execution, providing improved transparency to the OTC market.

http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117109.pdf

Structured Finance and Securitization

Interim Assistant Secretary for Financial Stability to Deliver Remarks on EESA

On October 9, the U.S. Department of the Treasury announced that Treasury Interim Assistant Secretary for Financial Stability Neel Kashkari will deliver remarks before the Institute of International Bankers at 8:00 a.m. EDT on Monday, October 13 at the Four Seasons Hotel, Salon A, 2800 Pennsylvania Avenue, NW in Washington, D.C. He will discuss financial markets and the Treasury's implementation of the Emergency Economic Stability Act, which created the Troubled Assets Relief Program (TARP).

http://www.treas.gov/press/releases/hp1191.htm

CFTC

CFTC Increases Monetary Penalties for Violations of CEA, CFTC Rules

The Commodity Futures Trading Commission has amended its rules to increase the maximum civil monetary penalties that may be assessed for violations of the Commodity Exchange Act (CEA) and CFTC rules thereunder. The CFTC amendments, which were not proposed for public comment, raise the maximum civil monetary penalty that may be assessed (i) pursuant to Section 6c or 6(c) of the CEA (relating to violations of the CEA or CFTC rules by CFTC registrants and market participants), to the greater of $140,000 (previously $130,000) or triple the monetary gain for such violation, and (ii)

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pursuant to Section 6b of the CEA (relating to violations of the CEA or CFTC rules by exchanges and other "registered entities"), to the greater of $675,000 (previously $625,000) or triple the monetary gain for such violation. These increases are intended to adjust the maximum penalties to account for inflation and will apply to violations occurring on or after October 23, 2008. The CFTC amendments also implement the higher maximum penalties established by Congress for actual or attempted manipulation in violation of Section 6(c), 6(d) or 9(a)(2) of the CEA, with each such violation committed on or after May 22, 2008, being subject to a maximum penalty of $1,000,000 or triple the monetary gain for such violation.

http://www.cftc.gov/stellent/groups/public/@lrfederalregister/documents/file/e8-23417a.pdf

Banking

Federal Reserve Announces Creation of Commercial Paper Funding Facility

On October 7, the Federal Reserve Board announced the creation of the Commercial Paper Funding Facility (CPFF). The CPFF is designed to provide much-needed liquidity to the term funding market via a special purpose vehicle (SPV) that will purchase three-month unsecured and asset-backed commercial paper directly from U.S. issuers (including U.S. issuers with a foreign parent). The Federal Reserve will commit to providing financing to the SPV at the target federal funds rate and will be secured by all of the assets of the SPV and in the case of unsecured paper, by the retention of up-front fees paid by the issuers or other forms of security acceptable to the Federal Reserve.

The Federal Reserve anticipates that the CPFF will eliminate much of the risk that eligible issuers will not be able to repay investors by rolling over their maturing commercial paper obligations, encouraging investor demand and thus lowering commercial paper rates, and enhancing the ability of financial intermediaries to accommodate the credit needs of businesses.

http://www.federalreserve.gov/newsevents/press/monetary/20081007c.htm

FDIC Board Proposes Higher Assessments on Insured Banks

On October 7, the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) voted to adopt a restoration plan accompanied by a notice of proposed rulemaking to increase the rates banks pay for deposit insurance while at the same time adjusting the system that determines the deposit insurance rate a bank pays to the FDIC.

Under the current deposit insurance system, banks pay between 5 basis points and 43 basis points for deposit insurance. Under the proposal by the FDIC Board, the assessment rate schedule would be raised uniformly by 7 basis points (annualized) beginning on January 1, 2009. In addition, under the proposal, beginning in the second quarter of 2009, changes would be made to the deposit insurance assessment system to make the increase in assessments fairer by requiring riskier institutions to pay higher deposit insurance assessments. The FDIC Board believes that these changes would differentiate risk between insured institutions and help ensure that the reserve ratio returns to at least 1.15 percent by the end of 2013.

The proposed revisions to the assessment system include, among other provisions, assessing higher rates to institutions with significant reliance on secured liabilities and assessing higher rates on institutions with significant reliance on brokered deposits, although such higher rates for well-managed and well-capitalized institutions would only be imposed when reliance on

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brokered deposits is accompanied by rapid asset growth.

Comments on the proposal are due no later than 30 days after publication in the *Federal Register*.

http://www.fdic.gov/news/news/press/2008/pr08094.html

UK Developments

FSA Increases Deposit Protection

On October 3, the UK Financial Services Authority (FSA) increased the compensation limit for bank deposits from £35,000 ($61,000) to £50,000 ($87,000) and joint bank accounts will be eligible to claim up to £100,000 ($174,000). The increase took effect on Tuesday, October 7.

The FSA also published CP08/15 *Financial Services Compensation Scheme: Review of limits* consultation paper on further reforms. The consultation considers whether the compensation limit should be raised further, how the UK Financial Services Compensation Scheme pays compensation, and the basis upon which bank deposits are covered. The consultation also sets out proposals to improve the overall scheme and to ensure consistency with respect to compensation limits for the investment, insurance and home finance sectors.

The consultation closes January 5, 2009.

www.fsa.gov.uk/pubs/cp/cp08_15.pdf

UK Announces Financial Support to Banking Sector

On October 8, the UK Government announced that it is introducing additional measures to ensure the stability of the UK financial system and to protect savers, depositors, businesses and borrowers.

The proposals are intended to: provide sufficient liquidity in the short term, make available new capital to UK banks and building societies, and ensure that the UK banking system has the funds necessary to maintain lending in the medium term.

The Bank of England will extend its facilities to provide short-term liquidity and the Government has announced that at least £200 ($347) billion will be made available to banks under a Special Liquidity Scheme. The Bank of England will continue to conduct auctions to lend sterling for three months, and also U.S. dollars for one week, against extended collateral. Bank debt that is guaranteed under the Government's guarantee scheme will be eligible in all of the Bank of England's extended-collateral operations.

The Government is also establishing a facility which will make available capital in appropriate form (expected to be preference shares or Permanent Interest Bearing Shares) to “eligible institutions”. Eligible institutions are UK incorporated banks (including UK subsidiaries of foreign institutions) which have a substantial business in the UK and building societies.

The Government has also announced that it will make available to eligible institutions for an interim period a Government guarantee of new short and medium term debt issues to assist in refinancing maturing, wholesale funding obligations as they fall due. The Government expects the take-up of the guarantee to be in the region of £250 ($434) billion.

www.publications.parliament.uk/pa/cm200708/cmbills/147/2008147.pdf

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EU Developments

CESR Publishes MiFID Supervisory Briefings

On October 6, the EU Committee of European Securities Regulators (CESR) published several briefings on key elements of the EU Markets in Financial Instruments Directive. The briefings were published as part of CESR's work to promote supervisory convergence across the EU and are aimed at regulators in EU Member States. The briefings covered conflicts of interest, best execution and inducements and summarize the main content of the rules.

www.cesr.eu/popup2.php?id=5287
www.cesr.eu/popup2.php?id=5288
www.cesr.eu/popup2.php?id=5289

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