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Corporate and Financial Weekly Digest

October 31, 2008

SEC/Corporate

SEC Division Director White Draws CD&A Lessons from TARP and 2008 Filings

John White, Director of the Division of Corporation Finance of the Securities and Exchange Commission, speaking at a proxy disclosure conference on October 21, stated that SEC reporting companies, in drafting their Compensation Discussion and Analysis (CD&A) sections of next year's proxy statements, should take close note of the new executive compensation provisions in the Emergency Economic Stabilization Act which created the Troubled Asset Relief Program (TARP).

TARP provides for substantive and procedural requirements with respect to the compensation of the senior executive officers (the definition is taken from the SEC's definition of "named executive officer" in Item 402 of Regulation S-K) of financial institutions that participate in TARP. The compensation committees of such financial institutions are required to certify in their CD&As that they have taken measures to ensure that executive incentive compensation policies have not encouraged and do not encourage "unnecessary and excessive risks that threaten the value of the financial institution by the executive officers".

While a great majority of SEC reporting companies will not be participating in TARP, White suggested that it would "be prudent for compensation committees [of all public companies], when establishing targets in creating incentives, not only to discuss how hard or how easy it is to meet the incentives, but also to consider the particular risks an executive might be incentivized to take to meet the target—with risks, in this case, being viewed in the context of the enterprise as a whole."

White also indicated that the Corporation Finance staff will focus in 2009 on a review of the annual reports, including proxy statement disclosure, of all of the largest financial institutions in the United States that are public companies. The annual reports and proxy disclosure of other public companies will continue to be reviewed on a regular and systematic basis, said White, in no event less frequently than once every three years, as mandated by Section 408 of the Sarbanes-Oxley Act.

Finally, White reviewed Corporation Finance's observations and comments with respect to executive compensation disclosure contained in proxy statements filed in 2008. Areas that received the most attention in 2008 executive compensation comment letters issued by the SEC were the need for more "analysis", the disclosure of performance targets and disclosure relating to benchmarking. As to performance targets, White stated that in every instance where the quantitative performance objectives tied to a named executive officer's incentive compensation have been omitted from CD&A, the staff in its comments has requested that the filer justify the omission in light of the appropriate standard in Instruction 4 to Item 402(b) of Regulation S-K.

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

While not expressly so stating, White indicated a skepticism with respect to the "competitive harm" exception for disclosure, and emphasized that if that exception is invoked, alternative disclosures must be made, including "meaningful disclosure that describes the degree to which performance goals or matrix were sufficiently challenging or appropriate .... and how achievement of the objectives actually rewarded performance." Further, he stated that there may need to be "a discussion of the extent to which incentive amounts were determined based upon a historical review of the predictability of achievement of the performance objectives and possibly a discussion of the relationship between historical and future achievement of the performance standard."

As to benchmarking, White stressed that disclosure must be made of the identity of companies that comprise the peer group used for benchmarking as well as the basis for selecting the particular peer group and the relationship between actual compensation and the benchmarking data.

Returning to the lack of "analysis", White stressed that many companies did not explain how and why specific compensation amounts and elements were determined and how each element of compensation impacted other compensation decisions. Further, White stated that where a comparison between actual results and performance objectives does not correspond with actual pay-outs, companies must provide appropriate qualitative disclosure reasons for the use of discretion to effect actual pay.

www.sec.gov/news/speech/2008/spch102108jww.htm

Litigation

LITIGATION

For more information, contact:

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

Cameron Balahan
212.940.6437
cameron.balahan@kattenlaw.com

Fugitive Not Entitled to Litigate by Mail

The Eastern District of New York denied a motion to dismiss claims asserted against an individual defendant charged with multiple counts of wire fraud and securities fraud arising from his alleged involvement in a scheme to manipulate the stock price of small public companies through fraudulent faxes and press releases.

A criminal complaint was originally filed against the defendant in October 1999. Shortly thereafter, the defendant moved to Canada where he successfully resisted efforts to extradite him to the United States for nearly seven years. In mid-2007, when these efforts finally failed, he was delivered to U.S. authorities, returned to the United States and, following his return, indicted. However, in December 2007, the indictment was dismissed without prejudice for violation of the Speedy Trial Act and, following the dismissal, the defendant returned to Canada prior to being re-indicted.

After the re-indictment, while refusing to return to the United States, the defendant filed his motion to dismiss the new indictment on a combination of substantive and procedural grounds. Rather than consider the motion on its merits, the district court, applying the "fugitive disentitlement doctrine," denied the defendant's motion. Under that doctrine, courts have "the authority to refuse to grant relief to those who flee from justice." To determine whether to apply the doctrine, courts examine whether any of four grounds are present: (i) assuring the enforceability of decisions rendered against the fugitive, (ii) imposing a penalty for flouting the judicial process, (iii) discouraging flights from justice, and (iv) avoiding prejudice to the other side caused by the defendant's escape.

Here, the court ruled that all four factors weighed in favor of denying the motion, and that the defendant should not be permitted to "try[] to secure a favorable decision without risking the consequences of an unfavorable decision." (*United States v. Gorcyca*, 2008 WL 4610297 (E.D.N.Y. Oct. 16, 2008))

“Foreign-Cubed” Securities Lawsuit Dismissed

In the first so-called “foreign-cubed” securities class action to reach the Second Circuit, the appeals court affirmed the dismissal on jurisdictional grounds of claims asserted against the National Australia Bank (NAB) for violations of Section 10(b) of the Securities and Exchange Act and Rule 10b-5 arising from alleged misstatements included in NAB’s filings with the Securities and Exchange Commission. A ”foreign-cubed” action is a claim brought by a foreign plaintiff against a foreign issuer with respect to securities transactions occurring in a foreign country.

The Second Circuit declined NAB’s argument that a bright-line rule should be set that jurisdiction should never be asserted in foreign-cubed actions, explaining that it was “leery” of establishing a rigid rule because “we cannot anticipate ... the ingenuity of those inclined to violate the securities laws.” Instead, the court determined that the usual rule governing the extraterritorial reach of Section 10(b) should be applied. Accordingly, the court applied its two-part “conduct test” and “effects test” to determine whether the assertion of jurisdiction over NAB was appropriate. Under these tests, a court asks “(i) whether the wrongful conduct occurred in the United States, and (ii) whether the wrongful conduct had a substantial effect in the United States or upon United States citizens.” Further, in evaluating the conduct in issue, the court focuses on that which is central or at the heart of the fraudulent scheme and not on acts that are “merely prepatory” or ancillary.

Applying these tests, the Second Circuit found that the plaintiffs failed to satisfy either. With respect to the “effects test,” the court ruled that plaintiffs failed to contend that NAB’s conduct had “any meaningful effect on America’s investors or its capital markets.” Under the “conduct test,” the court found that NAB’s U.S.-based subsidiary’s alleged manipulation of its internal records and its transmission of falsely inflated performance results to NAB in Australia which NAB then used to create and distribute its SEC filings were not sufficient to support the assertion of jurisdiction over NAB.

The court ruled that NAB (i) was responsible for overseeing its subsidiaries’ operations and ensuring the accuracy of its public statements, and (ii) had the ability to monitor the accuracy of its subsidiaries’ numbers before transmitting them to investors. Accordingly, the court concluded that “[t]he actions taken and the actions not taken by NAB in Australia were ... significantly more central to the fraud and more directly responsible for the harm to investors” than any alleged conduct in America. (*Morrison v. National Australia Bank Ltd.*, 2008 WL 4660742 (2d Cir. Oct. 23, 2008))

Broker Dealer

FINRA Proposes Rule Changes Regarding Research Quiet Period

The Financial Industry Regulatory Authority (FINRA) recently released and is requesting comments on its proposed research registration and conflict of interest rules. Among other changes, the proposed rules would change the “quiet period” during which a FINRA member firm participating in a securities offering cannot publish or distribute research reports about the issuer and the firm’s research analysts cannot make public appearances related to the issuer. Firms still would be required to comply with any additional quiet periods imposed by the federal securities laws.

The proposed rules would shorten the quiet period for an initial public offering (IPO) to at least 10 days after the IPO, as compared with the current rules’ requirements of a quiet period for lead underwriters of at least 40 days after

BROKER DEALER

For more information, contact:

Janet M. Angstadt
312.902.5494
janet.angstadt@kattenlaw.com

Gary N. Distell
212.940.6490
gary.distell@kattenlaw.com

Daren R. Domina
212.940.6517
daren.domina@kattenlaw.com

Patricia L. Levy
312.902.5322
patricia.levy@kattenlaw.com

the IPO and, for other underwriters or dealers, at least 25 days after the IPO. The proposed rules would also eliminate the current 10-day quiet period after secondary offerings and the 15-day quiet periods before and after the expiration, waiver or termination of a lock-up agreement.

FINRA has proposed these rule changes as part of its process to develop a new, consolidated rulebook, and these proposed changes would supersede the proposed changes to these rules pending before the Securities and Exchange Commission. FINRA has requested comments on these proposed rule changes; such comments must be received by November 14.

http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117213.pdf

CBOE Files Proposed Rules Governing Minimum Size Requirement for Quotations

The Chicago Board Options Exchange (CBOE) filed with the Securities and Exchange Commission a proposed rule change pertaining to the minimum size requirement for market maker quotations. Currently, the initial size of a market maker's electronic quotation must be for at least 10 contracts, unless the underlying primary market is disseminating a 100-share quote (in which case the quote size can be as low as one contract). In open outcry, the minimum quotation size is 10 contracts for non-broker-dealer orders and 1 contract for broker-dealer orders. The amended rule would give CBOE the flexibility to set a minimum quotation size requirement for electronic and open outcry quotes on a class by class basis (with a minimum of at least 1 contract).

http://sec.gov/rules/sro/cboe/2008/34-58828.pdf

Nasdaq and NYSE Arca Eliminate CROP/SROP Requirements

The Nasdaq Stock Market LLC (Nasdaq) and NYSE Arca Inc. (NYSE Arca) filed rule changes to amend each exchange's rules to eliminate provisions requiring each member doing a public customer business in options to designate specific individuals to act as a Senior Registered Options Principal (SROP) and as a Compliance Registered Options Principal (CROP). Under the proposed changes, members will instead be required to integrate the responsibility for supervision of their public customer options business into their overall supervisory and compliance programs. Each rule filing also included certain other elements designed to strengthen options supervision practices. Deleting the SROP/CROP requirements conforms Nasdaq and NYSE Arca rules to those of the Financial Industry Regulatory Authority and certain other options exchanges.

http://www.sec.gov/rules/sro/nasdaq/2008/34-58840.pdf
http://www.sec.gov/rules/sro/nysearca/2008/34-58748.pdf

Investment Companies and Investment Advisers

FinCEN Withdraws Dated Anti-Money Laundering Rule Proposals

On October 30, the Financial Crimes Enforcement Network (FinCEN) withdrew its proposed anti-money laundering rules for investment advisers, unregistered investment companies and commodity trading advisers. FinCEN proposed these rules in 2002 and 2003 and determined that it will not proceed without first publishing new proposals and allowing for industry comments.

While FinCEN continues to consider the extent to which Bank Secrecy Act (BSA) requirements should be applied directly to these entities, their activity will not be entirely outside BSA regulation. FinCEN noted that the financial

Ross Pazzol
312.902.5554
ross.pazzol@kattenlaw.com

James D. Van De Graaff
312.902.5227
james.vandegraaff@kattenlaw.com

Lance A. Zinman
312.902.5212
lance.zinman@kattenlaw.com

INVESTMENT COMPANIES AND INVESTMENT ADVISERS

Marybeth Sorady
202.625.3727
marybeth.sorady@kattenlaw.com

Daren R. Domina
212.940.6517
daren.domina@kattenlaw.com

Peter J. Shea
704.444.2017
peter.shea@kattenlaw.com

Kathleen H. Moriarty
212.940.6304
kathleen.moriarty@kattenlaw.com

transactions of investment advisers, unregistered investment companies and commodity trading advisers must be conducted through, and their assets maintained by, other financial institutions currently subject to BSA regulations (e.g., broker-dealers).

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

Structured Finance and Securitization

House Financial Services Committee Will Hold TARP Oversight Hearing

On November 18, the House Financial Services Committee will hold a hearing on the U.S. Department of the Treasury's Troubled Asset Relief Program created pursuant to the Emergency Economic Stabilization Act of 2008 and related initiatives taken by the Federal Reserve Bank and the Federal Deposit Insurance Corporation in response to the recent market turmoil. The committee expects to hear from institutions who are using or affected by the initiatives, senior officials and academic experts.

http://www.house.gov/apps/list/press/financialsvcs_dem/press102908.shtml

SEC Holds Roundtable on EESA Accounting Study

On October 29, the Securities and Exchange Commission held a roundtable on mark-to-market accounting practices. It addressed the effects of mark-to-market accounting on the market and on the reporting practices of financial institutions, the usefulness of the practice, and how accounting standards can be improved. The roundtable was held in conjunction with a congressionally mandated study authorized under the Emergency Economic Stabilization Act of 2008 that will focus on the effects of mark-to-market accounting on the 2008 bank failures, the balance sheets of financial institutions and other related topics.

http://www.sec.gov/news/press/2008/2008-255.htm

ERISA

DOL Sues Investment Adviser for Steering ERISA Clients into a Fund from Which It Received Fees

The Department of Labor (DOL) recently announced that it has brought an action against an investment manager who invested ERISA clients' money into a hedge fund and received a portion of the incentive fees earned by the hedge fund's manager. In addition it appears that the hedge fund's manager had an interest in the investment manager who directed its clients into the hedge fund.

If true, such transactions would appear to involve self dealing prohibited transactions and breaches of fiduciary duty under ERISA. The potential liabilities for the investment manager are significant and the manager's principals could be subject to personal liability in connection with these transactions. A prohibited transaction, in effect, gives the investing plan a rescission right; consequently the plan would have a right to be put into the same position by the investment manager as it would have been in had it never made the investment. Therefore, to the extent there have been any losses as a result of the investment in the underlying fund, the manager and its principals could be liable to reimburse any such losses to the investing ERISA plans. The investment manager would also be required to return to each ERISA plan its portion of the fees the investment manager received from the underlying fund's manager and the investment manager could incur significant excise taxes attributable those fees. In sum, the potential liabilities of the

STRUCTURED FINANCE AND SECURITIZATION

For more information, contact:

Eric S. Adams
212.940.6783
eric.adams@kattenlaw.com

Hays Ellisen
212.940.6669
hays.ellisen@kattenlaw.com

Reid A. Mandel
312.902.5246
reid.mandel@kattenlaw.com

ERISA

For more information, contact:

Gary W. Howell
312.902.5610
gary.howell@kattenlaw.com

Gregory K. Brown
312.902.5404
gregory.brown@kattenlaw.com

William B. Duff
212.940.8532
william.duff@kattenlaw.com

William E. Mattingly
312.902.5266
william.mattingly@kattenlaw.com

investment manager attributable to these transactions would be (i) losses incurred by the ERISA plans in connection with these investments (even if the losses are a result of a general market drop), (ii) returning to the ERISA plans the portion of the fees the investment manager received from the underlying fund attributable to those plans, and (iii) excise taxes calculated on those fees. In addition, there could also be personal liability for the investment manager's fiduciaries who elected to invest in the underlying hedge fund to make up those losses if the investment manager has insufficient assets or insufficient ERISA fiduciary insurance.

The DOL appears to be increasing its oversight of investment managers. Any investment manager who is an ERISA fiduciary (such as one managing separate accounts of ERISA investors or a manager of a fund with at least 25% of its interests held by benefit plan investors) should carefully review arrangements with anyone with whom it is affiliated or from whom it is receiving compensation, to determine if there are potential ERISA issues.

http://www.dol.gov/ebsa/newsroom/08-1536-SAN.html

Banking

BANKING

For more information, contact:

Jeff Werthan
202.625.3569
jeff.werthan@kattenlaw.com

Terra K. Atkinson
704.344.3194
terra.atkinson@kattenlaw.com

Christina J. Grigorian
202.625.3541
christina.grigorian@kattenlaw.com

Adam Bolter
202.625.3665
adam.bolter@kattenlaw.com

Federal Bank Regulators Issue Guidance on Tax Effect of Losses on Fannie Mae and Freddie Mac Preferred Stock

On October 24, a group of federal banking agencies issued a statement allowing banks to recognize the effect of tax changes enacted in Section 301 of the Emergency Economic Stabilization Act of 2008 (EESA) in their third quarter 2008 regulatory capital calculations.

Banks and thrifts holding Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) perpetual preferred stock for purposes other than trading are presumed to have incurred other-than-temporary impairment losses if the cost basis of these investments is well in excess of the current market price of the stock. These losses must be recognized in earnings in the Call Reports for banks and Thrift Financial Reports for savings institutions for September 30. Prior to the enactment of EESA on October 3, losses on sales of Fannie Mae and Freddie Mac preferred stock by banks generally were considered capital gains and losses for federal income tax purposes.

Section 301 of EESA allows banks and thrifts to treat losses on certain sales of this preferred stock as ordinary rather than capital losses, but under generally accepted accounting principles banks may not record the effect of this tax change in their balance sheets and income statements for financial and regulatory reporting purposes until the period in which the law is enacted, i.e., the fourth quarter of 2008. The interagency statement, issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, provides that, for purposes of the regulatory capital calculations, but not for balance sheet and income statement purposes, banks may elect to adjust the tax effect of losses on Fannie Mae and Freddie Mac perpetual preferred stock as if Section 301 of EESA had been enacted in the third quarter of 2008.

http://www.fdic.gov/news/news/financial/2008/fil08112a.pdf

Treasury Issues Summary List of Bank Transactions Closed Under TARP Capital Purchase Plan

On October 29, the U.S. Department of the Treasury issued a summary list of bank holding companies with which it had completed purchases under the

TARP Capital Purchase Plan of preferred stock and warrants in exchange for cash that will count as Tier 1 capital. Not surprisingly, the institutions listed were the nine companies that had received extensive publicity for the last several weeks. One transaction was deferred pending closing of a merger.

http://www.treas.gov/initiatives/eesa/transactions.shtml

FDIC and Treasury Consider Proposal to Assist Homeowners

As of October 30, the U.S. Department of the Treasury, with input from bank regulatory agencies including the Federal Deposit Insurance Corporation (FDIC), appears to be working on a program whereby the government will guarantee modified mortgages that would otherwise be at risk of foreclosure.

According to published reports regarding the proposal, one possible version of the program would cover up to 3 million homeowners in danger of foreclosure and would utilize between $40 billion and $50 billion of the recently passed $700 billion economic bailout package. The program could include loan modification provisions that could lower affected homeowners' interest rates for 5 years. The government could agree to share a portion of any losses associated with modified mortgages offered by lenders.

According to reports, this program is one of several ideas being considered to assist homeowners facing foreclosure. The timing of the announcement of a final proposal remains unclear.

UK Developments

FSA Amends Short Selling Disclosure Regime

Last week, the UK Financial Services Authority announced that it would amend its Code of Market Conduct so that once disclosure of a short position has been made, additional disclosures will only be required when that short position changes (as reported in the October 24, 2008, edition of *Corporate and Financial Weekly Digest*). The amendment was made on October 29.

www.fsa.gov.uk/pubs/handbook/2008_60_instrument.pdf

FSA Publishes Feedback on Unauthorized Trading and Market Abuse Controls

On October 30, the UK Financial Services Authority (FSA) published its latest *Market Watch* newsletter. The newsletter provides an update on market conduct and transaction reporting issues such as unauthorized trading, market abuse controls, technical reporting specifications for reporting derivatives and transaction reporting.

Particularly, the newsletter highlights the FSA's findings from its continuing work with respect to systems and controls necessary to deter and detect unauthorized trading. Specifically, the FSA has been interested in such things as front office culture and governance, trading mandates and limits, risk management and limits, use of management information, use of off-market rates, attribution of profit and losses, confirmations, margining, collateralization and cash management and the segregation of duties and IT security.

Market Watch 29 also includes feedback from the FSA's follow-up visits to hedge fund managers on market abuse controls. The feedback addresses firm culture and senior management responsibility, compliance, the control of inside

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

information, monitoring of trading activity, training, personal account dealing and use of telephone taping.

www.fsa.gov.uk/pubs/newsletters/mw_newsletter29.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
2900 K Street, NW
Suite 200
Washington, District of Columbia 20007-5118
202.625.3500 tel
202.298.7570 fax